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

REPLY BRIEF FOR PETITIONER-APPELLANT

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INTRODUCTION

Eleven days before its brief was due, the IRS issued proposed regulations that endorse SIH's principal arguments and contradict the IRS's position before this Court. *See Amount Determined Under Section 956 for Corporate United States Shareholders*, 83 Fed. Reg. 55,324, 55,325-27 (Nov. 5, 2018) ("NPRM").[1] Yet the IRS's brief completely ignores the NPRM.

First, the NPRM embraces SIH's arguments that the purpose of section 956 is to tax repatriation of CFC earnings, and that the IRS's regulations must be tailored to that purpose. The NPRM states that section 956 addresses the "repatriation of [CFC] earnings" through means other than a formal dividend; and it declares that the IRS's "longstanding practice" is to "conform[] the application of section 956 to its purpose" and to "tailor the application of section 956 to the abuse that motivated its adoption." *Id.* at 55,325-26. The IRS's brief contradicts the NPRM by asserting that it is "irrelevant" whether its regulations are tailored to the repatriation of CFC earnings.

[1] The NPRM is an official agency document subject to judicial notice. *See Kiick v. Metro. Edison Co.*, 784 F.2d 490, 496 (3d Cir. 1986). A copy of the NPRM is attached to this brief.

Second, the NPRM agrees with SIH that "the purpose of section 956 is generally to create symmetry between the taxation of actual repatriations and the taxation of effective repatriations, by subjecting effective repatriations to tax in the same manner as actual repatriations." *Id.* at 55,326. Indeed, the NPRM states that ensuring such symmetrical treatment is the "chief" purpose of section 956, and that "disparate treatment of actual dividends" and section 956 inclusions ("956 inclusions") would be "directly at odds with the manifest purpose of section 956." *Id.* at 55,325-26. Yet the IRS's brief argues for starkly disparate treatment of 956 inclusions and actual dividends that would more than double the applicable tax rate.

While failing to discuss the contradictions between the NPRM and its arguments in this case, the IRS's brief makes concessions that further undermine its position in this Court. It acknowledges that its categorical rules concerning CFC guarantees are not required by statute. The IRS does not argue that its rules are tailored to transactions that actually repatriate CFC earnings, and it has no meaningful response to SIH's argument that the agency adopted categorical rules without explaining

why it made this regulatory choice—or even recognizing that it had a choice to make.

The IRS also concedes (as quietly as possible) that the denial of qualified dividend treatment to 956 inclusions is not required by statute, as it previously claimed in the Tax Court and the Fifth Circuit. The IRS thus acknowledges that a key element of its arguments below and in the *Rodriguez* case is incorrect.

The IRS keeps trying to have it both ways. It simultaneously argues for and against dividend treatment of CFC guarantees, and for a result that contradicts its own public statements about the purpose and proper application of section 956.

The judgment should be reversed.

ARGUMENT

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

The IRS's NPRM confirms that the agency has authority "to ensure that the application of section 956 is consistent with the 'purposes of this section,'" and has "exercised this regulatory authority to tailor the application of section 956 to the abuse that motivated its adoption," which is "the tax-free effective repatriation of earnings through

transactions that are economically equivalent to a taxable dividend." 83 Fed. Reg. at 55,325 & n.1. The IRS's brief acknowledges that section 956(d) is ambiguous, and thus requires the IRS to use its expertise to interpret the statute. Yet the IRS gave no indication that it exercised this expertise, and failed to explain its decision to adopt rules that are not tailored to the purpose of section 956. Accordingly, the regulations are invalid.

A. The IRS's Argument Concerning the Statutory Text Undermines Its Position

1. The IRS does not contend that the statute requires the categorical rules it adopted. To the contrary, it recognizes that "[s]ection 956 does not directly address this 'precise question.'" IRS Br. 23 (citation omitted). In this situation, the agency must exercise its discretion to "make interpretive choices for statutory implementation." *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 56 (2011).

As the IRS acknowledges, an earlier version of section 956 included guarantees in the list of transactions that automatically give rise to inclusions (now codified in section 956(c)), but the final legislation moved guarantees into a separate subsection (now section 956(d)), as the sole category of transactions calling for regulatory implementation based on

the IRS's expertise. The IRS agrees that this separate treatment was warranted because guarantees "generally are not considered to be property" and have no adjusted basis, unlike the transactions identified in section 956(c). IRS Br. 37. Indeed, the IRS notes that Treasury itself sought the authority to separately address guarantees "under regulations." *Id.* at 36.

These concessions fatally undermine the section 956(d) regulations. The IRS argues that the regulations are valid because they "simply mirror the statutory language." IRS Br. 25. But as the IRS has recognized, Congress did not adopt a categorical statutory rule for guarantees. Instead, Congress directed the agency to use its expertise to determine when, and to what extent, guarantees should be treated as U.S. property. *See Dep't of Homeland Sec. v. MacLean*, 135 S. Ct. 913, 921 (2015) (statute providing that agency "shall prescribe regulations prohibiting" certain disclosures "does not prohibit anything" but rather "authorizes" the agency to "prescribe regulations"). Had Congress intended to adopt a categorical rule it need not have granted regulatory authority at all.

The statute's separate treatment of guarantees refutes the IRS's attempt to equate Congress's treatment of loans and guarantees. *See* IRS Br. 34. Congress determined that the repatriation and its amount are clear in the case of a loan, which transfers money directly from CFC to shareholder. But it required the IRS to use its expertise to address guarantees, which are not property of the CFC and have no tax basis. The IRS recognizes that section 956(d) is a "backstop" to the treatment of direct loans. IRS Br. 18. It should therefore cover guarantees that function like direct loans. The IRS never explains why it is reasonable to treat *every* CFC guarantee like a direct loan.

The IRS's suggestion that section 956(d) establishes a categorical statutory rule subject to regulatory exceptions is likewise incorrect. Congress knows how to draft self-executing tax rules subject to regulatory exceptions. It did not do so here. *See, e.g.,* 26 U.S.C. § 367(a)(2) ("Except to the extent provided in regulations, paragraph (1) shall not apply" to specified transactions.); *id.* § 6111(c)(2) ("The Secretary may prescribe regulations which provide … exemptions from the requirements of this section."). The IRS effectively asks the Court to rewrite section 956(d) to provide: "For purposes of subsection (a), and

except to the extent provided in regulations, a controlled foreign corporation shall be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligation." But a court will not "'rewrite the statute' to the Government's liking." *Nat'l Ass'n of Mfrs. v. Dep't of Def.*, 138 S. Ct. 617, 629 (2018) (citation omitted).

2. The IRS's argument that its regulations "essentially repeat[] a statutory provision," IRS Br. 27, undermines its claim to *Chevron* deference. "*Chevron* step 2 deference is reserved for those instances when an agency recognizes that the Congress's intent is not plain from the statute's face." *Peter Pan Bus Lines, Inc. v. FMCSA*, 471 F.3d 1350, 1354 (D.C. Cir. 2006). Where, as here, statutory ambiguity leaves the agency with a choice to make, "it is incumbent upon the agency not to rest simply on its parsing of the statutory language" but rather "[i]t must bring its experience and expertise to bear in light of competing interests at stake." *PDK Labs. Inc. v. DEA*, 362 F.3d 786, 797-98 (D.C. Cir. 2004). *See also GTE Serv. Corp. v. FCC*, 224 F.3d 768, 774-76 (D.C. Cir. 2000) (vacating where "the Commission never exercised its discretionary

authority to interpret the statute … because it believed that the plain text" governed).

These cases rebut the IRS's assertion (IRS Br. 30) that no case has ever invalidated a regulation that simply follows the statutory language—an assertion that is out of place here, given that section 956(d) does not provide a self-executing statutory rule. Where, as here, the agency gave no indication that it recognized there was a statutory gap to fill, a court will vacate the regulations so the agency can bring its expertise to bear. *See PDK Labs.*, 362 F.3d at 797-98.[2]

3. Tacitly recognizing that its regulations rest on shaky foundations, the IRS asserts—for the first time—that this Court may interpret section 956(d) to reach the same result even in the absence of regulations. IRS Br. 49-52. As the IRS acknowledges, this argument is clearly waived. In the Tax Court, SIH argued that the statute is not self-executing, Tax Ct. Dkt. 25 at 92-98 (Feb. 27, 2017), and the IRS argued

[2] This Court has not determined whether "deference is 'only appropriate when the agency has exercised its *own* judgment, not when it believes that [its] interpretation is compelled by Congress,'" but it has recognized that the law is well-established in the D.C. Circuit and other circuits. *See Martinez v. Att'y Gen. of U.S.*, 693 F.3d 408, 412 & n.4 (3d Cir. 2012) (citation omitted). The arguments in support of this principle are compelling, and the IRS makes no argument that it should be rejected.

only that its regulations are valid. Thus, this is far from the "rare case" in which the Court should "entertain an issue initially raised on appeal." *Taha v. Cty. of Bucks*, 862 F.3d 292, 300 (3d Cir. 2017).

