Tax Issues Raised by the Use of Cross-Border Partnerships

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In this report, Featherman explores various tax issues related to (or affecting) the use of cross-border partnerships, including issues concerning both inbound and outbound investments by U.S. investors.

A version of this report was presented to the Tax Forum on December 6, 2021.

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I. Introduction

In recent years, the global tax system has become more complex, as reflected by the steadily mounting conflict between multinational taxpayers attempting to take advantage of systemic differences in taxing jurisdictions and lawmakers and other intergovernmental organizations attempting to remove those advantages. These efforts have included (1) the OECD's base erosion and profit-shifting project, which began in 2013, was supplemented in 2019, and included actions intended to prevent multinationals from shifting profits from higher- to lower-tax jurisdictions, and (2) the Tax Cuts and Jobs Act, which included a number of provisions intended to reduce or eliminate some benefits of cross-border tax planning. These provisions included the base erosion and antiabuse tax, which was intended to prevent U.S. multinationals from reducing U.S. tax liability by shifting profits out of the United States (typically to lower-tax jurisdictions), and the global intangible low-taxed income regime, which effectively imposed a minimum tax on U.S. multinationals with offshore operations. In October 2021 officials from 136 countries (137 countries as of November 4) endorsed several new rules intended to impose a global minimum tax of 15 percent on corporations in the countries in which they operate, among other things.[1]

One area that has faced increased scrutiny is choice of entity. Notwithstanding the enhanced focus on cross-border tax planning, in the U.S. tax system, the use of entities classified as partnerships for cross-border tax planning purposes may continue to provide several advantages. This is because of several factors, including the favorable tax treatment afforded flow-through entities, the flexibility under the

[1] "G20 Leaders Endorse Global Minimum Corporate Tax Deal for 2023 Start," Reuters, Oct. 30, 2021. Also, recently proposed tax reform legislation released by the Biden administration would impose a minimum 15 percent minimum U.S. tax on the book earnings of some large corporations. *See* Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (May 2021).

U.S. tax law in allocating economic and governance rights, and the flexibility to use a hybrid entity — an entity treated as a partnership for U.S. tax purposes but as opaque under the laws of a foreign jurisdiction — as a partnership.[2]

This report describes some issues relating to the use of entities that are classified as partnerships for U.S. tax purposes in the cross-border context and comprises three sections. The first section summarizes the entity classification rules under U.S. tax law and other choice-of-entity issues; the second section explains the taxation of entities treated as partnerships for U.S. tax purposes, including some of the U.S. tax benefits of using partnerships versus corporations; and the third section discusses other issues relating to the use of cross-border partnerships, including the application of the attribution rules in the context of cross-border partnerships and the potential application of section 894.

II. U.S. Entity Classification Rules

A. Check-the-Box Regulations

There are two general distinct classes of entities for U.S. tax purposes: The first class is entities that are treated as separate taxpayers and are subject to tax based on the entity's net income. These are referred to as opaque entities and include associations taxable as corporations. The second class is entities that are not treated as separate taxpayers but are instead treated as indistinct from their owners. These are referred to as flow-through entities and include partnerships and disregarded entities. A key distinction between the two types of entities is that opaque entities are subject to two levels of tax (at the entity and owner levels), whereas flow-through entities are only subject to tax at the owner level.

The U.S. tax rules include a set of regulations, referred to as the check-the-box regulations, that provide taxpayers with significant flexibility in determining whether a legal entity is opaque or a flow-through. These regulations were issued in 1997 and replaced a regime whereby entities were classified based on a four-factor test.[3] Under the check-the-box regulations, an eligible entity may elect its entity classification for U.S. tax purposes. An eligible entity is a business entity that is not specifically required to be treated as a corporation for U.S. tax purposes.[4] For these purposes, a business entity is any entity recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment under the IRC.[5]

Under the check-the-box regulations, an eligible entity with at least two members can elect to be classified as either an association or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.[6] A check-the-box election must be viewed in the context of the default classification rules, which provide what the entity classification of an eligible entity is in the absence of a check-the-box election. Thus, a check-the-box election typically occurs only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification, although taxpayers will typically make a protective check-the-box election (that is, one that confirms its default classification status). An eligible entity cannot change its entity classification for 60 months after making a check-

[2] *But see* "Neutralizing the Effects of Hybrids Mismatch Arrangements — Action 2: 2015 Final Report" (2015); and section 267A, which was introduced in the TCJA and sought to deny U.S. tax deductions in connection with some related-party amounts paid or accrued in hybrid transactions or with hybrid entities.

[3] Former reg. section 301.7701-2 (32 F.R. 15372 (1967)); Rev. Proc. 91-13, 1991-1 C.B. 477; Rev. Proc. 89-12, 1989-1 C.B. 798. These factors included whether (i) members had limited liability, (ii) the entity had centralized management, (iii) interests were freely transferable, and (iv) the entity had continuity of life.

[4] *See* reg. section 301.7701-2(b)(1), (3)-(8) for regulations describing when a business entity must be treated as a corporation for federal tax purposes. These types of legal entities are typically referred to as per se corporations and include reg. section 301.7701-2(b)(1) (providing that a business entity organized under a federal or state statute or under a statute of a federally recognized Indian tribe is treated as a corporation for federal tax purposes if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic); reg. section 301.7701-2(b)(1)(6) (providing that a business entity wholly owned by a state or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in reg. section 1.892-2T, is treated as a corporation for U.S. federal tax purposes); and reg. section 301.7701-2(b)(1)(8) (providing a list of foreign jurisdictions and forms of legal entities in those jurisdictions that must be treated as corporations (*e.g.*, a public limited company formed under the laws of the United Kingdom)).

[5] Reg. section 301.7701-2(a). For rules regarding the tax classification of trusts, see reg. section 301.7701-4.

[6] Reg. section 301.7701-3(a). The IRS has ruled that a nominal owner (*i.e.*, one with no economic interest, or other rights, in the entity) is generally not considered to be an owner for purposes of these rules). *See, e.g.*, LTR 20020102.

the-box election except regarding a check-the-box election that is effective as of the date of formation of the entity.[7] A domestic eligible entity has as its default classification: (i) partnership if the entity has two or more members or (ii) disregarded as separate from its owner if it has a single owner.[8]

The determination of a foreign eligible entity's default classification is more complicated. A foreign eligible entity is by default:

- a partnership if it has two or more members and at least one member does not have limited liability;
- a corporation if all members have limited liability; or
- disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.[9]

A member of a foreign eligible entity has limited liability if it has no personal liability for the debts of, or claims against, the entity by reason of being a member. This is determined based on the statute or law under which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant.[10] A member has personal liability for purposes of the default classification rules even if the member makes an agreement under which another person assumes the liability or agrees to indemnify that member for the liability.[11] In some instances, it may be unclear under local law whether a member has limited liability. In that case, a protective election may be recommended.

One exception to the entity classification rules is a rule applicable to publicly traded partnerships. Specifically, notwithstanding the application of the entity classification rules (including any default classification or check-the-box election), under section 7704, a PTP is treated as a corporation for federal tax purposes. A PTP is any partnership whose interests are traded on an established securities market or are readily tradable on a secondary market.[12]

Typically, many partnership agreements in which the partnership's classification as a flow-through entity is important will include restrictions on the ability to sell interests in a way as to cause it to be treated as a PTP. Also, notwithstanding the general rule, a partnership that meets the trading test will avoid PTP treatment in a year if 90 percent or more of the partnership's gross income for the tax year consists of qualifying income.[13] Qualifying income for these purposes generally includes some types of passive income, including interest, dividends, rents, and some types of gains.[14] Royalties are excluded from the definition of qualifying income.

One thing to reiterate regarding entity classification rules as they apply to partnerships is that just because an entity is a partnership for legal purposes does not require it to be treated as a partnership for U.S. tax purposes. Correlatively, an entity does not have to be a legal partnership to be treated as a partnership for U.S. tax purposes.

B. Domestic vs. Foreign Entity

One other item relating to the classification of an entity that may have U.S. tax significance is whether the entity is classified as a U.S. or foreign person. The IRC provides that a U.S. person includes domestic corporations and partnerships.[15] For these purposes, the term "domestic" refers to entities or arrangements created or organized in the United States or under the law of the United States or of any state unless,

[7] Reg. section 301.7701-3(c)(1)(iv).

[8] Reg. section 301.7701-3(b)(1)(i), (ii).

[9] Reg. section 301.7701-3(b)(2)(i), (A), (B), (C). For rules applicable to foreign eligible entities that were in existence before the effective date of the check-the-box regulations, see reg. section 301.7701-3(b)(3)(ii), -3(d).

[10] Reg. section 301.7701-3(b)(2)(ii).

[11] *Id.*

[12] Section 7704(b).

[13] Section 7704(c)(2). The Wyden 2021 tax proposal, *infra* note 50, would eliminate the qualifying income exception to PTP treatment.

[14] Section 7704(d).

[15] Section 7701(a)(30). For purposes of this provision, (i) the term "corporation" includes associations, joint-stock companies, and insurance companies, and (ii) the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through which or by means of which any business, financial operation, or venture is carried on, and that is not, within the meaning of this title, a trust or estate or a corporation. Section 7701(a)(2), (3).

in the case of a partnership, the secretary provides otherwise by regulations.[16] The term "foreign" when applied to a corporation or partnership means a corporation or partnership that is not domestic.[17]

The distinction between a U.S. or domestic person and foreign person can be significant for U.S. tax purposes. For example, domestic corporations must pay U.S. tax on their worldwide taxable income, but foreign corporations only have to pay U.S. tax in limited circumstances, such as: withholding tax on some types of U.S.-source income (potentially reduced or eliminated under an income tax treaty);[18] tax on income from the disposition of U.S. real property interests in some circumstances;[19] and tax on net income effectively connected with a U.S. trade or business, or, in the case of most treaties, business profits attributable to a permanent establishment.[20]

Regarding partnerships, the distinction between a domestic partnership and a foreign partnership may also have U.S. tax significance even though a partnership doesn't pay U.S. tax under either scenario. For example, ownership of stock of a foreign corporation by a U.S. partnership may cause the foreign corporation to be treated as a controlled foreign corporation if the U.S. partnership is a U.S. shareholder — that is, a U.S. person that owns 10 percent or more of the vote or value of the foreign corporation.[21] Under the CFC rules, a foreign corporation is a CFC if U.S. shareholders own 50 percent of the vote or value of the foreign corporation.[22] For purposes of the definition of U.S. shareholder, a U.S. person includes a domestic partnership, regardless of whether it has owners that are U.S. taxpayers.[23] While a foreign partnership is not a U.S. person for purposes of these definitions, its owners may be treated as U.S. shareholders (depending on whether they are U.S. persons) because of the application of attribution rules that look through foreign partnerships to their ultimate owners.[24]

The potential treatment of a domestic partnership as a U.S. shareholder, notwithstanding the tax classification of its partners, is an example of the entity, rather than aggregate, approach to partnerships, which is discussed in further detail below.

