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Whether Treating a Domestic Partnership as an Aggregate Causes Small U.S. Partners to Become Subject to the PFIC Regime

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A foreign corporation can be a controlled foreign corporation (CFC) with respect to some U.S. shareholders and a passive foreign investment company (PFIC) as to other U.S. shareholders. Prior to 1997, it could be both. In 1997, §1297(d) was enacted to prevent the overlap of the two regimes. [1]

[1] All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

Section 1297(d) provides that a foreign corporation is not treated as a PFIC with respect to a shareholder in any period in which (1) the shareholder is a United States shareholder (as defined in §951(b)) (a "U.S. shareholder") of the foreign corporation and (2) the corporation is a CFC. Section 951(b) defines a U.S. shareholder as a United States person (as defined in §957(c)) who owns (within the meaning of §958(a)), or is considered as owning by applying the rules of ownership of §958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of the tested foreign corporation, or 10% or more of the total value of shares of all classes of stock of such foreign corporation. Section 957(c) defines a U.S. person by cross-reference to §7701(a)(30) to include a domestic partnership. Section 958(a)'s indirect ownership rules treat stock owned, directly or indirectly, by or for a foreign entity as being owned proportionately by its shareholders, partners, or beneficiaries. Section 958(b) provides that the constructive ownership rules of §318(a) apply to the extent that the effect is to treat any U.S. person as a U.S. shareholder within the meaning of §951(b).

The previous paragraph laid out the rules precisely for a reason. Since the June 2019 issuance of proposed regulations (the "Proposed Regulations") that would treat a domestic partnership as an aggregate for certain subpart F purposes, [2] commentators have fairly consistently taken the view that a domestic partnership no longer protects its smaller U.S. partners from being treated as owners of any PFIC owned by the partnership. [3] This article will parse the definitional rules above, the preamble to the Proposed Regulations, and the assumptions made by the aforementioned commentators, and will conclude that the better view is that a domestic partnership will continue to provide that protection from the PFIC regime even if the Proposed Regulations are finalized as written.

[2] REG-101828-19. For the preamble to these proposed regulations, see 84 Fed. Reg. 29,114 (June 21, 2019).

[3] See, e.g., NYSBA Tax Section Report No. 1423, "Report on June 2019 GILTI and Subpart F Regulations," at pp. 54, 62 et seq. (Sept. 18, 2019); "Final, temporary and proposed regulations on GILTI and ownership attribution affect domestic pass-through owners and individuals," EY Tax Alert I.D. No. 2019-1185; "Final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers," EY Tax Alert I.D. No. 2019-1132.

The IRS has for many years taken the view that because a domestic partnership is a U.S. person, a domestic partnership that owns 10% or more of the stock of a foreign corporation is a U.S. shareholder in its own right, essentially treating the partnership as an entity for this purpose. The IRS further reasons that it is only the domestic partnership, and not any of its

U.S. partners, that has subpart F inclusions, and that the income retains its character as subpart F income when it passes through to the partners under §702(b). Under this approach, which we'll call the traditional approach, all U.S. partners, even if they own less than 10% of the foreign corporation indirectly, must pick up their share of the partnership's subpart F income. [4] In contrast, if a foreign partnership owns the stock of a foreign corporation, the foreign corporation would be a CFC only as to any U.S. partner which itself owned at least 10% of the stock of such foreign corporation indirectly.

[4] SeePLR 200943004, PLR 201106003.

The partnership anti-abuse regulations contain an example confirming that the choice whether to use a domestic or foreign partnership to cause a foreign corporation to be treated as a CFC is elective. [5] In that example, X, a domestic corporation, and Y, a foreign corporation, formed a domestic partnership in which X owned a 40% interest and Y owned a 60% interest. The partnership held 100% of the voting stock of foreign corporation. The example stated as a given that by using a domestic rather than a foreign partnership, X sought to maximize its ability to claim foreign tax credits, which would be achieved only if the foreign corporation owned by the partnership were a CFC. The foreign corporation would not have been a CFC if X and Y had owned it directly, or if they had owned it through a foreign partnership.

[5] Reg. §1.701-2(f)Ex. (3).

The example stated that §957(c) and §7701(a)(30) “prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC.” Reasoning somewhat tautologically that “Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime,” the example concluded that the IRS could not treat the domestic partnership as an aggregate of its partners, at least for purposes of determining X's foreign tax credit limitation.

Based on these authorities, taxpayers also used domestic partnerships to disable the PFIC rules that would apply to smaller U.S. partners if a foreign partnership had been used instead. To illustrate, suppose two U.S. persons, X and Y, want to set up a foreign corporation that would be a PFIC if it were not a CFC in their hands. Suppose X would own 95% and Y would own 5% of such foreign corporation. Without the use of a domestic partnership, the foreign corporation would be a CFC, but not a PFIC, as to X, due to the application of §1297(d). However, because the foreign corporation would not be a CFC with respect to Y, it would be a PFIC as to Y. If X and Y formed a domestic partnership to own 100% of the foreign corporation, with X owning 95% and Y owning 5% of the partnership interests, the domestic partnership was treated as “the” sole U.S. shareholder of the foreign corporation, a CFC, and because Y did not own any stock indirectly through a foreign entity, it no longer has a PFIC problem.

The enactment of §951A, the Global Intangible Low-Taxed Income (GILTI) provision, caused the IRS to reconsider this traditional approach to domestic partnerships and their foreign corporate subsidiaries. Without going into detail, it is sufficient for present purposes to say that the mechanics of GILTI could not easily be squared with the traditional approach. To solve this problem, the final regulations under GILTI treat a domestic partnership as an “aggregate” for purposes of §951A. Specifically, the GILTI regulations provide that “a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a) … a domestic partnership is treated in the same manner as a foreign partnership under s ection 958(a)(2) for purposes of determining the persons that own stock of the foreign corporation within the meaning of sectio n 958(a).” [6] The Proposed Regulations would adopt the same rule for subpart F purposes, generally on the ground that it would be extremely complex to treat the partners of a domestic partnership differently for GILTI and subpart F purposes.