The IRS was correct to waive this argument, because it contravenes settled administrative law principles. "*Chevron*'s premise is that it is for agencies, not courts, to fill statutory gaps." *Nat'l Cable & Telecomm's. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005). This principle applies equally in the tax context: "Congress has delegated to the Secretary of the Treasury, not to this Court, the task of administering the tax laws of the Nation." *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 159 (1981) (internal quotation marks omitted). A court cannot exercise authority that Congress expressly delegated to the agency.

The IRS cites a line of cases in which courts have been persuaded to step into the shoes of the IRS when it failed to act. But these cases have been overtaken by the Supreme Court's decision in *Mayo*, which makes clear that courts evaluate tax regulations in the same manner as other regulations. *See* 562 U.S. at 55-56. As the Supreme Court has instructed, a statutory provision directing the agency to promulgate

regulations does not have independent effect. *See MacLean*, 135 S. Ct. at 921-22.[3] Accordingly, absent valid regulations section 956(d) cannot impose tax on SIH's CFC guarantees.

B. The Section 956(d) Regulations Are Contrary to the Purpose of Section 956

The statutory purpose confirms the invalidity of the IRS's regulations. The purpose of the statute is critical in evaluating whether a regulation "'harmonize[s]' with the statute" and is "reasonable in light of the legislature's revealed design." *Si Men Cen v. Attorney General*, 825 F.3d 177, 186-87 (3d Cir. 2016) (citation omitted). Citing legislative history, the NPRM reiterated that 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." 83 Fed. Reg. at 55,324 (quoting H.R. Rep. No. 87-1447, at 58 (1962)). The NPRM further states that the IRS has thus exercised its regulatory authority to "tailor the application of section 956 to the abuse that motivated its adoption, ensuring that the provision … does not extend to transactions the

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[3] The IRS's citation to *Pittway Corp. v. United States*, 102 F.3d 932, 936 (7th Cir. 1996), is particularly inapt. That case held that the statutory "language directs us to a single conclusion," indicating that, unlike here, the statute was unambiguous.

taxation of which would be inconsistent with the purpose of section 956." *Id.* at 55,325. *See also id.* ("chief among" the statute's purposes is to "ensure symmetry between the treatment of actual dividends and payments which are 'substantially the equivalent of a dividend'" (quoting S. Rep. No. 87-1881 at 88 (1962))).

Despite these unequivocal declarations, the section 956(d) regulations are completely untailored to the statutory purpose, imposing shareholder-level tax without regard to whether, or to what extent, CFC earnings have been repatriated. The IRS's brief asserts that "[i]t is irrelevant" under section 956(d) whether "earnings are actually repatriated," IRS Br. 34, but that is flatly inconsistent with the IRS's statements in the NPRM.

The IRS's categorical approach not only contravenes the purpose of section 956, but also violates the fundamental principle that taxation should reflect economic reality. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *Merck & Co. v. United States*, 652 F.3d 475, 483 (3d Cir. 2011). *See also* 83 Fed. Reg. at 55,325 n.1 (Congress's purpose in section 956 is to capture "transactions that are economically equivalent to a taxable dividend"). The regulations' departure from economic reality is

particularly egregious where, as here, they are applied to co-guarantors, which multiplies the amount of deemed investment in U.S. property with no connection to the value of the guarantees or the available assets of the CFCs, and a tenuous connection to the amount made available to the U.S. shareholder. That result violates the IRS's "longstanding practice" to "conform[] the application of section 956 to its purpose." 83 Fed. Reg. at 55,326. *See also* 80 Fed. Reg. 53,058, 53,061-62 (Sept. 2, 2015); FSA 200216022, at 12 (Jan. 8, 2002) (acknowledging that guarantee rule can lead to "strange results").[4]

Rather than address the purposes of section 956(d), the IRS mischaracterizes SIH's position, arguing that the legislative history does not specify a "facts-and-circumstances" test for guarantees. SIH, however, is not arguing that the IRS must adopt a "facts-and-circumstances" test, but only that it must adopt a test consistent with the statutory purpose and its "longstanding practice." *See* 83 Fed. Reg. at 55,326. A fact-based test is one way to achieve this result, as

[4] The IRS asserts that the co-guarantor issue is irrelevant because the untaxed earnings of the two CFCs were less than the total amount of the guaranteed borrowing. But the CFCs were two of 39 co-guarantors, whose collective earnings far exceeded the amount borrowed.

demonstrated by the IRS's adoption of such a test for conduit financing arrangements.[5]

C. The Section 956(d) Regulations Are Inadequately Explained

The IRS acknowledges that it provided only a one-sentence "explanation" for its rules, IRS Br. 45, stating that they were adopted to "conform" to the statute. 29 Fed. Reg. 2,599, 2,599 (Feb. 20, 1964). The IRS also acknowledges that the statute gives the agency discretion to fashion a wide range of regulations. A terse statement that the regulations are being adopted to "conform" to the statute says nothing about why the agency adopted the particular approach it chose. Indeed,

[5] The IRS also asserts that, because Congress has amended section 956 without changing the section 956(d) regulations, the regulations must be consistent with congressional intent. But "reliance on congressional inaction ... 'deserve[s] little weight in the interpretive process.'" *Alexander v. Sandoval*, 532 U.S. 275, 292 (2001) (citation omitted). The more likely explanation is that Congress focused its attention on "the phase of the problem which seem[ed] most acute to the legislative mind." *Williamson v. Lee Optical of Oklahoma Inc.*, 348 U.S. 483, 489 (1955). As the IRS notes, the regulations caused relatively little litigation until recently, likely because until the enactment of the qualified dividend rules, the IRS had limited interest in litigating timing adjustments under section 956, and until recently, the IRS used a fact-specific analysis to mitigate some of the harshness of its rules.

it is no explanation at all. *See Nat'l Parks Conservation Ass'n v. E.P.A.*, 803 F.3d 151, 166 (3d Cir. 2015).

The IRS contends that no additional explanation was needed because the regulations establish a clear, easily administrable rule. But the IRS did not offer this rationale when it adopted the rules, and it is a bedrock principle of administrative law that a court cannot consider post-hoc explanations for agency action. *See SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947). Nor is this reasoning "reflected in the language of the regulations," IRS Br. 46, which as the IRS notes simply parrot language from the statute.[6]

Moreover, the IRS could have adopted clear and administrable regulations that implement the statutory purpose of taxing repatriations of income. For example, an approach keyed to the value of the guarantee, measured by the cost of obtaining an equivalent guarantee from a third party, could meet these requirements. The IRS routinely applies such an approach to guarantees in other tax contexts. *See, e.g., Container Corp. v. Commissioner,* 134 T.C. 122, 133 (2010) (guarantor of affiliate's debt

[6] The IRS's reliance on *Gardner v. Grandolsky* 585 F.3d 786 (3d Cir. 2009), is misplaced. That case did not hold or suggest that a regulation can satisfy the APA based on post-hoc assertions of agency counsel.

must charge "the amount it would have charged had the transaction been made at arm's length with an uncontrolled third party").

The IRS also argues that its one-sentence explanation suffices because no commenters objected to the proposed rules. But an agency must consider "obvious" issues whether or not they are raised in comments. *Zen Magnets, LLC v. CPSC*, 841 F.3d 1141, 1151 n.11 (10th Cir. 2016) ("Claims not raised before an agency are not waived if 'the problems underlying the claim are 'obvious.'" (citation omitted) (collecting cases)); *Del. Riverkeeper Network v. U.S. Army Corps of Eng'rs*, 869 F.3d 148, 155 (3d Cir. 2017) (same). Here, the most obvious issues before the agency were whether and how the regulations should be tailored to apply to guarantees that actually result in a repatriation.