Historically, the entity approach resulted in the domestic partnership being the U.S. shareholder with an inclusion under subpart F.[25] This meant that each partner that is a U.S. taxpayer, regardless of their level of ownership or whether they would have been a U.S. shareholder had they held their shares of the foreign corporation directly, had to include in income their distributive share of the domestic partnership's subpart F inclusion.[26] By contrast, foreign partnerships were (and still are) treated as an aggregate of their partners for these purposes, with only U.S. persons that are partners of the foreign partnership that would have been U.S. shareholders if they had held their interest in the foreign corporation directly being required to have a subpart F inclusion. Thus, historically, the U.S. persons that are required to include subpart F income regarding their investment in a foreign corporation through a partnership might depend entirely on whether the partnership is domestic or foreign. The partnership antiabuse regulations in reg. section 1.701-2 (the antiabuse rule) contain an

[16] Section 7701(a)(4).

[17] Section 7701(a)(5).

[18] Section 881(a); section 1441(a).

[19] Section 897; section 1445.

[20] Section 882. One exception to this is a foreign entity treated as a domestic corporation as described in section 7874(b). A thorough analysis of the anti-inversion rules in section 7874 is outside the scope of this report.

[21] Section 951(b).

[22] Section 957(a).

[23] *See, e.g.*, reg. section 1.701-2(f), Example 3. In this example, the use of a domestic partnership to obtain CFC status for the partnership's foreign subsidiary provided a tax benefit to the partners. *See also* S. Rep. No. 1881 at 80 n.1 (1962) ("U.S. Shareholders are defined in the bill as 'U.S. persons' with 10-percent stockholding. U.S. persons, in general, are U.S. citizens and residents and domestic corporations, partnerships and trusts and estates.").

[24] Section 958(a)(2).

[25] Under the subpart F rules, U.S. shareholders must include in income (regardless of whether that income is distributed) their pro rata share of some types of the CFC's income, referred to as subpart F income. *See* section 951(a)(1)(A), (B). Subpart F income has generally included some types of passive income earned from related parties and income relating to investments by the CFC in U.S. property. Section 952; section 956.

[26] *See* section 702(b); LTR 200943004 and LTR 201106003.

example confirming that the choice of domicile for a partnership (foreign or domestic) is elective, notwithstanding that the choice may give rise to a different amount of subpart F inclusion for the partners.[27]

The TCJA introduced another class of subpart F income, referred to as GILTI, which was embodied in section 951A.[28] Section 951A did not contain rules relating to the treatment of domestic partnerships or their partners for GILTI purposes; however, proposed regulations under the GILTI rules provided that GILTI inclusion for a partner of a domestic partnership is determined under an aggregate approach, with the stock owned by the partnership being treated as owned by the partners for purposes of determining whether the partner was a U.S. shareholder solely for GILTI inclusion purposes.[29]

As part of the same proposed regulations, Treasury indicated that it would apply this same aggregate approach to determine subpart F inclusion outside the GILTI context. The preamble to the proposed regulations indicates that the aggregate approach is limited to this circumstance and is not being broadly applied to other circumstances in subpart F and the GILTI regime — for example, whether a U.S. person is a U.S. shareholder, whether a U.S. person is a controlling domestic shareholder (for purposes of reg. section 1.964-1(c)(5)), or whether a foreign corporation is a CFC.[30] The preamble makes clear that it does not apply for any other IRC purposes — for example, section 1248.

One uncertainty that has arisen, however, regarding the interaction of these regulations with other rules is how section 1297(d) applies considering these regulations. Specifically, section 1297(d)(2) provides that a foreign corporation is not treated as a passive foreign investment company[31] regarding a shareholder in any period in which (1) the shareholder is a U.S. shareholder of the foreign corporation and (2) the corporation is a CFC.

To illustrate, assume a domestic partnership (PS) with two owners — A and B — owns 100 percent of the stock of a foreign corporation (FC). A and B are both U.S. persons. A owns 95 percent of PS, and B owns 5 percent. Before the new regulations, section 1297(d) would apply to both A and B because (i) PS is a U.S. shareholder of FC from whom B is allocated its ratable share of subpart F income related to FC, and (ii) FC is a CFC. At least some commentators[32] believe that these regulations could now cause B to become subject to the PFIC rules — section 1297(d) would be inapplicable to B — because B would not be a U.S. shareholder of FC because it would be treated as owning less than 10 percent of FC.[33]

C. Other Factors Affecting Choice of Entity

Although U.S. tax considerations are often the most critical questions in terms of the selection of a legal entity in connection with an investment or operation of a business, other factors may be relevant or determinative. These include nonfederal income tax considerations (for example, state, local, non-income, and non-U.S. tax considerations), requirements of local law (for example, some types of legal entities can only own some types of assets), and liability protection of the owners of the entity.

III. Overview of Partnership Taxation

Having established what types of entities or arrangements can be treated as partnerships for

[27] Reg. section 1.701-2(f), Example 3.

[28] Broadly speaking, annual GILTI inclusion for a U.S. shareholder is the excess of its net CFC tested income over its net deemed intangible return, which, roughly speaking, is equal to 10 percent of its pro rata share of qualified business asset investment. Section 951A(b)(1), (2). U.S. shareholders that are corporations may receive a deduction equal to 50 percent of their GILTI inclusion, which will be reduced to 37.5 percent after December 31, 2025, and 80 percent of their deemed paid foreign tax credits. Section 250(a)(1)(B); section 960(d)(1).

[29] Reg. section 1.951A-1(e); prop. reg. section 1.958-1(d).

[30] *See* REG-101828-19; 84 F.R. 29, 114 (June 21, 2019).

[31] Generally, a non-U.S. corporation is a PFIC if either (i) 75 percent or more of its income for the tax year is passive income (the income test) or (ii) 50 percent or more of its assets produce passive income or are held for the production of passive income (the asset test). Section 1297(a)(1), (2). U.S. shareholders of a PFIC are subject to several detrimental tax consequences including, among others, tax and interest charges on either the disposition of appreciated PFIC stock or on the receipt of an ''excess'' distribution regarding the PFIC stock (with the tax being imposed at the highest ordinary income rate for that year).

[32] *See, e.g.*, New York State Bar Association Tax Section Report No. 1423, "Report on June 2019 GILTI and Subpart F Regulations," at 54, 62 et seq. (Sept. 18, 2019). *But see* Kimberly Blanchard, "Whether Treating a Domestic Partnership as an Aggregate Causes Small U.S. Partners to Become Subject to the PFIC Regime," *Bloomberg BNA*, Dec. 13, 2019.

[33] *See* section 958(b); section 318(a)(2)(A); prop. reg. section 1.958-1(d).

U.S. tax purposes,[34] the next step is to examine the characteristics of a partnership from a U.S. tax perspective, including how partnerships are taxed and what tax benefits might exist in using a partnership (as compared to a corporation).

A. Overview of Partnership Rules

1. Aggregate vs. entity theory.

Entities classified as partnerships for U.S. tax purposes are generally not separately subject to federal income tax. Instead, the partners are responsible for paying tax on their allocable shares of the partnership income.[35] This is the most fundamental example of what is referred to as the aggregate theory of partnerships, which provides that a partnership merely exists as a conduit for its owners who are separately subject to tax on the income of or allocated tax items regarding the partnership.

However, myriad tax rules applicable to partnership taxation are not all based on this aggregate theory of partnership taxation. Instead, the entity theory of partnership, which views some tax items at the partnership level rather than the partner level, may guide the tax treatment of items.

The determination of whether the entity or aggregate theory of partnerships applies in a particular context (which isn't necessarily delineated by statute or regulations)[36] can have material consequences. This is particularly true in the cross-border context in which, in several instances, the application of either entity or aggregate theory may be ultimately determinative of the relevant U.S. federal income tax treatment.

One such context is the characterization of some types of income. The application of entity or aggregate theory to characterize income was at the heart of *Brown Group*.[37] In that case, a partnership that was 88 percent owned by a CFC derived income from a U.S. corporation that was the CFC's sole shareholder. The question was whether the income earned by the partnership was derived from a related person that, under the law in place at the time of the facts of the case, would have caused the income to be foreign base company sales income — a category of subpart F income. Because of a quirk in the law at that time, although the partnership was not treated as related to the U.S. corporate payer, the CFC was because that relatedness for a corporation, but not a partnership, applied if the CFC was controlled by the payer. The determinative issue, therefore, was whether the aggregate theory could be applied to cause the income to be treated as related-party income earned by the CFC and therefore as subpart F income.

In this case, the Eighth Circuit determined that the characterization of the income as subpart F income (that is, whether it was related-party income) was made at the partnership rather than partner level. Thus, the income was not treated as subpart F income. By the time the court had issued its opinion but after the facts of the case had occurred and without retroactive effect to capture these facts, Congress changed section 954(d)(3), the provision defining relatedness for purposes of these rules, to result in the CFC partner having subpart F income under identical facts.[38]

The application of the aggregate-versus-entity approach was also at the heart of *Grecian Magnesite Mining*.[39] In this case, Grecian Magnesite Mining, a foreign corporation, recognized gain that may have been effectively connected with a U.S. trade or business upon the redemption of its interest in a partnership. The issue was whether the effectively connected income was U.S.-source income, which would have caused the ECI to be subject to tax in the United States.

[34] There are other types of entities, other than partnerships, that have similar attributes to partnerships, including, specifically, flow-through status. These include S corporations, real estate investment trusts, regulated investment companies, grantor trusts, and real estate mortgage investment conduits. A more fulsome discussion of these types of entities is outside the scope of this report.

