June 24, 2019

Treasury and IRS Release Final and Proposed Regulations on the GILTI and Subpart F Treatment of Domestic Partnerships

A Fundamental Change – Domestic Partnerships Will Be Treated as Aggregates for Many GILTI and Subpart F Purposes

SUMMARY

On June 21, 2019, the IRS and Treasury Department published final regulations (the "**Final Regulations**") in the Federal Register that would generally treat domestic partnerships as aggregates in determining whether income must be recognized under the U.S. "global intangible low-taxed income" ("**GILTI**") rules. The Final Regulations differ significantly from the "hybrid aggregate/entity" approach that was taken in the proposed GILTI regulations that were issued in October 2018 (the "**2018 Proposed Regulations**"). On the same day, the IRS and Treasury Department published proposed regulations (the "**Proposed Regulations**" and together with the Final Regulations, the "**Final and Proposed Regulations**") that would extend this "aggregate" treatment to the so-called "**subpart F**" rules, something that would represent a significant change to the treatment of domestic partnerships under subpart F. The Final and Proposed Regulations modify the U.S. "controlled foreign corporation" ("**CFC**") regime in the following ways:

- *First*, U.S. persons that directly, indirectly and constructively own less than 10% of a CFC ("**Sub-10% Holders**") through a domestic partnership that owns 10% or more of the CFC would generally not be required to recognize subpart F or GILTI inclusions from that CFC, meaning that the importance of "structuring out" of the CFC income inclusion regime (*e.g.*, by organizing fund vehicles in a non-U.S. jurisdiction) may be reduced.
- *Second*, it appears likely that Sub-10% Holders of a CFC that both: (i) qualifies as a "passive foreign investment company" ("**PFIC**") and (ii) is owned through a domestic partnership will be taxed under the PFIC rules rather than the CFC regime.

The Final and Proposed Regulations do not change the fact that a domestic partnership that owns 10% or more of a foreign corporation technically can be a "United States shareholder" of a foreign

corporation under Section 951(b) of the Code (a "**10% U.S. Shareholder**") or affect whether a foreign corporation technically is a CFC. Although the requirement to include subpart F income and GILTI from a CFC is often the most significant consequence of being a 10% U.S. Shareholder in a CFC, the status of a partnership as a 10% U.S. Shareholder and the status of a foreign corporation as a CFC can have other effects (such as, for example, additional limitations on the use of the "portfolio interest" exemption from U.S. interest withholding tax). These other consequences would not be modified by the Final and Proposed Regulations. Furthermore, the impact of subpart F and GILTI inclusions taken by 10% U.S. Shareholders on the "inside" basis of a domestic partnership through which CFC stock is owned and the manner in which the Final and Proposed Regulations will interact with Section 1248 is unclear.

The Final Regulations are effective for taxable years of foreign corporations beginning after December 31, 2017. Because the 2018 Proposed Regulations did not contain a "reliance statement", domestic partnerships and other taxpayers that have already filed 2018 tax returns using the 2018 Proposed Regulations to report their GILTI inclusions may need to amend those returns. In general, the Proposed Regulations (*i.e.,* the new Proposed Regulations for subpart F inclusions) are proposed to be effective for taxable years of foreign corporations that begin on or after the date on which the Proposed Regulations are published as final regulations in the Federal Register. However, subject to a consistency rule, domestic partnerships may optionally rely on the Proposed Regulations to report their subpart F income for other taxable years of foreign corporations that begin after December 31, 2017.

The Final and Proposed Regulations form part of a broader regulatory package that was published in the Federal Register on June 21, which includes both temporary regulations on the new Section 245A "participation exemption" and additional guidance on GILTI (including a new high-tax exception). Although we expect to prepare additional publications addressing key features of the guidance that was published on June 21, this memorandum is limited to our observations on the new guidance for domestic partnerships under the subpart F and GILTI rules.

BACKGROUND

Historically, U.S. tax law has treated domestic partnerships[1] as U.S. entities (rather than as aggregates) for subpart F purposes. Therefore, for example, a domestic partnership that owns 10% or more of a CFC generally has been treated as a 10% U.S. Shareholder of that CFC,[2] and under

[1] A domestic partnership includes any syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, that is not a trust, estate or corporation, and that is created or organized in the United States or under the law of the United States or any state thereof, unless the IRS provides otherwise by regulations.

