

# I'm Looking Through You, You're Not The Same: Partnership-Held CFCs

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In this report, Brenner and Child examine the complexity, uncertainty, and compliance burdens created by the treatment of domestic partnerships as aggregates in determining U.S. partners' inclusions from controlled foreign corporations under the proposed subpart F regulations and the final regulations on global intangible low-taxed income.

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## I. Introduction

Since Congress first decided to impose tax on U.S. shareholders that earned specified, largely passive, income indirectly through controlled foreign corporations, domestic partnerships have been analyzed as entities rather than as aggregates in computing U.S. shareholders' subpart F income. Although this approach can result in subpart F inclusions for small partners that would not have been required if they had owned their share of the partnership's CFC stock directly, it is based on a straightforward accounting model in which gross income and tax attributes flow up uniformly from the CFC, through the domestic partnership's income tax return, to all its partners. Domestic partnerships apply the accounting rules for U.S. shareholders by including the CFC's subpart F income and section 956 amount in their taxable income under section 951, maintaining previously taxed earnings and profits (PTEP) accounts,<sup>1</sup> making basis adjustments in their CFC stock to reflect the section 951 inclusions,<sup>2</sup> and benefiting from an overlap rule when CFCs are also passive foreign investment companies.<sup>3</sup> Partners determine the tax consequences of indirect CFC ownership through the partnership under the rules of subchapter K.

The enactment of the global intangible low-taxed income regime in the Tax Cuts and Jobs Act created a parallel system that operates independently of subpart F. Under these rules, U.S. shareholders make current inclusions based on various types of active "tested" income from CFCs. This regime is premised on a

<sup>1</sup>Section 959.

<sup>2</sup>Section 961.

<sup>3</sup>Section 1297(d).

fundamentally different accounting model in which a U.S. shareholder uses tested income and loss, qualified business asset investment, and other tax attributes of all its CFCs to compute a net inclusion of gross income. Although domestic partnerships conceivably could be analyzed as entities under this regime as well, an approach that requires taxable income to be calculated at the partnership level would prevent U.S. shareholder partners from netting tested income and loss from CFCs that they held through different chains of ownership. The inability to net results across CFCs would exacerbate the netting problem that already arises from a U.S. taxpayer's inability to carry forward tested losses for use against future tested income. Together, these rules would make tax outcomes highly sensitive to the legal form in which CFCs are held. Treasury therefore swiftly eliminated an entity approach from consideration, even though the GILTI inclusion rules of section 951A rely on the same section 958 rules that require an entity approach to subpart F inclusions by domestic partnerships.<sup>4</sup>

On June 21 Treasury promulgated final regulations under the GILTI regime (T.D. 9866) and proposed regulations under the subpart F rules (REG-101828-19) (collectively, the partnership-held CFC regulations) that try to construct a unified accounting model for cases in which U.S. shareholders own CFCs through partnerships. Under this model, a domestic partnership would continue to be analyzed as an entity when identifying U.S. shareholders of CFCs (under section 951(b)), but would be analyzed as an aggregate when identifying U.S. shareholders required to make subpart F and GILTI inclusions from a CFC (under sections 951(a) and 951A(a) and their cross-reference to section 958(a)). Foreign partnerships always have been explicitly treated as aggregates under subpart F, and Treasury reasoned that the new regime could tie into their historical treatment

because it was “relatively well-developed and understood.”<sup>5</sup> The new regime would apply the same inclusion rules to partnerships whether they are domestic or foreign, and would apply the same inclusion thresholds to U.S. partners under the subpart F and GILTI rules.

The simplicity of this change conceals the complexity of its effects. We agree with Treasury's objective in proposing a single regime that would allow consolidation at the U.S. shareholder level, but we are concerned that it will be difficult to implement in practice. An aggregate approach to inclusions under the CFC rules of subchapter N is fundamentally opposed to the entity approach to partnership income calculations under subchapter K. The interaction between these rules is poorly understood, despite their long-standing applicability to U.S. shareholders that own CFCs through foreign partnerships. One recent commentator discussing the rules applicable to a foreign partnership's PTEP accounts and CFC stock basis adjustments described the state of the law as “indecipherable.”<sup>6</sup> These issues may have had low visibility in the past, in part because foreign partnerships formed to invest in CFCs often are not obligated to file U.S. tax returns or comply with U.S. tax reporting rules, but they will come to the forefront when extended to domestic partnerships. Suggestions that the partnership-held CFC regulations merely extend the rules for foreign partnerships to domestic partnerships start from the wrong premise, because there are no such rules to extend, and thereby minimize the magnitude of the issues created by the regulations.

In this report, we review the U.S. tax rules for CFCs and PFICs held by partnerships and discuss practical conundrums created by the partnership-

<sup>5</sup> Preamble to T.D. 9866, 84 F.R. 29288, at 29316 (June 21, 2019).

<sup>6</sup> Monte A. Jackel, “Tax Rules for U.S. Partners of Foreign Partnerships That Hold CFC Stock Need Clarity,” *Multinational Tax & Transfer Pricing News* (Mar. 22, 2017). The commentary in this area generally addresses the complexity of accounting for U.S. shareholders' ownership of CFCs through foreign partnerships by calling for clarifying guidance or characterizing significant topics as beyond the scope of the discussion. See, e.g., Jackel and Robert J. Crnkovich, “CFC Stock Held by Foreign Partnerships: Confusion Galore,” *Tax Notes Int'l*, Aug. 24, 2009, p. 627 at 629; Chris Bowers and Natán J. Leyva, “The Application of Sections 959 and 961 to Indirectly Owned CFCs,” *34 Tax Mgmt. Int'l J.* 307 (June 2005); and New York State Bar Association Tax Section, “Report on 2006 Proposed Regulations Regarding the Exclusion From Income of Previously Taxed Earnings Under Section 959 and Related Basis Adjustments Under Section 961,” at 54 (Mar. 30, 2015).

