

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Guidance Under Subpart F Relating to Partnerships

### REG-112502-00

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** A notice of proposed rulemaking and notice of proposed rulemaking by cross-reference to temporary regulations published in the **Federal Register** on March 26, 1998, providing guidance under subpart F relating to partnerships and branches, were withdrawn by a notice of proposed rulemaking published in the **Federal Register** on July 13, 1999. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written comments and outlines of oral comments to be discussed at the public hearing scheduled for December 5, 2000, must be received by November 14, 2000.

**ADDRESSES:** Send submissions to: CC:M&SP:RU (REG-112502-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-112502-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/tax\\_regs/comments.html](http://www.irs.ustreas.gov/tax_regs/comments.html). The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Valerie Mark, (202) 622-3840; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION:

### Background

On March 26, 1998 (63 F.R. 14613), the IRS issued proposed regulations (REG-104537-97, 1998-1 C.B. 892) which contained two sets of provisions, one relating to the treatment under subpart F of a controlled foreign corporation's (CFC's) distributive share of partnership income (including a clarification of the manufacturing exception under the foreign base company sales income rules) and the other relating to hybrid branch transactions. The provisions relating to hybrid branch transactions were also issued as temporary regulations (T.D. 8767, 1998-1 C.B. 875). Congress and taxpayers raised concerns about the proposed and temporary regulations relating to hybrid branch transactions. To respond to these concerns, on July 6, 1998, Treasury and the IRS issued Notice 98-35 (1998-2 C.B. 34), which announced that they would withdraw the proposed regulations and remove the temporary regulations. Notice 98-35 also announced that Treasury and the IRS would issue two new separate sets of proposed regulations. One proposed regulation would contain hybrid branch rules. The other proposed regulation would contain rules pertaining to the treatment under subpart F of a CFC's distributive share of partnership income. On July 13, 1999, in furtherance of Notice 98-35, Treasury and the IRS published REG-113909-98 (1999-30 I.R.B. 125 [64 F.R. 37727]), which withdrew the proposed regulations and issued new proposed regulations containing the hybrid branch provisions with new dates of applicability to give Congress and the Treasury more time to evaluate the issues raised by these provisions. On the same date, T.D. 8827 (1999-30 I.R.B. 120 [64 F.R. 37677]) removed the temporary regulations relating to hybrid branch transactions. Treasury and the IRS are now proposing the regulations relating to the subpart F treatment of a CFC's distributive share of partnership income.

This document substantially restates the former proposed regulations relating to the treatment of a CFC's distributive share of partnership income under subpart

F. These new proposed regulations, however, do not contain the provisions of the former proposed regulations that clarified the manufacturing exception under subpart F. Regulations clarifying the manufacturing exception will be proposed at a later date.

### Explanation of Provisions

These proposed regulations clarify the appropriate treatment under subpart F of certain partnership items that had been the subject of *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), vacating and remanding 104 T.C. 105 (1995). In *Brown Group*, a Cayman Islands partnership with a Cayman Islands CFC partner earned commission income from purchasing footwear in Brazil on behalf of the CFC's U.S. parent. This commission income would have been subpart F income, specifically foreign base company sales income under section 954(d), to the CFC if it had earned this commission income directly and under the same circumstances in which the partnership earned this income. The Tax Court applied an aggregate theory of partnerships and held that the CFC's distributive share of this commission income was foreign base company sales income. The Eighth Circuit, vacating and remanding the Tax Court's decision, applied an entity theory of partnerships and held that the CFC's distributive share of this commission income was not foreign base company sales income.

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

The proposed regulations would provide guidance for the treatment under subpart F of a CFC partner's distributive share of subpart F income. The regulations would provide general rules to determine whether a CFC partner's distributive share of partnership income falls within, not only foreign base company sales income, the category of income at

issue in *Brown Group*, but any category of subpart F income. These regulations also would provide guidance about the treatment of a CFC partner's distributive share of foreign personal holding company income, foreign base company sales income, foreign base company services income, and earnings invested in United States property under certain specific provisions of subpart F.

The proposed regulations are based on the authority of subchapter K and subpart F and the policies underlying those provisions. The legislative history of subchapter K provides that a partnership distributive share should be characterized by using the approach that best serves the Internal Revenue Code or regulations section at issue.

To allow a CFC to avoid subpart F treatment for items of income through the simple expedient of receiving them as distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F. Subpart F was intended to limit deferral of U.S. income tax on passive income received by CFCs, as well as on certain other kinds of easily transferable income.

Under these proposed regulations, gross income would be characterized at the partnership level, as, for example, sales income. If any part of the partnership's gross income would be subpart F income if received directly by partners that are CFCs, it must be separately taken into account by each partner, under section 702. Thus, to the extent the separately stated income is subpart F income at the CFC partner level, it will be taken into account in determining the CFC's total subpart F income for the taxable year and U.S. shareholders of the CFC will currently include their pro rata share of this income in gross income to the extent provided under the rules of subpart F.