[2] In general, a 10% U.S. Shareholder is a United States individual or entity that owns at least 10% (by vote or value) of a foreign corporation, after taking into account both indirect ownership and the "constructive" ownership rules of Section 958(b) of the Code. *See* Section 951(b).

current law is required to include any “subpart F income”[3] earned by that CFC in its own income. Because a partnership (whether domestic or foreign) is fiscally transparent for U.S. tax purposes, domestic partnerships are not required to pay tax directly on “subpart F” inclusions that they recognize. Instead, a domestic partnership is generally required to allocate “subpart F” income—under the general rules applicable to partnership income—to its partners. To the extent that such partners are U.S. individuals or corporations, such partners are then required to include in income any “subpart F income” allocated to them and to pay tax on such income accordingly.

Notwithstanding the pass-through nature of both domestic and foreign partnerships for U.S. tax purposes, the historic treatment of domestic partnerships as entities under the U.S. CFC rules meant that whether a partnership was domestic or foreign could have significant tax effects. For example, if a domestic partnership owned 100% of a foreign corporation, that domestic partnership was treated as a 10% U.S. Shareholder of a CFC, and the U.S. partners of that domestic partnership were required to include “subpart F income” from that foreign corporation even if each partner in the domestic partnership owned less than 10% (by both vote and value) of the foreign corporation on a “look-through” basis. On the other hand, if a foreign partnership owned 100% of a foreign corporation, that foreign partnership was not considered a 10% U.S. Shareholder of a CFC. Therefore, only partners in such a partnership that owned 10% or more of a foreign corporation on a “look-through” or “constructive ownership” basis (which could be uncommon if, for example, the relevant partnership was a fund vehicle with dispersed ownership) would be required to include income under the CFC rules. Because, depending on the facts, CFC status and 10% U.S. Shareholder status can be either desirable[4] or undesirable, the treatment of domestic partnerships as entities for subpart F purposes meant that, in many cases, taxpayers could elect into (or out of) the subpart F rules by choosing to use a domestic (or foreign) partnership.[5]

Unlike subpart F income (which is determined at the CFC level and then flows up to shareholders), GILTI is computed at the 10% U.S. Shareholder level by combining certain amounts (such as “tested income”, “tested loss” and “qualified business asset investment”) that are determined at the CFC level. As a result, if domestic partnerships were consistently treated as entities for GILTI purposes, U.S. individuals and corporations could have multiple GILTI inclusion amounts, instead of a single GILTI inclusion amount. When the IRS and Treasury Department initially issued the 2018 Proposed Regulations,[6] they expressed concerns that computing GILTI at the level of a domestic partnership

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3 Very generally, “subpart F income” consists of certain types of passive or mobile income, such as dividends, interest, rents, royalties, capital gains from the sale of certain property, certain insurance income, and certain related-party sales income. Exceptions are available that exclude certain types of income described in the preceding sentence (*e.g.*, “active rental” income and certain related-party dividends) from the definition of “subpart F income”.

4 10% U.S. Shareholder status might be desirable because, for example, 10% U.S. Shareholders of CFCs are generally exempt from the PFIC rules.

5 The “partnership anti-abuse rules” specifically authorize the use of a domestic partnership to turn a foreign corporation into a CFC. *See* Treas. Reg. § 1.701-2(f), Example 3.

6 *See* Notice of Proposed Rulemaking, 83 Fed. Reg. 51,072.

that is a 10% U.S. Shareholder of a CFC could represent "both an inappropriate planning opportunity as well as a trap for the unwary".[7] On the other hand, the IRS and Treasury Department also indicated unease with the idea of treating domestic partnerships as aggregates for all GILTI purposes, as such an approach would mean that small partners in a domestic partnership would be exempt from GILTI entirely. As a result, the 2018 Proposed Regulations provided for a "hybrid aggregate/entity" approach under which a domestic partnership was treated, for GILTI purposes, as an aggregate to the extent that a partner was a 10% U.S. Shareholder of any CFC owned by the partnership, and as an entity (which computes a GILTI inclusion) otherwise.

DISCUSSION

The Final and Proposed Regulations do not adopt the "hybrid aggregate/entity" approach of the 2018 Proposed Regulations, but instead generally treat domestic partnerships as aggregates for the purpose of determining subpart F and GILTI inclusions. As discussed below, the Final and Proposed Regulations represent a fundamental change to the manner in which partnerships historically have been treated under the CFC rules.