<sup>4</sup> In rejecting this approach, Treasury stated: “An approach that dramatically alters a U.S. shareholder's inclusion under section 951A for a taxable year depending on the legal structure by which the shareholder owns each CFC presents both an inappropriate planning opportunity as well as a trap for the unwary. Such an approach is also inconsistent with the structure of section 951A, which requires an aggregation of all relevant items of a shareholder's CFCs in order to compute a single GILTI inclusion amount for a U.S. shareholder.” Preamble to REG-104390-18, 83 F.R. 51072, at 51079 (Oct. 10, 2018).

held CFC regulations. We then consider the consequences of the new rules for partners and partnerships that own CFCs, including information flows that may become necessary between partners and partnerships, the ability to identify U.S. shareholders from year to year, accounting complexity arising from subpart F and GILTI inclusions that leapfrog the partnership's taxable income, and the consequence of CFC-PFIC overlaps. We also examine Treasury's authority to issue the partnership-held CFC regulations. And while we explore a possible approach to these issues, we discuss reasons for skepticism about whether any approach to implementing the regulations will be administrable.

Although we do not discuss S corporations, we note that S corporations are generally treated as partnerships for purposes of the subpart F and GILTI rules and will also confront many of the issues addressed in this report.<sup>7</sup>

## II. Basic Definition and Inclusion Rules

Understanding the partnership-held CFC rules requires an appreciation of the distinction between the definitional provisions for CFCs and PFICs, as well as the triggers under which a direct or indirect U.S. owner must include income as a result of holding an interest in the CFC or PFIC.

### A. CFC Rules

#### 1. Definitional rules.

A foreign corporation is a CFC if it is more than 50 percent owned by U.S. shareholders, as defined in section 951(b). A U.S. shareholder is any U.S. person, as defined in section 957(c), that owns 10 percent or more of the stock of the foreign corporation by vote or value, applying the attribution rules under section 958. For this purpose, a U.S. person includes any U.S. person as defined in section 7701(a)(30), which generally includes a partnership created or organized in the United States.

<sup>7</sup>Section 1373(a). Although this rule does not apply for purposes of the PFIC rules, the PFIC regulations generally treat S corporations in a manner similar to domestic partnerships. *See, e.g.*, reg. sections 1.1291-1(b)(7) (S corporation not a PFIC shareholder, except for information reporting requirements), 1.1295-1(d)(2) (S corporations make qualified electing fund (QEF) elections), and 1.1296-1(h)(1) (S corporation makes mark-to-market election as a U.S. person).

Section 958(a) identifies the direct and indirect U.S. owners of a CFC and contains a proportionate look-through rule for foreign corporations, partnerships, trusts, and estates (direct or indirect CFC ownership). Section 958(b) identifies constructive owners of stock of the foreign corporation for various purposes, including status as a U.S. shareholder, by reference to a modified version of the ownership attribution rules under section 318 (constructive CFC ownership).

#### 2. Inclusion rules.

A U.S. person generally must take into account its pro rata share of the subpart F income and GILTI tested income or loss of a foreign corporation if (1) the foreign corporation was a CFC at any time during the year; (2) the U.S. person was a U.S. shareholder within the meaning of section 951(b) at any time during the year; and (3) the U.S. person has direct or indirect ownership of the CFC within the meaning of section 958(a) on the last day in the year on which the foreign corporation was a CFC, even if the U.S. taxpayer is no longer a U.S. shareholder at that time (an inclusion-required U.S. shareholder).<sup>8</sup>

Although they have similar triggers for inclusion, the subpart F and GILTI regimes have significant differences. Subpart F requires taxpayers to include gross income determined based on the results of a particular CFC, limited by its E&P. By contrast, the GILTI regime requires taxpayers to determine their inclusion after combining tested income and loss from all of their CFCs and excluding a deemed return on the QBAI of all of their tested income CFCs. Once the taxpayer determines its net GILTI inclusion, it must prorate the inclusion among its tested income CFCs, and treat the prorated amount as if it had flowed up from the CFC as an item of gross income, when determining the ancillary consequences of the inclusion (such as the adjustment to the shareholder's PTEP account, basis, and deemed-paid credits).<sup>9</sup>

<sup>8</sup>Sections 951(a) and 951A(a) and (e).

<sup>9</sup>Section 951A(f) and reg. section 1.951A-5(b).

## B. PFIC Rules

Whereas the definition of a CFC looks to a foreign corporation's U.S. owners, the definition of a PFIC looks to its gross assets and income. A foreign corporation is a PFIC for a tax year if 75 percent or more of its gross income is passive income, or if 50 percent or more of its average gross assets are held for the production of passive income, applying various look-through rules and other presumptions. By default, the PFIC rules tax U.S. owners on a retroactive basis that applies an interest charge to approximate the result that would have arisen if the owners had been taxed currently (the excess distribution regime). These rules can have harsh consequences, however, and U.S. taxpayers that are eligible to do so generally elect to be taxed on a current basis under the more favorable qualified electing fund (QEF) or mark-to-market rules.<sup>10</sup>

The obligations arising under these regimes are imposed on the PFIC's direct and indirect U.S. owners under a separate set of attribution rules that apply proportionate upward attribution from domestic and foreign partnerships.<sup>11</sup> If a foreign corporation is a PFIC in the hands of a domestic partnership, then the domestic partnership is a direct shareholder of the PFIC, and its U.S. partners are indirect shareholders of the PFIC, but both are shareholders of a PFIC. Leapfrogging inclusions can occur, and the risk of duplication is coordinated through special rules, if at all. Special rules of this kind, discussed in more detail later, coordinate the overlap case in which a foreign corporation is both a CFC and a PFIC in the hands of a particular U.S. shareholder.

### III. Partnership-Held CFC Regulations

#### A. Final and Proposed Regulations

The partnership-held CFC regulations would look through domestic partnerships when determining CFC stock ownership under section 958(a), solely for purposes of applying the inclusion rules of sections 951(a) and 951A and for purposes of any other provision that applies by

reference to those rules. Domestic partnerships would continue to be treated as entities when identifying U.S. shareholders under section 951(b) and classifying foreign corporations as CFCs under section 957(c).

In particular, the regulations would align the inclusion rules applicable to domestic partnerships with the inclusion rules for foreign partnerships, which, as noted, are explicitly looked through as foreign entities when determining the direct and indirect owners of a CFC under section 958(a)(2). The regulations are meant to lay the groundwork for a uniform set of principles to govern inclusions through partnerships under the subpart F and GILTI regimes.

The partnership-held CFC regulations have been finalized for GILTI inclusions but remain proposed for subpart F inclusions.<sup>12</sup> The proposed regulations would supersede the GILTI regulations effective for tax years of foreign corporations beginning on or after the date the regulations are published as final in the *Federal Register*, and for tax years of U.S. shareholders in or with which those years end.