D. The IRS's Additional Arguments Do Not Save the Regulations

Ultimately, the IRS resorts to arguing that its regulations should be upheld simply because they have been in effect for many years. But the regulations' age has no bearing on their validity. The Supreme Court has "instructed that 'neither antiquity nor contemporaneity with [a] statute is a condition of [a regulation's] validity.'" *Mayo*, 562 U.S. at 55 (quoting *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 740 (1996)). As a

result, "no amount of historical consistency can transmute an unreasoned statutory interpretation into a reasoned one." *Se. Ala. Med. Ctr. v. Sebelius*, 572 F.3d 912, 920 (D.C. Cir. 2009).

Resorting to hyperbole, the IRS argues that SIH seeks a "sea change" in the law—but SIH seeks only to restore longstanding IRS practice. Moreover, the future impact of this case will be modest given section 956's limited role following the 2017 tax law changes. Under the NPRM, any earnings eligible for tax-free repatriation under the new "territorial" tax system will be exempt from section 956.

Finally, the IRS contends that deferral of income tax is a privilege, and therefore must be strictly construed. IRS Br. 22. But because a corporation and its shareholders are separate taxpayers, *Moline Properties v. Commissioner*, 319 U.S. 436, 438-39 (1943), corporate income is not shareholder income. At issue here is *shareholder* taxation of corporate earnings, which generally occurs only when the shareholder receives a distribution or sells shares. Section 956 accelerates shareholder taxation, and, under *Gould v. Gould*, 245 U.S. 151, 153 (1917), ambiguities in taxing statutes like section 956 must be strictly construed against the government. The IRS ignores the controlling

Gould doctrine, and instead invokes a doctrine that would apply only if income taxable to the shareholder were being deferred.

II. PRECEDENTIAL IRS GUIDANCE REQUIRES A REVIEW OF THE FACTS

Even if the section 956(d) regulations could survive judicial review, precedential IRS guidance requires that "the facts and circumstances of each case must be reviewed to determine if, in substance, there has been a repatriation of … earnings." Rev. Rul. 89-73 (May 22, 1989). The IRS does not dispute any of SIH's factual assertions, including that SIG's U.S. affiliates had more than sufficient assets on deposit with Merrill Lynch to fully collateralize the borrowing, and that the guarantees were intended to prevent SIG from restricting Merrill Lynch's access to these U.S. assets by transferring them to the CFCs. *See* SIH Br. 42-46. Instead, the IRS asserts only that these factual issues are "wholly irrelevant." IRS Br. 43.

The IRS argues that Revenue Ruling 89-73 is inapplicable because SIH is seeking to change the form of its transaction, from a guarantee to something else. IRS Br. 41. That misstates SIH's argument. SIH is not seeking to alter the form of its transaction; rather, SIH argues that IRS guidance requires consideration of whether a repatriation in substance

has occurred even when the form of the transaction meets the literal requirements for a 956 inclusion.

The IRS is simply wrong when it asserts that its "repatriation in substance" rulings are limited to situations where "taxpayers designated their transactions as something *other* than a guarantee or loan to avoid triggering income inclusion under § 956." IRS Br. 40. SIH's opening brief cites several rulings in which a transaction met the literal requirements of section 956, but the IRS declined to apply the statute because there was no repatriation in substance. *See* SIH Br. 33-34 & nn.8-9. For example, the IRS determined that, even though a CFC held tangible property that constituted "U.S. property" under a literal reading of section 956, there was no repatriation in substance where the property was in the United States only temporarily. *See* Rev. Rul. 67-130 (1967). Similarly, the IRS considered a situation in which a U.S. parent pledged CFC stock to secure financing and concluded 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," and thus no 956 inclusion. T.A.M. 8042001 (Mar. 18, 1980).

In short, the IRS does not dispute any of SIH's factual assertions, and the agency's description of its own rulings is plainly incorrect. Accordingly, at a minimum, this case should be remanded for an examination of whether the CFC guarantees resulted in an effective repatriation of CFC earnings.

III. 956 INCLUSIONS SHOULD BE TAXED AS DIVIDENDS

The IRS's statements in its recent NPRM strongly support SIH's argument that 956 inclusions should be taxed as dividends rather than as ordinary income. The NPRM declares that ensuring "symmetry between the treatment of actual dividends and payments which are 'substantially the equivalent of a dividend'" under section 956 is "chief among" the purposes of section 956. 83 Fed. Reg. at 55,325 (quoting S. Rep. No. 87-1881 at 88). This symmetry is achieved through "the IRS's longstanding practice of conforming the application of section 956 to its purpose." *Id.* at 55,326. The IRS's brief not only fails to inform the Court of this recent declaration of the agency's longstanding policy, but persists in arguing *against* symmetry between the treatment of actual dividends and 956 inclusions, contrary to the statutory purpose and the IRS's public position.

The IRS also makes a key concession that undermines its reliance on *Rodriguez v. Commissioner,* 722 F.3d 306 (5th Cir. 2013). That decision rests on a conclusion that Congress by statue "specifically designates when § 951 inclusions are to be treated as dividends." *Id.* at 311. But the IRS now concedes that its own regulations—which apparently were never brought to the Fifth Circuit's attention—repeatedly treat 956 inclusions as dividends *without* any specific statutory authorization.

The IRS's argument for starkly asymmetrical treatment of 956 inclusions and formal dividends should be rejected.

A. The Purposes of Sections 956 and 1(h)(11) Support Dividend Treatment

The IRS acknowledges that whether 956 inclusions should be taxed as dividends subject to the qualified dividend income ("QDI") rate is a question of statutory interpretation, but never acknowledges its own recent declaration that the "chief" and "manifest" purpose of section 956 is to "create symmetry between the taxation of actual repatriations and the taxation of effective repatriations." 83 Fed. Reg. at 55,325-26. In the IRS's view, Congress "enacted section 956 … to tax a CFC's investment of earnings in United States property *in the same manner* as if it had

distributed those earnings to the United States." *Id.* at 55,324 (emphasis added); *id.* at 55,325 ("Section 956 was thus designed to ensure symmetry between the tax treatment of repatriations through dividends and effective repatriations."). Therefore, "disparate treatment of" 956 inclusions and formal dividends is "directly at odds with the manifest purpose of section 956." *Id.* at 55,326.

The IRS's "longstanding practice" has been to "conform[] the application of section 956 to its purpose." *Id.* That purpose is served by "subjecting effective repatriations to tax in the same manner as actual repatriations." *Id.* Thus, the NPRM proposes to "maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations" by ensuring that 956 inclusions are taxed the *same* as actual dividends. *Id.* ("The proposed regulations exclude corporate U.S. shareholders from the application of section 956 to the extent necessary to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations."). There is symmetry between the taxation of actual dividends and 956 inclusions only if both are subject to the same tax rate. The IRS nevertheless argues for starkly *disparate* tax treatment of 956 inclusions and formal dividends. But taxing 956

inclusions at more than double the rate that applies to dividends is, in the IRS's own words, "directly at odds with the manifest purpose of section 956." *Id.* The IRS's statements in the NPRM thus pull the rug out from under its position in this case.

Taxing 956 inclusions as dividends is also consistent with the purpose of section 1(h)(11), which is to encourage the distribution of corporate earnings to shareholders. *See* SIH Br. 51-52. The section 956(d) regulations deem U.S. shareholders to have made use of CFC earnings through the guarantee, consistent with the QDI rules' purpose of encouraging shareholder use of corporate earnings.

More generally, investments in U.S. property return value to the U.S. economy and therefore are just as much a repatriation of earnings as a formal dividend. *See* 83 Fed. Reg. at 55,325 n.1 (section 956 taxes "effective repatriation of earnings through transactions that are economically equivalent to a taxable dividend"). Thus, repatriations via section 956 are entirely consistent with the purpose of section 1(h)(11) to encourage shareholder access to corporate earnings. As the NPRM stated, section 956 ensures "parity of treatment for different ways that

CFC earnings can be made available for use in the United States or for use by the U.S. shareholder." *Id.* at 55,325.

B. The IRS Concedes That Express Congressional Authorization Is Not Required For Dividend Treatment

In arguing that 956 inclusions are not eligible for the QDI rate, the IRS relies heavily on the Fifth Circuit's decision in *Rodriguez*. *Rodriguez*, in turn, rests on a conclusion that Congress "specifically designates when § 951 inclusions are to be treated as dividends." 722 F.3d at 311. But the IRS quietly makes a critical concession that fatally undermines its reliance on *Rodriguez*. The IRS's own regulations and rulings repeatedly accord dividend treatment to 956 inclusions *without any express statutory authorization for such treatment*. *See* IRS Br. 66-67 (acknowledging that its regulations "set[] out specific instances in which § 951(a)(1)(B) inclusions would be treated as dividends"); SIH Br. 56-57 (identifying five such regulations). These regulations negate the argument that dividend treatment is prohibited unless expressly authorized by specific statutory language.

