International Tax Considerations: Inbound & Outbound (slides)

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Repository Citation
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Agenda

• Primer on US Taxation of Outbound Investment
• Entity Classification Issues
  - Entity (partnership) classification
• International Tax Considerations for US Partners (Outbound)
  - § 367(a) issues involving partnerships
  - CFC issues
  - Partnerships and § 956
  - Foreign dividends and § 902 credits
  - PFIC issues
  - § 987 and partnerships
Primer on US Taxation of Outbound Investment
• US persons (citizens, resident aliens and domestic corporations) are subject to tax on their worldwide income

• US tax liability on “foreign source” income can be offset by credit for foreign taxes paid
  - Mechanical rules for computing foreign tax credit limitation (foreign source income x US taxes paid ÷ worldwide income)
  - Determined separately for “passive” income and “general basket income”
Source of income

- Source determined differently for different classes of income:
  - Interest – residence of the payor (for partnership based on existence of US trade or business, not solely place of formation)
  - Dividends – in general, place of incorporation of payor
  - Rents/royalties – where property is used
  - Sales of inventory – 50% place of manufacture (if seller is manufacturer)/50% title passage (all title passage if buy-sell)
  - Capital gains – residence of seller
  - Notional principal contracts – in general, residence of recipient
Like a domestic corporation, a foreign corporation generally is treated as a taxpayer wholly separate from its shareholders
- US tax paid on US source income at corporate level
- No US tax paid on foreign source income at corporate level
- Shareholder taxed only on sale of stock or receipt of dividends

Creates opportunity for substantial deferral of US tax on foreign income earned through foreign corporation

Two major anti-deferral regimes
- CFC and PFIC
CFC and PFIC

- **CFC**: Foreign corporation where “US shareholders” (US persons owning ≥ 10% voting power) own > 50% voting power or value
  - “US shareholder” taxed currently on:
    - Share of “subpart F income” and
    - “Increase in investment in US property”
    - Generally limited to E&P of CFC

- **PFIC**: Foreign corporation that satisfies either of following tests:
  - 75% or more of corporation’s income for the year consists of passive income
  - At least 50% of the corporation’s assets are used to produce passive income
    - (Irrelevant what percentage of stock is owned by US persons or US person’s ownership percentage)

- Where both CFC and PFIC rules apply to shareholder, CFC rules take precedence
Entity Classification
Issues
Entity Classification – Initial “Check-the-Box” Regulations Determinations

Is the arrangement an entity?

If an entity, is it a business entity (i.e., not a trust)?

If it is a business entity, is it listed as a per se corporation?

If not a per se corporation, is the eligible entity domestic or foreign?

What is the default classification?
Is the Arrangement an Entity?
De Facto Partnerships in the Foreign Arena

- Contractual arrangement can sometimes constitute a partnership/business entity
  - See discussion *infra*.
- Scrutinize:
  - Contractual arrangements with elements of joint profit sharing
  - Service fees determined on profits of entity
  - "Virtual Mergers"
  - "Formula Allocations" of partnership income based on the results of global activities of the "group"
  - 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.
What Is a Partnership?

- **Statute:** 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).

- **Regulations:** 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."
  - Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes."
  - Reg. § 301.7701-1(a)(2)

- A partnership is a matter of federal tax law and is not dependent upon whether the organization is recognized under local law.
Key “Partnership” Authorities

- **Commissioner v. Culbertson**, 337 U.S. 733 (1949)
  - No one set of factors
  - Not based on state law
  - Key factor: Intent to join together in the present conduct of an enterprise
  - Look for evidence of intent based on objective factors
    - Agreement
    - Conduct of parties
    - Relationship of the parties
    - Respective abilities and capital contributions
    - Actual control of income and purposes for which it is used