For simplicity, when describing the partnership-held CFC regulations, this report addresses the effect of the proposed unified regime with the understanding that it has already been finalized for GILTI inclusions.

#### B. Effect on Partner Inclusions From CFCs

Because a domestic partnership would cease to be an inclusion-required U.S. shareholder, it would have no income inclusions at the partnership level and would not itself have any subpart F or GILTI tested income to allocate to its partners. A partnership would have gross income only when it receives a distribution from or disposes of the CFC. A partner that is not itself a section 951(b) U.S. shareholder (a deferral-eligible partner) generally would be taxable only when it is allocated a distributive share of this income from the partnership.

<sup>10</sup> Sections 1293 and 1295 (QEF rules) and 1296 (mark-to-market rules).

<sup>11</sup> Reg. section 1.1291-1(b)(8).

<sup>12</sup> Prop. reg. section 1.958-1(d)(4). The final rule for GILTI inclusions is applicable for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in or with which those years end. Reg. section 1.951A-7.

If a partner is itself a U.S. shareholder of the CFC, the partner will have direct subpart F and GILTI inclusions from the CFC. If the CFC is also a PFIC, a U.S. partner that is not a U.S. shareholder should expect to have direct inclusions under the PFIC rules even if the partner qualifies for deferral under the CFC rules. As discussed later, inclusions that leapfrog the partnership's taxable income raise several questions about how to implement related provisions, such as tracking PTEP and stock basis under sections 959 and 961, recasting gain on a sale of the CFC stock as a dividend under section 1248, and making elections in cases of CFC/PFIC overlap.

Individuals who hold indirect portfolio interests in CFCs through domestic partnerships generally will benefit from the deferral provided by the new rules, assuming the CFC is not a PFIC. Corporate U.S. partners with insufficient ownership to qualify as U.S. shareholders of the CFC in their own right will not qualify for the 100 percent dividends received deduction under section 245A and will be disadvantaged relative to the treatment they would have received had section 958(a) continued to be applied as it has in the past.

### C. Effect on Partnership Elections for CFCs

Domestic partnerships, rather than their partners, would continue to be the controlling domestic shareholders responsible for making various elections regarding a CFC that are binding on all of its U.S. shareholders, such as the computation of E&P, the allocation of interest expense, or the election of subpart F or GILTI high-tax exceptions.<sup>13</sup>

## IV. Administrative Complexity

The partnership-held CFC regulations raise several questions about how partners' inclusions will be coordinated with other provisions of the code. We first discuss the partnership-held CFC regulations' interactions with subchapter K, which raise significant administrative concerns about the information flows required between

partners and the partnerships and the risk of double taxation of income generated by the CFC. We then turn to the regulations' interaction with the PFIC rules.

### A. Reporting Requirements

Understanding how information will be reported by partnerships and their U.S. partners will be a matter of first importance under the partnership-held CFC regulations because the practical compliance burdens on partnerships and their partners are likely to inform the approach taken to the substantive rules. For example, compliance considerations will influence whether and how the partnership maintains its own set of tax attributes concerning a CFC under sections 959, 961, and 1248, and at what level elections should be made (for example, as discussed later, QEF elections under the PFIC rules).

#### 1. Information flows.

Inclusions that leapfrog the partnership's taxable income will be difficult to coordinate with subchapter K as an administrative matter. Subchapter K generally assumes that a partner's distributive share of partnership income is the only amount that the partner will be required to include because of owning its partnership interest.

By contrast, the partnership-held CFC regulations require partners to include items as if they were the direct owners of the CFC, rather than as a share of partnership income. The partners' tax consequences under these rules generally would depend on their own facts and circumstances and would not be determinable by the partnership itself:

- Partnerships might not know whether their partners are U.S. shareholders of underlying CFCs, because a U.S. partner's status could depend on holdings in the CFC directly or by attribution through other ownership chains. Partnerships may be unable to determine the status of their U.S. partners even in cases in which the partnership owns 100 percent of the CFC, because section 958(b) could result in attribution between partners depending on their relationships at upper tiers.

<sup>13</sup> Prop. reg. section 1.958-1(d)(2), cross-referencing reg. section 1.964-1(c)(5).

- Partnerships would be unable to determine the extent of their partners' GILTI inclusions from a CFC. Even if a partnership can identify its U.S. shareholder partners, it will not necessarily know whether a partner had tested losses from other CFCs that offset the tested income from the partnership-owned CFC and, if so, what portion of the GILTI inclusion is attributable to the partnership-owned CFC. Under section 951A(f), the ancillary consequences of a GILTI inclusion can be determined only by prorating the partner's net GILTI inclusion from all its CFCs among its tested income CFCs and then attributing the appropriate fraction back to the CFC as if it were a gross item of subpart F income.

**a. Partnership reporting to partners.**

Clearly, partnerships will need to report separately stated tax results on a CFC-by-CFC basis when reporting tax information to their partners to enable U.S. shareholder partners to determine their own tax consequences under the subpart F and GILTI regimes. If applicable, partnerships will also be required to report information for individual CFCs so that PFIC shareholder partners can determine their consequences under the excess distribution, QEF, or mark-to-market rules.

**b. 'Reverse' reporting from partners.**

The question these information dynamics raise, however, is whether partners will then be required to report information back to the partnership (that is, after they have determined their U.S. shareholder status and the portion of their GILTI inclusion allocable to the underlying CFCs) to enable the partnership to take that into account when reporting its results to the partner or a successor in the future.

A "reverse reporting" rule of this kind would invert the traditional reporting model. We are skeptical that such a system is even feasible in practice (for example, through tiered partnerships). Moreover, we do not believe that it is appropriate for the government to require partners to disclose this information to a partnership, given taxpayers' interests in maintaining confidentiality about their investments, their relationships with affiliates,

and their U.S. tax reporting information. If these disclosures were required, we would anticipate widespread noncompliance.

