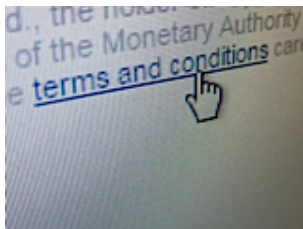


Financial Products

U.S. Property Exception Expanded for Controlled Foreign Companies

BNA Snapshot

- IRS says obligations won't be considered U.S. property if they don't exceed collateral
- Collateral must be provided by U.S. or foreign securities or commodities dealers



By Alison Bennett

U.S. owners of foreign broker-dealers will benefit from new IRS guidance allowing a broader exception to the definition of U.S. property for U.S. shareholders of controlled foreign corporations, a tax practitioner told Bloomberg Tax.

Under tax code Section 956, a U.S. shareholder of a controlled foreign corporation must include in gross income the quarterly average amount of U.S. property held directly and indirectly by the CFC. That makes the definition of U.S. property critical for taxpayers with shares in CFCs who

want to avoid income inclusions that will trigger taxes.

The Internal Revenue Service, in Notice 2018-46 released May 4, expanded the exception to the regulations for obligations associated with financial instruments known as notional principal contracts. Those are contracts based on an underlying “notional” amount where neither party is required to actually hold the property comprising that amount.

Cash, Securities Value

The agency said it would broaden an exception found in temporary regulations (T.D. 9719), issued in 2015, that granted an exception for certain obligations arising from “upfront payments.”

In Notice 2018-46, the IRS said it plans to issue regulations providing that U.S. persons will get an exception if the principal amount of the obligation doesn't exceed the fair market value of cash and “readily marketable” securities posted as margin or collateral by U.S. or foreign commodities dealers.

In the financial sector, margin is collateral that the holder of a financial instrument has to deposit with a counterparty (most often their broker or an exchange) to cover some or all of the credit risk the holder poses for the counterparty.

Welcome News

Mark Leeds, a partner with Mayer Brown LLP in New York, said Notice 2018-46 is welcome news because “it allows U.S. owners of non-U.S. broker/dealers to continue to be able to accept collateral posting and upfront swap posting without causing the U.S. owner to experience a Section 956 inclusion.”

The notice also extends the rule permitting CFCs to post collateral for virtually any obligation arising between a non-U.S. broker-dealer and its U.S. affiliates, and to post readily marketable securities, without that Section 956 income inclusion, Leeds said in an email.

“This is welcome expansion of the collateral rules,” he said.

Notice Offers Flexibility

Before the final regulations come out, the IRS said, taxpayers can rely on the provisions of the notice, including for obligations arising before May 4, 2018. As an alternative, they can rely on the full margin or cash collateral exception provided in the 2015 regulations.

John Harrington, a partner at Dentons in Washington and chairman of the Bloomberg Tax International Advisory Board, said it's "noteworthy" that the IRS issued a notice rather than finalizing the temporary regulations.

This implies the agency didn't have time to issue final rules in the face of the mountain of guidance needed to implement the 2017 tax act (Pub. L. No. 115-97), he said in an email.

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