

Tax Court Upholds Validity of Section 956 Regulations and Requires Partnership to Recognize Ordinary Income from CFCs that Guaranteed Loans

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On January 18, 2018, the Tax Court in *SIH Partners LLLP v. Commissioner*¹ upheld, against taxpayer challenge, the validity of Treasury Regulations issued under Section 956 relating to guarantees by controlled foreign corporations (“CFCs”). Applying these Treasury Regulations, the Tax Court held that a partnership that was a U.S. shareholder in two CFCs had Section 956 income inclusions in 2007 and 2008 arising from the CFCs’ guarantees of notes issued by an entity under common ownership with the Taxpayer.

Relevant Entities

SIH Partners LLLP (the “Taxpayer”) was a Delaware partnership that was owned by six Delaware corporations that were treated as S corporations for federal income tax purposes. The six S corporation partners were, in turn, owned by five individuals.²

The five individual ultimate beneficial owners of the Taxpayer also owned, collectively and through certain entities, 100% of the interests in SIG. SIG and its U.S. affiliates constituted an investment firm that traded most listed financial products and asset classes.

The Taxpayer owned (through one or more entities that were disregarded for federal income tax purposes) 100% of the stock of two foreign corporations: (i) Susquehanna Ireland Holdings Limited (“SIHL”), a corporation organized under the laws of Ireland, and its successor, Susquehanna Europe Holdings Limited (“SEHL”), a corporation organized under the laws of Ireland and whose tax residency was in Luxembourg (together “SIHL/SEHL”);³ and (ii) Susquehanna Trading Services, Inc. (“STS”), a company organized under the laws of the Cayman Islands that was treated as a corporation for federal income tax purposes.

During the tax years 2007 and 2008, each of SIHL/SEHL and STS was a “controlled foreign corporation” within the meaning of Section 957(a). The Taxpayer, as the owner of 100% of the stock of each of SIHL/SEHL and STS, was a “U.S. shareholder” of each such entity within the meaning of Section 958(a).

SIG Notes and CFC Guarantees

On October 2, 2007, SIG issued three notes (the “SIG Notes”) which, in aggregate, evidenced \$1.485 billion in borrowing. Pursuant to a guarantee agreement dated October 2, 2007, the SIG Notes were guaranteed by 39 entities, including SIHL and STS. Under the guarantee agreement, each guarantor assumed joint and several liability for full payment of the SIG Notes, subject to a “pro rata provision” under which any guarantor that made a payment was entitled to contribution payments from the remaining guarantors.

Section 956 Inclusion

Under Section 951(a), a U.S. shareholder of a CFC must include in gross income its pro rata share of certain items attributable to the CFC, including “the amount determined under section 956.” The amount determined under Section 956 is the lesser of: (i) the shareholder’s pro rata share of the average amount of “United States property” held by the CFC during the taxable year (less the amount of any previously taxed earnings and profits), or (ii) the shareholder’s pro rata share of the CFC’s “applicable earnings.”

Section 956(c) defines “United States property” to include “the obligation of a United States person.” For purposes of this definition, Section 956(d) provides that a CFC “shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if . . . [the CFC] is a pledgor or guarantor of such obligation.” Treas. Reg. section 1.956-1(e)(2) provides that “the amount taken into account with respect to any pledge or guarantee . . . shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledger or guarantor.”

Summary of the Parties’ Arguments

In *SIH Partners*, the Internal Revenue Service (the “IRS”) contended that the Taxpayer had required Section 956 income inclusions attributable to the SIHL/SEHL and STS guarantees of the SIG Notes. Under Treas. Reg. section 1.956-1(e)(2), the amount required to be taken into account with respect to the SIHL/SEHL and STS guarantees was the unpaid principal amount under the SIG Notes. Because the unpaid principal under the SIG Notes exceeded each of SIHL/SEHL’s and STS’s applicable earnings, the IRS argued the Taxpayer had income inclusions equal to each entity’s applicable earnings for 2007 and 2008.

The Taxpayer’s principal contention was that the applicable Treasury Regulations issued under Section 956 are invalid and thus could not be applied to require the Taxpayer to have income inclusions arising from the CFC guarantees. This contention was based on the Taxpayer’s arguments that the Treasury Regulations were “arbitrary and capricious” both in the process by which they were promulgated and in their substance.