**c. Partner-level reconciliation approach.**

If reverse reporting is not required, however, the partnership reporting rules generally would need to assume that a partnership has no information about the subpart F and GILTI consequences to its partners, and partners would be required to reconcile inside partnership items with outside tax attributes. Partnership reporting of partners' pro rata shares of subpart F and GILTI tested income would be made purely for informational purposes, analogous to the rules under which an indirect shareholder of a PFIC can obtain an annual intermediary statement from a foreign intermediary reporting the owner's pro rata share of QEF inclusions.<sup>14</sup>

Partnerships presumably would be required to report each partner's share of dividend income and gain, and (as an informational matter) each partner's pro rata share of subpart F and GILTI tested income. Partnerships would not be responsible for tracking partner-by-partner inside attributes in a manner analogous to adjustments under sections 734(b) or 743(b). Rather, each U.S. partner would be required to reconcile its share of the partnership's items for each CFC with its own partner-level attributes for that CFC under the subpart F and GILTI regimes. For example, the reconciliation may require a U.S. partner to reclassify a distribution that was a dividend in the hands of the partnership as a PTEP distribution in its hands.

We are hesitant to present this approach as a recommendation, even though it appears to be the most administrable alternative, because it would present a compliance burden for U.S. shareholder partners and PFIC shareholder partners. As discussed later, it would create new challenges when a partnership must determine the tax consequences to its partners of transactions involving a foreign corporation, or when it must determine its partners' expected U.S. tax liabilities for purposes of making tax distributions from year to year. The partner-level reconciliation approach, however, would provide a method

<sup>14</sup> See reg. section 1.1295-1(g)(3).

under which a partnership generally can compute its own tax results as an entity using only information that is readily available to it. Thus, the remainder of this report generally assumes that a reconciliation-based approach would be used to implement the partnership-held CFC regulations.<sup>15</sup>

## 2. Partnership audits.

As these considerations suggest, the partnership-held CFC regulations would undermine the trend toward centralizing compliance and reporting obligations in the partnership reflected in the centralized audit regime of the Bipartisan Budget Act of 2015. These rules apply to partnerships that are required to file U.S. tax returns, and generally provide — unless specific elections are available and are made — that for any partnership-related item, audits will be conducted, adjustments will be taken into account, and liabilities will be paid, at the partnership level.<sup>16</sup> Partnership-related items generally include items that are reflected, or required to be reflected, on a partnership tax return or related filings, or that are required to be maintained in the partnership's books and records, but they exclude items that are based on the facts and circumstances of a particular partner (such as outside basis).<sup>17</sup>

If a partnership is analyzed as an aggregate under the CFC rules, subpart F and GILTI inclusions generally would be determined based on particular partners' facts and circumstances, and so should not be subject to audit under the centralized regime. We have assumed, however,

that the partnership would continue to account for the tax consequences to it of owning a CFC under the rules applicable to U.S. persons that are not U.S. shareholders of a CFC or shareholders of a PFIC (for example, in determining dividends and gain). If the partnership-level amounts remain partnership-related items and can give rise to imputed underpayments on audit, a partnership typically would need to obtain information from its U.S. shareholder partners and PFIC shareholder partners to confirm the partners' PTEP accounts and stock basis adjustments to obtain appropriate reductions in the partnership-level tax liability under the procedures for rate modifications.<sup>18</sup> This would be administratively burdensome. For clarity and consistency, therefore, we recommend that Treasury consider providing that no CFC-related amounts would be viewed as partnership-related items.

## B. Identifying U.S. Shareholders

Because partnerships are vehicles that allow flexible divisions of economic and management rights, identifying partners that are U.S. shareholders under section 951(b) may be a nontrivial exercise in many cases. Although the identification process will require information from partners, as discussed earlier, it is also likely to require centralized reporting by the partnership to ensure a consistent allocation of voting power and value to its partners.

When an entity is looked through under the section 958(a) regulations, a U.S. taxpayer's percentage ownership of the underlying CFC is based on all the facts and circumstances, taking into account the purpose for which the rule is being applied. The amount of CFC stock attributed to a person under these rules is generally determined by reference to the person's interest in the income of the CFC, while the voting power attributed to a person is generally determined by reference to the person's indirect voting power in the CFC.<sup>19</sup>

<sup>15</sup> In this regard, our approach differs from those taken in comments by major bar associations, which assume that partnerships will be able to obtain partner-level U.S. tax information. See, e.g., New York State Bar Association Tax Section, "Report on June 2019 GILTI and Subpart F Regulations," Report No. 1423, at 45 n.85 (Sept. 18, 2019); American Bar Association Section of Taxation, "Comments on Temporary Regulations Addressing Section 245A, Proposed Regulations Addressing Sections 951A and 958, and Final Regulations Addressing Section 951A," at 54 (Sept. 11, 2019) (the "ABA report"). Despite taking this approach, the bar associations have noted that there is currently no mechanism to ensure that partners will provide the necessary information to the partnership on an accurate and timely basis, and have previously questioned whether it would be appropriate to require reverse reporting. See ABA report at 67; NYSBA Tax Section, "Report on Proposed GILTI Regulations," Report No. 1406, at 49 (Nov. 26, 2018) ("Many partners will not be willing to give this information to their partnerships and should not be required to do so.").

<sup>16</sup> Section 6221(a).

<sup>17</sup> Section 6241 and reg. section 301.6241-1(a)(6)(ii).

<sup>18</sup> Reg. section 301.6225-2(d).

<sup>19</sup> Reg. section 1.958-1(c)(2).

## 1. Value.

Private equity and venture capital funds often have distribution waterfalls that entitle limited partners to all returns up to a hurdle rate and compensate the general partner at one or more percentages thereafter that increase as the partnership's aggregate returns achieve various thresholds, many times with catch-up allocations to the general partner as each new threshold is met.

In some cases these waterfalls operate on an investment-by-investment basis, and in others they are based on the overall results of all partnership investments. The waterfalls are usually based on the realized results of the partnership. It would not be uncommon, for example, for a fund partnership to hold an investment for several years without receiving any dividends or realizing any gains, while its partners that are U.S. shareholders would need to include subpart F income and GILTI. Moreover, because these returns are usually based on the time value of money, a general partner's entitlement can move back and forth between different provisions of the waterfall from year to year. Therefore, a U.S. partner could move in and out of U.S. shareholder status from year to year as a result of the allocation of partnership book income and gain that is unrelated to the CFC.

Although these issues have always existed in determining how a U.S. partnership allocates subpart F income to its partners, the partnership-held CFC regulations create a cliff effect under the subpart F and GILTI regimes for partners that are attributed 10 percent or greater ownership of a CFC by value for any tax year, which puts enormous pressure on how the determination is made. Further, this issue previously applied only to CFCs with subpart F income. The enactment of the GILTI regime has extended the importance of this issue to virtually all CFCs.