A. THE FINAL AND PROPOSED REGULATIONS

1. General Rule

Subject to certain exceptions (which are disclosed below), the Final Regulations provide that for purposes of Section 951A of the Code (which requires a 10% U.S. Shareholder to include its pro rata share of GILTI) and any provision that "applies by reference to" Section 951A of the Code, a domestic partnership is not treated as owning stock in a foreign corporation. The Proposed Regulations extend the same rule to Section 951 of the Code (which requires a 10% U.S. Shareholder of a CFC to include its pro rata share of "subpart F income"). The preambles to the Final and Proposed Regulations specifically identify Section 959 (which governs the treatment of "previously taxed income"), Section 960 (which allows 10% U.S. Shareholders of CFCs to claim "deemed paid" foreign tax credits subject to limitations) and Section 961 (which can increase the basis of CFC stock when a 10% U.S. Shareholder recognizes income under the CFC rules and decrease the basis of CFC stock when a CFC distributes "previously taxed income") as provisions that "apply by reference to" Sections 951 and 951A.

2. Exceptions

Notwithstanding the general "aggregate" approach discussed above, the Final and Proposed Regulations state that a domestic partnership is treated as owning stock in a foreign corporation for the following three purposes: (i) determining whether a U.S. person is a 10% U.S. Shareholder, (ii) ascertaining whether any 10% U.S. Shareholder is a "controlling domestic shareholder" (as defined in

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[7] *See id.* at 51,079.

Treasury Regulations Section 1.964-1(c)(5)),[8] and (iii) establishing whether a foreign corporation is a CFC. According to the preambles to the Final and Proposed Regulations, these exceptions were included because the IRS and Treasury Department believe that a rule that treated domestic partnerships as aggregates under the CFC rules in their entirety would be inconsistent with relevant statutory provisions.

The preambles to the Final and Proposed Regulations also provide that aggregate treatment "does not apply for any other purposes of the Code, including for purposes of Section 1248".[9]

3. Effective Date

The Final Regulations are effective for taxable years of foreign corporations beginning after December 31, 2017. Because the 2018 Proposed Regulations did not contain a "reliance statement", it may be necessary for taxpayers that have already filed 2018 tax returns that reported GILTI in accordance with the 2018 Proposed Regulations to amend those returns.

The Proposed Regulations are intended to be effective for taxable years of foreign corporations beginning on or after the date when the Proposed Regulations are published as final regulations in the Federal Register, and to taxable years of a U.S. person in which or with which such taxable years of foreign corporations end. However, subject to a consistency rule (which requires a domestic partnership and all other domestic partnerships that are "related" for U.S. tax purposes[10] to the first domestic partnership—together with any 10% U.S. Shareholder partners of such partnerships—to apply the Proposed Regulations consistently to all foreign corporations that are owned through such domestic partnerships), domestic partnerships that own stock in CFCs may apply the Proposed Regulations to earlier taxable years of foreign corporations that begin after December 31, 2017.

B. IMPLICATIONS AND UNCERTAINTIES

1. In General

Under the Final and Proposed Regulations, domestic partnerships will not recognize subpart F income or GILTI, and such income will instead be included under the subpart F and GILTI regimes by any U.S. individual or corporate partners of those domestic partnerships if (and only if) such partners are 10% U.S. Shareholders of an underlying foreign corporation. Prior to this change, many taxpayers avoided forming a domestic partnership that otherwise would have been a 10% U.S. Shareholder of a foreign corporation. Instead, they organized investment fund vehicles in non-U.S.

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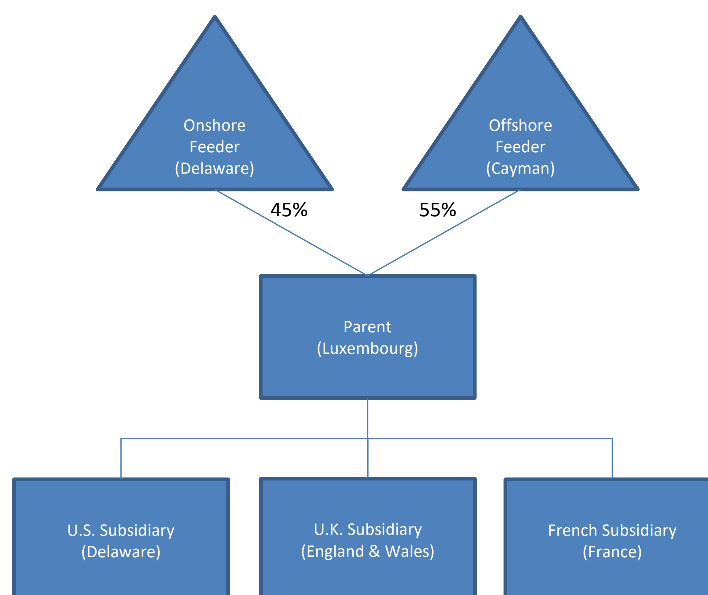
[8] "Controlling domestic shareholders" are entitled to make various elections for CFCs, including whether or not a CFC will apply the newly proposed high-tax exception to GILTI. *See* Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(A).