  - List of factors in determining whether parties intended to form a partnership/separate entity”
    - The agreement of the parties and their conduct (indicating intent to join together in present conduct of an enterprise)
    - Joint contributions of money, property, and/or services to the venture
    - Parties’ control over income and capital and separate rights to make withdrawals
    - Joint profit sharing and obligation to share losses
    - Mutual control and mutual responsibilities
    - Business conducted in joint names of the parties
    - Representations to 3rd parties - partnership returns
    - Separate books of account
Effect of Treating an Arrangement as a Partnership (cont’d)

- International tax considerations
  - Status as domestic or foreign (which country?) entity
  - Status of corporate subsidiaries as controlled foreign corporations
  - Characterization of income earned by partners
    - Distributive share of operating income versus services-interest-royalty-income etc.
    - Source of income
    - ECI versus FDAP taxation regimes for foreign partners
    - Treatment under tax treaty provisions
  - Ability to rely on elections that impact the computation of taxable income
Entity Classification – Is the Entity Domestic or Foreign?

- Domestic: Created or organized in US or under the law of the US or of any state  § 7701(a)(4)
- Foreign: other than domestic  § 7701(a)(5)
- Dual-Chartered Entities:
  - A business entity treated as created or organized under the laws of more than one jurisdiction at a time (a dual chartered entity).
  - If a dual-chartered entity is organized in the U.S., it is a domestic entity (even though also organized in a foreign jurisdiction).
  - If a dual-chartered entity is a per se corporation in either jurisdiction, it is a per se corporation for US federal tax purposes.

- If 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
  - Determines whether corporation is foreign or domestic
  - Affects application of “same country” subpart F exceptions
  - Not necessarily just a matter of what law governs disputes under the contract
Domestic entity default classification depends on the numbers of "members"

- More than one member: default is partnership
- One Member: default is disregarded entity
Foreign entity default classification depends on "members" that have or do not have "limited liability"

- All members have limited liability: default is association
- Entity has two or more members and at least one does not have limited liability: default is partnership
- Entity has single owner that has unlimited liability: default is disregarded as separate from owner
A is a legal member in PRS and under foreign law has unlimited liability for the debts of PRS. A has nominal assets.

All the other interests in PRS have limited liability for the liabilities of PRS.

A is responsible for making sure financial statements for PRS are drawn up, and for ensuring that tax returns get prepared.

A is a noneconomic GP: it has contributed no capital to PRS, and has a zero interest in the profits or losses of PRS.

A receives solely a $30,000 per year fee for administrative services.

What is the default classification of the foreign partnership under the check the box regulations?
How Many "Members" (Partners)?

- Grantor formed Grantor Trust
- Grantor Trust owns Corporation
- Corporation is a member of LLC under local law
- Corporation has no interest in LLC's profits and losses
- Corporation's purpose is to prevent LLC from declaring bankruptcy
How Many “Members” (Partners)?

- Corporation’s membership interest does not rise to level of partner for tax purpose – no sharing in profits and no management powers
- LLC treated as single member entity for federal tax purposes – disregarded as an entity separate from Grantor, unless it elects otherwise
- PLR 199911033
- See other authorities addressing whether interest in eligible entity respected as partnership interest (e.g., Pritired, Castle Harbour)
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.

• 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.”
  - The entity classification of the series is determined under the current regulations (§§ 301.7701-1, -2, -3, and -4).

• Exception
  - Proposed regulations do not apply to foreign non-insurers.
  - However, no inference is to be drawn from the exclusion.
Proposed Series LLC Regulations

What is a Series?

