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International Tax Considerations: Inbound & Outbound

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I. **Primer on US Taxation of Outbound Investment**

- A. US persons (citizens, resident aliens and domestic corporations) are subject to tax on their **worldwide income**, subject to a foreign tax credit.
- B. US tax liability on “foreign source” income can be offset by a **credit for foreign taxes paid** (section 901).
 - 1. There are mechanical rules for computing the foreign tax credit limitation (foreign source income x US taxes paid ÷ worldwide income) (Section 904).
 - 2. The foreign tax credit limitation is determined separately for “passive” income and “general basket” income (Section 904(d)).
- C. **Source of income** (US v. foreign) is determined differently for different classes of income.
 - 1. **Interest income** is sourced based on the residence of the payor (for partnerships, source is based on existence of a US trade or business, not solely the place of formation of the partnership) (section 861(a)(1)).
 - 2. **Dividends** are sourced, in general, based on the place of incorporation of the payor (section 861(a)(2)).
 - 3. **Rents/royalties** are sourced based on where the property giving rise to the rents and royalties is used (section 861(a)(4)).
 - 4. **Sales of inventory** are sourced based 50% on the place of manufacture (if the seller is the manufacturer) and 50% based on title passage (all title passage if buy-sell)(section 865).
 - 5. **Capital gains** are sourced based on the residence of the seller (section 865).
 - 6. **Notional principal contracts** generally are sourced based on the residence of the recipient (Treas Reg § 1.863-7).

D. **Current Inclusion vs Deferral**

- 1. Like a domestic corporation, a foreign corporation generally is treated as a taxpayer wholly separate from its shareholders.
 - a. US tax is paid on US source income at the corporate level.
 - b. No US tax is paid on foreign source income at the corporate level, with some exceptions for foreign source income connected with a US business.
- 2. The shareholder of a foreign corporation is taxed only upon the sale of stock of the foreign corporation, or the actual or constructive receipt of dividends from the corporation.

3. Taxation at the shareholder level creates an opportunity for substantial deferral of US tax on foreign income earned through foreign corporations.
4. There are two major anti-deferral regimes: CFC and PFIC.

E. Controlled Foreign Corporations (“CFCs”)

1. A CFC is a foreign corporation in which more than 50 percent (by vote or value) of the stock of is owned by “US shareholders” (section 957).
 - a. A US shareholder is US person who owns 10 percent or more of the voting stock of a foreign corporation (section 951(b)).
 - i. Voting power is determined based on all facts and circumstances (Treas Reg § 1.951-1(g)).
 - ii. A 2013 proposal in the Senate Finance Committee’s discussion draft on foreign-source income tax reform would expand the definition of US shareholder under subpart F to include any US person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation (JCX-15-13).
 - b. Direct, indirect, and constructive ownership is taken into account in determining whether more than 50 percent of the stock is owned by US Shareholders (section 958).
 - c. Example: A foreign corporation with eleven unrelated US corporations as shareholders, each of whom owns approximately 9.09% of the foreign corporation, would not be a CFC because there are no US Shareholders.

2. Consequences of CFC status

- a. A US shareholder of a CFC must include in income its pro rata share of subpart F income to the extent of the earnings and profits (“E&P”) of the CFC (sections 951-952).
- b. A US shareholder of a CFC must include in income its pro rata share of investments in “US property” under section 956 (also limited by E&P). US property includes (section 956(c)):
 - i. Tangible property located in the United States
 - ii. Stock of related US corporations
 - iii. Rights to use intangible property in the United States
 - iv. Obligations of related US persons

- v. Guarantees and pledges of more than 2/3 of the stock of a CFC with respect to such obligations
 - vi. Any right to use intangible property in the United States
- c. A US shareholder of a CFC must apply section 1248 to characterize the gain upon dispositions of stock of the CFC. Section 1248 originally was intended to prevent conversion of ordinary income (dividends) to capital gain but it was largely mooted for individuals by section 1(h)(11). Section 1248 now is viewed as beneficial for the management of foreign tax credits.
3. Because Subpart F income inclusions constitute “dry income” taxpayers explore various means of **mitigating Subpart F exposure**:
- a. A purchasing corporation can clean up the E&P of new foreign subsidiaries by making a section 338 election when it purchases the stock of a foreign corporation, thereby trigger a deemed sale of the foreign corporation’s assets with a resulting step up in the basis of the assets for depreciation and amortization purposes.
 - b. US shareholders may monitor inter-company transactions that could result in subpart F inclusions, or make “check-the-box” elections to convert foreign CFCs to entities that are disregarded for US federal tax purposes, thereby eliminating inter-company transactions that could potentially result in subpart F income.
 - c. US shareholders should examine security or guarantee packages for financing to confirm that they do not trigger the application of section 956.
 - d. U. S. shareholders can consider using structures that involve foreign rather than domestic partnerships (see below).