The regulations under section 702 would be clarified to expressly provide that an item must be separately taken into account when, if separately taken into account by any partner, the item would result in an income tax liability for that partner, or any other person, different from that which would result if the partner did not take the item into account separately. This clarification incorporates into the regulations Rev. Rul. 86-138 (1986-2 C.B. 84), which holds that a subsidiary

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

The regulations under section 952 also would be clarified to expressly include within the definition of subpart F income a CFC's distributive share of any item of gross income of a partnership to the extent the income would have been subpart F income if received by the CFC partner directly. Comments are requested as to whether this rule should apply for ownership interests that fall below certain thresholds.

The proposed regulations would provide further that, generally, in determining whether a distributive share of partnership income is subpart F income, whether an entity is a related person and whether an activity takes place in or outside the CFC's country of incorporation is determined with respect to the CFC partner and not the partnership. Applying these rules to the *Brown Group* facts, the income would be characterized at the partnership level as commission income from the purchase of shoes in Brazil on behalf of the U.S. parent for sale in the U.S. Each partner would be required to separately take into account its distributive share of this commission income. It would then be determined at the CFC partner level that the shoes were manufactured and sold for use outside of the CFC's country of incorporation (Cayman Islands), and that the U.S. parent was a related person with respect to the CFC. Thus, the CFC's distributive share of commission income would be foreign base company sales income.

The proposed regulations also would address whether a CFC's distributive share of partnership income can qualify for the exceptions from foreign personal holding company income treatment that are based on the activities performed by the CFC in connection with the property through which it earns the income. The proposed regulations would provide that an exception requiring activity would generally apply if the exception would have applied to the income if the CFC itself had directly earned the income taking into account only the property and activities of the partnership. This requirement

is not met if the partnership can qualify for the exception only by taking into account the separate activities of its partners. Thus, for example, if the partnership earns rental income from leasing real property that it owns and with respect to which it performs active and substantial management functions, the CFC partner's distributive share of the rental income can be excluded from subpart F income under the active rents exception of section 954(c)(2)(A) if the rental income is earned from a person that is not a related person with respect to the CFC partner. However, if the partnership owns the real property but the CFC contracts to perform the management functions, the rental income is not excludible under this exception.

These proposed regulations would clarify how the manufacturing exception of §1.954-3(a)(4) applies in the context of the distributive share rules. The proposed regulations would provide that the manufacturing activities of a partnership may be taken into account under the distributive share rules when the partnership sells the property that it manufactures. As previously noted, the general rules would provide that income that could be foreign base company sales income at the CFC partner level is separately stated and that determinations as to relatedness and the relevant country are made at the partner level. Consistent with the general rules outlined above, these regulations would allow a CFC's distributive share of sales income to be excluded, under the manufacturing exception of §1.954-3(a)(4), when the partnership manufactures the property that it sells (without regard to the activities of the CFC partner or any other person).

The general rule, described above, would determine whether a CFC partner's distributive share of partnership income is foreign base company services income when the income is earned from performing services for or on behalf of a person that is a related person with respect to the CFC partner. These proposed regulations also would describe how the substantial assistance rule of §1.954-4(b)(1)(iv) applies when the CFC earns services income through a partnership. When the partnership is performing services for a person unrelated to the CFC partner but the CFC partner, or a related person, provides sub-

stantial assistance to the partnership contributing to the performance of those services, the CFC partner and the partnership would be regarded as separate entities and the substantial assistance provided to the partnership by the CFC partner, or a related person, would cause the CFC's partner's distributive share of the services income to be treated as foreign base company services income. Treasury and the IRS are considering applying similar principles to branches of CFCs. Comments are requested on this issue.

Finally, consistent with Rev. Rul. 90-112 (1990-2 C.B. 186), the regulations would provide that, for purposes of section 956, a CFC partner's investment in U.S. property includes the U.S. property held by a partnership to the extent of the CFC's interest in the partnership. Comments are requested as to whether, for purposes of section 956, a CFC partner's interest in a partnership should be based on the CFC's capital interest in the partnership, the CFC's interest in partnership profits, or another standard, such as the facts and circumstances relating to the CFC's interest in the partnership.

Treasury is currently conducting a study to review the provisions of subpart F. The study may examine the foreign base company rules, contract manufacturing, and the use of hybrid partnerships under subpart F. Although comments will be sought separately on the study, comments received on these regulations will be reviewed in connection with the study.

### Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after the date the final regulations are published in the **Federal Register**. For prior periods, the IRS will rely on principles and authorities under subpart F and subchapter K to apply an aggregate approach, (including §1.701-2(e) and (f) of the regulations for periods for which it is applicable).

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5

U.S.C. chapter 5) does not apply to these regulations, and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying. The IRS and Treasury specifically request comments on the clarity of these proposed regulations and how they may be made easier to understand.