Having made this critical concession as quietly as possible, the IRS falls back to an argument that "specific regulatory authority" (as opposed

to specific *statutory* authority) is required to tax 951 inclusions as a dividend. That is also incorrect. Section 1(h)(11) provides that "dividends" are subject to the QDI rate, and the statutory definition of "dividends" is broad enough to encompass any shareholder access to corporate earnings, including constructive dividends. *See* SIH Br. 49-52. Moreover, the IRS has issued numerous interpretive rulings that read the term "dividend" to cover 956 inclusions in the absence of a regulation, demonstrating that no specific authorization, statutory or regulatory, is required to support that result. *Id.* at 56-58. These rulings, while not precedential, "reveal the interpretation put upon [the relevant provisions] by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-87 (1962).

The IRS's concession that no express statutory authority is needed for dividend treatment of 956 inclusions forecloses its reliance on *Rodriguez*. Based on the information provided to it, the Fifth Circuit held that "Congress specifically designates when § 951 inclusions are to be treated as dividends." *Rodriguez*, 722 F.3d at 311. But it appears that the Fifth Circuit in *Rodriguez* was never told that the IRS has issued

multiple regulations treating 951 inclusions as dividends in the absence of specific congressional authority. Accordingly, *Rodriguez*'s holding rests on an incomplete understanding of the relevant law, and this Court should not follow it.[7]

The IRS regulations and rulings discussed above also undercut the Fifth Circuit's conclusion that treating 956 inclusions as dividends would result in disfavored statutory "surplusage." *See* 722 F.3d at 311. The IRS has promulgated multiple regulations that create the same alleged redundancies that it warned the Fifth Circuit to avoid. "[I]n a statutory scheme as complex as the Internal Revenue Code and its implementing Treasury Regulations, [courts] should not be surprised to find repetitive 'surplusage.'" *Callaway v. Commissioner*, 231 F.3d 106, 131 (2d Cir. 2000) (quoting *J.C. Penney Co. v. Commissioner*, 312 F.2d 65, 72 (2d Cir. 1962) (Friendly, J.)). *See also* SIH Br. 61-63 (explaining that section 951(a)(1)(A) inclusions are not covered by the dividend-equivalence rationale, and therefore Congress may have avoided ambiguity by specifically providing for dividend treatment in certain circumstances).

[7] *Rodriguez* does refer to some "non-binding" IRS rulings, and declines to give them weight because they were issued before Congress adopted section 1(h)(11) in 2003. But post-2003 rulings continue to treat subpart F income as dividends. *See, e.g.*, PLR 201430017 (Jul. 25, 2014).

The IRS stresses that section 1248 specifies dividend treatment, while sections 951 and 956 do not. IRS Br. 64-65. But the IRS ignores the relevant history, which explains the difference. When section 1248 was enacted in 1962, its effect was to convert what were otherwise capital gains from stock sales into ordinary income by recharacterizing such gains as dividends. Because dividends were taxed as ordinary income in 1962, specifying dividend treatment for 956 inclusions at that time would not have changed their tax treatment, and thus Congress had no reason to do so.

The IRS also cites *Rodriguez* in support of an argument based on language in section 956 that Congress repealed 25 years ago, well before the advent of the QDI rules. *See* IRS Br. 64. Whatever weight this language may have carried before 1993 is long gone. Even if the repealed statutory language were considered relevant, it would not support the IRS's claim. The IRS quotes an incorrect statement in *Rodriguez* that the "original version of § 956 specifically stated that Congress did not intend amounts calculated thereunder to constitute dividends." 722 F.3d at 311. Actually, the repealed language said no such thing. Instead, it provided a computational rule that ensured symmetry between actual

and deemed distributions of CFC earnings, and thus reinforced the identity between actual dividends and 956 inclusions. *See* Revenue Act of 1962, Pub. L. No. 87-834, Sec. 12, 76 Stat. 960, 1006, 1015-16 (taxing amounts held as investments in U.S. property "to the extent such amount would have constituted a dividend ... if it had been distributed").

For all of these reasons, the Court should not follow *Rodriguez*. But *Rodriguez* also differs from this case in that it concerned an investment in tangible property, not a guarantee. In *Rodriguez*, no cash ended up in the hands of the U.S. shareholder. Under the IRS's treatment of guarantees, however, cash does end up in the hands of the U.S. shareholder through the guaranteed loan. That cash distribution distinguishes this case from *Rodriguez*.

The other cases the IRS cites do not advance its argument. *Smith v. Commissioner* simply reiterates the Tax Court's holding in this case without separate analysis. 2018 WL 4490923, at *19 (T.C. Sept. 18, 2018). And *Principal Life Insurance Company v. United States* merely stated, in a footnote, that 951 inclusions are not "actual dividends," without addressing whether they may be constructive dividends. 120 Fed. Cl. 41, 43 n.5 (2015).

The IRS criticizes SIH for not addressing Treasury Notice 2004-70, which states the IRS's position that section 951(a)(1) inclusions do not constitute qualified dividend income. SIH did not address that Notice because the IRS itself recognized in *Rodriguez* that "the notice is of no consequence." *Rodriguez v. Commissioner*, IRS Br. 36, 2012 WL 5902697 (5th Cir. filed 2012). As the IRS explained, the Notice "would have relevance in this case only if the Commissioner's litigating position were contrary to the position announced in that notice." *Id.* The IRS's litigating position is not contrary to Notice 2004-70, and therefore the Notice has no bearing here. In any event, nothing in the Notice overcomes the flaws in the IRS's position.

C. 956 Inclusions Are Constructive Dividends

SIH's opening brief explained that taxing 956 inclusions at the QDI rate as constructive dividends is consistent with both section 1(h)(11) and section 956. *See* SIH Br. 49-56. Rather than confronting SIH's arguments, the IRS attacks a strawman, arguing that a loan guarantee is not a formal dividend. But SIH has not argued that a guarantee is a

formal dividend. Instead, SIH's position is that a 956 inclusion arising from a guarantee is a constructive dividend.

When the IRS addresses SIH's actual argument, it concedes that a constructive dividend occurs when the corporation confers a benefit on its shareholder and the corporation does not receive equivalent value in return. *See* IRS Br. 58-59; *Neonatology Assocs., P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002). The IRS then asserts—without argument or explanation—that a loan guarantee does not transfer value from the corporation to its shareholder. As a general statement, that is clearly wrong: While the benefit conferred by a particular loan guarantee varies with the facts and circumstances, some guarantees plainly confer a benefit. That is why Congress included loan guarantees in section 956. It is also why a shareholder often would have to pay a substantial sum to obtain a loan guarantee from a third party. Indeed, the IRS's assertion that loan guarantees do not transfer value conflicts with its argument that guarantees result in an inclusion because parties would not enter them unless they conveyed value. IRS Br. 19.

The IRS claims that a 956 inclusion is not value provided to the shareholder "out of [the CFC's] earnings and profits," *Neonatology*, 299

F.3d at 231, because the CFC's earnings are not reduced at the time of the inclusion. But if the 956 inclusion is not from the earnings of the CFC, what is it from? The IRS does not suggest any alternative source for the value taxed by section 956, and there is none. The amount of a 956 inclusion is measured by the CFC's earnings, which shows that the inclusion is "out of" those earnings. And following a 956 inclusion, the earnings are earmarked as "previously taxed" and are not taxed again when distributed. 26 U.S.C. § 959(a). This treatment recognizes that section 956 taxed the CFC's earnings because they were deemed repatriated, just as an actual distribution of those earnings would have been taxed. In any event, the IRS's premise that dividend treatment is always linked to earnings reduction is simply incorrect. For example, section 1248 inclusions are treated as dividends, but they do not reduce earnings and profits, *id.* § 959(e).[8]

Remarkably, the IRS asserts that whether constructive dividends can ever qualify as dividends under section 1(h)(11) is an issue of first

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[8] The IRS acknowledges that a statutory provision entitled "constructive dividends" applies to 956 inclusions (and other section 951(a) inclusions), but argues that this heading is simply "incorrect." IRS Br. 60-61. Arguing that statutory language should be disregarded because Congress made a mistake is an argument of last resort.

impression that has not yet been decided by a court or addressed by the IRS in precedential guidance. IRS Br. 59. This statement is carefully worded—although not mentioned in its brief, the IRS in past cases has not disputed that constructive dividends qualify for the QDI rate. *See Luczaj & Associates v. Commissioner*, 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)"). This concession is hardly surprising, since a constructive dividend is a dividend within the meaning of section 316, and therefore is a dividend for purposes of section 1(h)(11). *See* SIH Br. 49-52. In any event, the IRS does not argue to this Court that constructive dividends do *not* qualify for the QDI rate. Consequently, for purposes of this case the Court should assume that they do.