Treasury should adopt clear rules for determining a U.S. partner's percentage ownership of a CFC by value under section 958(a). We recommend that Treasury require partnerships to identify and report partners' pro rata shares and percentage shares of a CFC's income in a manner consistent with the subchapter K principles that would apply to an allocation of partnership taxable income derived

from the CFC. More generally, Treasury also should issue regulations clarifying how the allocations should be made in cases in which the partners' taxable income arises before the partnership's related book income, as will be typical.

## 2. Voting power.

It is also unclear how voting power in a CFC should be attributed to partners. Under current guidance, it is conceivable that a general partner could be attributed all the voting power in each CFC.

We recommend that Treasury issue guidance clarifying that partners are treated as holding voting power in a CFC to the extent that they are entitled to income from the CFC's voting stock. The rationale for this approach is that the general partner exercises voting power as a fiduciary for the other partners. The situation is akin to one in which shareholders have a voting agreement delegating voting power to a single shareholder, which does not result in the shareholder to whom the vote has been delegated being attributed ownership of the stock under the attribution rules of section 958(b).

## C. Risk of Double Taxation

The partnership-held CFC regulations do not clarify how partners should implement basic accounting principles under the anti-deferral rules to avoid duplicative inclusions. For the most part, the rules simply exacerbate gaps in prior law concerning foreign partnerships, although some issues are peculiar to domestic partnerships. As discussed later, it is unclear how partnerships should apply the code to straightforward transactions involving CFCs, such as determining gain on sale under section 1001, excluding distributions as PTEP under section 959, or recasting gain as dividend income under section 1248.

### 1. PTEP and basis adjustments.

The subpart F and GILTI rules contain provisions intended to prevent the double taxation of a CFC's E&P after it flows up to U.S. shareholders. Section 959(a) provides that PTEP will not again be included in the U.S. shareholder's gross income when the amount is distributed to it, directly or indirectly through a



chain of ownership described in section 958(a). Section 961(a) and (b) provide that upon a subpart F or GILTI inclusion, a U.S. shareholder makes a corresponding upward basis adjustment in the CFC stock (or in the asset by reason of which it was considered to own the CFC stock under section 958(a)(2)), and upon a distribution of previously taxed income, the U.S. shareholder makes a corresponding downward basis adjustment (or, if available basis is insufficient, recognizes gain). These rules are intended to work in tandem to prevent double taxation whether the previously taxed amounts are monetized as a distribution or as a disposition.

When U.S. shareholders own CFCs through partnerships looked through under section 958(a), the application of the code is not entirely clear, and Treasury has not yet issued clarifying guidance. The difficulties in this area stem from the fact that sections 959 and 961 and their regulations generally prescribe consequences only for the U.S. shareholder that is ultimately required to make the subpart F or GILTI inclusion, rather than addressing the treatment of intermediate entities in the chain of ownership between the U.S. shareholder and the CFC. More specifically:

- Section 959(a) is quite clear that a U.S. shareholder can exclude a distribution of PTEP from income even if the CFC is held through a chain of partnerships. However, the rule applies “when such amounts are distributed to” the U.S. shareholder. It is not entirely clear how the exclusion should apply if the CFC makes a distribution to a partnership, and the partnership does not immediately distribute the proceeds to its partners, now that a domestic partnership would no longer be the U.S. shareholder required to make the inclusion under section 951(a).
- Section 961 and the regulations thereunder permit the U.S. shareholder to adjust outside basis in partnerships through which the CFC is held, but they do not expressly permit partnerships to make corresponding adjustments to their inside basis in the CFC stock (or lower-tier partnerships through which the CFC is held). Section 961(c) authorizes upper-tier CFCs to make basis

adjustments in the stock of lower-tier CFCs, but only in determining the subsequent section 951 inclusions of the U.S. shareholder. Congress’s enactment of this provision for CFCs in 1997 can be read to create a negative inference that no similar basis adjustments are allowed when partnerships hold CFCs.<sup>20</sup>

To address these issues, Treasury should issue regulations providing that U.S. shareholder partners are entitled to the benefit of PTEP accounts and inside basis adjustments in CFC stock to the same extent, and in the same manner, as if the subpart F and GILTI inclusions were gross income that had flowed up to the partner from the CFC through all intermediate entities in the section 958(a)(2) chain of ownership.

For example, when a CFC distributes E&P to a domestic partnership, the partnership would report the distribution as a dividend, and a U.S. shareholder partner would treat an appropriate amount of the dividend as a return of PTEP, even if at that time the U.S. shareholder partner has not yet received an actual distribution through the section 958(a)(2) chain of ownership as described in section 959(a)(1).

## 2. Knock-on effects.

We have assumed, consistent with the notion that a U.S. partnership is not a section 958(a) shareholder, that a partnership will not maintain its own PTEP account under section 959 or make CFC stock basis adjustments under section 961. In particular, we are not aware of any authority that would allow more than one U.S. shareholder in a section 958(a) chain of ownership to have a PTEP account in a share of CFC stock. Moreover, we have assumed that a partnership will not be required to track the individual PTEP accounts or

<sup>20</sup> Partnerships are allowed to make those basis adjustments to avoid double taxation in analogous areas. The section 965 regulations contain a rule expressly authorizing foreign partnerships to adjust their basis in CFC stock. Reg. section 1.965-2(h)(5)(ii). In the PFIC setting, the mark-to-market rules authorize looked-through entities to adjust their basis in the PFIC in determining the subsequent treatment of the indirect U.S. owner under the mark-to-market rules. Reg. section 1.1296-1(d)(2)(i). Under the QEF regime, section 1293(d) contains rules similar to section 961(c), which authorizes adjustments only to the basis of assets held by the U.S. owner required to make the QEF inclusion. In that context, the IRS has issued a letter ruling authorizing taxpayers to step up basis in intermediate passthroughs in determining their subsequent treatment under the QEF regime. LTR 200838003.

CFC stock basis adjustments of its partners, for the reasons discussed earlier. These rules will have various knock-on effects for contributions to partnerships and for transition rules.