[35] Section 701. Note that the determination of taxable income that flows through to the partners is determined at the partnership level. *See* section 703.

[36] For an example of when courts have made the determination of whether entity or aggregate theory applied, see *Brown Group v. Commissioner*, 77 F.3d 217 (8th Cir. 1996).

[37] *Brown Group*, 77 F.3d 217.

[38] Treasury made wholesale changes to the subpart F rules to bring them in line with the aggregate approach. *See* reg. sections 1.952-1(g), 1.954-1(g), and 1.956-2(a)(3). These are generally referred to as the *Brown Group* regulations and are discussed further below.

[39] *Grecian Magnesite Mining, Industrial and Shipping Company SA v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019).

Under the general sourcing rules of section 865, gain is typically sourced based on the residence of the party recognizing gain, which would have in this case resulted in the ECI being treated as foreign source.[40] The following exception to this general rule applies: "If a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States."[41] Grecian Magnesite Mining had an office in the United States, but it had little to do with the business of the partnership in question. However, based on the relevant assets of the partnership, the gain from the sale of the partnership would have been U.S. source if an aggregate approach had applied — that is, if the assets of the partnership were attributed to Grecian Magnesite Mining for purposes of determining whether income was U.S. source.

The D.C. Circuit, affirming the Tax Court, rejected the IRS's argument that the aggregate approach should apply and concluded that the redemption of the partnership is not attributable to a U.S. office of Grecian Magnesite Mining — and thus any gain was not U.S. source — because it was not within the office's ordinary course of the business.[42] This holding was effectively overturned legislatively in 2017 by section 864(c)(8), which now applies an aggregate approach to the disposition of partnership interests.

Similarly, in a flexible spending account from 1994,[43] the IRS considered the aggregate-versus-entity theory in the context of the application of the portfolio interest rules, which exempt some types of interest income from U.S. withholding tax, in section 871(h). Under these rules, an exception to the portfolio interest rule applies if the lender owns 10 percent or more of the vote or value of the borrower. To determine who is a 10 percent shareholder under these rules, some attribution rules apply that, among other things, attribute stock owned by an entity to the entity's owner. However, this upward attribution rule does not apply to stock treated as owned by the holder of an option.[44]

In the FSA, the IRS considered the application of this option exception to upward attribution to convertible debt held by a partnership that, upon conversion, would have caused the partnership to be a 10 percent shareholder of the borrower. The IRS pointed out that while the aggregate approach — which would result in the partners of the lending partnership being treated as holding the option — might be more appropriate (particularly considering that the partners would include their distributive share of the partnership's interest income and would ultimately be the party that would benefit from the application of the portfolio interest exception), section 318 and section 871(h)(3) were clear that the entity approach should apply and that ownership of the option should not be attributed to the partners of the lending partnership. In this instance, the IRS seemed to fall back on the policy behind the rules, which is to encourage foreign lending.

2. Allocations of partnership income.

In many instances, partners in a partnership will share proportionately in each item of partnership income in proportion to their economic interests in the partnership. The simplest example of this would be if A and B contribute property with equal value to a partnership and agree to split all the income of the partnership — whether generated by the property contributed by A or B — 50-50.

However, there is nothing requiring partnership income be allocated in this way. Section 704(a) provides that "a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." In other words, the partnership rules allow for allocations of specific partnership items, referred to as special allocations, to a partner in a manner that isn't

[40] Section 865(a).

[41] Section 865(e)(2)(A).

[42] 926 F.3d at 827. This holding also repudiates a long-standing IRS position embodied in Rev. Rul. 91-32, 1991-1 C.B. 107, which had applied the aggregate approach to a partnership sale in this context.

[43] 1994 WL 1866354.

[44] Under section 318(a)(4), the holder of an option is treated as owning the stock that would be received upon exercising the option.

necessarily pro rata to the partner's economic interest in the partnership. As described below, special allocations of partnership items can be a useful cross-border planning tool.

But partners are not granted the unlimited ability to make special allocations. There are specific rules that may cause special allocations to be disregarded or recomputed, the most prominent of which is section 704(b)(2), which provides that "a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership if . . . the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect."

The regulations that help determine whether an allocation has substantial economic effect are complex, and a fulsome discussion of these regulations is outside the scope of this report. The following is thus a summary of what is required for an allocation to have substantial economic effect. It is important to note that the broad purpose of these rules is to ensure that tax and economics match to the greatest extent possible. For a special allocation to have substantial economic effect, (i) it must have economic effect under the capital account analysis, and (ii) the economic effect must be substantial.[45]

Regarding item (i), an allocation will have economic effect if the partnership agreement provides:

- The determination and maintenance of the partners' capital accounts must be made in accordance with the section 704(b) regulations.[46]
- Liquidating distributions must be made in accordance with the positive capital account balances of the partners, as determined after considering all capital account adjustments for the partnership tax year during which the liquidation occurs.[47]
- If a partner has a deficit balance in their capital account following the liquidation of their partnership interest, as determined after considering all capital account adjustments for the partnership tax year during which the liquidation occurs, they are unconditionally obligated to restore the deficit balance amount to the partnership, which amount shall, upon liquidation of the partnership, be paid to partnership creditors or distributed to other partners in accordance with their positive capital account balances.[48]

Regarding item (ii), the allocation's economic effect is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.[49] In other words, a partner should believe there could be some ultimate economic benefit or detriment by agreeing to a special allocation.[50]

In addition to the substantial economic effect rules, there are several rules that further limit the ability to allocate items of income. For example, section 704(c) includes rules for the allocation of recognized built-in gain in property that has been

[45] Reg. section 1.704-1(b)(2)(i). Another way for a partnership allocation to be respected is if it is in accordance with the partner's interest in the partnership as described in reg. section 1.704-1(b)(3) or deemed in accordance with the partner's interest in the partnership as described in reg. section 1.704-1(b)(4). *See* reg. section 1.704-1(b)(1)(i).

[46] Reg. section 1.704-1(b)(2)(ii)(b)(1). For a discussion of the rules relating to maintenance of capital accounts, see reg. section 1.704-1(b)(2)(iv).

[47] Reg. section 1.704-1(b)(2)(ii)(b)(2).

[48] Reg. section 1.704-1(b)(2)(ii)(b)(3). There is an alternative to the capital account deficit restoration requirement if the partnership agreement contains a qualified income offset, in which case the allocation to a partner will be treated as having economic effect if it doesn't cause or increase a deficit balance in the partner's capital account.

[49] Reg. section 1.704-1(b)(2)(iii).

[50] Recently proposed legislation released by Senate Finance Committee Chair Ron Wyden, D-Ore., would enact several provisions that would eliminate the ability of taxpayers to use special allocations. Finance Committee, "Wyden Unveils Proposal to Close Loopholes Allowing Wealthy Investors, Mega-Corporations to Use Partnerships to Avoid Paying Tax" (Sept. 10, 2021). This release includes draft legislative language. This tax proposal would eliminate the substantial economic effect safe harbor, which would effectively require that all partnership allocations be made in accordance with the partner's interest in the partnership. It would also require partnerships to consistently allocate all items based on partner net contributed capital in instances in which partners and members of their controlled group together own 50 percent or more of partnership capital or profits.

contributed by a partner to a partnership.[51] Some of these limits are particularly relevant in the cross-border context and are discussed in greater detail below.

3. Contributions of property to a partnership.

Generally, the contribution of property to a partnership can occur on a tax-deferred basis.[52] When a contribution of property by a partner is preceded or followed by a distribution of money or other property to the partner, however, the contribution and distribution may be recharacterized as a sale of property rather than a separate contribution and distribution (the disguised sale rule).[53] If a contribution and distribution are recharacterized as a sale under the disguised sale rule, gain or loss must be recognized as though the partner sold a portion of the contributed property to the partnership in exchange for the money or other property received in the distribution.[54] For purposes of the disguised sale rule, a contribution and distribution are properly characterized as a sale or exchange if, based on the facts and circumstances, (i) the distribution would not have been made but for the contribution, and (ii) when the contribution and distribution do not occur simultaneously, the latter transfer (either the contribution or distribution) is not dependent on the entrepreneurial risks of partnership operations.[55]

Under the disguised sale rule, some contributions and distributions may be presumed to be a sale, and conversely, other contributions and distributions are presumed not to be sales. Specifically, a contribution and distribution occurring within a two-year period are presumed to be a sale unless the facts and circumstances clearly establish otherwise.[56] In contrast, a contribution and distribution occurring more than two years apart are presumed not to be a sale unless the facts and circumstances clearly establish otherwise.[57]

4. Tax rules specific to cross-border context.

In addition to the generally applicable partnership rules described, there are several partnership rules that apply in the cross-border context. A selection of these is discussed below.

a. Rules applicable to CFCs and other outbound investments.

i. *The* Brown Group *regulations*. Considering the holding in *Brown Group*, the IRS amended regulations under sections 952, 954, 956, and 702 to apply an aggregate theory to subpart F income. These *Brown Group* regulations generally require determining whether a CFC partner's distributive share of income is subpart F income to be made by

[51]Under section 704(c), the allocation of tax items for property contributed with a built-in gain or loss must be made using a reasonable method. The regulations identify three methods that are considered reasonable: the traditional method, the traditional method with curative allocations, and the remedial method. *See* reg. section 1.704-3(b), (c), (d). A full discussion of these allocations is outside the scope of this report. However, the remedial method is generally considered to be the most likely to prevent shifts of income from one partner to another (and is therefore considered to be the least taxpayer favorable). The Wyden proposal would force taxpayers to use the remedial method of allocations. *See also* T.D. 9891, discussed later, which includes regulations that require taxpayers to use the remedial method regarding some contributions of property to achieve tax-free treatment on the contribution.

[52]Section 721(a).

[53]Section 707(a)(2)(B); reg. section 1.707-3.

[54]Reg. section 1.707-3.