[9] Section 1248 generally applies when a 10% U.S. Shareholder sells the shares of a CFC and, to the extent of the CFC's relevant earnings and profits allocable to the shares sold, requires dividend treatment for any capital gain recognized by the 10% U.S. Shareholder.

[10] "Related" for this purpose is defined by reference to Sections 707(b) and 267(b) of the Code. In general, a partnership and another person are "related" if the other person owns more than 50% of the capital or profits of the partnership, and two partnerships are "related" if the same persons own more than 50% of the capital or profits interests in both partnerships.

jurisdictions and formed "alternative investment vehicles" to hold interests in foreign corporations outside the principal investment fund. Under the Proposed and Final Regulations, the incentives for taking these steps may significantly have been reduced.

Treating domestic partnerships as aggregates may also mitigate the impact of the repeal of former Section 958(b)(4) on certain structures. For example, prior to the 2017 tax reform legislation (the "**Act**"), it was not uncommon for private equity investment structures to look similar to the following simplified diagram:



Prior to the Act, Parent, U.K. Subsidiary and French Subsidiary in the diagram above were not CFCs because, although the U.S. constructive ownership rules generally provide that stock owned by a parent corporation is attributed "downward" to any subsidiary of that parent corporation, former Section 958(b)(4) prohibited "downward" CFC attribution from a foreign entity. Therefore, Onshore Feeder (and its U.S. investors) were not required to include income from these entities under the CFC rules. After Section 958(b)(4) was repealed, foreign entities were required to attribute their holdings "downward". Therefore, in the diagram above, U.S. Subsidiary is—under current law—treated as constructively owning (for CFC purposes) all stock that is owned by Parent, including 100% of the shares of U.K. Subsidiary and French Subsidiary, meaning that U.K. Subsidiary and French Subsidiary (but not Parent) are currently CFCs. Although U.S. Subsidiary does not directly or indirectly own any stock in U.K. Subsidiary or French Subsidiary (meaning that U.S. Subsidiary is not required to include subpart F income or other amounts earned by these entities), Onshore Feeder is both: (i) a 10% U.S. Shareholder and (ii) a direct or indirect owner of these entities. Accordingly, while it is not clear that this result was intended by Congress,[11] it literally appears that under current law,

[11] The Senate report to the Act states that the repeal of Section 958(b)(4) was "not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a [10%] U.S. Shareholder as a result of attribution of ownership under [S]ection 318(a)(3) to a U.S.

Onshore Feeder must include in income on a current basis its share of any subpart F income earned by these entities (and, potentially more significantly, any Section 956 inclusions from these entities, which could arise if, for example, lenders had required U.K. Subsidiary and French Subsidiary to guarantee the debt of U.S. Subsidiary).[12]

The Final and Proposed Regulations would significantly mitigate the consequences from this result. In particular, while U.K. Subsidiary and French Subsidiary would still be CFCs, Onshore Feeder would not be required to include any income from these entities under subpart F or Section 956. Therefore, unless a U.S. individual or corporation indirectly or constructively owned at least 10% of one or both of these entities, no subpart F or Section 956 inclusions would be required.

2. Exceptions

Notwithstanding these changes, the Final and Proposed Regulations will not affect whether or not a foreign corporation is technically a CFC, and do not apply in contexts other than income recognition under the subpart F or GILTI rules. Therefore, the preambles to the Final and Proposed Regulations specifically mention that the Final and Proposed Regulations do not affect the operation of Section 1248.