Series LLC

- A: Short-term bonds
- B: Long-term bonds
- C: Preferred
- D: US Common
- E: Foreign Stock
International Tax Considerations for US Partners (Outbound)
International Tax Considerations for US Partners (Outbound)

- Section 367(a) Issues Involving Partnerships
Section 367(a) Outbound Transfers to Foreign Corporations

- Outbound transfers by US persons of assets to foreign corporations in §§ 332, 351, 354, 356, or 361 transactions may be subject to gain recognition under § 367(a)
- Various exceptions depending on types of assets transferred
- Stock transfers
  - Less than 5% owners, no application
  - 5%-50% owners, no gain so long as gain recognition agreement (GRA) is entered into
  - >50% owners, gain recognition
- Basis of assets transferred are stepped up for any gain recognized under § 367(a)
- IRS may provide by regulation application of outbound transfer rules to transfers of intangible property to partnerships under § 367(d)(3), but such regulations have not been issued
- New § 367(d) regulations provide that § 367(d) does not apply to an outbound transfer of foreign goodwill or going concern value
Outbound Transfers to Foreign Corporations – Partnership Transferors

- Transfers made by partnerships treated as made proportionately by partners
  - What is “proportionate”?
- GRAs entered into at partner level
- § 367(a) gain recognized at partner level and therefore seemingly **not** a partnership item
  - Thus does not appear to be partnership 704(b) income or affect the waterfall
  - Partnership should footnote partner information
- **Note:** Interaction with Notice 2015-54 (discussed below) if P was formed after August 7 2015 and has both US and foreign partners
What basis implications if § 367(a) gain is recognized by a partner?

- Partners increase basis in partnership interest for § 367(a) gain
- Partnership does not generally increase its basis in foreign corporation stock, unless § 754 election in effect
  - § 367 regulations provide that the partner's § 367(a) increase to the basis of its partnership interest is treated as a transfer for purpose of §743(b)
  - If the partnership has a § 754 election in effect, a partner that recognizes gain under § 367(a) will get a basis adjustment in the foreign corporation stock
  - Note issue with where, under § 755, basis adjustment would go
- Tiered partnerships? § 754 elections must be in effect at each level
Outbound Transfers to Foreign Corporations – Transfers of Partnership Interests

- Transfers of partnership interests treated as transfer of partner’s proportionate share of the partnership’s property
- Partners increase their basis in foreign corporation stock and transferee foreign corporation increases its basis in partnership interest for § 367(a) gain but partnership does not generally increase its common basis in the property deemed transferred (unless § 754 election in effect)
- Exception for limited partnership interests regularly traded on an established securities market (treated like a stock transfer)
Outbound Transfers to Foreign Corporations – New Notice 2015-54

- Treasury and IRS concerned with US taxpayers contributing appreciated property to partnerships and allocating income from gain to related foreign partners
- 1997 enactment of sections 367(d)(3) and 721(c) governing asset transfers to partnerships
- New Rule under § 721(c): Gain recognition upon transfer of appreciated property to domestic or foreign partnership if gain, when recognized, would be includible in income of foreign person
  - § 367(d)(3) applies only to IP assets, so rules issued under § 721(c).
  - § 721(a) non-recognition possible if Gain Deferral Method is applied
Outbound Transfers to Foreign Corporations – New Notice 2015-54 Definitions

- **General Rule:** § 721(a) will NOT apply to a transfer of § 721(c) property to a § 721(c) Partnership unless Gain Deferral Method
  - § 721(c) property: property with built-in gain (other than Excluded Property (cash equivalents, securities, <20K, etc.))
  - § 721(c) partnership: domestic or foreign partnership if US Transferor contributes § 721(c) property, and after contribution:
    - Related Foreign Person is Direct or Indirect partner
    - US Transferor and one or more Related Persons > 50% interest in partnership
  - **Gain Deferral Method (GDM):** (i) remedial allocation method for partnership; (ii) § 704(b) allocations remain proportionate; (iii) reporting requirements; (iv) gain recognized upon Acceleration Event; (v) GDM applies to all subsequent contributions of § 721(c) property
Outbound Transfers to Foreign Corporations – New Notice 2015-54: Example 1

- **USP transfers following assets to PRS:**
  - patent: FMV = 1.2m
    - Basis = 0
    - BIG = 1.2
  - security: FMV = 100k
    - Basis = 20K
    - BIG = 80k
  - machine: FMV = 200k
    - Basis = 600K
    - BIL = (400)