[55]Reg. section 1.707-3(b)(1). Generally, the facts and circumstances existing on the date of the earlier transfer are those used for the disguised sale rule. Reg. section 1.707-3(b)(2). The regulations provide a nonexclusive list of factors that tend to indicate a sale or exchange. *Id.* These are: (i) the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of the earlier transfer, (ii) the transferor has a legally enforceable right to the subsequent transfer, (iii) the partner's right to receive the distribution is secured, (iv) any person has made or is legally obligated to make contributions to the partnership to permit the partnership to make the distribution to the transferor, (v) any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the distribution, (vi) the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to make the distribution, (vii) the partnership holds money or other liquid assets beyond the reasonable needs of the business, (viii) the partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership, (ix) the distribution is disproportionately large in relationship to the partner's general and continuing interest in partnership profits, and (x) the partner has no obligation to return or repay the money or other consideration to the partnership. Reg. section 1.707-3(b)(2)(i)-(x).

[56]Reg. section 1.707-3(c)(1). *See also* reg. section 1.707-3(f), Example 3 (illustrating the operation of the presumption that a contribution and a distribution occurring within a two-year period are presumed to be a sale).

[57]Reg. section 1.707-3(d).

viewing the income item as if it had been received directly by the partner.[58]

The aggregate approach is applied to determine (i) when an entity is related to a specific CFC and (ii) whether activities take place outside or inside a CFC's country of incorporation, including the application of the same-country exception to subpart F income in section 954(c)(3).[59] However, in some instances, the entity approach may apply to some exceptions to subpart F income by asking whether the exception would have applied if the partnership itself was a CFC. This would include (i) the active rent and royalties; export financing; dealer, inventory, and business needs; and the activity commodity producer exception to foreign personal holding company income;[60] and (ii) the manufacturing exception to foreign base company sales income.[61]

For section 956,[62] the *Brown Group* regulations provide that determining whether a CFC has an investment in U.S. property regarding property owned by a partnership in which it is a partner, the CFC is treated as owning the property of the partnership equal to its ownership in the partnership.[63]

ii. Definition of U.S. shareholder. Recent regulations changed how stock held by a U.S. partnership is treated as held by a U.S. shareholder. Specifically, the aggregate — as opposed to entity — approach applies, which results in the determination of whether a foreign corporation owned by a U.S. partnership has U.S. shareholders being made by reference to the partners, as opposed to the partnership. This puts the determination of a U.S. shareholder regarding stock held by a U.S. or foreign partnership on similar footing.

iii. GILTI, determination of qualified business asset investment, and tested income and loss. Under the GILTI rules, a U.S. shareholder of a CFC must include in income for a tax year the excess of its net CFC tested income for the year over its net deemed tangible income return for the year.[64] The net deemed tangible income return is equal to 10 percent of the U.S. shareholder's share of the QBAI of the CFC.

Under section 951A(d)(3), if a CFC holds an interest in a partnership, the CFC's QBAI regarding partnership property is equal to the CFC's distributive share of the aggregate of the partnership's adjusted basis in tangible property held by the partnership to the extent the property (1) is used in the trade or business of the partnership, (2) is of a type with respect to which a deduction is allowable under section 167, and (3) is used in the production of tested income determined regarding the CFC's distributive share of income regarding the property. For these purposes, the CFC's distributive share of the property's adjusted basis is the CFC's distributive share of income regarding the property.

The GILTI rules lack a specific rule relating to the determination of tested income or loss regarding income earned and deductions accrued by a CFC through a partnership. Instead, the regulations cross-reference regulations in section 1.952-2, which include a general rule that a CFC's income should be determined by treating it as if it were a domestic corporation taxable under section 11 and by applying the principles of section 61 and related regulations.[65] Thus, the implication is that tested income or tested loss is any item of the CFC that would be reflected on a Schedule K-1 issued to the CFC, which represents a pure version of the aggregate approach.

iv. Foreign taxes. Under section 901, U.S. persons are entitled, subject to limitations, to credit foreign taxes paid against their U.S. taxes owed. In some circumstances, the partnership,

[58] Reg. section 1.952-1(g).

[59] Reg. section 1.954-1(g).

[60] *See* reg. section 1.954-2(a)(5)(ii).

[61] *See* reg. section 1.954-3(a)(6).

[62] A U.S. shareholder must include in income as subpart F income an amount equal to its share of the CFC's investment in U.S. property under section 956. *See* section 951(a)(1)(B); section 956(a). The investment in U.S. property is the quarterly average of the CFC's tax basis in U.S. property that includes, but is not limited to, investments in tangible property located in the United States, stock of a U.S. corporation, and debt obligations of U.S. persons, which in some circumstances may include guarantees and pledges of assets in support of debt obligations. Section 956(c), (d). The amount of income under section 956 is capped at the earnings and profits of the CFC. Section 956(a)(1)(B).

[63] Reg. section 1.956-2(a)(3).

[64] Section 951A(b)(1).

[65] Reg. section 1.951A-2(c)(2). This regulation cross-references the section 952 regulation in connection with the definition of gross income and allowable deduction, which are components of tested income and tested loss.

which may be a separate taxpayer for non-U.S. tax purposes, may pay foreign taxes. Section 702(a)(6) provides that to the extent a partnership does pay foreign taxes, its partners are entitled to a credit regarding their distributive share of the partnership's foreign taxes.[66]

As an alternate to claiming a tax credit, a taxpayer may elect to deduct the foreign taxes.[67] This may occur if, for example, they don't expect to have the capacity to use their foreign tax credits before they expire. Section 703(b)(3) provides that the decision to deduct or credit a foreign tax is made at the taxpayer level (that is, the aggregate approach applies).

Treasury regulations provide that the special allocation of foreign taxes does not have substantial economic effect and would thus not be respected.[68] Instead, foreign taxes must be allocated in accordance with the partners' interests in the partnership. It is easy to see the planning opportunities that would exist in the absence of this rule. For example, foreign taxes could be allocated away entirely from an FTC-indifferent partner — for example, a non-U.S. taxpayer (like a foreign person or tax-exempt taxpayer) or a partner with no FTC capacity — and allocated to a partner with full capacity to use the credits.

These regulations provide a safe harbor under which an allocation of a foreign tax is deemed in accordance with the partners' interests in the partnership if (1) the foreign tax is allocated to each partner and reported on the partnership return in proportion to the partners' category shares of income to which the foreign tax relates, and (2) allocations of all other partnership items that materially affect the foreign taxes allocated to a partner are valid.[69] Stated more simply, the objective of the safe harbor is to try to match allocations of foreign taxes with the income that generates the foreign taxes to the greatest extent possible.

v. Rules applicable to PFICs. The PFIC regime contains rules for looking through to the income and assets of a partnership owned by a foreign corporation for purposes of determining whether the asset test or income test has been satisfied regarding the foreign corporation.[70] The application of the partnership lookthrough rules to the asset test and income test has elements of both the aggregate and entity approaches (like the *Brown Group* regulations).

For purposes of applying the asset test, a foreign corporation is treated as if it held its proportionate share of each asset of a lookthrough partnership (discussed later), determined based on the tested foreign corporation's percentage ownership by value of the lookthrough partnership on the relevant measuring date. A foreign corporation's proportionate share of a lookthrough partnership's asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of the partnership.[71]

For income test purposes, a foreign corporation is treated as if it received directly its proportionate share of any item of gross income or loss of a lookthrough partnership regarding the foreign corporation for the corporation's tax year. For these purposes, the exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to the partnership income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the partnership, determined by taking into account only partnership activities. In other words, the entity approach applies for these exceptions.[72]

For these purposes, a lookthrough partnership is a partnership that is either (i) at least 25 percent owned (by value) by the foreign

[66] *See also* section 901(b)(5).

[67] *See* section 164(a)(3). Under section 275(a)(4), a taxpayer that decides to credit a tax under section 901 is not allowed to deduct the tax.

[68] Reg. section 1.704-1(b)(4)(viii)(a).

[69] Reg. section 1.704-1(b)(4)(viii)(a)(1) and (2). There are several fairly detailed rules for purposes of determining how this safe harbor operates. *See* reg. section 1.704-1(b)(4)(viii)(b) through (d). A detailed discussion of these rules is outside the scope of this report.

[70] *See generally* reg. section 1.1297-2.

[71] Reg. section 1.1297-2(b)(3)(i).

[72] Reg. section 1.1297-2(b)(3)(ii).

corporation over a relevant period of time or (ii) regarding which the foreign corporation satisfies the active partner test.[73] The active partner test is satisfied if the foreign corporation would not have satisfied the asset test and income test without regard to the relevant partnership interest.[74] A foreign corporation may elect to not have the active partner test apply to it.[75]

Finally, for PFIC purposes, stock owned by a partnership is treated as owned proportionately by its owners.[76] This may be relevant, for example, for determining income inclusion under these rules.

b. Rules applicable to inbound investments.

i. Sections 864(c)(8) and 1446(f). After *Grecian Magnesite Mining*, section 864(c)(8), which applies an aggregate approach to the disposition of partnership interests, was recently added to the code. This provision provides that if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership that is engaged in a trade or business in the United States, gain or loss on the sale or exchange of all the partnership interest is treated as effectively connected with the conduct of a U.S. trade or business.[77] The amount treated as effectively connected with the partner's U.S. trade or business is the portion of the partner's distributive share of the amount of gain, which would have been effectively connected with the conduct of a trade or business in the United States if the partnership had sold all its assets at their fair market value as of the date of the sale or exchange of the interest.[78] For these purposes, a partner's distributive share of gain or loss on the deemed sale is determined in the same manner as the partner's distributive share of the non-separately stated taxable income or loss of the partnership.[79]

Under section 1446(f), the mechanism for collecting this tax is a 10 percent withholding tax imposed on the proceeds from the sale of a partnership interest. This withholding tax is not imposed if the seller provides an affidavit of non-foreign status (including a U.S. taxpayer identification number) to the buyer.[80]

ii. Section 59A: The base erosion and antiabuse tax. Under section 59A, a minimum tax is imposed on some U.S. taxpayers[81] that use base erosion payments (that is, deductible payments to related foreign persons)[82] and other related deductions (collectively, base erosion tax benefits)[83] to reduce their U.S. tax bills. Under the BEAT, a taxpayer must pay a minimum tax equal to 10 percent of their taxable income, determined without regard to base erosion tax benefits.[84]

The BEAT rules generally apply an aggregate approach to partnerships. In particular, (i) for purposes of determining the partner's base erosion payments, any amount paid or accrued by the partnership is treated as paid or accrued by the partner based on the partner's distributive share of the item of deduction regarding that amount,[85] and (ii) a partner's distributive share of any deduction or reduction in gross receipts attributable to a base erosion payment is treated as the partner's base erosion tax benefit.[86]

Finally, an antiabuse rule specific to the BEAT applies to partnership allocations. If a partnership receives or accrues an amount from a person not acting in a partner capacity (including a person who is not a partner) and allocates the income or loss regarding that amount to its partners with a principal purpose of avoiding a base erosion payment or reducing the amount of a base erosion payment, the taxpayer transacting directly or indirectly with the partnership will determine its base erosion payment as if the allocations had not

[73] Reg. section 1.1297-2(g)(4)(i).