F. Passive Foreign Investment Companies (PFICs)

1. A **foreign corporation is a PFIC** if it satisfies either of the following tests in any taxable year:
 - a. 75% or more of the corporation’s income for the year consists of passive income (section 1297(a)(1));
 - b. At least 50% of the corporation’s assets are used to produce passive income (section 1297(a)(2));
 - c. For purposes of this test, it is irrelevant what percentage of stock is owned by US persons, or the specific US person’s ownership percentage; there is no threshold analogous to the US shareholder (10%) definition in the CFC context.

- d. There are “look through” rules for 25 percent-owned subsidiaries of the relevant foreign corporation (section 1297(c)).
- e. Once a PFIC, always a PFIC.

2. Consequences of PFIC status

- a. US owners of stock in a PFIC must pay an Interest charge on the deferred tax amount (section 1291).
 - b. Gains from the sale of PFIC stock by a US person are treated as ordinary income (section 1291).
3. US owners of a PFIC may make a **Qualified Electing Fund (QEF) election** for the PFIC and recognize gain currently (section 1295).
- a. A QEF election can be made by a US owner of PFIC stock in the first year of PFIC ownership (section 1295(b)).
 - b. The PFIC must agree to provide the necessary information to the IRS (section 1295(a)(2)).
 - c. QEF Election result:
 - i. A taxpayer who owns stock in a PFIC faces current inclusion of share of PFIC’s ordinary income and capital gains (“dry income”).
 - ii. The QEF election ensures capital gain treatment upon disposition of the PFIC stock and for the PFIC’s sales of capital assets.
 - iii. Reporting requirements apply (section 1295(a)(2)).
 - d. Where both CFC and PFIC rules apply to a shareholder, CFC rules take precedence (section 1297(d)).

II. Entity Classification Issues

A. Under the “Check--the-Box” regulations, entity classification involves the following steps:

1. First, determine if the arrangement constitutes an entity.
2. If it is an entity, determine whether it is a business entity (i.e., not a trust).
3. If it is a business entity, check to see if it is listed in Treas Reg § 301.7701-2(b)(8) as a “per se” corporation.

4. If it is not a per se corporation, determine whether the eligible entity is domestic or foreign for purposes of applying the default classification rules.

B. Entity classification: Is the Arrangement an Entity?

1. What is a partnership?

- a. Statutory definition: A partnership is a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or trust or estate. (sections 7701(a)(2) and 761(a)).
- b. Regulatory definition: An arrangement “may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture, and divide the profits therefrom.” (Reg. section 301.7701-1(a)(2))
 - i. “Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes.” (Reg. section 301.7701-1(a)(2))
- c. A partnership is a matter of federal tax law, and is not dependent upon whether the organization is recognized under local law.
- d. **Key “Partnership” Authorities:**
 - i. While there are many federal US tax cases that explore the definition of a partnership, they are inherently fact specific, so it is difficult to derive conclusive authority out of any one case.
 - ii. The leading case is *Commissioner v. Culbertson*, 337 US 733 (1949). From *Culbertson*, we can glean:
 - a) No one set of factors is dispositive.
 - b) The answer is not based on state law.
 - c) One key factor is the intent to join together in the present conduct of an enterprise.
 - d) It is important to look for evidence of intent based on objective factors, such as:
 - i. Agreement
 - ii. Conduct of parties
 - iii. Relationship of the parties

- iv. Respective abilities and capital contributions
 - v. Actual control of income and purposes for which it is used
- iii. *Luna v. Commissioner*, 42 T.C. 1067 (1964) and *S & M Plumbing v. Commissioner*, 55 T.C. 702 (1971) list the following factors in determining whether the parties intended to form a partnership/separate entity:
- a) The agreement of the parties and their conduct (indicating intent to join together in present conduct of an enterprise)
 - b) Joint contributions of money, property, and/or services to the venture
 - c) Parties' control over income and capital and separate rights to make withdrawals
 - d) Joint profit sharing and obligation to share losses
 - e) Mutual control and mutual responsibilities
 - f) Business conducted in joint names of the parties
 - g) Representations to 3rd parties - partnership returns
 - h) Separate books of account
2. **De Facto Partnerships in the foreign arena:** Contractual arrangements can sometimes constitute a partnership/business entity. See discussion *infra*. The following arrangements can raise red flags:
- a. Contractual arrangements with elements of joint profit sharing
 - b. Service fees determined based on the profits of the entity
 - c. "Virtual Mergers"
 - d. "Formula Allocations" of partnership income based on the results of global activities of the "group"
 - e. Separate legal partnership structures with a common partner (e.g., a general partner) whose distributive share is based in part on the results of both structures.
3. Determining whether or not an arrangement is a partnership, and therefore an entity, will impact various international tax considerations.