**a. Contributions.**

If a U.S. shareholder partner owns a CFC in which it has a PTEP account and a section 961(a) stock basis increase, and it contributes the CFC to a domestic partnership, the partnership will acquire the CFC stock but not the related attributes. The U.S. shareholder will retain the PTEP account and section 961(a) basis adjustment, which will need to be backed out of the CFC stock basis in the hands of the partnership. If the partnership then sells the CFC stock, the section 704(c) gain will be reported to the contributing partner and will need to be recast as a return of basis at the partner level through the reconciliation process.

**b. Transition rules.**

On the transition to the partnership-held CFC rules, a domestic partnership that has a historical PTEP account and section 961(a) adjustments in a CFC will need to apportion them among its partners. The apportionment should occur in proportion to the partners' aggregate prior allocations of the related subpart F income. Those partners that are U.S. shareholders would then recover their PTEP and section 961(a) adjustments through the reconciliation process.

One of the questions the regulations should address is what happens to the PTEP accounts and basis adjustments attributable to the deferral-eligible partners. Forfeiture of their basis is clearly inappropriate, but it is unclear how they could continue to have basis in the CFC. At worst, they should at least retain their basis in their partnership interests.

**3. Character and timing mismatches.**

Partner-level PTEP accounts and CFC stock basis adjustments will create inherent problems for non-pro rata partnerships, however. Subpart F and GILTI inclusions attributable to a CFC usually arise before the related book income from a CFC. If distribution waterfall allocations vary over time, the U.S. shareholder partner that had the subpart F or GILTI inclusion may not be allocated the related item of book income under the partnership agreement. As a result, the

partner will not necessarily be allocated a separately stated CFC item for tax purposes against which to use its PTEP account and CFC stock basis adjustments in a reconciliation process.

For example, suppose a U.S. shareholder partner has made subpart F or GILTI inclusions from a CFC, and the partnership disposes of the CFC in a period when the partner is not allocated any book income from the CFC because they are due to the general partner under a catch-up provision. The U.S. shareholder partner should be entitled to recover its section 961(a) basis increase by claiming a loss at that time, rather than by claiming a loss on its outside basis only on the final liquidation of the partnership, and regulations should so provide.

**4. Section 1248.**

Although the partnership-held CFC regulations generally try to unify the treatment of partnership inclusions from CFCs, Treasury explicitly stated that the aggregate treatment does not apply for purposes of section 1248.<sup>21</sup> Section 1248 is a rule closely entwined with sections 951, 951A, 959, and 961. Its omission from the new rules creates administrative and conceptual problems, because treating a partnership as an entity in accordance with the statute requires the partnership to have tax attributes that it will no longer have once it is treated as an aggregate.

Very generally, section 1248 provides that when a U.S. person sells stock in a foreign corporation and holds, or has held within the prior five years, the stock as a U.S. shareholder of a CFC, the gain recognized on a sale is recast as a dividend to the extent of the foreign corporation's E&P accumulated during the post-1962 period in which it was a CFC. Section 1248(j) confirms that the gain recast as a dividend is eligible for the 100 percent dividends received deduction to a 10 percent corporate U.S. shareholder under section 245A.

Importantly, the gain analyzed under section 1248(a) generally would be reduced by the U.S. person's basis increases under section 961(a), and the E&P taken into account when recasting gain as a dividend excludes the U.S. shareholder's

<sup>21</sup> Preamble to REG-101828-19, 84 F.R. at 29119.

unrecovered PTEP under section 1248(d)(1). Under the partnership-held CFC regulations, however, a domestic partnership would be an aggregate rather than an entity, and therefore would not have its own PTEP account or CFC stock basis increases. A domestic partnership will thus report more gain and a greater dividend to its U.S. shareholder partners than it would if it were regarded as an entity, which will have to be addressed in the reconciliation process.

### 5. Direct and indirect acquisitions of CFCs.

Potential double taxation issues also arise when partners make direct or indirect transfers of stock in a CFC, whether in a taxable or nontaxable transaction. Section 959(a) clearly provides that PTEP accounts carry over to the U.S. purchaser if it can document its PTEP, and the ability to recover PTEP without further U.S. tax is a tax attribute that will often have substantial value. Section 961(a) basis adjustments generally would carry over in a nontaxable transfer to a U.S. person. Treasury should provide guidance so that U.S. taxpayers involved in a transfer of partnership interests between partners or a transfer of CFC stock by partnerships know how to document the transfers and can be assured that they will not be double taxed.

For taxable transfers, guidance should address how partnerships and their U.S. shareholder partners track PTEP and stock basis adjustments in a CFC, and how domestic partnerships report section 1248 dividends. Among other things, the guidance should ensure that when a U.S. taxpayer purchases a CFC from a partnership, the purchaser can accurately determine the amount of E&P of the CFC that it is entitled to treat as PTEP without the need for due diligence on the historical tax treatment of CFC inclusions by the partners in the partnership. For example, if a domestic partnership computes its gain on a sale of the CFC without regard to any section 961(a) adjustments and computes its section 1248 dividend without regard to any PTEP, the regulations should provide that the entirety of the resulting section 1248 dividend will constitute PTEP in the purchaser's hands.<sup>22</sup>

<sup>22</sup> See sections 1248(k) and 959(e).

For nontaxable transfers, this may not be possible. If a partnership disposes of stock in a CFC in a carryover basis transaction, the partnership generally will not have information about its U.S. shareholder partners' historical PTEP accounts and basis adjustments under sections 961(a) and 1293 to allow the partnership and the recipient to determine the consequences of the transfer. For example, if a partnership contributes its CFC stock to a domestic corporation in a nontaxable transaction, the partnership's basis in the domestic corporation, and the domestic corporation's PTEP account and basis in the CFC stock, generally would depend on partner-level attributes. The result in these cases is likely to be double taxation.

### D. CFC-PFIC Overlaps

Coordinating regulations will also be needed to address CFC-PFIC overlaps, because the current guidance for domestic partnerships is based on an assumed relationship between sections 951(a), 951(b), and 958(a) that would no longer hold.

#### 1. The overlap rule.

Under the anti-overlap rule in section 1297(d), a foreign corporation is not a PFIC in the hands of a particular shareholder during the qualified portion of the taxpayer's holding period in the PFIC stock. The qualified portion is the period after December 31, 1997, in which the PFIC was a CFC and the taxpayer was a U.S. shareholder. If the qualified portion ends, then for purposes of the PFIC regulations the taxpayer's holding period is deemed to restart on the next day. Thus, a taxpayer that has always been a U.S. shareholder of a CFC but becomes a shareholder of a PFIC is generally entitled to make a new QEF or mark-to-market election.

