Dipping Our Toes in Foreign Waters: Outbound International Partnership Issues

Partnership Committee

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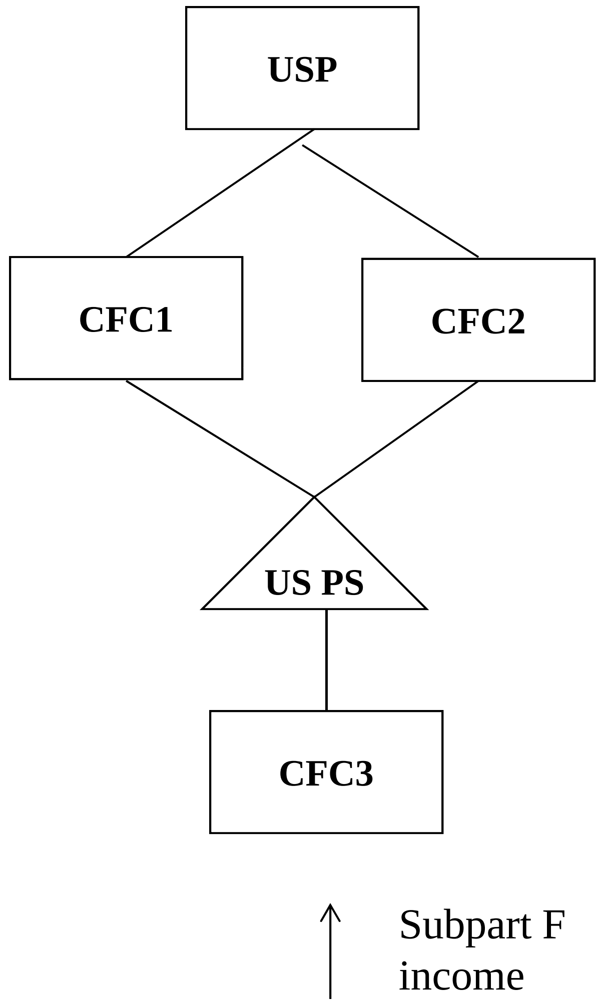
Issues in Entity Classification

Entity Classification Issues – Overrides in International Context

- Various incursions on the check-the-box regulations
  - Section 894 regulations govern availability of treaty benefits on payments to “regular” hybrids (passthrough for US tax purposes) and payments by “reverse” hybrids (passthrough for foreign tax purposes)
  - Notice 2010-41 – regulations to treat domestic partnerships as foreign partnerships for certain subpart F purposes (see infra)
  - Dual consolidated loss rules – “indirect foreign use” of DCL can result from disregarded payments giving rise to deductions under foreign tax law
  - Reg. §1.881-3 – treat a disregarded entity as “person” in determining whether there is a “financing arrangement”
  - Section 909 FTC anti-splitter rules – special rules for income of reverse hybrids and partnership inter-branch payments and -3T(b) anti-abuse rule
- Potential overrides that have not been adopted
  - Administration’s 2009 proposal to prevent disregarded entity treatment for a second- or lower-tier entity not organized in its owner’s country
  - Notice 98-11 and Notice 98-35

Entity Classification Issues – Notice 2010-41

- Taxpayers took position that US PS was US shareholder for subpart F purposes. Avoids subpart F inclusion to USP. IRS viewed this result as inconsistent with purpose of subpart F
- US shareholders include "US persons." Section 951(b).
- Notice 2010-41 – regulations will provide that US PS is treated as a foreign partnership for purposes of identifying US shareholders of CFC3
  - Attribution rules effectively look through foreign business entities (e.g., foreign partnerships). Section 958(a)(2).
  - Under Notice, USP would be treated as US shareholder required to take into account subpart F inclusion



Entity Classification Issues – Contractual Arrangements

- Contractual (as opposed to juridical) business entity – "if the participants carry on a … business … and divide the profits therefrom" (Reg. § 301.7701-1(a)(2))
  - Whether foreign contractual arrangement gives rise to "business entity" that can be "checked" may be difficult threshold question
- Certain foreign countries also recognize contractual P/Ss for tax
  - Might not be an entity in sense that it can own property or sue or be sued, but nonetheless is a "business entity" under check-the-box regs (e.g., English law partnership or Dutch CV)
  - In some cases tax authorities may assert a contractual P/S against T/P, in circumstances where might not be a "business entity" – eg, India assertion of AOP against Linde re consortium with Samsung
  - Some foreign countries do not treat any entities as passthroughs (e.g., Hungary—a general P/S is treated as corp)—Reg. §1.894-1(d) problem.