[6] Reg. §1.951A-1(e)(1).

Many commentators believe that the change proposed by the Proposed Regulations would cause less-than-10% partners of a domestic partnership that owns a foreign corporation otherwise classified as a PFIC to be subject to the PFIC rules. They reason that since those smaller partners will no longer have subpart F inclusions, §1297(d) should not apply to them.

However, this conclusion ignores specific language in the GILTI final regulations and the Proposed Regulations. Those regulations state that aggregate treatment “does not apply for purposes of determining whether any United States person is a United States shareholder (as defined in section 951(b)), … or whether any foreign corporation is a controlled foreign corporation (as defined in section 957(a)).” [7] Identical language is incorporated into proposed Reg. §1.958-1(d), which would apply equally for purposes of §951 and §951A. On its face, this language clearly means that **a domestic partnership remains a U.S. shareholder of a CFC within the meaning of §951(b)** , even if the GILTI or subpart F consequences of CFC status are determined at the partner, rather than at the partnership, level. If the domestic partnership continues to be treated as a U.S. shareholder within the meaning of §951(b), then §1297(d) would not treat a foreign corporation owned by the domestic partnership as a PFIC with respect to the domestic partnership. This is so, because the domestic partnership remains a U.S. shareholder as defined in §951(b), and the corporation remains a CFC as to it.

[7] Reg. §1.951A-1(e)(2).

One might be tempted to counter that it shouldn't matter that the domestic partnership is not subject to PFIC treatment, since under the new approach, it is not the domestic partnership that is picking up the subpart F inclusion. Most commentators appear to assume that §1297(d) turns off PFIC status only for the particular U.S. shareholder as to which the foreign corporation is a CFC. Under this reading, a less-than-10% partner would not get the benefit of §1297(d). But §1297(d) is not drafted in that way. It requires that there be a shareholder that is a U.S. shareholder and that the foreign corporation be a CFC; it does not require that the foreign corporation be a CFC as to that particular shareholder. And even under the traditional approach, the foreign corporation was not actually a CFC with respect to a less-than-10% partner.

Similarly, most commentators assume that a person cannot be a U.S. shareholder within the meaning of §951(b) unless it is what is colloquially referred to as an "inclusion shareholder." Some language in the legislative history of §1297(d) supports this view. Although the only rationale offered for the change was to simplify complex rules, the House Report stated assumptions as follows:

In the case of a PFIC that is also a CFC, the bill generally treats the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule applies if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of such corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation)…. Accordingly, **a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock**. The PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote). [8]

[8] H.R. 105-148, Pub. L. No. 105-34, p. 534 (emphasis added).

At the time the House Report was written, these assumptions were not unremarkable. Moreover, it is not clear in the context of §1297(d) that the House was aware of the IRS's traditional approach to partnerships, pursuant to which a domestic, but not a foreign, partnership could cut off PFIC attribution to its partners. That approach reflected a nuance that is not reflected in the House's language. It is certainly true that if a domestic partnership can continue to block PFIC inclusions for less-than-10% partners, that is a change from the manner in which the traditional approach applied. But viewing the issue in this way ignores the fact that a domestic partnership was **never** an inclusion shareholder, even under the traditional approach. A partnership is not a taxpayer, and cannot have inclusion; only its partners can. The traditional approach decoupled the identity of the "U.S. shareholder" from the identity of the person required to include subpart F amounts in income.

Another reason that one might think the new approach to domestic partnerships changes the §1297(d) analysis could be based on Example 3 in the partnership anti-abuse rules. That example appears premised on the notion that a domestic partnership serves to "block" PFIC status only because it is treated as an entity, rather than as an aggregate. If the theory of the new approach is that a domestic partnership is an aggregate, one might conclude that the approach no longer is valid. But this theory too does not hold up under scrutiny. For one thing, the Proposed Regulations would continue to treat a domestic partnership as an entity for every purpose other than attribution of subpart F (and GILTI) income under §958(a). More fundamentally, the traditional approach to domestic partnerships was never truly about entity theory at all. It was based on a literal reading of the term "U.S. person" in subpart F, with very little further thought given to whether a partnership should be treated as an entity or as an aggregate. The fact that the new approach recognizes that the domestic partnership might not be the **only** U.S. shareholder of a CFC reinforces the view that this is not about aggregate vs. entity at all.

It is unclear what the IRS believes concerning the application of §1297(d) under its new approach. The preamble of the Proposed Regulations requests comments in a manner that suggests the IRS assumed that §1297(d) would no longer be available to less-than-10% U.S. partners. But nothing in the preamble actually states that result. Instead, the preamble focuses almost exclusively on the fact that the change in approach relates solely to the manner in which §958(a) applies, without changing the fact that a domestic partnership is an entity for all other purposes.

There are reasons to believe that the IRS might welcome the conclusion that a domestic partnership continues to shield less-than-10% U.S. partners from the PFIC regime. If nothing in respect of the PFIC issue has changed, this would moot many difficult questions of coordination and interpretation. These questions are laid out in some detail in the NYSBA report cited at note 3 above. But if in the end the IRS objects to the notion that a less-than-10% partner can avoid PFIC inclusions and CFC/GILTI inclusions simultaneously, a better approach would be to treat domestic partnerships as aggregates across the board — something that the preamble stated the IRS was not yet willing to do.