[74] Reg. section 1.1297-2(g)(4)(ii).

[75] Reg. section 1.1297-2(g)(4)(iii).

[76] Section 1298(a)(3).

[77] Section 864(c)(8)(A).

[78] Section 864(c)(8)(B).

[79] *Id.*

[80] Section 1446(f)(2).

[81] The BEAT generally applies to corporate taxpayers with average annual gross receipts for the three-year tax period ending with the tax year preceding the relevant tax year of at least $500 million (the gross receipts test). Section 59A(e). Applicable taxpayers do not include those whose base erosion tax benefits fall below a de minimis percentage of total deductions for the year (currently 3 percent).

[82] Section 59A(d).

[83] Section 59A(c)(2).

[84] Section 59A(b)(1)(A). This percentage increases to 12.5 percent for tax years beginning after December 31, 2025.

[85] Reg. section 1.59A-7(c)(1).

[86] Reg. section 1.59A-7(d)(1). The aggregate approach also applies for purposes of determining whether the gross receipts test applies. Reg. section 1.59A-7(e)(2).

been made and the items of income or loss had been allocated proportionately.[87]

iii. Section 385: Debt vs. equity. Section 385 generally relates to the characterization of investments in corporate entities as either debt or equity for income tax purposes. The characterization of an instrument as either debt or equity can have material income tax consequences. For example, (i) payments of interest on debt is deductible and payments of dividends are not, and (ii) repayments of principal occur tax free, and redemptions of stock may be characterized as a dividend or capital gain. In the cross-border context, payments of interest and principal on debt may carry different and generally more favorable withholding tax consequences than payments of dividends and redemptions of stock.[88]

Under case law, the determination of whether an instrument is debt or equity is based on weighing factors that vary between circuit courts.[89] Section 385 attempts to codify this case law by providing factors for determining whether a debtor-creditor or a corporate shareholder relationship exists.[90] Many of these factors overlap with the existing case law; practitioners typically view section 385 as supplementing rather than superseding case law.

In 2016 Treasury issued regulations under section 385 that go beyond the facts and circumstances analysis. Under these rules, debt issued in specific transactions described in these regulations is recharacterized as equity regardless of whether the instrument would have been recharacterized as equity under a facts and circumstances analysis.[91] These rules generally apply to debt issued by U.S. corporations to members of their expanded group.[92]

These regulations were issued primarily to curb the use of intercompany debt in the cross-border context. Because of the difference between the U.S. corporate tax rate and the corporate tax rate in most foreign jurisdictions at the time these regulations were issued, multinational groups could obtain a favorable tax arbitrage by having the U.S. corporate borrower issue debt to a foreign related person. The regulations thus targeted transactions in which the U.S. borrower issued debt when there was not an actual funding of the debt and therefore did not represent an outlay or investment by the lender. These types of transactions (which include, for example, distribution of a note by a U.S. borrower to its foreign parent) are referred to as general rule transactions.[93] Also, the regulations targeted transactions in which there is an actual funding of the debt, but the economic effect of the loan and some related transactions are the same as a general rule transaction. This would include a loan under which the borrower distributes the loan proceeds to a member of the expanded group.[94] These transactions are referred to as funding rule transactions, and the transactions whereby the borrowed funds leave the borrower (that is, the cash distribution to the expanded group member) are referred to as defunding transactions.

Although the regulations typically apply only to borrowers that are domestic corporations, special rules apply if the borrower is a controlled partnership, which is a partnership regarding which at least 80 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of the expanded group.[95]

[87] Reg. section 1.59A-9(b)(6).

[88] For example, (i) U.S.-source interest payments are entitled to zero withholding tax if the portfolio interest exception is satisfied and there is no analogous provision for U.S.-source dividend payments, (ii) redemptions of stock may, if they are dividend equivalent, result in withholding tax, whereas repayments or principal do not, and (iii) withholding tax rates under many treaties are lower for interest payments than they are for dividend payments.

[89] *See Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) (16-factor test); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (13-factor test); *A.R. Lantz Co. v. Commissioner*, 424 F.2d 1330 (9th Cir. 1970) (11-factor test); *J.S. Biritz Construction Co. v. Commissioner*, 387 F.2d 451 (8th Cir. 1967) (10-factor test).

[90] Section 385(b). The factors to consider include: (i) whether there is a written and unconditional promise to pay on demand or on a specific date a sum in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (ii) whether the loan has priority over any other indebtedness; (iii) the borrower's debt to equity ratio; (iv) whether there is convertibility into the corporation's stock; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[91] Reg. section 1.385-1(a).

[92] Reg. section 1.385-3.

[93] *See* reg. section 1.385-3(b)(2).

[94] *See* reg. section 1.385-3(b)(3).

[95] Reg. section 1.385-1(c)(1). A modified version of the section 318 constructive ownership rules applies to determine indirect owners of a partnership. *Id.*

The regulations generally provide that the aggregate theory applies to controlled partnerships. This means that debt issued by a controlled partnership is treated (in part) as debt issued by the partners of the controlled partnership that are members of the expanded group, and that defunding transactions and general rule transactions undertaken by a controlled partnership are treated as having been undertaken by the expanded group member that is the partner.[96]

Finally, when debt issued by a controlled partnership is recharacterized as equity, the controlled partnership is not treated as issuing debt. Instead, regulations provide that the instrument holder is treated as exchanging the debt instrument for stock of the expanded group partners.[97]

B. Advantages and Disadvantages of Using a Partnership in the Cross-Border Context

Notwithstanding the complexity of these rules, partnerships may provide many tax advantages. However, these advantages may apply to varying degrees in the cross-border context.

1. No entity-level tax.

As noted earlier, the taxation of partnership income falls within the aggregate theory of partnership under which no entity-level tax is imposed on the partnership. In general, this would provide the obvious benefit of avoiding the two levels of tax on income earned by a partnership that would have occurred if the same income had been earned by a corporation.

a. Foreign investors into the United States.

For some foreign investors making investments into the United States, the investment into a U.S. business through a partnership, as opposed to a corporation, does not necessarily avoid the two levels of tax, at least regarding some U.S.-source income. Assume two scenarios regarding the investment by FC, a foreign corporation, into a U.S. business owned by Delaware LLC. In Scenario 1, no check-the-box election is made for Delaware LLC, and it defaults to partnership status;[98] and in Scenario 2, Delaware LLC elects to be treated as a corporation.

Generally, the same amount of U.S. tax will be paid on the U.S.-source net income relating to the U.S. business owned by Delaware LLC under both scenarios. Under Scenario 1, the net income is likely to be ECI or business profits attributable to a PE under a relevant income tax treaty of FC and therefore subject to U.S. corporate tax at a rate of 21 percent in the hands of FC.[99] Also, a branch profits tax of 30 percent — which is reduced or eliminated under many income tax treaties — applies to the repatriation by Delaware LLC of these earnings to FC.[100]

Under Scenario 2, the net income is subject to tax in the hands of Delaware LLC at the same 21 percent corporate tax rate. Also, repatriation of these earnings via a dividend from Delaware LLC to FC would result in a withholding tax at a rate of 30 percent that, like the BPT, is reduced or eliminated under many income tax treaties, with the same treaty rate often applying to dividend withholding as applies to the BPT.

That said, there are several advantages and disadvantages for FC investing through a Delaware LLC treated as a partnership. The primary advantage is that FC is only subject to U.S. corporate tax on U.S.-source income that is ECI or business profits attributable to a PE. It pays no U.S. tax on any foreign-source income of Delaware LLC. By contrast, if Delaware LLC is a corporate entity, it is subject to U.S. tax on its worldwide income — whether U.S.- or foreign-source income — subject to the limited deferral available under the CFC regime.

One example of a disadvantage is that, unlike the disposition by FC of a partnership that operates a U.S. trade or business, which is now subject to tax under section 864(c)(8), FC is not subject to U.S. tax on its disposition of corporate stock (unless Delaware LLC is a corporation that holds U.S. real property). For this and many other

[96] *See* reg. section 1.385-3(f)(2), (3).

[97] *See* reg. section 1.385-3(f)(4).

[98] This assumes Delaware LLC has multiple regarded owners for U.S. tax purposes.

[99] Section 882.

[100] *See* section 884.

reasons, foreign investors will often invest in flow-through entities through a corporate entity referred to as a blocker.

b. U.S. investors investing offshore.

A U.S. investor investing into either a foreign partnership or a corporate entity that is a CFC is generally expected to be subject to no more than one level of tax regarding most of the foreign entity's earnings; however, the timing and amount of income inclusion may be different. The investment by a U.S. investor in a foreign entity treated as a corporation will result in some level of deferral of the income earned by the CFC to the extent the earnings are not subpart F income or GILTI. To the extent the CFC's earnings are neither subpart F income nor GILTI, those earnings may in fact be subject to no U.S. tax in the hands of a U.S. investor that is a corporation and 10 percent shareholder of the CFC since the distribution of those earnings would be tax free under section 245A.[101]

Under the CFC rules, double taxation of earnings that are subpart F income or GILTI can generally be avoided. This is because those earnings will either increase the tax basis in the CFC under section 961 (resulting in the mitigation of gain upon the CFC's sale regarding appreciation related to those earnings) or result in a tax-free distribution of previously taxed income under section 959 when those earnings are distributed. This may be complicated if the CFC earns U.S.-source income because CFCs are subject to the same ECI and PE rules as any other foreign corporation. In that case, CFC earnings may be subject to two levels of U.S. tax.

Finally, a U.S. investor in a foreign partnership is treated as paying its proportionate share of non-U.S. taxes of the partnership for FTC purposes.[102] By contrast, with the TCJA mostly repealing section 902 (except for limited circumstances related to GILTI and subpart F income), U.S. investors are no longer entitled to their shares of FTCs related to their investments in a CFC.

