Proposed regulations look to close CFC loopholes

The IRS recently issued proposed regulations that would amend the controlled foreign corporation (CFC) related party and CFC active rent rules to close certain loopholes. Here are some details on each of the loopholes.

Related party loophole

The IRS is concerned that, in certain situations, the current rules and regulations could produce inappropriate results when defining a "related person" for purposes of Internal Revenue Code Sec. 954(d)(3). The proposed regulations would provide that the applicable rules and related regulations wouldn't apply for purposes of Sec. 954(d) (3) and related regulations. However, this wouldn't preclude a corporation, partnership, trust or estate from being treated as controlled by the same person or persons that control a CFC under the other rules that remain applicable.

For example, let's say one domestic corporation (USP1) held 51% of the stock of a joint venture corporation, while an unrelated domestic corporation (USP2) held 49% of its stock. The joint venture corporation would continue to be a related person with respect to a CFC in which USP1 owned 51% of the stock (CFC1) because of USP1's direct ownership of more than 50% of both entities — notwithstanding the fact that the joint venture corporation would no longer be treated as owning the stock of CFC1 owned by USP1.

The proposed regulations also provide that Sec. 318(a) (4) wouldn't apply to treat a person that has an option to acquire stock or an equity interest, or an interest similar to such an option, as owning the stock or equity interest for purposes of the related person definition if a principal purpose for the use of the option or similar interest is to cause a person to be treated as a related person with respect to a CFC (the option anti-abuse rule).

Recent IRS guidance stated that regulations containing a similar rule will be issued. These regulations will provide that, if a principal purpose for the use of the option or similar interest is to qualify dividends, interest, rents or royalties paid by a foreign corporation for the allowed exception, the dividends, interest, rents or royalties received or accrued from such foreign corporation won't be treated as being received or accrued from a CFC payer and, therefore, won't be eligible for the Sec. 954(c) (6) exception. The proposed regulations will also contain the "Notice 2007-9 option anti-abuse rule."

Active rent loophole

In addition, the proposed regulations would close a loophole in the definition of adjusted leasing profit for purposes of the active rent rule. A CFC may derive rent from leasing property that it doesn't own. In that case, the CFC likely will make payments to the owner of the property, which may be characterized as rent. For purposes of applying the safe harbor, the regulations provide that rents paid or incurred by the CFC with respect to the rental income:

- Aren't considered in determining active leasing expenses, and
- Are considered for purposes of determining adjusted leasing profit. (In other words, they reduce the CFC's gross income for purposes of determining adjusted leasing profit).

These rules reflect the principle that, when a lessor CFC derives rents from property that it doesn't own, the substantiality of the CFC's marketing organization should be determined under the safe harbor on the basis of the CFC's income and expenses net of any payments that it makes for the use of the property.

The IRS is aware that, in cases in which a lessor CFC derives rent from leasing property that it doesn't own, the CFC may make payments to the owner of the property that are characterized as royalties rather than rent. For example, a CFC pays $100 for the transfer of a computer program and, in turn, transfers the computer program to an unrelated person for $150 in a transaction that is treated as a lease under the applicable regulations.

The IRS says that the determination of whether the CFC satisfies the applicable safe harbor shouldn't depend on whether the transaction pursuant to which the CFC received the computer program is characterized under the applicable regulation as:

- A license, under which the CFC pays royalties, or
- A lease, under which the CFC pays rents.

In both cases, the CFC's $100 payment for use of the computer program should be excluded from active leasing expenses and reduce the CFC's adjusted leasing profit to ensure that only expenses related to the marketing organization are considered in assessing its substantiality.

Accordingly, the proposed regulations would revise the existing applicable regulations to apply generally to amounts paid or incurred, including both rents and royalties, by the lessor CFC for the right to use the property (or a component thereof) that generated the rental income.

Proposed applicability dates

The regulations generally are proposed to apply for tax years of CFCs ending on or after the date of publication in the Federal Register of the Treasury decision adopting these rules as final regulations. They're also proposed to apply for the tax years of U.S. shareholders in which or with which such tax years end.

However, the Notice 2007-9 option anti-abuse rule is proposed to apply for tax years of CFCs beginning after December 31, 2006, and ending before the date of publication in the Federal Register of the Treasury decision adopting these rules as final regulations. The rule is also proposed to apply for the tax years of U.S. shareholders in which or with which such years end.

Until the effective date of the final regulations, CFCs may rely on the rules in existing applicable regulations for tax years ending on or after the proposed regulations' date of filing for public inspection, provided that they consistently apply the rules in the proposed regulations for all such tax years.

Due diligence

As part of regular due diligence, the IRS is always looking to close loopholes. These are but two of the latest. Work closely with your CPA to understand how they might affect your tax situation. •