- a. The status of the entity as a domestic or foreign entity
- b. The status of any corporate subsidiaries of the entity as controlled foreign corporations
- c. The characterization of any income earned by partners:
 - i. Whether partners are earning a distributive share of operating income versus services, interest, or royalty income etc.
 - ii. The source of income from the entity
 - iii. Whether foreign partners in the entity are subjected to tax on effectively connected income (“ECI”) or are subject to fixed and determinable annual or periodic income (“FDAP”) taxation
 - iv. The treatment of the entity under tax treaty provisions
- d. The partners in the entity’s ability to rely on elections that impact the computation of taxable income

C. Entity Classification – Is the Entity Domestic or Foreign?

- 1. Domestic: Any entity created or organized in the United States or under the law of the United States or of any state (section 7701(a)(4)).
- 2. Foreign: any entity other than a domestic entity (section 7701(a)(5)).
- 3. Dual-Chartered Entities:
 - a. Definition: A dual chartered entity is a business entity treated as created or organized under the laws of more than one jurisdiction at a time.
 - b. If a dual-chartered entity is organized in the United States, it is a domestic entity (even though it also is organized in a foreign jurisdiction).
 - c. If a dual-chartered entity is a *per se* corporation in either jurisdiction, it is a *per se* corporation for US federal tax purposes.
- 4. If you elect to treat a contractual arrangement as a corporation, there is an issue as to what country the corporation will be considered organized under for US tax purposes.
 - a. This determines whether a corporation is foreign or domestic.
 - b. It also will have an impact on the application of the “same country” subpart F exceptions.

- c. This determination does not necessarily rely on what law governs disputes under the contract.
- D. **Default Entity Classification Rules** – Is the entity a partnership, an association, or a disregarded entity? Once you have determined whether the entity is domestic or foreign, separate default entity classification rules apply for determining what type of entity it is.
 - 1. **Domestic Eligible Entity** - Domestic entity default classification depends on the numbers of “members” (see Reg. section 301.7701(b)(1)).
 - a. If a domestic entity has more than one member, the default entity classification is partnership.
 - b. If a domestic entity has one member, the default entity classification is as an entity disregarded as separate from its owner.
 - 2. **Foreign Eligible Entity** - Foreign entity default classification depends on “members” that have or do not have “limited liability” (see Reg. section 301.7701(b)(2)).
 - a. If all members have limited liability, the default entity classification is association.
 - b. If an entity has two or more members, and at least one member does not have limited liability, the default entity classification is partnership.
 - c. If an entity has a single owner that has unlimited liability, the default entity classification is as an entity disregarded as separate from its owner.
- E. **Proposed Series LLC Regulations** – On September 14, 2010, proposed regulations were published that addressed whether “series” of a “series organization” would be treated as separate entities for US tax purposes. (REG-119921-09, 75 Fed. Reg. 55699 *et. seq.*)
 - 1. A “series limited liability company (LLC)” is a relatively new form of entity, authorized by state statute in a several different states to facilitate subdividing an LLC into separate series for liability shield purposes, and to minimize legal, accounting, and recording fees. Although series of a series LLC generally are not treated as separate entities for state law purposes and, thus, cannot have members, each series has “associated” with it specified members, assets, rights, obligations, and investment objectives or business purposes. Members’ association with one or more particular series is comparable to direct ownership by the members in such series, in that their rights, duties, and powers with respect to the

series are direct and specifically identified. If the conditions enumerated in the relevant statute are satisfied, the debts, liabilities, and obligations of one series generally are enforceable only against the assets of that series and not against assets of other series or of the series LLC.

2. **General Rule:** Under the proposed regulations, all domestic series and foreign insurance series organizations are treated as separate entities if formed pursuant to a “series statute.”
 - a. The entity classification of the series is determined under the current regulations (Treas Reg §§ 301.7701-1, -2, -3, and -4).
 - b. Exception: the proposed regulations do not apply to foreign non-insurers. However, no inference is to be drawn from the exclusion.

III. International Tax Considerations for US Partners (Outbound)

A. Section 367(a) Issues Involving Partnerships

1. Section 367(a) Outbound Transfers to Foreign Corporations

- a. Outbound transfers by US persons of assets to foreign corporations in sections 332, 351, 354, 356, or 361 transactions, while generally subject to non-recognition in the domestic context, may be subject to gain recognition pursuant to section 367(a).
- b. The basis of any transferred assets is stepped up to account for any gain recognized under section 367(a).
- c. There are various exceptions to section 367(a) gain recognition depending on the types of assets transferred.
- d. The application for section 367(a) to stock transfers varies depending on the percentage of stock of the foreign transferee held by the US transferor immediately post transfer:
 - i. If the transferor holds less than 5% of the stock of the transferee, no gain is recognized.
 - ii. If the transferor holds 5%-50% of the stock of the transferee, no gain is recognized as long as the transferor enters into a gain recognition agreement (GRA) with the IRS.
 - iii. If the transferors hold more than 50% of the stock of the transferee, gain recognition.
- e. Section 367(d) is an exception to section 367(a) treatment for the transfer of intangible property, and provides that the US transferor is treated as having sold the intangible property in exchange for

payments that are contingent upon the future productivity, use, or disposition of such property.