2. No tax on transfer of assets to a partnership.

The partnership rules generally allow for an easier tax-free contribution of assets to a partnership than the rules that govern tax-free contributions to a corporation. Section 721 generally allows for the tax-free contribution of assets to a partnership, regardless of the level of ownership the contributing partner has in the partnership. By contrast, under section 351, parties that contribute property to a corporation must own 80 percent of the voting stock and 80 percent of all other classes of stock of the corporation (referred to as the control requirement) to obtain tax-free treatment.[103]

In the cross-border context, section 367 adds further difficulty to the incorporation of assets by a U.S. person into a foreign corporation. Generally, section 367 effectively turns off section 351 regarding outbound property transfers and requires full gain (but not loss) recognition.[104] Also, section 367(d) requires a deemed royalty back to the transferor on the outbound transfer of intellectual property.

One structure that has been frequently used in many different contexts, including the cross-border context, that blends the attributes of a partnership and corporate structure is an umbrella partnership C corporation (Up-C) structure. Under this structure, a partner transfers assets to a partnership that also has a significant corporate owner (often a publicly traded company). In exchange for the asset transfer, the partner receives a bundle of rights that generally includes an economic interest in the partnership, a noneconomic voting right in the corporate partner, and a right to exchange interests in the partnership for stock of the corporate partner at some point in the future. In at least one example in the partnership antiabuse regulations, Treasury has indicated that an Up-C arrangement would be respected as a direct transfer of assets to the partnership rather than the corporate partner

[101] In some instances, gain from the sale of shares attributable to those earnings is not taxed by application of section 245A to that portion of the gain. *See generally* section 1248.

[102] Section 702(a)(6).

[103] Section 368(c).

[104] Section 367(a). Reg. section 1.367(a)-1(c)(3)(ii)(A) states that if a U.S. person transfers an interest in a partnership (whether foreign or domestic) in an exchange described in section 367(a)(1), then that person is treated as having transferred a proportionate share of the property of the partnership in an exchange described in section 367(a)(1).

notwithstanding the current and future rights the transferor has in the corporate partner.[105]

3. Flexible economic arrangements.

Because of the ability to specially allocate income, the use of partnerships is especially beneficial in the cross-border context when specific types of income may be subject to different tax treatment depending on whether the recipient is U.S. or foreign. A few examples of common special allocation structures used in the cross-border context are described below.

a. Mixing bowl partnership.

i. Overview of benefits. A mixing bowl partnership is a partnership under which income generated by one partner is specially allocated to a noncontributing partner. To illustrate how this can be beneficial in the cross-border context, assume FC, a foreign corporation, and USP, a U.S. corporation, form a partnership, PS, with FC contributing stock of its U.S. subsidiary, USS, to PS and USP contributing stock of a CFC. Under the partnership agreement, FC is allocated 90 percent of the income generated by the CFC stock with USP allocated the remaining 10 percent, and USP is allocated 90 percent of the income generated by USS with FC allocated the remaining 10 percent. Finally, seven years after formation, PS liquidates and distributes the CFC stock to FC and the USS stock to USP.

This structure can provide several tax benefits. First, dividend income from USS that is allocated to USP may qualify for the dividends received deduction, which would impose a tax rate of either 7.35 percent or 10.5 percent depending on the level of ownership USP is treated as having in USS.[106] This may be more beneficial than the tax rate imposed on dividends paid from USS to FC, particularly if FC does not qualify for a reduced rate of withholding.

Second, distributions from a CFC that are allocated to FC may not be subject to U.S. tax if FC is not a CFC or a PFIC. Also, many jurisdictions outside the United States have a participation exemption regime that exempts dividends received by foreign subsidiaries; thus, the dividend may also avoid non-U.S. tax.

The U.S. tax benefit of special allocations of CFC dividend income under this fact pattern may not be as strong as compared to the law pre-TCJA. Under that law, dividends received by a U.S. corporation from a CFC were subject to corporate tax at the full 35 percent U.S. corporate rate, potentially reduced by indirect FTCs under section 902. However, the TCJA added section 245A, which provides for a dividends received deduction for U.S. corporations in most instances upon the receipt of a dividend from a 10-percent-owned CFC. There are several exceptions to section 245A; thus, the special allocation of CFC dividend income could continue to provide a benefit.[107]

Another reason the mixing bowl structure may be less beneficial (especially under post-TCJA law) is that USP may still be subject to U.S. tax on the CFC stock under subpart F and the GILTI regime because it will continue to own an indirect economic interest in the CFC via its interest in PS. The subpart F and GILTI rules provide that a U.S. shareholder must include in income its pro rata share of the CFC's subpart F income or tested income or loss. For these

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[105] Reg. section 1.701-2(d), Example 4. In this example, two partnerships with substantial real estate assets, ABC and DEF, formed a partnership with X, a newly formed corporation that elected to be treated as a real estate investment trust. X contributed cash proceeds from a public offering to the partnership. ABC and DEF each contributed real estate assets that were subject to liabilities exceeding the aggregate bases of the contributed assets; following the contributions, ABC and DEF terminated. According to the example, the parties chose to form a partnership because ABC and DEF would have recognized gain under sections 351(e) and 357(c) if they contributed the encumbered assets directly to X. In addition to receiving interests in the partnership, some ABC and DEF partners received a right that permitted them to require X to redeem their partnership interest for either X stock or cash (at X's option), exercisable two years after formation of the partnership.

In concluding that the antiabuse rule does not apply, the example states that the avoidance of gain recognition under sections 351(e) and 357(c) is consistent with the intent of subchapter K. The example notes that because some ABC and DEF partners received an exchange right, it could be argued that the transaction should be recast as a contribution directly to X, thus disregarding the existence of the partnership. The example, however, explains that the exchange right is not treated as exercised before its actual exercise because the partners were not compelled, as a legal or practical matter, to exercise their exchange right at any time.

[106] U.S. corporations are generally entitled to a dividends received deduction of 50 percent regarding stock received from other U.S. corporations (resulting in a 10.5 percent corporate tax rate on the dividend, assuming a 21 percent corporate tax rate). *See* section 243(a)(1). However, if the recipient owns 20 percent or more of the stock of the corporation by vote and value, the dividends received deduction increases to 65 percent, resulting in a 7.35 percent tax rate on the dividend, assuming a corporate tax rate of 21 percent.

[107] *See, e.g.*, section 245A(e), which denies the dividend received deduction for hybrid dividends, *i.e.*, generally, dividends the payment of which are treated as a deductible payment for non-U.S. tax purposes.

purposes, the pro rata share is the amount that would have been distributed to the U.S. shareholder based on the stock it is treated as owning under section 958(a), which includes stock owned directly and stock owned through some entities, including foreign partnerships.[108] Stock owned by a foreign partnership is treated as owned proportionately by its shareholders.[109] A discussion of the potential methods for determining how this standard is applied to CFC stock owned indirectly by USP through PS for GILTI and subpart F purposes is discussed later.

Third, the eventual liquidation of PS can lock in permanent U.S. tax benefits. After the liquidation, (i) the CFC may no longer be a CFC with U.S. shareholders and thus may no longer be subject to GILTI and the subpart F regime; and (ii) USS can join the USP consolidated group (thus allowing dividends to flow from USS to USP without generating any U.S. income tax).

ii. Limits on the benefits of mixing bowl partnerships. In addition to the substantial economic effect rules described above that limit special allocations, there are several other rules that may mute the benefits of a mixing bowl partnership.

Disguised sale rules. There are several rules that could cause a mixing bowl partnership to be treated as a disposition of property. First, many practitioners believe that the maximum percentage of income that can be allocated from property contributed by one partner to another partner without treating the transaction as a transfer of the property from one partner to the other is 90 percent.[110] Also, if the value of assets contributed by the partners differs, this may affect the ability to undertake special allocations without the transaction being treated as a disposition of property, or — at a minimum — affect the likelihood that the special allocations have substantial economic effect.

In the example above, if the CFC was worth $100 and USS was worth $50, a 90 percent allocation of CFC income and a 10 percent allocation of USS income to FC would cause FC to receive $95 of value, which is greater than the $50 of value it contributed. Similarly, a 90 percent allocation of USS income to USP and 10 percent allocation of CFC income to USP would cause USP to receive $55 of value versus $100 of value contributed. This transaction may be viewed by the IRS as a disposition by USP of a fairly significant portion of CFC stock.

In this example, it could still be possible to undertake a mixing bowl. However, to ensure a value-for-value transfer, USP would need to maintain greater than a 10 percent interest in CFC income of $55 based on these values. To the extent the partners are all related, valuations may be particularly subject to IRS scrutiny as not being arm's length under the transfer pricing rules of section 482.

Finally, under section 704(c)(1)(B), if a partner contributes property to a partnership, and within seven years of the contribution, the partnership distributes the property to another partner, the contributing partner recognizes gain or loss in the same amount as if the partnership had sold the property for its FMV at the time of the distribution.[111] This effectively means that a mixing bowl partnership cannot unwind within seven years of formation, which can delay the unlocking of the benefit and lead to the administrative burdens of maintaining a partnership for that period of time.

Partnership antiabuse rule. The antiabuse rule authorizes the IRS to disregard, in whole or in part, the status of a purported partnership or purported partners in some circumstances.[112] As demonstrated below, the risk inherent in the potential application of the antiabuse rule to a mixing bowl partnership is that, to the extent the U.S. tax benefits of the partnership materially outweigh any other purpose for forming the partnership, the IRS could collapse the arrangement.

[108] *See* sections 951(a)(2), 951A(e), and 958(a)(1), (2). Even though section 958(a)(2) only references foreign partnership, recently proposed regulations would apply the same principles to domestic partnerships. *See* prop. reg. section 1.958-1(d).

[109] Section 958(a)(2).

[110] *See* reg. section 1.707-3(f), Example 8.

[111] The Wyden proposal would eliminate this seven-year window and make gain recognition potentially occur on a distribution of contributed property regardless of when the contribution and distribution occur relative to each other.

[112] Reg. section 1.701-2(b).