- **Result:**
  - Patent = § 721(c) property
  - Security = Excluded Property
  - Machine has BIL so not § 721(c) property

- **Therefore, PRS = § 721(c) Partnership: must follow Gain Deferral Method or recognize gain**
Outbound Transfers to Foreign Corporations – New Notice 2015-54: Example 2

- **USP transfers following assets to PRS:**
  - **Asset 1:** § 721(c) Property
  - **Asset 2:** BIG = 100k but de minimis exception does not apply, due to Asset 1
    => Asset 2 also § 721(c) Property

- **Partnership allocations of § 704(b) items from Asset 2:**
  - Income, gain, loss: 20% USP/80% FS
  - Deductions: 90% USP/10% FS

- **Allocations violate Gain Deferral Method, causing Acceleration Event:**
  - Gain on Asset 2 must be recognized
  - Gain on Asset 1 must be recognized due to Acceleration Event

- **Contributions of assets under section 351**
  - Do not cause Acceleration Event if transferee is domestic, or
  - Cause Acceleration Event only to the extent of FS’s share of property if transferee is foreign
International Tax Considerations for US Partners (Outbound)

- CFC Issues
• General rule: No taxation with respect to an investment in stock in a foreign corporation until receipt of distribution or sale of stock
  - Significant "anti-deferral" exceptions – CFCs and PFICs

• Consequences of CFC status
  - Inclusion of pro rata share of subpart F income to extent of earnings and profits ("E&P") of CFC
  - Inclusions with respect to investments in US property under § 956 (also limited by E&P)
  - Application of § 1248 upon dispositions of stock
Subpart F – What is a CFC?

- A foreign corporation more than 50 percent (by vote or value) of the stock of which is owned by US Shareholders
  - US Shareholder is US person who owns 10 percent or more of voting stock of foreign corporation (Note Baucus proposal to change test to 10 percent of vote or value of stock)
  - Voting power is determined based on all facts and circumstances
  - Direct, indirect and constructive ownership taken into account
CFC Status With Direct Holdings

- Eleven shareholders - each owns about 9.09% of FC

Is FC a CFC?

11 US Unrelated Corps

U.S.

FC
CFC Status When Foreign Corporation Held through a Partnership

- Eleven partners, each owns about 9.09% of PRS

If PRS is domestic, is FC a CFC?

If PRS is foreign, is FC a CFC?
To determine whether Foreign Corp is a CFC, must look at indirect ownership rules of § 958(a)(2) and Treas. Reg. 1.958-1, and the constructive ownership rules of § 958(b) and Treas. Reg. 1.958-2
- Constructive ownership rules follow § 318(a).

What does it mean that stock directly or indirectly owned by a partnership shall be considered as being owned proportionately by its partners? The answer may be different depending on whether one is looking at indirect vs. constructive ownership.

What voting power does GP have in Foreign Partnership and thus Foreign Corp? Is a fiduciary duty to LPs enough to give the LPs voting power?
Mitigating Subpart F Exposure

• Subpart F income inclusions constitute “dry income”

• Mitigating Subpart F Exposure
  - 338 elections (clean up E&P of foreign subsidiaries, step up basis of assets for depreciation and amortization)
  - Monitor inter-company transactions or make check-the-box elections
  - Examine security/guarantee package for financing
  - Use foreign rather than domestic partnership
Nuances on Subpart F Income – Sales of Partnership Interests by CFC

• A sale of a partnership interest is generally treated as capital gain or loss (subject to § 751(a))

Does the gain constitute Sub F income at CFC level?

• § 954(c)(4) “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
  - A sale by a CFC of a partnership interest is treated as a sale of the proportionate share of partnership assets
  - Only applies to CFCs owning directly at least 25% capital or profits interest
  - Secretary granted authority to write anti-abuse regulations
• US Partnership recognizes Sub F inclusion, and allocates to its partners.