- i. Temporary regulations issued in 1986, consistent with the legislative history of section 367(d), carve out goodwill and going concern value from the definition of intangible property for this purpose. Newly proposed section 367(d) regulations would eliminate this carve out (80 Fed. Reg. 55568 (Sept. 16, 2015)).
- ii. The IRS may issue regulations governing the application of outbound transfer rules to the transfer of intangible property to partnerships under section 367(d)(3); such regulations have not yet been issued. But see Notice 2015-54.

2. Outbound Transfers to Foreign Corporations by a Partnership

- a. Transfers made by a partnership to a foreign corporation are treated as made proportionately by its partners.
- b. GRAs are entered into at the partner level.
- c. Section 367(a) gain is recognized at the partner level and therefore is seemingly not a partnership item.
- d. Thus, there does not appear to be partnership 704(b) income.
- e. The partnership should footnote partner information.
- f. Partners with varying interests in partnership profits over time may recognize gain under section 367(a) in a ratio different from their share of the proceeds on ultimate disposition of the foreign corporation stock.
- g. Recently-released IRS Notice 2015-54, 2015-34 I.R.B. 210 describes IRS and Treasury intent to issue regulations under section 721(c) that would limit non-recognition treatment to situations in which certain conditions are satisfied. Such regulations would provide for recognition of gain upon transfer of appreciated property to a domestic or foreign partnership if the gain, when recognized, would be includible in income of a foreign person. Under the regulations, section 721(a) will NOT apply to a transfer of **Section 721(c) property** to a **Section 721(c) Partnership** unless the **Gain Deferral Method** is applied.
 - i. **Section 721(c) property:** property with built-in gain (other than Excluded Property (cash equivalents, securities, de minimis amounts, etc.))

- ii. **Section 721(c) partnership:** domestic or foreign partnership if US Transferor contributes section 721(c) property, and after the contribution:
 - a) A related foreign person is a direct or indirect partner, and
 - b) The US transferor and one or more related persons have a greater than 50% interest in the partnership
- iii. The **Gain Deferral Method (GDM)** involves:
 - a) **Use by the partnership of the** remedial allocation method under section 704(c)
 - b) Section 704(b) allocations must remain proportionate;
 - c) Certain reporting requirements must be satisfied;
 - d) Gain must be recognized by the transferor recognized upon an Acceleration Event;
 - e) The Gain Deferral Method applies to all subsequent contributions of section 721(c) property to the partnership.

3. **Basis Implications of Outbound Transfers to Foreign Corporations by a Partnership**

- a. When section 367(a) gain is recognized by a partner, the partner increases its basis in the partnership interest to account for the gain.
- b. A partnership generally does not increase its basis in foreign corporation stock, unless a section 754 election is in effect.
- c. Section 367 regulations provide that the partner's section 367(a) increase to the basis of its partnership interest is treated as a transfer for purposes of §743(b).
- d. If the partnership has a section 754 election in effect, a partner that recognizes gain under section 367(a) will get a basis adjustment in the foreign corporation stock.
- e. In a tiered partnership, a section 754 election must be in effect at each level in order for the partner to receive a basis adjustment in the foreign corporation stock.
 - i. Under section 755, it is not entirely clear where the basis adjustment would be allocated.

4. **Outbound Transfers to Foreign Corporations of Partnership Interests**

- a. Transfers of partnership interests are treated as a transfer of the partner's proportionate share of the partnership's property.
- b. Partners transferring a partnership interest to a foreign corporation increase their basis in the transferee foreign corporation's stock.
- c. A transferee foreign corporation receiving a partnership interest:
 - i. increases its basis in the partnership interest to account for any section 367(a) gain;
 - ii. but generally does not increase its common basis in the property deemed transferred (unless a §754 election is in effect).
- d. Exception: limited partnership interests regularly traded on an established securities market are treated like a stock transfer.

B. CFC Issues

1. Ownership of Foreign Corporations through Partnerships

- a. **CFC status when a foreign corporation is held through a partnership:**
Assume a foreign corporation that has 100 percent of its shares held by a partnership with eleven unrelated US corporations as partners.
 - i. If the partnership is a US partnership, the foreign corporation is a CFC because there is 100 percent ownership by a US shareholder.
 - ii. If the partnership is a foreign partnership, the foreign corporation is not a CFC.
- b. **Indirect and Constructive Ownership of Foreign Corporations through Foreign Partnerships:** To determine whether a foreign corporation is a CFC, look at the indirect ownership rules of section 958(a)(2) and Treas. Reg. 1.958-1, and the constructive ownership rules of section 958(b) and Treas. Reg. 1.958-2.
 - i. The constructive ownership rules cross-reference the constructive ownership rules of section 318(a).
 - ii. Stock that is directly or indirectly owned by a partnership is considered owned proportionately by its partners.
 - iii. The answer may be different depending on whether one is looking at indirect vs. constructive ownership.

3. Sales of partnership interests by a CFC as a way of mitigating subpart F exposure

- a. A sale of a partnership interest generally is treated as capital gain or loss (subject to section 751(a)).