The premise of the overlap rule is that a U.S. shareholder (as defined under section 951(b)) will always be required to include subpart F income attributable to stock of the PFIC that it owns directly or indirectly (under section 958(a)). When partners in domestic partnerships are not themselves U.S. shareholders, they have historically been required to include a distributive share of the domestic partnership's subpart F income. On that basis, the IRS has issued guidance

allowing them to claim the benefit of the overlap rule and avoid PFIC inclusions.<sup>23</sup>

Under the partnership-held CFC regulations, the premise for this guidance would cease to apply to deferral-eligible U.S. partners, although the statutory overlap rule would continue to apply by its terms to the domestic partnership itself and to its U.S. shareholder partners.

In cases of CFC-PFIC overlap, therefore, a foreign corporation would be a CFC for the domestic partnership and U.S. shareholder partners, a PFIC for all other U.S. partners, and a foreign corporation for any non-U.S. partners. This, in turn, means that the domestic partnership's income from the CFC could be taken into account under three different but parallel U.S. tax regimes. Each would require a separate set of books (typically on a partner-by-partner basis) and would have different consequences upon a sale of the CFC or a transfer of partnership interests.

## 2. QEF and mark-to-market elections.

A related question is whether the PFIC elections should be made by the partnership or its partners. Under the current regulations, the elections are made by the partnership when the PFIC is held through a domestic partnership, and by the partners when the PFIC is held through a foreign partnership. Under the partnership-held CFC regulations, the partnership in question would be domestic, suggesting that it must make the elections; but the partnership would not be treated as holding a PFIC, suggesting that its partners should make the elections.

To reduce complexity, Treasury should clarify that a domestic partnership will continue to make QEF and mark-to-market elections even when the entity is a CFC rather than a PFIC in its hands. This would be consistent with continuing to treat domestic partnerships as controlling domestic shareholders of a CFC. Partnership-level elections would limit the multiplicity of U.S. tax reporting regimes that would apply to the CFC-PFIC and reduce related compliance burdens, because subpart F and GILTI information could be incorporated into a PFIC annual intermediary statement. Domestic partnerships would continue

to make PFIC elections in cases in which there is no CFC-PFIC overlap, so this rule also would provide uniformity and prevent confusion when the qualified portion of a domestic partnership's holding period ends. And, of course, domestic partnerships would have a direct relationship to the CFC, are accustomed to complying with U.S. tax rules, and are best positioned to obtain the necessary information on behalf of all small U.S. partners.

## 3. Previously taxed income and basis adjustments.

Like the CFC rules, the PFIC regulations applicable to QEF and mark-to-market elections contain rules under which a U.S. shareholder of a PFIC recovers its PTEP and makes PFIC basis adjustments. The application of these rules to partnerships has many of the same ambiguities as in the CFC context, particularly regarding whether and how partners benefit from inside basis adjustments reflecting QEF inclusions under section 1293(c) and (d). Treasury should clarify these rules as part of a project to coordinate sections 959, 961, and 1248(d).

## V. Effect on Tax Distributions

Domestic partnerships that own CFCs will need to be attentive to several practical consequences of the partnership-held CFC rules in order to make appropriate tax distributions. In particular, some partnerships will need to amend their tax distribution provisions to ensure that cash is distributed for U.S. partners' income inclusions (under subpart F, GILTI, QEF, or mark-to-market regimes) that are no longer part of the partnership's taxable income.

Partnership tax distributions under the new rules may be based on a "greater of" formula that takes into account the U.S. tax liability that would be imposed under the subpart F and GILTI regimes, or in cases of CFC-PFIC overlap, under the QEF or mark-to-market regimes. The hypothetical GILTI inclusion would assume that partners are taxable on their share of net tested income (adjusted for their share of QBAI) of only the partnership's own CFCs, as if netting had occurred at the partnership level. The hypothetical PFIC inclusion would take account of the base and character differences applicable to

<sup>23</sup> See, e.g., LTR 201107005 and LTR 200943004.

gross income that flows up under the QEF and mark-to-market rules. The hypothetical usually assumes that the U.S. taxpaying partner is an individual and would need to clarify whether the individual is presumed to make a section 962 election.

Because current inclusions under the CFC rules give rise to timing differences, deferral-eligible partners typically will be allocated taxable income after the U.S. shareholder partners or PFIC shareholder partners. One approach to making tax distributions would be to assume that the deferral-eligible partners have invested any tax distributions to satisfy their future tax liability. However, this could result in hardship in cases in which partners' distributive shares vary over time based on a tiered waterfall. The deferral-eligible partner may not have previously received a corresponding allocation of CFC income, and therefore may not have received a tax distribution to invest.

## VI. Susceptibility to Challenge

The partnership-held CFC regulations are susceptible to challenge, given the history and structure of sections 951 to 965. When originally promulgating the rules, Treasury appealed to its general authority to treat domestic partnerships as aggregates or entities for purposes of a particular section of the code under the legislative history and court interpretations of subchapter K deriving from the Internal Revenue Code of 1954.<sup>24</sup> Treasury set forth a clear rationale for treating domestic partnerships as entities capable of direct or indirect ownership of CFC stock when identifying the U.S. shareholders of a CFC under section 951(b).

By contrast, Treasury's rationale for treating domestic partnerships as aggregates when identifying U.S. shareholders required to include CFC income under sections 951(a) and 951A is based principally on the observations that Congress regarded section 958(a) as a "limited rule of stock ownership for determining the amount taxable to a United States person" when the statute was enacted in 1962, and that "GILTI inclusions are generally treated similarly to

subpart F inclusions" when the TCJA was enacted in 2017. Treasury (1) argued that Congress did not speak expressly to whether domestic partnerships should be regarded as aggregates or entities when identifying the U.S. person taxable under the GILTI regime, (2) decided that an aggregate approach would be preferable, and (3) concluded that therefore it is "consistent with the intent of the Act" to look through domestic partnerships when identifying the U.S. person taxable under the subpart F regime, such that domestic partnerships will be treated in the same manner as foreign partnerships under both regimes.<sup>25</sup>

There is no authority to support this theory. Accordingly, a strong argument can be made that the partnership-held CFC regulations are *ultra vires*. Indeed, the available evidence suggests that to the extent Congress considered the treatment of partnerships, it intended that they be regarded as owners of CFC stock under section 958(a) when identifying U.S. persons taxable under the GILTI rules, consistent with how domestic partnerships have been treated for more than 50 years under the subpart F rules.