This would appear to mean that if a domestic partnership sells stock in a CFC (including a CFC that has no 10% U.S. Shareholders other than the domestic partnership itself), gain on that sale would generally be recharacterized as a dividend to the extent of any undistributed "earnings and profits" in the CFC (at least to the extent, although the Final and Proposed Regulations provide no specific guidance on this subject, such "earnings and profits" have not been previously taxed to a higher-tier 10% U.S. Shareholder as subpart F income or GILTI). The application of Section 1248 in this context raises a number of questions and, depending on the status of both the foreign corporation and its ultimate U.S. owners, could be either beneficial or detrimental. For example, corporate 10% shareholders of foreign corporations are generally entitled to treat Section 1248 deemed dividends as exempt under the Section 245A "participation exemption".[13] Non-corporate shareholders are not eligible for the Section 245A "participation exemption". Nonetheless, deemed dividends arising under Section 1248 are generally eligible to be treated as "qualified dividend income" (which is taxable at the preferential rates applicable to long-term capital gains) by non-corporate U.S. taxpayers provided that the foreign corporation from which the Section 1248 dividend is deemed paid is eligible for benefits under a comprehensive U.S. tax treaty (or is otherwise a "qualified foreign corporation").[14] Therefore,

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person that is not a related person (within the meaning of [S]ection 954(d)(3)) to such [10%] U.S. Shareholder". *See* S. Rep't No. 115-20 (115th Cong., 2017) at 383.

[12] Although recently issued regulations under Section 956 provide that Section 956 does not apply to the extent that an actual distribution from a CFC would be exempt from U.S. tax under the Section 245A "participation exemption", the "participation exemption" applies only to 10% shareholders that are corporations. *See* Section 245A(a).

[13] *See* Section 1248(j).

[14] *See* Notice 2004-70, 2004-2 C.B. 724 § 4.01. "Qualified foreign corporations" are defined in Section 1(h)(11)(C).

if a domestic partnership owned by individuals were to wholly own a qualified foreign corporation (but have no partners that are 10% U.S. Shareholders of the foreign corporation), any Section 1248 deemed dividend would be taxed to such partners at long-term capital gains rates. Such treatment would be equivalent to the treatment of a similarly situated foreign corporation that is owned by a foreign partnership that is not subject to Section 1248. However, if the underlying foreign corporation were not a "qualified foreign corporation", the resulting Section 1248 deemed dividend would—unlike the result if the domestic partnership were foreign—be taxed to non-corporate U.S. taxpayers at higher ordinary income rates.

Other provisions of U.S. tax law where the Final and Proposed Regulations' aggregate approach will not apply appear to include:

- Section 881(c)(4) (which provides that interest received by a CFC from a related domestic person is not "portfolio interest" that is exempt from U.S. withholding tax);
- the definition of a "U.S. payor" (meaning that such foreign corporations may still be subject to additional "backup withholding" and Form 1099 information reporting requirements);[15]
- the special rules of Section 881(c)(5) (which disapply certain exceptions, such as the *de minimis* rule of Section 954(b)(3), to the definition of subpart F income in the case of "portfolio interest" received by a CFC); and
- the PFIC "asset test" (meaning that a foreign corporation that is a CFC solely because of an interest held by a domestic partnership is likely to be required to use adjusted basis, rather than fair market value, in applying the PFIC "asset test").[16] Because goodwill often both: (i) has a high fair market value relative to its tax basis and (ii) is generally an "active" asset for PFIC purposes, the non-availability of the "fair market value" approach to the "asset test" to foreign corporations that are owned through domestic partnerships may mean that such corporations are more likely to be PFICs.

3. "Inside" Basis of a Domestic Partnership

A further significant question that the Final and Proposed Regulations do not answer is how domestic partnerships with partners that are 10% U.S. Shareholders in an underlying CFC should determine their "inside" basis in CFC stock. Current regulations under Section 961 provide that a 10% U.S. Shareholder of a CFC must: (i) increase its basis in CFC stock to the extent it includes "subpart F income" from that CFC[17] and (ii) decrease its basis in CFC stock to the extent it receives a distribution of "previously taxed income" from that CFC.[18] Because historically, a domestic partnership that owned 10% or more of a CFC's stock has been a 10% U.S. Shareholder of that CFC, domestic

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[15] *See* Treas. Reg. § 1.6049-5(c)(5).

[16] Under the "asset test", a foreign corporation is generally a PFIC if at least 50% of the corporation's assets are considered held for the production of "passive" income. *See* Section 1297(a)(2). In general, a foreign corporation that is publicly traded must value its assets for this purpose by reference to fair market value, while a non-publicly traded CFC must value its assets by reference to adjusted basis, and a non-publicly traded non-CFC may elect whether to use fair market value or adjusted basis to value its assets. *See* Section 1297(e).