- b. Section 954(c)(4) “Foreign Personal Holding Company Income (FPHCI) Partnership Interest Look-Through” rules provide look-through treatment on the sale by a CFC of a partnership interest for purposes of determining FPHCI.
 - i. A sale by a CFC of a partnership interest is treated as a sale of the proportionate share of partnership assets.
 - ii. Look-through treatment applies only to CFCs owning directly at least 25% capital or profits interest in the partnership.
 - iii. Section 954(c)(6)(A) grants the Secretary authority to write anti-abuse regulations.

4. Partnership ownership of a CFC – Subpart F inclusions and basis

a. US Partnerships

- i. Generally, a US partnership must recognize and allocate to its partners that are US shareholders any subpart F inclusions.
- ii. A US partner recognizes its distributive share of the subpart F inclusion in income, and increases its basis in the partnership under section 705.
- iii. A US partnership increases its basis in the stock of the CFC under section 961(a). The basis increase is applied to:
 - a) The US shareholder’s stock in the CFC, or
 - b) The basis of property by reason of which the US shareholder is attributed CFC stock ownership.
- iv. Under section 961(b), such basis is reduced when the CFC’s earnings are distributed as previously-taxed income (PTI) and excluded from income under section 959.

b. Foreign Partnerships

- i. Section 961(a) increases the basis attributable to a CFC’s earnings included in the income of a US shareholder as subpart F income. The basis increase is applied to:
 - a) The US shareholder’s stock in the CFC, and
 - b) The basis of property by reason of which the US shareholder is attributed CFC stock ownership (*i.e.*, the foreign partnership interest)
 - c) Under section 961(b), such basis is reduced when the CFC’s earnings are distributed as PTI and excluded from income under section 959.

- ii. It is not entirely clear how basis in the CFC stock held by the foreign partnership is adjusted and how section 959 and 961 apply when the earnings are distributed as PTI by the CFC to the foreign partnership, and then by the foreign partnership to the partners.
- iii. This uncertain treatment creates the potential for double-taxation and potentially problematic inside-outside basis differences.

5. Partnership Ownership of a CFC and section 1248 – Sale by a Partnership of a CFC

- a. Section 1248(a) generally recharacterizes gain recognized on the sale of stock of a foreign corporation by a US person as dividend income.
 - i. This dividend income will be foreign source and potentially carry with it foreign tax credits for the corporate partners, to the extent of the foreign corporation's earnings accumulated while the stock was held by the US person and the foreign corporation was a CFC.
- b. A domestic partnership is treated as a US person for this purpose. Thus, sale by a domestic partnership of the stock of a foreign corporation is subject to section 1248(a).
- c. If the partnership is a foreign partnership with some US shareholders, regulations under section 1248 (effective for sales after July 30, 2007) clarify that the stock of any foreign corporation owned by a foreign partnership is treated as "owned proportionately by its partners" for purposes of section 1248(a).
 - i. The US Shareholder partners in the foreign partnership will be allocated gain upon the sale of the CFC, and they will need information on their applicable section 1248 amounts.

6. Sale of an Interest in a Partnership Holding a CFC, and section 1248

- a. If a partner sells its interest in a partnership holding a CFC, section 1248(a) does not apply to the gain (whether the partnership is domestic or foreign).
 - i. The IRS states in the preamble to final section 1248 regulations that the regulations are not intended to be interpreted as providing for aggregate treatment of a foreign partnership upon a sale by a partner of its partnership interest (this would be contrary to section 1248(g)(2)(B)).
- b. HOWEVER, the gain on sale of the interest of a partnership holding a CFC may be treated as ordinary under section 751(a).

- i. Section 751(c) unrealized receivables include 1248 amounts from stock in a foreign corporation.
- ii. The benefits of recharacterization as dividend income under section 1248 would not apply here.
- iii. There is no policy rationale for this result; Treasury and the IRS have stated that they believe they did not have authority for a different answer.

B. Partnerships and Section 956

1. Basic Principles of Section 956

- a. **Inclusion Rule:** Under §951(a)(1)(B), each US Shareholder of a CFC must include in gross income its pro rata share of the §956 amount for that year, which generally is equal to the lesser of the amount of "US property" held (directly or indirectly) by the CFC and the CFC's E&P, reduced for any previous income inclusions.
- b. See description of "US property" at (I)(E)(b)(ii).
- c. **Pledges and Guarantees:** Under section 956(d), a CFC is treated as holding an obligation of a US person if the CFC is a pledgor or guarantor of that obligation.
 - i. If a US obligor pledges more than two-thirds of the stock of a CFC to the lender and the stock pledge is accompanied by negative covenants designed to protect the lender against dissipation of the CFC's assets, the stock pledge will be treated as an indirect pledge of the CFC's assets.
- d. **Anti-avoidance:** IRS and Treasury have statutory authority under section 956(e) to issue regulations necessary to carry out the purposes of section 956, including anti-avoidance regulations.
- e. **Calculating the amount of the investment in US property:** The amount of a US shareholder's inclusion in income based on its CFC's investment in US property is calculated in one of two ways:
 - i. The shareholder's pro rata share of the average quarterly amounts of US property held directly or indirectly by the CFC, minus PTI (determined in section 959(c)(1)(A) and including both section 956 PTI and subpart F PTI); or
 - ii. The shareholder's pro rata share of the "Applicable Earnings" of the CFC (the sum of the CFC's current and accumulated E&P that have not been distributed or previously taxed).
 - iii. US property acquired before the corporation became a CFC is disregarded.