The antiabuse rule is generally applicable when, based on all the facts and circumstances, a partnership was formed or availed of in connection with a transaction a principal purpose of which was to substantially reduce the present value of the partners' aggregate federal income tax liability in a way inconsistent with the intent of subchapter K.[113] The determination of whether the antiabuse rule applies is generally based on all the facts and circumstances, including a comparison of the business purpose for the transaction and the claimed tax benefits resulting from the transaction.[114]

In other contexts, a transaction that reduces non-U.S. taxes has been accepted as a valid business purpose.[115] To the extent the mixing bowl partnership is a hybrid entity (that is, a separate taxpayer for foreign tax purposes), it may be easier to demonstrate a non-U.S. tax benefit.

Rules applicable to IP partnerships. In 2015 the IRS issued a notice that significantly reduced the benefit of using a mixing bowl partnership to allocate income from IP and other built-in gain property contributed by a U.S. person to a foreign, noncontributing partner.[116] This notice, and regulations that were finalized in 2020,[117] provides that section 721 does not apply to the transfer by some U.S. persons of IP with beyond a de minimis amount of built-in gain to a partnership if (i) some related foreign persons are partners in the partnership, and (ii) the U.S. transferor and related persons own more than 50 percent of the interests in the partnership capital, profits, deductions, or losses.

An exception to this rule applies if, among other requirements, (i) the partnership adopts the remedial allocation method regarding the built-in gain in the relevant IP, and (ii) to the extent there is remaining built-in gain, the partnership allocates all items of section 704(b) income, gain, loss, or deduction to the partners in the same proportion. By forcing partners to use the remedial method, which prevents shifts of income relating to contributed property from the contributing partner to the noncontributing partner, the notice effectively eliminates many of the benefits in forming an IP partnership.

b. Freeze partnerships.

In a freeze partnership, a partner contributes a high-growth asset to the partnership for a preferred interest in the partnership that generates a fixed return. The residual amount of income after the fixed return is generally allocated to the noncontributing partner. Freeze partnerships are particularly useful in the cross-border context for U.S. multinationals with high-growth offshore operations — for example, U.S. multinationals expanding into new developing markets.

The primary downside to freeze partnerships is economic rather than tax driven, although the limits on mixing bowl partnerships — particularly the antiabuse rule and valuations and transfer pricing concerns — are generally applicable here as well. Primarily, a freeze partnership is a bet that the contributed property will continue growing, and if that does not occur, the contributing partner could end up being allocated more than its share of income via the preferred return than it would have been allocated if a different type of partnership arrangement had been used.

IV. Other Selected Cross-Border Partnership Issues

A. Attribution Through Partnerships in the Cross-Border Context

In the cross-border context, there are several rules, the application of which depend on the taxpayer's ownership interest in an entity. These include: (i) the application of the CFC rules, including determining whether an entity is a CFC, who is a U.S. shareholder, the amount of a U.S. shareholder's subpart F and GILTI income, and whether some exceptions to subpart F or GILTI might apply; (ii) the application of the BEAT rules;

[113] *Id.*

[114] *Id.*

[115] *See* reg. section 1.355-2(b)(2); Rev. Rul. 89-101, 1989-2 C.B. 67.

[116] Notice 2015-54, 2015-34 IRB 210.

[117] T.D. 9891. In recent field attorney advice (FAA), the IRS advised that the section 704(c) antiabuse rule applies to contributions that a U.S. corporate taxpayer made of built-in gain assets to a partnership formed with a related foreign entity. The partnership used the traditional method, with curative allocations that were limited to gain on the disposition of the contributed property, for purposes of making allocations regarding the built-in gain under section 704(c). The IRS exercised its authority to apply a curative method to cure the distortion. FAA 20204201F (Apr. 22, 2020). The FAA states that the facts predate the effective date of the new section 721(c) regulations.

(iii) the application of some income tax treaties, including the applicability of the limitations on benefits provisions and the relevant rate of withholding; and (iv) the application of section 385.

A partner's percentage ownership in stock held by a partnership will often be relatively clear. This will be the case when, for example, a partner's interest in the profits and capital of a partnership — the two most obvious ways of determining percentage ownership of partnership assets — are the same, and the partnership does not have any special allocations.[118]

In many cases, however, the flexible economic arrangements relating to partnerships make it difficult to determine precisely at a given time what partnership assets are owned by a particular partner. Among other instances, this would occur regarding (i) the use of mixing bowl partnerships, when a partner's percentage interest in the profits or capital of a partnership could vary from its income entitlement regarding a specific asset, and (ii) the use of profits interests — that is, a specific class of equity interests that entitle the holder to a share of the profits in exchange for services but not property (referred to as a carried interest or a profits interest), which could result in a difference between partner capital and interest in profits.

As a result, there are not consistent rules across contexts that explain how stock owned by a partnership is attributed to a partner to determine how much stock is owned by that partner. The following is a summary of several rules that attribute ownership of stock held by partnerships to partners under several different methods.

1. Proportionate beneficial interest.

a. Section 318.

Section 318 provides rules that attribute ownership of corporation stock to persons when the stock is held by family members or by other entities. The rules of section 318 are used to determine constructive ownership for numerous code provisions in the cross-border context, including sections 958 and 385.[119] Section 318 applies only when a statute expressly makes it applicable.[120]

Under section 318(a)(2)(A), stock owned, directly or indirectly, by or for a partnership is considered owned proportionately by its partners. The legislative history to section 318 provides that "a person will be treated as owning his proportionate beneficial interest in stock owned directly or indirectly by or for a partnership of which such person is a partner, either active or limited."[121]

Section 318 does not explicitly state how a proportionate beneficial interest should be determined; however, the legislative history recommended that, when the partner holds differing capital or profits interest, the interest be measured by the greater of the partner's capital or profits interest.[122] Although this recommendation was not enacted by Congress, it may be consistent with the inclination in section 318 toward "widening the net" of ownership. This is evidenced by reg. section 1.318-1(b)(2), which provides that "in any case in which an amount of stock owned by any person may be included in the computation more than one time, such stock shall be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership."

Although this may address the question of capital versus profits, the regulations and legislative history are otherwise silent on the potential application of these rules to partnerships with special allocations.

b. Section 958(a).

Section 958 provides rules for determining both whether a foreign corporation is a CFC and the amount of subpart F income that must be included by an individual U.S. shareholder of a CFC. Like section 318, the general rule under section 958 is to allocate stock owned by a partnership to its partners by attributing direct

[118] *See, e.g.*, LTR 200842010; LTR 8603015; LTR 8132061.

[119] Reg. section 1.385-1(c)(4)(iii).

[120] *See* section 318(b).

[121] H.R. Rep. No. 83-1337 (1954).

[122] *See* "Revised Report on Corporate Distributions and Adjustments of the Subchapter C Advisory Group," 85th Cong., 2d Sess. (1958).

and indirect ownership of a foreign corporation's stock through foreign entities based on proportionate interests.[123] In fact, section 958(b) states that section 318(a) generally applies for purposes of applying section 958 (with modifications not relevant here).

Unlike section 318, section 958(a) clarifies what a proportionate interest may look like in the context of a partnership with special allocations. Reg. section 1.958-1(c)(2) provides that the determination of a person's proportionate interest in a foreign partnership will be made based on the facts and circumstances of each case. This regulation continues:

> In determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation.[124]

This suggests that the ownership under section 958 regarding partnerships with special allocations would be tied to the source of income rather than capital or profits. This specific intent-based guidance in section 958 would appear to provide a more taxpayer-favorable result for partnerships with special allocations than a capital or profits approach would, particularly when the CFC income is allocated away from the non-U.S. shareholder partner.

What is less clear is what it means in other contexts to apply section 318 to partnerships with special allocations when the intent is not as clear. For example, the preamble to the section 385 regulations explicitly refuses to offer any additional commentary on what proportionate interest means in this context, stating:

> The proper interpretation of "proportionately" in the context of section 318(a)(2)(A) is relevant to many provisions. See sections 304(c)(3) (providing constructive ownership rules for purposes of determining control), 355(e)(4)(C)(ii) (providing attribution rules applicable on a distribution of stock and securities of a controlled corporation), and 958(b) (regarding constructive ownership of stock for many international provisions). Thus, the Treasury Department and the IRS have determined that providing guidance on this issue is beyond the scope of these regulations because these regulations do not require a different application of section 318(a)(2)(A).[125]

2. Greater of capital or profits.

Section 1563 provides rules for controlled groups of corporations. Section 1563 tries to limit some of the arbitrage opportunities available to controlled groups of corporations, such as apportioning income between group members to take advantage of progressive tax rates. To this end, section 1563 provides ownership attribution rules that seek to include as many corporations under common control as possible.

Section 1563 is a common attribution rule used in the cross-border context. Specifically, section 267(b)(3), which determines when two corporations are related, cross-references the concept of a controlled group of corporations within the meaning of section 1563 (with some modifications).[126] As a result, relatedness for purposes of section 267(a)(3), which is a provision denying deductions on some payments made to foreign related persons, and the BEAT (among other provisions) rely on section 1563 principles.

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[123] Section 958(a). *See also* reg. section 1.958-1(d), Example 2 (C, a U.S. person, treated as owning 12 percent of foreign corporation R through 60 percent of the interests in foreign partnership X, which owns a 40 percent of the stock of foreign corporation Q, which owns 50 percent of the interests in foreign partnership Y, which owns all the stock of foreign corporation Y (60 percent of 40 percent of 50 percent of 100 percent)).

[124] Reg. section 1.958-1(c)(2). *See also* reg. section 1.1291-1(b)(8)(i)(A) (applying a facts and circumstances test to attribution (including through partnerships) under the PFIC rules).

[125] T.D. 9790.

[126] *See* section 267(f)(1). Section 267(c)(1) states that "stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries." It is unclear how this interacts with the application of section 1563 (in particular, section 1563(e)(2)). However, based on the meaning of proportionate interest, it may be possible that the result is the same whether section 267(c)(1) is considered in determining common control for section 1563 purposes.

Under section 1563(e)(2), stock owned directly or indirectly by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either capital or profits of the partnership, whichever proportion is greater. As alluded to earlier, the greater of capital or profits provides computational complexities regarding partnerships with profits interests or special allocations.