D. The IRS Fails to Confront the Timing Anomalies Created by Its Position

SIH showed in its opening brief that failing to treat 956 inclusions as dividends creates timing anomalies that contravene Supreme Court precedent. SIH Br. 64-66. Specifically, taxing 956 inclusions as ordinary income more than doubles the tax rate based entirely on the timing of two related events: a CFC's investment (or deemed investment) in U.S.

property resulting in the acceleration of taxation of CFC earnings under section 956 and the later formal distribution of those earnings. *See id.*

The IRS addresses this argument in a one-sentence footnote, asserting only that a 956 inclusion and any subsequent formal dividend are "substantively unrelated transactions." IRS Br. 68 n.19. This is clearly incorrect. When a 956 inclusion results in immediate taxation of undistributed CFC earnings, no further tax on those earnings is due when they are formally distributed to the shareholder. Given that both the inclusion and the distribution involve the very same CFC earnings, the events are not "substantively unrelated." Indeed, a more direct relationship between the inclusion and the formal dividend is difficult to imagine.[9]

[9] The IRS asserts that SIH's timing argument is raised for the first time on appeal. But SIH's arguments to the Tax Court addressed the anomaly between the rate applied to SIH's guarantees and its later distributions. *See* Tax Ct. Dkt. 25 at 119-20. There is no bar against citing an additional line of precedent to support arguments made to the Tax Court.

CONCLUSION

The judgment of the Tax Court should be reversed.

Respectfully submitted,

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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 6,495 words, excluding the parts of the brief exempted by Rule 32(f). 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

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December 12, 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 December 12, 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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December 12, 2018

ADDENDUM

Amount Determined Under Section 956 for Corporate United States Shareholders, 83 Fed. Reg. 55,324 (Nov. 5, 2018)…………………………..1a

AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

Column Labeling, and Miscellaneous Topics.'' We are issuing the draft guidance consistent with our good guidance practices regulation (21 CFR 10.115). The draft guidance, when finalized, will represent the current thinking of FDA on this topic. It does not establish any rights for any person and is not binding on FDA or the public. You can use an alternate approach if it satisfies the requirements of the applicable statutes and regulations. This guidance is not subject to Executive Order 12866.

The draft guidance, when finalized, will provide questions and answers on topics related primarily to implementing two final rules: (1) ''Food Labeling: Serving Sizes of Foods That Can Reasonably Be Consumed At One Eating Occasion; Dual-Column Labeling; Updating, Modifying, and Establishing Certain Reference Amounts Customarily Consumed; Serving Size for Breath Mints; and Technical Amendments'' (81 FR 34000 (May 27, 2016)) and (2) ''Food Labeling: Revision of the Nutrition and Supplement Facts Labels'' (81 FR 33742 (May 27, 2016)). This draft guidance also discusses formatting issues for dual-column labeling, products that have limited space for nutrition labeling, and additional issues dealing with compliance.

II. The Paperwork Reduction Act

This draft guidance refers to previously approved collections of information found in FDA regulations. These collections of information are subject to review by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520). The collections of information in 21 CFR part 101 have been approved under OMB control number 0910–0381.

III. Electronic Access

Persons with access to the internet may obtain the draft guidance at either *https://www.fda.gov/FoodGuidances* or *https://www.regulations.gov.* Use the FDA website listed in the previous sentence to find the most current version of the guidance.

Dated: October 30, 2018.

Leslie Kux,

Associate Commissioner for Policy.

[FR Doc. 2018–24124 Filed 11–2–18; 8:45 am]

BILLING CODE 4164–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–114540–18]

RIN 1545–BO88

Amount Determined Under Section 956 for Corporate United States Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that reduce the amount determined under section 956 of the Internal Revenue Code with respect to certain domestic corporations. The proposed regulations affect certain domestic corporations that own (or are treated as owning) stock in foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by December 5, 2018.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–114540–18), Internal Revenue Service, Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–114540–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–114540–18).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Rose E. Jenkins, (202) 317–6934; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Section 956

The Revenue Act of 1962 (the ''1962 Act''), Pub. L. 87–834, sec. 12, 76 Stat. at 1006, enacted sections 951 and 956 as part of subpart F of part III, subchapter N, chapter 1 of the 1954 Internal Revenue Code (''subpart F''), as amended. Subpart F was enacted in order to limit the use of low-tax jurisdictions for the purposes of obtaining indefinite deferral of U.S. tax on certain earnings that would otherwise be subject to U.S. federal income tax. H.R. Rep. No. 1447 at 57 (1962). Congress enacted subpart F in part to address taxpayers who had ''taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income.'' *Id.* at 58.

Before the 1962 Act, United States shareholders (as defined in section 951(b)) (''U.S. shareholders'') of controlled foreign corporations (as defined in section 957) (''CFCs'') were not subject to U.S. tax on earnings of the foreign corporations unless and until earnings of the foreign corporations were distributed to the shareholders as a dividend. S. Rep. No. 1881 at 78 (1962). The subpart F regime eliminated deferral for certain—generally passive or highly mobile—earnings of CFCs by subjecting those earnings to immediate U.S. taxation regardless of whether there was an actual distribution. *Id.* at 80. Earnings that were not subject to immediate U.S. taxation under the subpart F regime were generally taxable only upon repatriation, as those earnings did not present the same concerns regarding indefinite tax deferral compared to earnings subject to subpart F.

Section 956 was enacted alongside the subpart F regime in the 1962 Act to ensure that a CFC's earnings not subject to immediate tax when earned (under the subpart F regime) would be taxed when repatriated, either through a dividend or an effective repatriation. Recognizing that repatriation of foreign earnings was possible through means other than a taxable distribution, Congress enacted section 956 ''to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation.'' H.R. Rep. No. 1447 at 58. Congress determined that the investment by a CFC of its earnings in United States property, including obligations of a U.S. person, ''is substantially the equivalent of a dividend.'' *See* S. Rep. No. 1881 at 88 (1962). *See also* S. Rep. No. 94–938 at 226 (1976) (''[S]ince the investment . . . in the stock or debt obligations of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed.''). Accordingly, Congress enacted section 956 as an anti-abuse measure to tax a CFC's investment of earnings in United States property in the same manner as if it had distributed those earnings to the United States. *See* JCS–10–87 at 1081–82 (1987) (''In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, an actual dividend payment ends deferral. . . . Second, in

the case of a controlled foreign corporation, an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a repatriation that ends deferral (Code sec. 956).''). Failure to tax CFC investments in United States property would have allowed taxpayers to circumvent the U.S. system of deferral by effectively repatriating earnings without paying U.S. tax on the substantial equivalent of a taxable dividend. Section 956 was thus designed to ensure symmetry between the tax treatment of repatriations through dividends and effective repatriations. *See generally* Notice 2014–52, 2014–42 I.R.B. 712 (''In the absence of section 956, a U.S. shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by the payment of an actual taxable dividend, such that there would be no reason for the U.S. shareholder to incur the dividend tax. Section 956 eliminates this disincentive to pay a dividend by ensuring parity of treatment for different ways that CFC earnings can be made available for use in the United States or for use by the U.S. shareholder.'').

Section 951(a)(1)(B) requires a U.S. shareholder of a CFC to include in gross income the amount determined under section 956 (the ''section 956 amount'') with respect to the CFC to the extent not excluded from gross income under section 959(a)(2) (the inclusion, a ''section 956 inclusion''). *See* sections 951(a)(1)(B), 959(a)(2), and 959(f)(1). Section 951(b) defines a U.S. shareholder as a United States person that owns within the meaning of section 958(a), or is considered as owning by reason of the constructive ownership rules of section 958(b), 10 percent or more of the voting power or value of a foreign corporation. A U.S. shareholder's section 956 amount with respect to a CFC for a taxable year is the lesser of (1) the excess (if any) of such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year, over 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 the CFC. *See* section 956(a). Applicable earnings are defined as the sum of accumulated earnings and profits (not including deficits) described in section 316(a)(1) and current earnings and profits described in section 316(a)(2), reduced by distributions made during the year and earnings and profits described in section 959(c)(1). *See* section 956(b)(1). Under section 956(c), United States property includes tangible property located in the United States, stock of a domestic corporation, an obligation of a United States person, and any right to use in the United States certain intangible property. Enacted as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103–66, sec. 13232(b), 107 Stat. 312, section 956(e) grants the Secretary of the Department of Treasury (the ''Secretary'') the authority to 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.''