- f. US taxpayers may make affirmative use of section 956 and section 960(c) to bring up foreign tax credits.
2. A new “**funding rule**” under recently-released temporary regulations (TD 9733) targets transactions involving the funding of CFC-controlled foreign partnerships to avoid section 956.
 - a. Existing Treas Reg § 1.956-1T(b)(4) gave the IRS authority to consider a CFC as indirectly holding investments in US property acquired by any other CFC that it controls if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other CFC is to avoid the application of section 956 with respect to the first CFC.
 - b. New Treas Reg § 1.956-1T(b)(4) expands the rule to include transactions involving partnerships. Under the new rule, a CFC is treated as indirectly holding an entire obligation held by a foreign partnership that it controls if
 - i. the property would be US property if held directly by the CFC; and
 - ii. A principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is to avoid the application of section 956 with respect to the CFC.
 - c. Example: Under the existing rules, a CFC would contribute cash in exchange for an interest in a nominal foreign partnership, which, in turn, would lend the cash to a US shareholder of the CFC. Taxpayers took the position that the CFC should not be treated as indirectly holding the entire obligation of the US shareholder, but, as holding the obligation only to the extent of the CFC’s interest in the partnership under Treas Reg § 1.956-2(a)(3).
 - d. A **coordination rule** in Treas Reg § 1.956-1T (b)(4)(iii) applies the new “indirect funding” rule only to the extent the amount of US property treated as held by a CFC under the rule exceeds the proportionate amount of US property treated as held by the CFC under existing Treas Reg § 1.956-2(a)(3).
 - e. **Effective date:** The new funding rule is effective immediately (Treas Reg § 1.956-1T(g)).
 3. A new “**loan rule**” in the recently-released temporary regulations covers situations in which the CFC does not necessarily control the foreign partnership, but has funded the partnership for purposes of making a distribution to its US shareholder.

- a. Treas Reg § 1.956-1T(b)(5) treats a CFC's partnership's obligations as the obligation of the distributee US partner when:
 - i. The foreign partnership distributes an amount of money or property to the US partner;
 - ii. The foreign partnership would not have made the distribution **but for a funding** of the partnership through the obligation; and
 - iii. The partner is related to the CFC within the meaning of section 954(d)(3).
 - b. The loan rule limits the amount of the obligation that is treated as an obligation of the distributee US partner to the lesser of:
 - i. The amount of the partnership distribution that would not have been made but for the funding of the partnership, or
 - ii. The amount of the obligation of the foreign partnership that is held (or treated as held under Reg. section 1.956-2(c)) if the obligation were an obligation of a US person.
4. **Aggregate approach under Proposed Regulations:** Under New Proposed Treas Reg §1. 956-4(b)(1), a partner in a partnership is treated as holding its attributable share of any property held by the partnership. Proposed Reg. 1. 956-4(c)(1) would treat the obligation of a foreign partnership as the obligation of the partners to the extent of each partner's share of the obligation, based on each partner's interest in partnership profits.
- a. The partnership need not distribute loan proceeds to any of its partners for this rule to apply.
 - b. Each partner's proportionate share of partnership profits would be determined at the end of each quarter.
 - c. The IRS solicited comments regarding whether the liquidation value percentage method or another method would be a more appropriate basis for determining a partner's share of a foreign partnership's obligation.
 - i. Section 752 regulations contain a definition of partnership profits that could be cross-referenced.
 - d. The proposed rules contain an exception under which the aggregate approach would not apply to partnership obligations where neither the lending CFC, nor any person related to the lending CFC (within the meaning of section 954(d)(3)), is a partner in the partnership.
 - e. The current rule providing that a CFC is treated as holding an obligation of a US person if the CFC is a pledgor or guarantor of that

obligation would be extended to cover indirect guarantees by CFCs and partnerships under Treas Reg § 1.956-2(c)(1), although a CFC would not automatically be treated as a guarantor of the obligation.

- f. Proposed Treas Reg § 1.956-4(c)(3) contains the same rule as Treas Reg § 1.956-1T(b)(5) described above which treats a CFC's partnership obligations as the obligation of a distributee US partner to the extent of the lesser of the amount of the distribution that would not have been made "but for" the funding of the partnership or the amount of a foreign partnership obligation.