What are the basis consequences to the inclusion?

• US partner recognizes its distributive share of the subpart F inclusion in income, and increases basis in Partnership under § 705.

• US Partnership increases its basis in stock of the CFC.
  - § 961(a). The basis increase is applied to:
    - US shareholder’s stock in the CFC, or
    - Basis of property by reason of which the US shareholder is attributed CFC stock ownership

• Under § 961(b), such basis is reduced when the earnings are distributed as PTI and excluded from income under § 959
What result if Partnership is Foreign?

- § 961(a) increases basis attributable to a CFC’s earnings included in income of a US shareholder as subpart F income. Basis increase is applied to:
  - US shareholder’s stock in the CFC
  - Basis of property by reason of which the US shareholder is attributed CFC stock ownership, i.e., the FP interest

- Under § 961(b), such basis is reduced when the earnings are distributed as PTI and excluded from income under § 959

- Unclear if basis in CFC stock held by FP is adjusted and how §§ 959 and 961 apply when PTI is distributed by the CFC to FP and then by FP to the partners
  - creates potential for double-taxation and potentially problematic inside-outside basis differences
Partnership sells stock in a CFC. What result?

- § 1248(a) generally recharacterizes gain recognized on the sale of stock of a foreign corporation by a US person as dividend income
  - Dividend income will be foreign source and potentially carry foreign tax credits for 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.

- A domestic partnership is treated as a US person for this purpose
  - Sale by a domestic partnership of the stock of a foreign corporation is subject to § 1248(a)
What difference if Partnership is foreign?

- Regulations under § 1248 (effective for sales after July 30, 2007) clarify that stock of any foreign corporation owned by a foreign partnership is treated as “owned proportionately by its partners” for purposes of § 1248(a)
  - In this situation, it’s likely foreign partnership is not widely held.
  - US Shareholder partners will be allocated gain on sale of CFC; they will need information on their applicable § 1248 amounts.
What result under § 1248 if a Partner sells its interest in the partnership holding the CFC?

- § 1248(a) does not apply to the gain (whether partnership is domestic or foreign)
  - IRS states in preamble to final § 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 (would be contrary to § 1248(g)(2)(B)).

- HOWEVER, the gain may be treated as ordinary under § 751(a)
  - § 751(c) unrealized receivable includes 1248 amounts from stock in a foreign corporation.
  - NOTE: the benefits of recharacterization as dividend income under § 1248 do not attach.

- No policy rationale for this result; Treasury/IRS have stated they believe they did not have authority for a different answer
Sale of Interest in Partnership Holding CFC – Example

- US Corp sells its interest in US Partnership and realizes a $100 gain
- US Corp will recognize:
  - $25 ordinary gain under § 751(a)
  - $75 capital gain under § 741
- US Corp does not treat ordinary income amount as a “dividend” and does not therefore have § 902 benefits

What Result if USP is a Foreign Partnership?

Stock in CFC:
- FMV: $100
- A/B: $50

CFC
- E&P: $75
- (potential §1248 amount = $50)
International Tax
Considerations for US Partners (Outbound)

• *Partnerships and Section 956*
Partnerships and §956 – Basic Rules

- **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.

- **US property includes (among other things):**
  - Tangible property located in the United States.
  - Stock of a related domestic corporation (i.e., a US Shareholder or 25% or more (by voting power) owned (or considered as being owned) by the CFC’s US Shareholders).
  - Obligations of a related US person (note special rule for unincorporated US persons – §956(c)(2)(L)).
  - Any right to use intangible property in the United States.

- **Indirect and Attributed Investments**
- **Property Acquired When Not A CFC**
Partnerships and §956 – Basic Rules (cont’d)

- **Pledges and Guarantees**
  - A CFC is treated as holding an obligation of a US person if the CFC is a pledgor or guarantor of that obligation.
    - 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.