Since most holders of profits interests will have contributed little to no capital for their interests, it will be necessary to determine the value of their profits interest; however, this adds significant complexity to the analysis. Valuing a profits interest, especially at a time after receipt, is an unsettled area of the law. There are, however, techniques available to value a profits or carried interest.[127] One common method is taking the percentage of FMV of the assets the partner would be entitled to if the partnership were to distribute them in a hypothetical liquidation based on FMV and legal entitlement to assets at the time of the hypothetical liquidation (generally referred to as the liquidation method). Since the relative entitlement to assets (and therefore the value of the profits interest) may change over time under the liquidation method, the method raises the question of when the appropriate time to measure would be (for example, annually, only when it is relevant, and so forth).

Regarding special allocations, determining what is considered profits in the partnership may hinge on whether the concept is applied to the overall interest in the partnership or a specific asset. The section 958 regulations fall on the side of tracing profits to a specific asset, but it is less clear if this principle would be universally applicable.

3. Hypothetical liquidation.

Section 367 provides special rules that make otherwise tax-free transactions taxable when a party to the transaction is a foreign corporation. Section 367(e) operates to impose gain recognition on some outbound section 355 distributions (that is, distributions by a domestic corporation to foreign shareholders).[128] Generally, gain recognition is imposed when a domestic corporation makes a distribution under section 355 to a person who is not a qualified U.S. person.[129] A qualified U.S. person is a U.S. citizen or resident or a domestic corporation.[130]

Reg. section 1.367(e)-1(b)(2) provides special rules when the stock of the distributing corporation is owned by a partnership. Under this section, a partner in a partnership is deemed to own a distributing corporation's stock and securities in proportion to its partnership interest.[131] The proportionate share is equal to the partner's distributive share of the gain that would have been recognized had the partnership sold the stock or securities at a gain immediately before the distribution. The distributive share is determined under the rules and principles of sections 701 through 761 and the regulations thereunder. This would arguably allow special allocations to be considered, since section 704 states that a distributive share of income is determined by the partnership agreement.

4. Voting power and CFCs.

One other theory of attribution through partnerships is the retention of voting power over the entities owned by the partnership. Unlike other formulations of ownership tests, the CFC rules specifically call out voting power retention as a relevant determination.[132] This appears to be more flexible and less mathematical than the more common formulation of ownership of voting stock. There is uncertainty, though, as to how the concept relates to attribution through a

[127] Profits or carried interests may be valued using different methods. *See, e.g.*, Francis Mainville and Andrew Reddington, "Techniques for Valuing Carried Interests," Valuation Strategies (May/June 2016); Bruce Richman and Michael D. Whitty, "Valuing Private Equity Interests in Estate Planning," 86 *Prac. Tax Strategies* 25 (Jan. 2011); Marc J. Bloostein, "Planning for Private Equity Professionals," SP020 ALI-ABA 397 (Sept. 4-5, 2008); *see also Northern Trust v. Commissioner*, 87 T.C. 349 (1986) (examining valuation issues related to closely held stock in the estate tax context and approving of the discounted cash flow method as a valuation method).

[128] Section 367(e) covers corporations making distributions under section 332 or 355.

[129] Reg. section 1.367(e)-1(b)(1).

[130] *Id.*

[131] The residence of the partnership (*i.e.*, foreign or domestic) is not relevant for purposes of reg. section 1.367(e)-1(b)(2).

[132] *See* section 951(b) (The definition of a U.S. shareholder for CFC purposes hinges on whether the relevant U.S. person owns "10 percent or more of the total combined voting power of all classes of stock."), and section 957(a)(1) (The definition of a CFC that requires U.S. shareholders to own, among other things, "more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote.").

partnership. A particular question arises as to whether and to what extent the ability to control the partnership is relevant to the voting power of the entities owned by the partnership.

To illustrate, assume a partner owns 100 percent of the general partnership interest in a partnership (which interest has little or no economic value) that owns 45 percent of the voting stock of a foreign corporation. A possible outcome under these facts is that because the partner owns the general partnership interest (which generally allows the partner to control the partnership's activities), the partner has the effective right to control all the voting power of the foreign corporation held by the partnership (that is, 45 percent). There are two assumptions built in to accepting this outcome. The first is that voting power in the upper-tier entity (the partnership) is relevant to the determination of voting power of the lower-tier entity (the foreign corporation). Although this approach makes sense, there is not clear support in the law for this proposition. For example, the section 958 regulations, which state that "if the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person,"[133] do not offer helpful guidance on this point.

The second assumption is that a general partnership interest is akin to voting power. Voting power is generally defined to mean the power to elect the board of directors.[134] It is unclear how voting power is calculated when dealing with an entity that is treated as a partnership. Although a traditional legal partnership generally does not have a board of directors, it is the general partner that controls the partnership's activities, effectively giving them the same rights as a board of directors. Also, in the CFC context, the determination of voting power is a facts and circumstances determination,[135] which may provide additional support for treating a general partnership interest as a voting interest.

Instead of using a legal partnership in the illustration above, assume that the entity holding the foreign corporation stock is a non-U.S. eligible entity treated as a partnership for U.S. tax purposes but with an ownership structure more like a corporation in its voting rights and control than a traditional legal partnership. In this situation, there would be separate classes of voting shares — those that have voting rights that convey control rights — and nonvoting shares that do not have these rights. These types of entities are referred to as hybrid entities. This would appear to take the second issue of whether the partner holds a voting interest off the table, but the first issue would remain.

B. Section 894(c)

There may be a difference between how an entity is treated for U.S. income tax purposes and how it is treated for legal and non-U.S. tax purposes. A hybrid entity is one that is a flow-through (that is, a partnership or disregarded entity) for U.S. tax purposes but is treated as a separate taxpayer for non-U.S. tax purposes. Conversely, a reverse hybrid is one that is a corporation for U.S. tax purposes but is a flow-through for non-U.S. tax purposes.[136]

In the absence of special U.S. tax rules, the use of hybrid entities could provide a tax benefit. To illustrate, assume that A and B, residents of Country X, own LLC, a Delaware LLC treated as a partnership for U.S. tax purposes but treated as

[133] Reg. section 1.958-1(c)(2).

[134] *See, e.g.*, reg. section 1.957-1(b)(1); *Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999); and *Erie Lighting Co. v. Commissioner*, 93 F.2d 883 (1st Cir. 1937).

[135] Reg. section 1.957-1(b)(1). *See also CCA Inc. v. Commissioner*, 64 T.C. 137 (1975) (no CFC when preferred shareholders who were foreign persons or U.S. persons holding less than 10 percent of the foreign corporation's stock had the right to elect half of the board of directors, received preferred dividends at a market rate, and the corporation could not redeem the preferred shares at will).

[136] Hybridity can also refer to the differing treatment of an item for tax purposes depending on the jurisdiction, *e.g.*, treatment of an instrument as debt in one jurisdiction and equity in another. There are several code provisions, including sections 245A(e), 267A, and 909, that address the U.S. tax treatment of hybrid instruments. This treatment is outside the scope of this report.

opaque for Country X purposes. If LLC were to earn U.S.-source dividend income,[137] the U.S. withholding tax consequences would generally be determined on a partner-by-partner basis (that is, by looking at the U.S. income tax treaty with Country X).[138]

If we were to assume further that (1) A and B are not subject to Country X tax on U.S.-source dividend income earned through LLC but would be subject to Country X tax on U.S.-source dividend income if earned directly; and (2) A and B would be subject to a 0 percent U.S. withholding tax rate under the income tax treaty between the United States and Country X on U.S.-source dividend income (in the absence of the rules discussed below), the result is that the U.S.-source dividend income would not appear to be subject to tax anywhere — it is not subject to tax in the United States because LLC is not a separate taxpayer and there is no U.S. withholding tax, and it is not subject to tax in Country X because it was treated as received through LLC. The same beneficial treatment would occur if instead of being formed in Delaware, LLC was formed as a hybrid entity under the laws of a country that imposed no income tax and that the United States had no income tax treaty with, like the Cayman Islands.

This result is antithetical to the policy behind reduced withholding tax rates under income tax treaties, which is that the U.S. government has deferred to the taxing jurisdiction of its treaty partner in terms of the taxation of specific items of income.[139] In this case, even though Country X is the treaty partner for purposes of the withholding tax rates, Country X does not impose any taxing authority over the U.S.-source income.

In response, Congress enacted section 894(c), which generally denies the benefits of an income tax treaty with the United States regarding an item of income derived through a hybrid entity in situations in which (1) the item is not treated for purposes of the tax laws of such foreign country as an item of income of such person (that is, in our example, the item is not treated as an item of income of A and B under Country X laws); (2) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership; and (3) the foreign country does not impose tax on a distribution of the item of income from the entity to the person (that is, Country X does not impose a tax on A and B when LLC distributes the income to them).[140]

The ability to claim treaty benefits is not limited by section 894(c) if the income is treated as derived by a resident of the relevant country. Reg. section 1.894-1(d) states that an "item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction . . . with respect to the item of income."[141] Many income tax treaties have rules addressing whether items earned through hybrid entities or reverse hybrid entities are treated as derived by a resident for purposes of the treaty.[142]

To that end, many income tax treaties treat hybrid entities as residents for purposes of the treaty if they are taxpayers in the jurisdiction of incorporation.[143] This can be beneficial to taxpayers if, for example, the hybrid entity is entitled to treaty benefits under the U.S. treaty with its country of formation, but the owners of the hybrid entities are not so entitled. ■

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[137] The same analysis would apply to any U.S.-source income that is fixed, determinable, annual, or periodical as described in sections 871 and 881.

[138] Reg. section 1.1441-6T(b)(2)(i).

[139] *See* T.D. 8889, 65 F.R. 40993 (July 3, 2000); H.R. Rep. No. 105-148, 105th Cong., 1st Sess., at 550 (1997).

[140] Section 894(c)(1)(A)-(C). Section 894(c)(2) granted regulatory authority to Treasury, which adopted the regulations in section 1.894-1(d). *See* T.D. 8889, 65 F.R. 40993 (July 3, 2000).

[141] For purposes of this regulation, "an entity is fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity." Reg. section 1.894-1(d)(3).

[142] *See, e.g.*, Article IV, paras. 6 and 7 of the Convention With Respect to Taxes on Income and on Capital, U.S.-Canada., Sept. 26, 1980, as amended by the protocols of June 14, 1983, Mar. 28, 1984, Mar. 17, 1995, and July 29, 2007.

[143] This is the position in article 1, para. 6 of the U.S. Model Income Tax Convention (2016).