This regulatory authority is not limited to the adoption of anti-avoidance rules, but rather permits the Secretary to ensure that the application of section 956 is consistent with the ''purposes of this section''—chief among them, to ensure symmetry between the treatment of actual dividends and payments which are ''substantially the equivalent of a dividend.'' S. Rep. No. 1881 at 88 (1962). Consistent with this understanding, the Department of Treasury (the ''Treasury Department'') and the IRS have exercised this regulatory authority to tailor the application of section 956 to the abuse that motivated its adoption, ensuring that the provision applies to the transactions Congress sought to tax, but does not extend to transactions the taxation of which would be inconsistent with the purpose of section 956.[1] For example, in 1964, shortly after section 956 was first enacted, the Treasury Department and the IRS issued regulations containing Treas. Reg. section 1.956–2(d)(2)(ii), providing that any debt collected within one year from the time incurred did not constitute an obligation that could be United States property. *See* T.D. 6704, 29 FR 2599, 2603. This short-term loan exception was removed when the Treasury Department and the IRS issued regulations in 1988 regarding the treatment of factoring receivables as United States property. *See* T.D. 8209, 53 FR 22163, 22169. A one-year debt exception would have been inconsistent with Congress's expansion of section 956 in 1984 to reach factoring receivables, which are often outstanding for less than one year.

Alongside the removal of the 1964 short-term loan exception in the 1988 regulations, the Treasury Department and the IRS issued Notice 88–108, 1988–2 C.B. 466, which indicated that regulations would be issued providing a narrower exception from the definition of obligation for purposes of section 956 for obligations collected within 30 days from the time incurred (the ''30-day rule''). However, the notice provided that the exception would not apply to a CFC that holds for 60 or more calendar days during the taxable year obligations which, without regard to the 30-day rule, would constitute United States property. The 30-day rule was expanded to 60 days in order to facilitate the flow of funds from foreign subsidiaries during a financial crisis beginning in 2008, which expansion was also extended to 2009 and 2010. *See* Notice 2008–91, 2008–43 I.R.B. 1001; Notice 2009–10, 2009–5 I.R.B. 419; Notice 2010–12, 2010–4 I.R.B. 326. The 30 day rule was ultimately adopted in final regulations issued on July 12, 2018, as Treas. Reg. section 1.956–2(d)(2)(iv). *See* T.D. 9834, 83 FR 32524, 32537–38.

Since 1964, Congress has modified section 956 several times without addressing Treasury's short-term debt exception; indeed, since then Congress adopted section 956(e) as a positive grant of regulatory authority in 1993, and explicitly validated the short-term debt exception in its legislative history. *See* H.R. Rep. 103–111 at 701 (1993) (''The bill is not intended to change the measurement of U.S. property that may apply, for example, in the case of certain short-term obligations, as provided in IRS Notice 88–108 (1988–2 C.B. 445), interpreting present law.'').

Conversely, the Treasury Department and the IRS have at times expanded the scope of section 956 by regulation to ensure that the provision reaches the type of transactions intended by Congress. *See, e.g.,* T.D. 9402, 73 FR 35580, 35582 (adding rules modifying the basis of property transferred to a CFC in certain non-recognition transactions solely for the purposes of

[1] In addition to authorizing regulations by the Treasury Department and the IRS, Congress has acted on occasion to both expand and contract the scope of section 956 based on an evolving understanding of the potential means by which taxpayers could achieve the abusive results that gave rise to its enactment (that is, the tax-free effective repatriation of earnings through transactions that are economically equivalent to a taxable dividend). Thus, for example, Congress contracted the scope of section 956 in 1976, exempting investments in the stock of unrelated (tested using a 25 percent ownership threshold) U.S. corporations from the definition of United States property. *See* Pub. L. 94–455, sec. 1021, 90 Stat. 1520. Conversely, Congress expanded the scope of section 956 in the Deficit Reduction Act of 1984, Pub. L. 98–369, sec. 123(b), 98 Stat. 494, by adding certain factoring receivables as a type of United States property because it recognized that certain ''corporations based in the United States are using foreign subsidiaries to factor receivables as a device for repatriating foreign earnings tax-free.'' H.R. Rep. No. 98–432 at 1305 (1984).

section 956 and providing that ''[t]he purpose of this [rule] is to prevent the effective repatriation of earnings and profits of a controlled foreign corporation that acquires United States property in connection with an exchange to which this [rule] applies without a corresponding income inclusion under section 951(a)(1)(B) by claiming a basis in the United States property less than the amount of earnings and profits effectively repatriated''). *See also* T.D. 9834, 83 FR 32524.

II. Adoption of Participation Exemption System

On December 22, 2017, Congress enacted the Tax Cuts and Jobs Act, Public Law 115–97 (the ''Act''), which established a participation exemption system for the taxation of certain foreign income. Under section 245A(a), in the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to such foreign corporation, there is allowed as a deduction an amount equal to the foreign-source portion of such dividend. A specified 10-percent owned foreign corporation is defined in section 245A(b) as any foreign corporation (other than certain passive foreign investment companies) with respect to which a domestic corporation is a U.S. shareholder. Section 245A(g) grants the Secretary authority to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 245A, including regulations for the treatment of U.S. shareholders owning stock of a specified 10-percent owned foreign corporation through a partnership.

Under section 246(c)(1) and (5), a domestic corporation that is a U.S. shareholder is not permitted a section 245A deduction in respect of any dividend on any share of stock of a specified 10-percent owned foreign corporation that the domestic corporation holds for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. Under section 246(c)(1)(B), a section 245A deduction is also not allowed to the extent the domestic corporation is under an obligation to make related payments with respect to positions in substantially similar or related property.

Explanation of Provisions

The Treasury Department and the IRS have determined that as a result of the enactment of the participation exemption system, the current broad application of section 956 to corporate U.S. shareholders would be inconsistent with the purposes of section 956 and the scope of transactions it is intended to address. Congress determined that certain investments by a CFC of its earnings in United States property are ''substantially the equivalent of a dividend'' and enacted section 956 to provide similar treatment for dividends and certain investments in United States property constituting effective repatriations. S. Rep. No. 1881 at 88. Before the Act, section 956 applied appropriately to domestic corporations because both dividends from, and investments in United States property by, CFCs were included in income by such domestic corporations. As noted, the purpose of section 956 is generally to create symmetry between the taxation of actual repatriations and the taxation of effective repatriations, by subjecting effective repatriations to tax in the same manner as actual repatriations. Under the participation exemption system, however, earnings of a CFC that are repatriated to a corporate U.S. shareholder as a dividend are typically effectively exempt from tax because the shareholder is generally afforded an equal and offsetting dividends received deduction under section 245A. A section 956 inclusion of a corporate U.S. shareholder, on the other hand, is not eligible for the dividends received deduction under section 245A (because it is not a dividend). As a result, the application of section 956 after the Act to corporate U.S. shareholders of CFCs that would qualify for section 245A deductions would result in disparate treatment of actual dividends and amounts ''substantially the equivalent of a dividend''—a result directly at odds with the manifest purpose of section 956.

Accordingly, the proposed regulations continue the Treasury Department and the IRS's longstanding practice of conforming the application of section 956 to its purpose. The proposed regulations exclude corporate U.S. shareholders from the application of section 956 to the extent necessary to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations. In general, under section 245A and the proposed regulations, respectively, neither an actual dividend to a corporate U.S. shareholder, nor such a shareholder's amount determined under section 956, will result in additional U.S. tax.

To achieve this result, the proposed regulations provide that the amount otherwise determined under section 956 with respect to a U.S. shareholder for a taxable year of a CFC is reduced to the extent that the U.S. shareholder would be allowed a deduction under section 245A if the U.S. shareholder had received a distribution from the CFC in an amount equal to the amount otherwise determined under section 956. The proposed regulations provide special rules with respect to indirect ownership. Due to the broad applicability of section 245A, in many cases a corporate U.S. shareholder will not have a section 956 inclusion as a result of a CFC holding U.S. property under the proposed regulations.