- **Calculating the Amount of the Investment**

- **Limitations on the Amount of the Inclusion**
  - Shareholder’s Pro Rata Share of US Property over Earnings
    - Adjustment to earnings for §956 PTI
  - Applicable Earnings as a Limitation
    - Adjustment to earnings for Sub F PTI
    - Adjustment to earnings for §956 PTI

- **Affirmative Use of §956 and §960(c)**
Partnerships and §956 – New Temporary Regulations “Indirect Funding Rule” for Back-to-Back Loans thru Partnership

- **Existing Rule:** CFC treated as holding 60% of US prop ($60 of $100 loan)

- **New Indirect Funding Rule:** CFC treated as indirectly holding entire $100 obligation if:
  - Property would be US Property if held directly by CFC; and
  - A principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) partnership is to avoid application of § 956 wrt CFC

- **Coordination Rule applies new rule only to extent:**
  - amount of US property treated as held by CFC under “indirect funding” rule ($100) exceeds
  - amount of US Property treated as held by CFC under existing partnership rule ($60)
  - \( \rightarrow 40 + 60 = 100 \)
Partnerships and §956 – CFC Loan to Foreign Partnership: New Temporary Regulations and Partnership Distributions Funded by CFC

- New temp reg "loan rule" treats partnership obligation from a CFC as obligation of distributee US partner
  - To extent of lesser of amount of distribution that would not have been made but for
    - funding of the partnership or
    - amount of foreign partnership obligation
- Also included as a new proposed reg
Proposed Reg treats obligation of foreign partnership as obligation of the partners

- To extent of each partner's share of obligation, based on partner's interest in partnership profits
- Quarterly determination of partner's share
- Comments solicited on share determination
- Exception for partnership obligations where neither lending CFC, nor any person related to lending CFC, is a partner
Partnerships and §956 – Foreign Partnership Borrowing with CFC Guarantee under Temporary and under Proposed Regulations

- 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 under the temp regs? Does this change under the proposed regs?

- How do the temp regs apply if FP distributes the loan proceeds to USP?

- How do the temp regs apply if USP owns only a 10% partnership interest in FP?

- What if FP invests the loan proceeds in US property?

- What if FP conducts no operations and its sole asset is CFC stock?

- What if FP pledges the CFC stock instead?

- What if FP is a domestic partnership?
Partnerships and §956 – Pledge of Foreign Partnership Interest

- Is this an indirect pledge of CFC stock by USP which would cause CFC to be treated as holding an obligation of a US person?
- What if USP provides negative covenants over FP’s assets only?
- What if FP is engaged in an active business in FP’s country of formation and holds significant assets other than the CFC stock?
- What if FP guarantees USP’s debt instead?
- What if FP is a domestic partnership?
Partnerships and §956 – Special Allocations and New Proposed Regulations

- Special allocations of income (or gain) in partnership agreement respected → provided special allocation does not have a principal purpose of avoiding §956.

- Cf. PLR 200832024
International Tax Considerations for US Partners (Outbound)

- Foreign Dividends and Section 902 Credits
Foreign subsidiary pays dividend to Partnership
• Can US1 take into account foreign taxes under § 902?
  - US corporate shareholder must own 10 percent or more of the voting stock of the foreign corporation to qualify for § 902 credits
  - Stock owned directly or indirectly by or for a partnership treated as actually owned by the partners for purposes of § 902 (§ 902(c)(7))
  - US1 treated as directly owning 20% of FC and thus may compute § 902 credits on dividends distributed to PS
  - AJCA 2004 change codifies Rev. Rul. 71-141
• Note: Where foreign tax is imposed at the entity level on income of a hybrid partnership, the entity is treated as the taxpayer
  - § 901 credit
  - Tax is then allocated among partners under § 704(b) regulations
Foreign Source Dividends – Ownership Requirements for § 902 credits (cont’d)

- § 902(c)(7) provides the Secretary 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.

- In the preamble to regulations under § 902 issued in 1997, the Service 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 § 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.”