Statutory and Regulatory History

The U.S. Department of Treasury (“Treasury”) promulgated the Treasury Regulations at issue following the passage of the Revenue Act of 1962, which enacted Sections 951 and 956 as part of Subpart F. In April 1963, Treasury issued a Notice of Proposed Rulemaking, which set forth and solicited public comment on regulations proposed under several provisions of Subpart F, including Section 956. These Treasury Regulations were issued in final form in February 1964.

Procedural Requirements

The Taxpayer did not argue that Treasury’s rulemaking process failed to comply with the general “notice and comment” requirements applicable to “legislative rules” such as the Treasury Regulations at issue.⁴ Rather, the Taxpayer argued that the process by which the Treasury Regulations at issue were promulgated was “arbitrary and capricious.” Consequently, the Taxpayer argued, the Treasury Regulations must be set aside as invalid.

The Taxpayer contended that Treasury’s rulemaking process was “arbitrary and capricious” because Treasury failed to consider “important aspect[s] of the problem” associated with CFC pledges and guaranties.⁵ In this regard, the

Taxpayer argued that Treasury, in designing rules to implement the pledge or guarantee provision of Section 956(d), should have considered economic and other factors relevant to distinguishing between pledges and guarantees that effectively repatriate earnings (and thus warrant an income inclusion under Section 956) and those that do not.

The Tax Court disagreed, holding that Treasury was not required to consider or weigh any particular factors when it promulgated rules under Section 956(d). In this regard, the Tax Court noted that there was nothing in the text or legislative history of Section 956 that indicated that Congress intended for Treasury to take any particular factors into account in determining when a CFC pledge or guarantee should give rise to an income inclusion. To the contrary, Congress stated clearly in the statute that any CFC guarantor shall be treated as holding the underlying obligation, and expressly delegated to Treasury broad authority to promulgate rules to address issues not expressly addressed in the statute.⁶ In the Tax Court's view, Treasury acted within this broad grant of legislative authority in its promulgation of the Treasury Regulations under Section 956.

Substantive Construction of the Statute

The Taxpayer also argued that, in addition to their procedural deficiencies, the Treasury Regulations at issue were arbitrary and capricious in substance.⁷ In this regard, the Taxpayer argued that Congress, in enacting Section 956(d), was concerned only with investments in U.S. property that repatriate earnings, and that a CFC's guarantee of an obligation is not necessarily a transaction that repatriates earnings. Whether and the degree to which any given guarantee can be considered to have repatriated earnings are fact-specific questions, which will depend on the facts and circumstances of the transaction. Because the subject Treasury Regulations do not take such facts and circumstances into account but rather treat any CFC guarantor as holding United States property equal to the full unpaid principal amount of the obligation, the Taxpayer argued that such rules are arbitrary and capricious.⁸

The Tax Court rejected the Taxpayer's arguments, holding instead that the Treasury Regulations were not arbitrary or capricious in substance, or contrary to the plain language or intent of Section 956. In reaching this conclusion, the Tax Court noted that the legislature granted Treasury broad authority to promulgate regulations implementing the pledge and guarantee rules of Section 956. The Tax Court also found it significant that, subsequent to the promulgation of the Treasury Regulations in final form in 1964, Congress has passed several amendments to Section 956, including amendments altering the scope of "United States property," but has never directly amended Section 956(d). This suggested to the Tax Court that Congress's view of the proper scope of Section 956(d) is consistent with the "unpaid principal" rule set forth in the Treasury Regulations.

Applicable Tax Rate

The Taxpayer also argued that any income inclusions arising from the SIHL/SEHL guarantee should be "qualified dividend income" under Section 1(h)(11).⁹ The Tax Court rejected this argument, citing a prior Tax Court that held a Section 956 income inclusion did not constitute a "dividend" to the U.S. shareholders.¹⁰ The Tax Court thus held that the Taxpayer's income inclusions arising from the CFC guarantees were ordinary income to the Taxpayer.

¹ 150 T.C. No. 3 (2018).

² The Taxpayer was formed on April 2, 2007, in the final step in a series of transactions in which the assets of an S corporation in which four of the five individual ultimate beneficial owners of the Taxpayer and another individual were shareholders ultimately were transferred to the Taxpayer.