Section 956 will continue to apply without modification to U.S. shareholders other than corporate U.S. shareholders, such as individuals, to ensure that, consistent with the purposes of section 956, amounts that are substantially the equivalent of a dividend will be treated similarly to actual dividends. This treatment will apply to individuals regardless of whether they make an election under section 962. Because individuals are not eligible for a dividends received deduction under section 245A even if they make an election under section 962, the current application of section 956 to individuals is still necessary to ensure substantial equivalence between an actual repatriation and a deemed repatriation. Similarly, section 956 will continue to apply without reduction to regulated investment companies and real estate investment trusts because they are not allowed the dividends received deduction under section 245A. *See* sections 852(b)(2)(C) and 857(b)(2)(A).

In addition to carrying out the purposes of section 956, the proposed regulations would significantly reduce complexity, costs, and compliance burdens for corporate U.S. shareholders of CFCs. Absent the proposed regulations, corporate U.S. shareholders would need to continue to carefully monitor the application of section 956 to their operations, including provisions related to loans, guarantees, and pledges, to ensure that earnings were repatriated only through actual dividends, and therefore allowed a participation exemption, rather than through a deemed repatriation under section 956 subject to additional U.S. tax. Similarly, in the absence of the proposed regulations, a U.S.-parented group in many cases would need to engage in complex and costly restructuring upon the acquisition of a foreign corporation that owns domestic subsidiaries (since the foreign corporation becomes a CFC and the stock of its domestic subsidiaries represents United States property)

solely to avoid a section 956 inclusion. Absent the proposed regulations, section 956 could also serve as a ''trap for the unwary'' for domestic corporations that fail to recognize that, even though they are entitled to the deduction under section 245A for actual dividends, their section 956 inclusions would continue to be fully subject to U.S. tax.

The proposed regulations also add, in proposed § 1.956–1(g)(5), the effective date for § 1.956–1(e)(6) that was inadvertently deleted in TD 9792, published in the **Federal Register** on November 3, 2016 (81 FR 76497, as corrected at 81 FR 95470 and 95471).

Conforming Amendments

The Treasury Department and the IRS intend to make conforming amendments to the examples throughout the regulations under section 956 upon finalization of the proposed regulations.

Applicability Date

These changes are proposed to apply to taxable years of a CFC beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register** (the ''finalization date''), and to taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end. With respect to taxable years of a CFC beginning before the finalization date, a taxpayer may rely on the proposed regulations for taxable years of a CFC beginning after December 31, 2017, and for taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end, provided that the taxpayer and United States persons that are related (within the meaning of section 267 or 707) to the taxpayer consistently apply the proposed regulations with respect to all CFCs in which they are U.S. shareholders.

Special Analyses

The Administrator of the Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget, has waived review of this proposed rule in accordance with section 6(a)(3)(A) of Executive Order 12866. OIRA will subsequently make a significance determination of the final rule, pursuant to section 3(f) of Executive Order (E.O.) 12866 and the April 11, 2018, Memorandum of Agreement between the Department of Treasury and the Office of Management and Budget (OMB).

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation, if adopted, will not have a significant economic impact on a substantial number of small entities, although some small entities that are domestic corporations could be affected by the regulation and comments are requested on the application of the regulation to domestic partnerships. However, even if a substantial number of small entities were to be affected by this regulation, the Treasury Department and the IRS estimate that the economic impact on such small entities would not be significant as the regulation is expected to marginally reduce compliance costs for smaller entities. This is because the Treasury Department and the IRS believe that the cost-saving benefits of the proposed regulations with respect to complex third-party borrowing arrangements, internal financial management structures, and restructurings of worldwide operations will generally be available only to large U.S. multinational corporations with 20 or more CFCs. The Treasury Department and the IRS believe that U.S. multinational corporations with less than 20 CFCs generally will not have the types of arrangements in place that would otherwise need to be structured and monitored to avoid section 956. The proposed regulations, if adopted, generally will not affect small entities that are not domestic corporations. The Treasury Department and the IRS invite comments on the impact of this rule on small entities.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. In particular, comments are requested as to the appropriate application of the proposed regulations to U.S. shareholders that are domestic partnerships, which may have partners that are a combination of domestic corporations, U.S. individuals, or other persons. For example, one approach could be to reduce the amount otherwise determined under section 956 with respect to a domestic partnership to the extent that a domestic corporate partner would be entitled to a section 245A deduction if the partnership received the amount as a distribution. An alternative could be to determine a domestic partnership's section 956 amount and section 956 inclusion without regard to the status of its partners, but then provide that a corporate U.S. shareholder partner's distributive share of the section 956 inclusion is not taxable. Comments are also requested with respect to the maintenance of previously taxed earnings and profits accounts under section 959 and basis adjustments under section 961. Additionally, comments are requested on the interaction between the proposed regulations and section 245A(e). All comments will be available at *http://www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry to read in part as follows:

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

Section 1.956–1 also issued under 26 U.S.C. 245A(g) and 956(e).

* * * * *

Par. 2. Section 1.956–1 is amended by:

1. Revising paragraph (a).
2. In the first sentence of paragraph (g)(1), removing the language ''Paragraph (a)'' and adding in its place ''Paragraph (a)(1)''.
3. Adding paragraphs (g)(4) and (5).

The revisions and additions read as follows:

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

(a) *Overview and scope*—(1) *In general.* Subject to the provisions of

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

(2) *Reduction for certain United States shareholders*—(i) *In general.* For a taxable year of a controlled foreign corporation, the amount determined under section 956 with respect to each share of stock of the controlled foreign corporation owned (within the meaning of section 958(a)) by a United States shareholder is the amount that would be determined under section 956 with respect to such share for the taxable year, absent the application of this paragraph (a)(2) for the taxable year (such amount, the *tentative section 956 amount,* and in the aggregate with respect to all shares owned (within the meaning of section 958(a)) by the United States shareholder, the *aggregate tentative section 956 amount*), reduced by the amount of the deduction under section 245A that the shareholder would be allowed if the shareholder received as a distribution from the controlled foreign corporation an amount equal to the tentative section 956 amount with respect to such share on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation (*hypothetical distribution*).

(ii) *Determination of the amount of the deduction that would be allowed under section 245A with respect to a hypothetical distribution.* For purposes of determining the amount of the deduction under section 245A that a United States shareholder would be allowed with respect to a share of stock of a controlled foreign corporation by reason of a hypothetical distribution, the following rules apply—

(A) If a United States shareholder owns a share of stock of a controlled foreign corporation indirectly (within the meaning of section 958(a)(2)), then—

(*1*) Sections 245A(a) through (d), 246(a), and 959 apply to the hypothetical distribution as if the United States shareholder directly owned (within the meaning of section 958(a)(1)(A)) the share;

(*2*) Section 245A(e) applies to the hypothetical distribution as if the distribution were made to the United States shareholder through each entity by reason of which the United States shareholder indirectly owns such share and pro rata with respect to the equity that gives rise to such indirect ownership;

(*3*) To the extent that a distribution treated as made to a controlled foreign corporation pursuant to the hypothetical distribution by reason of paragraph (a)(2)(ii)(A)(*2*) of this section would be subject to section 245A(e)(2), the United States shareholder is treated as not being allowed a deduction under section 245A by reason of the hypothetical distribution; and

(*4*) Section 246(c) applies to the hypothetical distribution by substituting the phrase ''owned (within the meaning of section 958(a))'' for the term ''held'' each place it appears in section 246(c); and

(B) Section 246(c) applies to the hypothetical distribution by substituting ''the last day during the taxable year on which the foreign corporation is a controlled foreign corporation'' for the phrase ''the date on which such share becomes ex-dividend with respect to such dividend'' in section 246(c)(1)(A).

(3) *Examples.* The following examples illustrate the application of paragraph (a)(2) of this section.

(i) *Example 1.* (A) *Facts.* (*1*) USP, a domestic corporation, owns all of the single class of stock of CFC1, which is treated as equity for U.S. income tax purposes and under the laws of the jurisdiction in which CFC1 is organized and liable to tax as a resident. The stock of CFC1 consists of 100 shares, and USP satisfies the holding period requirement of section 246(c) (as modified by paragraph (a)(2)(ii)(B) of this section) with respect to each share of CFC1 stock. CFC1 owns all of the stock of USS, a domestic corporation. CFC1's adjusted basis in the stock of USS is $0x.