5. **Foreign Partnership Borrowing with CFC Guarantee** – Assume a US corporation (USP) holds a 60% share of a foreign partnership (FP) that is the sole owner of a CFC. CFC guarantees, or pledges its assets to guarantee, a third party loan to the foreign partnership. Does CFC's guarantee (or pledge of assets) with respect to FP's debt cause CFC to be treated as holding an obligation of a US person?

- a. **Under Proposed Treas Reg § 1.956-4(c)(3)**, FP's obligation would be treated as a separate obligation of each of the partners – including USP – in accordance with the partner's interest in profits. If it were USP's obligation, CFC's guarantee (or pledge of assets) with respect to FP's debt would cause CFC to be treated as holding the obligation (Treas Reg § 1.956-2(c)).
- b. **Under the current and temporary regulations**, consider the following:
 - i. **If FP invests the loan proceeds in US property**, there is a chance CFC could be regarded under Treas Reg § 1.956-1T(b)(4)(ii) as "controlling" FP and indirectly holding the US Property, if a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is in order to avoid the application of section 956 to CFC.
 - ii. **If FP uses the loan proceeds in an active business in FP's country of formation**, the assets would not be US assets, and there is less evidence of a motive to avoid section 956.
 - iii. **If FP conducts no operations and its sole asset is CFC stock**, there is greater risk of a look through FP to consider its obligation to be the obligation of its partners, such as USP.
 - iv. **If FP distributes the loan proceeds to USP**, Treas Reg § 1.956-1T(b)(5) causes CFC to be viewed as holding the obligation of USP under the loan rule.

- a) However, if USP owns only a 10% partnership interest in FP, the USP is not related to the CFC within the meaning of section 954(d)(3), and the loan rule does not apply.
- v. **If FP pledges at least 66 2/3% of the CFC stock**, it could be seen as pledging the assets of CFC.
- vi. **If FP is a domestic partnership**, FP's obligation is the obligation of a US person, and CFC's guarantee of the debt results in CFC being treated as holding the obligation directly under Reg. section 1.956-2(c).

6. Pledge of a Foreign Partnership Interest to support loan to a US Partner (USP):

- a. USP's pledge of an interest in a foreign partnership with a wholly-owned CFC could be considered an indirect pledge of the CFC stock by USP, which could cause the CFC to be treated as holding an obligation of a US person.
- b. This risk could be mitigated if USP held a smaller than 66 2/3% share in the foreign partnership.
- c. This risk could be mitigated by the US partner providing negative covenants over only the foreign partnership's assets.
- d. This risk could also be mitigated if the foreign partnership is engaged in an active business in its country of formation and holds significant assets other than the CFC stock.
- e. If the foreign partnership instead guarantees USP's debt, it would be important to determine whether the foreign partnership has many assets in addition to the stock of CFC.
- f. If the foreign partnership were a domestic partnership, there remains a risk that US P is viewed as pledging the stock of a CFC.

7. Special Allocations:

- a. As a carve-out to the general aggregate approach provided in new Proposed Treas Reg § 1.956-4(b)(1), Proposed Treas Reg § 1.956-4(b)(2)(ii) would respect special allocations of income (or gain) in a partnership agreement that differ from the partner's liquidation value in a particular year, as long as ***the special allocation does not have a principal purpose of avoiding section 956.***
- b. See new Proposed Reg. 1.956-4(b)(3) Example 2: USP, a domestic corporation, wholly owns FS, a CFC which, in turn, owns an interest in FPRS, a foreign partnership. The remaining interest in FPRS is owned by an unrelated foreign person. FPRS holds non-depreciable

property, with an adjusted basis of \$100x that would be US property if held by FS directly. At the close of quarter 1, year 1, the liquidation value percentage determined under the regulations for FS with respect to FPRS is 25%, but the partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to US property to FS. Because the special allocation does not have a principal purpose of avoiding the purposes of section 956, the special allocation is respected and FS's attributable share of US property held by FPRS is 80%, so FS is treated as holding US property with an adjusted basis of \$80x.

- c. *Cf.* PLR 200832024 (A CFC partner in a foreign partnership with two disregarded entities (holding US and non-US property, respectively) was specially allocated income, gain, and loss from non-US property only and given liquidation rights only in the non-US assets. The disregarded entities maintained separate books and records and were not allowed to fund each other. The IRS ruled that because the CFC did not have any economic interest in the US property, and the disregarded entity holding US property would not receive any loans, other funds or credit support from non-US disregarded entity, the CFC's status as a partner in the foreign partnership did not cause it to be treated as holding an interest in US property for purposes of section 956.

C. Foreign dividends and section 902 credits

1. **Ownership Requirements** for section 902 credits when a foreign subsidiary pays a dividend to a partnership with US partners.
 - a. The US corporate shareholder must own 10 percent or more of the voting stock of the foreign corporation to qualify for section 902 credits.
 - b. Stock owned directly or indirectly by or for a partnership is treated as actually owned by the partners for purposes of section 902 (section 902(c)(7)).
 - c. AJCA 2004 change codifies Rev. Rul. 71-141 (holding that each of two corporations forming a partnership to acquire a 40% interest in a foreign corporation that paid the partnership compensation for services and products, and also dividends, were entitled to a credit for foreign taxes withheld on the compensation and deemed paid on the dividends).
2. Note: Where a foreign tax is imposed at the entity level on income of a hybrid partnership, the entity is treated as the taxpayer.
 - a. The partnership, thus, is entitled to a section 901 credit.