³ From April 3, 2007, to December 3, 2007, the Taxpayer owned (through an entity that was disregarded for federal income tax purposes) 100% of the stock of SIHL. On December 4, 2007, in a series of transactions that constituted a reorganization under Section 368(a)(1)(F), SIHL was acquired by SEHL, and SIHL elected to be classified as a disregarded entity for federal income tax purposes. From December 4, 2007, through December 31, 2008, the Taxpayer owned (through several entities that were disregarded for federal income tax purposes) 100% of the stock of SEHL.

⁴ These "notice and comment" requirements, set forth in the Administrative Procedure Act (APA), provide that an agency promulgating regulations by informal rulemaking must (1) publish a notice of proposed rulemaking in the Federal Register, (2) provide "interested persons an opportunity to participate . . . through submission of written data, views, or arguments," and (3) "[a]fter consideration of the relevant matter presented, . . . incorporate in the rules adopted a concise general statement of their basis and purpose." In *SIH Partners*, the Tax Court found that the administrative record reflected that

Treasury complied with these requirements, and the Taxpayer did not dispute this finding.

⁵ In support of this argument, the Taxpayer relied on *Motor Vehicle Manufacturers Association of the U.S. v. State Farm Mutual Auto Insurance Company*, 463 U.S. 29 (1983). In *State Farm*, the Supreme Court held that an agency's decision to rescind a prior regulation was arbitrary and capricious, and thus must be set aside, because the agency failed to present an adequate basis for its decision. *State Farm*, 463 U.S. at 34. The Taxpayer argued that, under the standard articulated by the Supreme Court, an agency must "articulate a satisfactory explanation for its action" and the court must determine, in light of that explanation, whether the agency's decision "was based on a consideration of the relevant factors and whether there has been a clear error of judgment." The Tax Court held that these more stringent "reasoned decision making and reasoned explanation requirements" that the Supreme Court applied in *State Farm* were not warranted in this case. In *State Farm*, the agency action in question was a clear and abrupt reversal in agency policy, and the earlier policy was supported by a substantial body of facts developed by the agency itself. In *SIH Partners*, in contrast, the Treasury Regulations in question did not reverse previously settled agency policy, and they were not promulgated contrary to facts or analysis that supported a different outcome. Accordingly, the Tax Court applied the more general "arbitrary and capricious" standard and did not subject the Treasury Regulations in question to the more stringent *State Farm* "reasoned decision making and reasoned explanation requirements."

⁶ Section 956(d) (emphasis added).

⁷ In reviewing the substantive construction of Section 956 in the Treasury Regulations in question, the Tax Court applied the two-step test provided in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Under step one, the court asks "whether Congress has directly spoken to the precise question at issue." In this case, neither party contended that the legislature had directly spoken to the precise question at issue—that is, when and in what amount a CFC will be considered to hold United States property under Section 956 as a result of its guarantee of an obligation of a United States person. Accordingly, the court turned to step two of the *Chevron* test, which asks only whether the agency's position "is based on a permissible construction of the statute." In the case of "legislative rules" such as the Treasury Regulations at issue, a court will defer to the agency's construction unless it is arbitrary and capricious in substance.

⁸ The Taxpayer also argued that, even if the Treasury Regulations are not invalidated, they cannot be applied to require the Taxpayer to have income inclusions equal to the full amount of the CFCs' applicable earnings. According to the Taxpayer, a full analysis of the facts and circumstances surrounding the guarantees, including facts indicating that there was more than adequate credit support even without the CFCs' guarantees, would require an apportionment of the United States property in question among the CFCs and the 37 other guarantors under Section 956(d). The Tax Court declined to allow such an apportionment, pointing to the absence of any support for it in the applicable Treasury Regulations.

⁹ Because STS was organized under the laws of the Cayman Islands, which has no comprehensive income tax treaty, the IRS contended that STS was not a qualified corporation whose dividends would constitute qualified dividend income under Section 1(h)(11). The Taxpayer did not contend otherwise.

¹⁰ *Rodriguez v. Commissioner*, 137 T.C. 147 (2011), aff'd, 722 F.3d 306 (5th Cir. 2013).

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