[17] *See* Treas. Reg. § 1.961-1.

[18] *See* Treas. Reg. § 1.961-2.

partnerships have generally adjusted their basis in CFC stock under these rules.[19] Such adjustments can be important because, absent such a mechanism, a 10% U.S. Shareholder partner in a domestic partnership that owns a CFC might be taxed twice on the same income if: (i) the CFC earns subpart F income or GILTI and (ii) the domestic partnership sells some or all of the stock in the CFC.[20]

The IRS and Treasury Department have opened a project to update the current regulations that address "previously taxed income" (and in connection with this project specifically requested comments on how the basis-adjustment rules should apply to domestic and foreign partnerships),[21] but the Final and Proposed Regulations themselves provide no specific guidance in this area. Regulations implementing the Section 965 "transition tax" provide that a foreign partnership is entitled to increase its "inside" basis in a "deferred foreign income corporation" with respect to which a 10% U.S. Shareholder has a "previously taxed income" account under rules similar to the Section 961 regulations,[22] and it is possible that the IRS will apply a similar approach to domestic partnerships after the Final and Proposed Regulations. Alternatively, as discussed above, the preambles to the Final and Proposed Regulations state that domestic partnerships are not treated as aggregates under Section 1248, meaning that in most cases, a domestic partnership that sells stock in a CFC will be subject to Section 1248. It would therefore also seem possible that the IRS will issue guidance to the effect that a domestic partnership is not entitled to increase its basis in CFC stock when a 10% U.S. Shareholder partner recognizes subpart F income or GILTI and that instead, a 10% U.S. Shareholder partner is entitled to exclude certain Section 1248 deemed dividends that arise from a sale of CFC stock that are in its distributive share of partnership income (*e.g.*, to the extent that a 10% U.S. Shareholder has "previously taxed income" from the same CFC).

4. PFIC Rules

U.S. taxpayers that own CFCs that are otherwise treated as PFICs through domestic partnerships also appear to be affected by the Proposed Regulations, to the extent such owners are Sub-10% Holders. In particular, under Section 1297(d) of the Code (the "**Subpart F Priority Rule**"), a 10% U.S. Shareholder of an entity that is both a CFC and a PFIC is normally taxed solely under the CFC Rules, and is not treated as owning PFIC stock. Under prior law, the IRS had interpreted the Subpart F Priority Rule to mean that if a domestic partnership owned 10% or more of an entity that was both a CFC and a PFIC, Sub-10% Holders of such a CFC through the domestic partnership were generally

[19] Additionally, U.S. partners in such partnerships have been required under the general U.S. partnership rules to: (i) increase their basis in their partnership interests to the extent such partners were allocated subpart F income and (ii) reduce their basis in their partnership interests to the extent such partners received distributions. *See* Section 705; Section 731.

[20] In such a case, the 10% U.S. Shareholder partner's "outside" basis in the domestic partnership would also be increased twice. However, the additional "outside" basis may not be recovered until either the 10% U.S. Shareholder sells its interest in the domestic partnership or the domestic partnership liquidates, which could be many years after the "double" income inclusion.

[21] *See* Notice 2019-1, 2019-1 I.R.B. § 5.

[22] *See* Treas. Reg. § 1.965-2.

not subject to the PFIC rules.[23] The aggregate approach of the Proposed Regulations appears to mean that Sub-10% holders that own CFC stock through a domestic partnership will be required to treat stock in such CFCs as PFIC stock. However, the Proposed Regulations do not provide specific guidance or transition rules on this subject.

C. REQUEST FOR COMMENTS

The IRS and Treasury Department have requested comments on the following aspects of the Proposed Regulations:

- appropriate transition rules (including necessary adjustments to "previously taxed earnings and profits" and basis amounts after the Proposed Regulations are finalized);
- whether aggregate treatment should be extended to pass-through entities other than domestic partnerships (including certain trusts or estates); and
- the application of the PFIC rules to domestic partnerships after the Proposed Regulations are finalized (including whether PFIC income inclusions and PFIC-related elections—such as "qualified electing fund" and "mark-to-market" elections—should be made at the level of a domestic partnership or by individual partners, and how any recommended approach would interact with the determinations of a partner's basis in its interest and capital account).

Comments on the Proposed Regulations should be submitted by September 19, 2019.

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[23] *See* PLR 200943004.

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