(*2*) The functional currency of CFC1 is the U.S. dollar. CFC1 has $100x of undistributed earnings as defined in section 245A(c)(2), $90x of which constitute undistributed foreign earnings as defined in section 245A(c)(3), and $10x of which are described in section 245(a)(5)(B) (that is, earnings attributable to a dividend that CFC1 received from USS). CFC1 would not receive a deduction or other tax benefit with respect to any income, war profits, or excess profits taxes on a distribution. None of the earnings and profits of CFC1 are described in section 959(c)(1) or (2) or are earnings and profits attributable to income excluded from subpart F income under section 952(b). CFC1's applicable earnings (as defined in section 956(b)(1)) are $100x. CFC1 also has held an obligation of USP with an adjusted basis of $120x on every day during the taxable year that was acquired while all of its stock was owned by USP.

(B) *Analysis.* Because USP directly owns all of the stock of CFC1 at the end of CFC1's taxable year, USP's aggregate tentative section 956 amount with respect to CFC1 is $100x, the lesser of USP's pro rata share of the average amounts of United States property held by CFC1 ($120x) and its pro rata share of CFC1's applicable earnings ($100x). Under paragraph (a)(2)(i) of this section, USP's section 956 amount with respect to CFC1 is its aggregate tentative section 956 amount with respect to CFC1 reduced by the deduction under section 245A that USP would be allowed if USP received an amount equal to its aggregate tentative section 956 amount as a distribution with respect to the CFC1 stock. With respect to the tentative distribution from CFC1 to USP, USP would be allowed a $90x deduction under section 245A with respect to the foreign-source portion of the $100x hypothetical distribution (that is, an amount of the dividend that bears the same ratio to the dividend as the $90x of undistributed foreign earnings bears to the $100x of undistributed earnings). Accordingly, USP's section 956 amount with respect to CFC1 is $10x, its aggregate tentative section 956 amount ($100x) with respect to CFC1 reduced by the amount of the deduction that USP would have been allowed under section 245A with respect to the hypothetical distribution ($90x).

(ii) *Example 2.* (*A*) *Facts.* The facts are the same as in paragraph (A) of *Example 1* in paragraph (a)(3)(i) of this section, except that all $100x of CFC1's undistributed earnings are described in section 959(c)(2).

(B) *Analysis.* As in paragraph (B) of *Example 1* in this paragraph (a)(3)(i) of this section, USP's aggregate tentative section 956 amount with respect to CFC1 is $100x, the lesser of USP's pro rata share of the average amounts of United States property held by CFC1 ($120x) and its pro rata share of CFC1's applicable earnings ($100x). However, paragraph (a)(2) of this section does not reduce USP's section 956 amount, because USP would not be allowed any deduction under section 245A with respect to the $100x hypothetical distribution by reason of section 959(a) and (d). Accordingly, USP's section 956 amount is $100x. However, under sections 959(a)(2) and 959(f)(1), USP's inclusion under section 951(a)(1)(B) with respect to CFC1 is $0, because USP's section 956 amount with respect to CFC1 does not exceed the earnings and profits of CFC1 described in section 959(c)(2) with respect to USP. The $100x of earnings and profits of CFC1

described in section 959(c)(2) are reclassified as earnings and profits described in section 959(c)(1).

(iii) *Example 3.* (A) *Facts.* (*1*) USP, a domestic corporation, owns all of the single class of stock of CFC1, and has held such stock for five years. CFC1 has held 70% of the single class of stock of CFC2 for three years. The other 30% of the CFC2 stock has been held by a foreign individual unrelated to USP or CFC1 since CFC2's formation. All of the stock of each of CFC1 and CFC2 is treated as equity for U.S. income tax purposes and under the laws of the jurisdiction in which each respective corporation is organized and liable to tax as a resident. CFC2 has a calendar taxable year. On December 1, Year 1, CFC1 acquires the remaining 30% of the stock of CFC2 for cash. On June 30, Year 2, CFC1 sells to a third party the 30% of CFC2 stock acquired in Year 1 at no gain. CFC2 made no distributions during Year 1.

(2) The functional currency of CFC1 and CFC2 is the U.S. dollar. CFC2 has $120x of undistributed earnings as defined in section 245A(c)(2), all of which constitute undistributed foreign earnings. Neither CFC1 nor CFC2 would receive a deduction or other tax benefit with respect to any income, war profits, or excess profits taxes on a distribution. None of the earnings and profits of CFC2 are described in section 959(c)(1) or (2) or are earnings and profits attributable to income excluded from subpart F income under section 952(b). CFC2's applicable earnings (as defined in section 956(b)(1)) are $120x. CFC2 has held an obligation of USP with an adjusted basis of $100x on every day of Year 1 that was acquired while USP owned all of the stock of CFC1 and CFC1 held 70% of the single class of stock of CFC2.

(B) *Analysis.* Because USP indirectly owns (within the meaning of section 958(a)) all of the stock of CFC2 at the end of Year 1, USP's aggregate tentative section 956 amount with respect to CFC2 for Year 1 is $100x, the lesser of USP's pro rata share of the average amounts of United States property held by CFC2 ($100x) and its pro rata share of CFC2's applicable earnings ($120x). Under paragraph (a)(2)(i) of this section, USP's section 956 amount with respect to CFC2 for Year 1 is its aggregate tentative section 956 amount with respect to CFC2 reduced by the deduction under section 245A that USP would be allowed if USP received an amount equal to its aggregate tentative section 956 amount as a distribution with respect to the CFC2 stock that USP owns indirectly within the meaning of section 958(a)(2). For purposes of determining the consequences of this hypothetical distribution, under paragraph (a)(2)(ii)(A)(*1*) of this section, USP is treated as owning the CFC2 stock directly. In addition, under paragraph (a)(2)(ii)(A)(*4*) of this section, the holding period requirement of section 246(c) is applied by reference to the period during which USP owned (within the meaning of section 958(a)) the stock of CFC2. Therefore, with respect to the hypothetical distribution from CFC2 to USP, USP would satisfy the holding period requirement under section 246(c) with respect to the 70% of the CFC2 stock that USP indirectly owned for three years through CFC1, but not with respect to the 30% of the CFC2 stock that USP indirectly owned through CFC1 for a period of less than 365 days. Accordingly, USP's section 956 amount with respect to CFC2 for Year 1 is $30x, its aggregate tentative section 956 amount ($100x) reduced by the amount of the deduction that USP would have been allowed under section 245A with respect to the hypothetical distribution ($70x).

* * * * *

(g) * * *

(4) Paragraphs (a)(2) and (3) of this section apply to taxable years of controlled foreign corporations beginning on or after the date of publication of the Treasury decision adopting paragraphs (a)(2) and (3) of this section as final regulations in the **Federal Register**, and to taxable years of a United States shareholder in which or with which such taxable years of the controlled foreign corporation end.

(5) Paragraph (e)(6) of this section applies to property acquired in exchanges occurring on or after June 24, 2011.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2018–24140 Filed 11–1–18; 4:15 pm]

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NATIONAL LABOR RELATIONS BOARD

29 CFR Chapter I

RIN 3142–AA13

The Standard for Determining Joint-Employer Status

AGENCY: National Labor Relations Board

ACTION: Proposed rulemaking; extension of comment period.

SUMMARY: The National Labor Relations Board (the Board) published a Notice of Proposed Rulemaking in the **Federal Register** of September 14, 2018, seeking comments from the public concerning the standard for determining joint-employer status under the National Labor Relations Act. The date to submit responses to the Notice is extended for 30 days.

DATES: The comment period for the notice of proposed rulemaking published at 83 FR 46681 is extended. Comments must be received by the Board on or before December 13, 2018. Comments replying to the comments submitted during the initial comment period must be received by the Board on or before December 20, 2018.

Dated: October 31, 2018.

Farah Z. Qureshi,

Associate Executive Secretary.

[FR Doc. 2018–24134 Filed 11–2–18; 8:45 am]

BILLING CODE P

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 111

[Docket ID: DOD–2016–OS–0116]

RIN 0790–AI99

Transitional Compensation (TC) for Abused Dependents

AGENCY: Office of the Under Secretary of Defense for Personnel and Readiness, DoD.

ACTION: Proposed rule.

SUMMARY: Transitional compensation is one of the many resources available to victims of domestic abuse. The Transitional Compensation for Abused Dependents program is a congressionally-authorized program which provides temporary monetary payments and military benefits to dependents of Service members, when the member has been separated from the military due to a dependent-abuse or child abuse offense. If adopted as final, this rulemaking would establish requirements and describes authorized benefits for an abused spouse and/or abused children affected by the separation or forfeiture of pay and allowances of a military Service member.

DATES: Comments must be received by January 4, 2019.

ADDRESSES: You may submit comments, identified by docket number and/or RIN number and title, by any of the following methods:

- *Federal Rulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.