A public hearing has been scheduled for December 5, 2000, at 10 a.m., in room 4718, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

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

Persons that wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by November 14, 2000.

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

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

### Drafting Information

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

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### Proposed Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

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

1. Paragraph (a)(8)(ii) is revised.
2. Paragraph (c)(1)(iii) is amended by removing the word "and".
3. Paragraph (c)(1)(iv) is amended by removing the period at the end and adding "; and" in its place.
4. Paragraph (c)(1)(v) is added.

The addition and revision read as follows:

#### *§1.702-1 Income and credits of partner.*

(a) \* \* \*

(8) \* \* \*

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

come or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after the date final regulations are published in the Federal Register.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

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

\* \* \* \* \*

Par. 3. In §1.952–1, paragraph (g) is added to read as follows:

*§1.952–1 Subpart F income defined.*

\* \* \* \* \*

(g) *Treatment of distributive share of partnership income—* (1) *In general.* A controlled foreign corporation’s distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§1.954–1(g), 1.954–2(a)(5), 1.954–3(a)(6), and 1.954–4(b)(2)(iii).

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

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

(3) *Effective date.* This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after the date final regulations are published in the Federal Register.

Par. 4. In §1.954–1, paragraph (g) is added to read as follows:

*§1.954–1 Foreign base company income.*

\* \* \* \* \*

(g) *Distributive share of partnership income—*(1) *Application of related per-*

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

(2) *Examples.* The application of paragraph (g)(1) of this section is illustrated by the following examples:

*Example 1.* CFC, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country A. All of the stock of CFC is owned by USP, a U.S. corporation. Partnership earns commission income from purchasing Product O on behalf of USP, from unrelated manufacturers in Country B, for sale in the United States. To determine whether CFC’s distributive share of Partnership’s commission income is foreign base company sales income under section 954(d), CFC is treated as if it purchased Product O on behalf of USP. Under section 954(d)(3), USP is a related person with respect to CFC. Thus, with respect to CFC, the sales income is deemed to be derived from the purchase of personal property on behalf of a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC’s country of organization, CFC’s distributive share of the sales income is foreign base company sales income.

*Example 2.* (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. To determine whether CFC1’s distributive share of Partnership’s sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC1’s country of organization, CFC1’s distributive share of the sales income is foreign base company sales income.

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

(3) *Effective date.* This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after the date final regulations are published in the Federal Register.

Par. 5. In §1.954–2, paragraph (a)(5) is added to read as follows:

*§1.954–2 Foreign personal holding company income.*

(a) \* \* \*

(5) *Special rules applicable to distributive share of partnership income.* (i) [Reserved]

(ii) *Certain other exceptions applicable to foreign personal holding company income.* To determine the extent to which a controlled foreign corporation’s distributive share of an item of income of a partnership is foreign personal holding company income, the exceptions contained in section 954(c) that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business, including section 954(c)(2), (h) and (i), and paragraphs (b)(2) and (6), (e)(1)(ii) and (3)(ii), (iii) and (iv), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii) of this section, shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(iii) [Reserved]

(iv) *Effective date.* This paragraph (a)(5) applies to taxable years of a controlled foreign corporation beginning on or after the date final regulations are published in the Federal Register.

\* \* \* \* \*

Par. 6. In §1.954–3, paragraph (a)(6) is added to read as follows: §1.954–3 Foreign base company sales income.

(a) \* \* \*

(6) *Special rule applicable to distributive share of partnership income—*(i) *In general.* To determine the extent to which a controlled foreign corporation’s distribu-

tive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(ii) Example. The application of paragraph (a)(6)(i) of this section is illustrated by the following example:

*Example.* CFC, a controlled foreign corporation organized under the laws of Country A, is an 80-percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, within the meaning of paragraph (a)(4) of this section, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly. (The branch rule of paragraph (b) of this section does not apply to these facts).

(iii) *Effective date.* This paragraph (a)(6) applies to taxable years of a controlled foreign corporation beginning on or after the date final regulations are published in the **Federal Register**.

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

*§1.954-4 Foreign base company services income.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(iii) *Special rule applicable to distributive share of partnership income.* A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of

section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation, or a person that is a related person with respect to the controlled foreign corporation, provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person. This paragraph (b)(2)(iii) applies to taxable years of a controlled foreign corporation beginning on or after the date final regulations are published in the **Federal Register**.

\* \* \* \* \*

Par. 8. In §1.956-2, paragraph (a)(3) is added to read as follows:

*§1.956-2 Definition of United States property.*

(a) \* \* \*

(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 the date final regulations are published in the **Federal Register**.

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Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

(Filed by the Office of the Federal Register on September 19, 2000, 8:45 a.m., and published in the issue of the Federal Register for September 20, 2000, 65 F.R. 56836)