- b. Tax is then allocated among partners under the section 704(b) regulations.
3. Section 902(c)(7) provides authority to prescribe “such rules to account for special partnership allocations of dividends, credits, and other incidents of ownership of stock in determining proportionate ownership,” but no such regulations have been promulgated.
4. In the preamble to regulations under section 902 issued in 1997, the IRS stated that it was “still considering” under what circumstances other than those specifically addressed in Rev. Rul. 71-141 (which involved a GP) stock owned by a pass-through entity should be attributed to the owners of the entity for section 902 purposes. In particular, the Service requested “comments on whether the holding of Rev. Rul. 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, and beneficiaries of domestic or foreign trusts and estates or interest holders in other pass-through entities.”
5. Thus, there is some indication that special allocations of economic or voting rights should be taken into account in determining whether the ownership requirement of section 902 is met.

D. Passive Foreign Investment Companies (PFIC) issues

1. **Gain from the sale of a partnership interest:** If a US partner holds a greater than 25% interest in an active foreign partnership through a foreign corporation:
 - a. Section 954(c)(4) provides that a 25% partner’s gain is pro rata from the deemed sale of underlying assets for subpart F purposes.
 - b. Some of the section 954(c) exceptions to foreign personal holding company income do apply for PFIC purposes. (See FSA 200031015, indicating that in applying exceptions from PPHCI that turn on whether payments were from a related person, the section 954(d)(3) definition of related for subpart F purposes also applies for PFIC purposes).
2. **PFIC Ownership Through Domestic Partnerships**
 - a. A domestic partnership is treated as a United States person for purposes of the PFIC regime.
 - b. QEF elections can be made at the domestic partnership level.
 - c. QEF inclusions or the PFIC excess distribution regime are also applied at the domestic partnership level, arguably increasing the

partnership's section 704(b) income and its basis in the foreign corporation.

- d. Compliance Issues. Assume a US person owns two tiers of PFICs through a domestic partnership.
 - i. The US person would be considered to own all the PFIC stock owned by the domestic partnership (section 1298(a)(3)).
 - ii. IRS regulations do not prevent attribution through a US partnership, and generally disregard the US partnership as a shareholder, with exceptions.
 - iii. Only the US partnership can make a QEF election (see Reg. section 1.1295-1(d)(2)).
 - iv. If no QEF election is made by the US partnership, both the US partnership and the ultimate US owner must file Form 8621 (See Prop. Reg. sec. 1.1291-1(b)(7)).
 - v. If the US partnership makes QEF election, generally, only the US partnership may be required to file Form 8621 (See Prop. Reg. sec. 1.1291-1(i), and Instructions to Form 8621).
 - a) The ultimate US owner would include amounts under the partnership rules, not under the PFIC rules (Reg. sec. 1.1295-1(d)(2)(i)).

3. PFIC Ownership Through Foreign Partnerships

- a. A foreign partnership is not a United States person, including for purposes of the PFIC regime.
 - i. QEF elections must be made by the foreign partnership's US partners.
 - ii. QEF inclusions and the PFIC excess distribution regime are applied at the partner level.
 - a) Such items do not increase the foreign partnership's section 704(b) income.
 - b) Such items do increase the foreign partnership's basis in foreign corporation stock under section 1293(g)(2).
 - iii. US partners need specific information from the foreign partnership in order to know their share of any QEF inclusions:
 - a) each partner's pro rata share of the partnership's ordinary earnings and long term capital gain

- b) how to apply the partnership's allocations, especially in the context of a progressive waterfall
- c) A reporting partnership may not have visibility into whether or not all partners make QEF inclusions.

E. Section 987 and partnerships

1. Section 987 deals with the recognition of currency gains or losses from qualified business units (QBUs), including those conducted through partnerships that have a different functional currency.
2. In 2006, the IRS issued proposed regulations under section 987 that generally adopted an aggregate approach to partnerships for purposes of applying the rules of section 987.
3. The IRS announced in early 2008 that it would begin in summer 2008 to finalize the proposed regulations, but the regulations have yet to be finalized.
4. Currently, it would not appear that you must apply the section 987 methodology to partnership QBUs.
 - a. The proposed regulations are not final authority.
 - b. The legislative history is not clear regarding the treatment of partnership QBUs.
 - c. Section 731 has an express rule regarding non-recognition on distributions, and
 - d. The partnership rules, through their basis rules on distributed property and the basis adjustment rules in the partnership effectively capture foreign exchange fluctuations.
 - e. Absent final regulations, it would be a reasonable interpretation of the interaction of subchapter K and section 987 to not apply section 987 in this context.