- Thus, some indication that special allocations of economic or voting rights should be taken into account in determining whether the ownership requirement of § 902 is met.
International Tax Considerations for US Partners (Outbound)

- PFIC Issues
Passive Foreign Investment Companies (PFIC)-Overview

- **Consequences of PFIC status**
  - Interest charge on deferred tax amount
  - Ordinary income treatment of gains

- **What is a PFIC?**
  - A foreign corporation if any taxable year:
    - 75 percent or more of gross income is passive income
    - 50 percent or more of assets are held for the production of passive income
  - Note "look through" rules for 25 percent-owned subs
  - Once a PFIC, always a PFIC
Passive Income - Is Gain From Sale of Partnership Interest Passive Income?

Does F1 Have Passive Income From Sale of Partnership Interest?

§ 954(c)(4): 25% Partner’s Gain Is Prorata from Deemed Sale of Underlying Assets For Subpart F Purposes

F LP Has Active Business

Some § 954(c) exceptions apply for PFIC purposes:

FSA 200031015

> 25% Interest
Passive Foreign Investment Companies (PFIC) - Overview (cont’d)

• Qualified Electing Fund (QEF) election
  – Election can be made by US Shareholder in first year of PFIC ownership
  – PFIC must agree to provide necessary information

• QEF Election result
  – Current inclusion of share of PFIC’s ordinary income and capital gains
    ▪ Dry income
  – Ensures capital gain treatment on exit and from PFIC’s sales of capital assets
  – Reporting requirements
A domestic partnership is treated as a United States person for purposes of the PFIC regime

- QEF elections can be made at the domestic partnership level
- QEF inclusions or PFIC excess distribution regime is also applied at the domestic partnership level, arguably increasing the partnership’s § 704(b) income and its basis in Foreign Corp.
Who Owns PFIC1 and PFIC2?

- US LP owns PFIC1 and owns PFIC2 through PFIC1
  - § 1298(a)(2)(B)
- US Considered to Own PFIC Stock Owned by US LP
  - § 1298(a)(3)
- Regs do not prevent attribution through US partnership, and generally disregard US partnership as shareholder with exceptions
Who files Form 8621 if no QEF Election and § 1291 does apply?

- Both US LP and US must file Form 8621 if no QEF Election is made by US LP
  - See Prop. Reg. § 1.1291-1(b)(7)
Who makes QEF Elections?

- Only US LP
  - See Reg. § 1.1295-1(d)(2)
Who files Form 8621 if QEF Election is made?

- Generally, only US LP may be required to file Form 8621 if US LP makes QEF Election
  - See Prop. Reg. § 1.1291-1(i), and Instructions to Form 8621.

- US includes amounts under partnership rules, not under PFIC rules
  - Reg. § 1.1295-1(d)(2)(i).
A foreign partnership is not a United States person, including for purposes of the PFIC regime

- QEF elections must be made by its US partners
- QEF inclusions and PFIC excess distribution regime is applied at the partner level
  - Do such items increase the foreign partnership’s § 704(b) income?
  - Do such items increase Foreign Partnership’s basis in foreign corporation stock under § 1293(d)?
- US Partners need to know their share of QEF inclusions
  - What is each partner’s pro rata share of the partnership’s ordinary earnings and long term capital gain?
  - If the partnership’s allocations are based on a progressive waterfall, how do you apply it?
  - What if not all partners make QEF inclusions? Does the reporting partnership even know?
International Tax Considerations for US Partners (Outbound)

- Section 987 and Partnerships
Section 987 and Partnerships

- § 987 deals with recognition of currency gains or losses from qualified business units (QBUs), including those conducted through partnerships, that have a different functional currency.

- In 2006, the IRS issued proposed regulations under § 987 that generally adopted an aggregate approach to partnerships for purposes of applying the rules of § 987.

- 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.

- What is the current view on the application of proposed § 987 regulations to partnership QBUs?