Congress appears to have intended domestic partnerships to be treated the same under the GILTI rules as they have historically been treated under the subpart F regime. Congress did not change the plain language of section 958(a). The look-through rule in section 958(a)(2) contains a specific reference to foreign partnerships, but not to domestic partnerships, and reg. section 1.958-1(b) interprets section 958(a)(2) to mean that "since the rule applies only to stock owned by a foreign entity, attribution under the rule stops with the first United States person in the chain of ownership running from the foreign entity." Domestic partnerships are plainly U.S. persons as a general matter under sections 957(c) and 7701(a)(30).<sup>26</sup> This was well-settled law as of 2017. To the extent that it considered the issue at all, Congress would reasonably have expected domestic partnerships to be regarded as owning CFC stock under section 958(a) when it enacted

<sup>24</sup> Preamble to REG-101828-19, 84 F.R. at 29116.

<sup>25</sup> *Id.* at 29116-29117. See also preamble to T.D. 9866, 84 F.R. 29288, at 29315.

<sup>26</sup> Section 7701(a)(4) authorizes Treasury to create general exceptions to the definition of a domestic partnership (*i.e.*, a partnership created or organized in the United States).

the GILTI regime. Yet Treasury's argument effectively converts the lack of an express statement about the nature of partnerships under the GILTI rules into legislative intent to upend the treatment of partnerships under subpart F.

Further, although Treasury states that it is relying on its authority to treat partnerships as aggregates or entities for purposes of a particular section of the code, it does not in fact treat partnerships as aggregates for all purposes of section 958(a). Treasury is applying section 958(a) to domestic partnerships in a nonuniform manner under sections 951(a) and 951A, under which they would be aggregates, and under section 951(b), under which they would be entities. We know of no authority for Treasury to do so.

Thus, if Congress clearly conceives of domestic partnerships as U.S. persons and has not authorized Treasury to treat domestic partnerships as foreign for purposes of section 958(a)(2), Treasury is acting beyond its mandate and contrary to legislative intent.

Although the partnership-held CFC regulations could be seen as a concession — especially to deferral-eligible U.S. partners — there may be an incentive for taxpayers to challenge them if they give rise to adverse results that would have been avoidable by treating domestic partnerships as entities. For example, this could occur because corporate U.S. partners lose the benefit of the GILTI deduction, because individual U.S. partners have larger current inclusions under the PFIC rules than under the subpart F and GILTI regimes,<sup>27</sup> or because the coordination of subchapter K accounting with the anti-deferral rules ultimately provides inadequate relief from double taxation.

## VII. Conclusion

The partnership-held CFC regulations sweep away more than 50 years of common understanding about the mechanical application of subpart F. Foreign partnerships are cited as an administrable reference point for aggregate treatment. However, there is no authority as to

<sup>27</sup> However, the QEF rules (unlike subpart F) would preserve the character of the CFC's underlying income and allow an individual to claim a reduced rate of tax on long-term capital gain for dispositions by the CFC. Section 1293(a).

how the subpart F rules apply to foreign partnerships, and practitioners have encountered large gaps in the application of subpart F to those partnerships. These problems have historically been limited to the infrequent case in which a foreign partnership owns a CFC that earns subpart F income. The greater reach of GILTI and its U.S. shareholder-level netting creates new issues for such foreign partnerships. Without further guidance, the U.S. shareholder partners — as the only persons typically required to file returns — will presumably manage these issues by applying a de facto reconciliation process to the tax information reported by the foreign partnership. Yet rather than containing these problems, the partnership-held CFC rules exacerbate them by extending them to domestic partnerships, in which context they will be amplified by the need for the domestic partnership to file its own U.S. tax returns, the complexity resulting from the domestic partnership's own status as a "U.S. shareholder," and the sheer number of domestic partnership-held CFCs.

Although we appreciate the policy goal that Treasury seeks to achieve with this approach, we have severe doubts about its authority to promulgate the partnership-held CFC regulations. But regardless of whether Treasury has the necessary authority, if it claims the right to issue these regulations, it must address the numerous problems they create. We are not enamored of the reconciliation approach we have proposed; it is far too complex, imposes compliance burdens on the wrong parties, and creates the potential for timing and character mismatches. We table it largely because any alternative requires partners to provide information to the partnership that they should not be required to provide, and it requires the partnership to continue to track the very tax attributes that the regulations transfer to its partners.

If the aggregate approach is otherwise regarded as viable, to relieve taxpayers of the compliance burdens they create, Treasury could consider allowing domestic partnerships to elect to be taxed on subpart F and GILTI inclusions on an entity basis. Because of concerns about netting under the GILTI rules, this answer would be

unsatisfying as a matter of tax policy, but it may be attractive to some partnerships that are concerned about their partners' ability to track and apply the consequences of the CFC rules on an aggregate basis. An opt-out rule would also provide a firmer footing for Treasury's authority to prescribe aggregate treatment of domestic partnerships.

Absent such an election, in some situations taxpayers may seek to use self-help to avoid imposing compliance burdens on U.S. shareholder or PFIC shareholder partners. A partnership could form a domestic corporate blocker to hold some or all of its interests in CFCs and achieve entity treatment. For example, a fund may cause an onshore feeder partnership for U.S. taxable investors to form a domestic corporation to invest in the master fund that owns CFCs. The domestic corporation would be a U.S. shareholder partner of the master fund, so this structure might accelerate U.S. tax on subpart F and GILTI inclusions for small U.S. partners and would require netting under the GILTI rules to occur at a lower tier for investors that otherwise would be U.S. shareholder partners. But it would relieve U.S. partners in the onshore feeder partnership of the burden of performing separate partner-level tax calculations for the fund's CFCs.

We are skeptical that Treasury can solve all the issues that it has created with the partnership-held CFC regulations, but we see no administrable alternative. Ultimately, entity-level netting — if not by election, then by self-help — may be the only administrable result for many partnerships. ■

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