Entity Classification Issues – Contractual Arrangements, Cont'd

- If a contractual arrangement constitutes a "business entity," how to apply relevant geographical concepts?
  - §7701(a)(4) – partnership is domestic if "created or organized *in*" the US or "*under the law of*" the US ; §7701(a)(5) -- otherwise foreign.
- But, for subpart F §954(c)(4) "same-country" exceptions:
  - Dividends and interest - payer "created or organized *under the law of* the same foreign country (the country of organization) as is the controlled foreign corporation" (Reg. § 1.954-2(b)(4))
  - Similarly, FBC Sales and Services Income - same-country exceptions, same-country purchase or sale exception, and branch rules depend on "country *under the laws of* which…created or organized"
  - Per *Hecht v. Malley*, 265 U.S. 144 (1924), concept of "created or organized *under the laws of*" cannot be relevant for a contractual entity.
  - Hence, use of Scottish P/S where needed for sub F ; risk re China trust.

Foreign Partnership Safe-Harbor Compliance

Foreign Partnership Economic Effect Safe-Harbor Compliance

- Big Three
  - Maintain Partner Capital Accounts in Accordance with the Regulations.
  - Liquidate in Accordance with Partner Positive Capital Accounts.
  - Deficit Restoration Obligation if any Partner's Capital Account has a Deficit upon Liquidation.
- §1.704-1(b)(2)(ii)(b) safe harbor mandates that the Big Three are satisfied "if and only if, throughout the full term of the partnership, the partnership agreement provides" for the Big Three.
- Alternate Test for Economic Effect
  - Requires Liquidation in Accordance with Positive Capital Accounts.
- Economic Effect Equivalence
  - Ambiguous
- (We set aside the "substantiality" requirement for this discussion.)

Foreign Partnership Safe-Harbor Compliance

- Unlike Delaware law, even after some recent revisions to foreign statutes, it is still not entirely clear whether you can achieve the equivalent of US partnership tax law capital account liquidation under the commercial laws of many countries.
- Liquidation regime under the commercial laws of many countries may not track the Treasury regulation capital account maintenance requirements.
- If not, if may not be possible to satisfy the liquidate in accordance with partner positive capital account balances requirement.
- Solution is to use targeted allocations and rely on PIP.

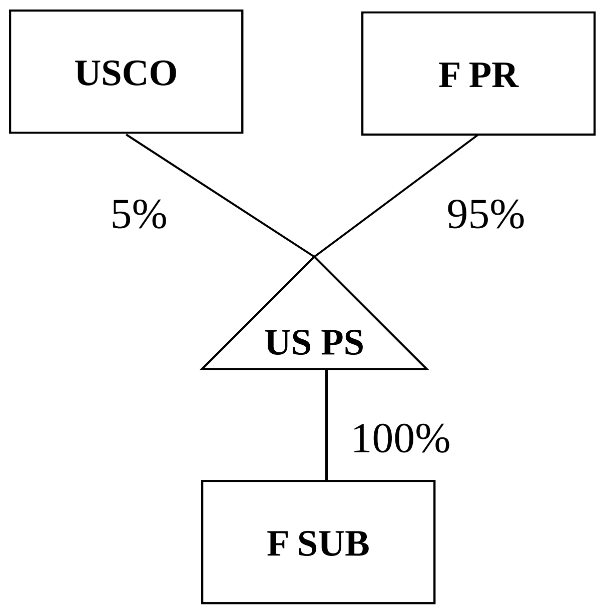
Foreign Partnership Economic Effect Safe-Harbor Compliance

- Under PIP, no assurance partnership allocations will be respected.
- Moreover, using targeted allocations and relying on PIP, under current US partnership tax law, prevents the foreign partnership from relying on certain additional safe harbors the operation of which are contingent on satisfying the safe harbor.
  - §1.704-2(e)(1)
  - Others?

Select Issues Involving CFCs and Partnerships

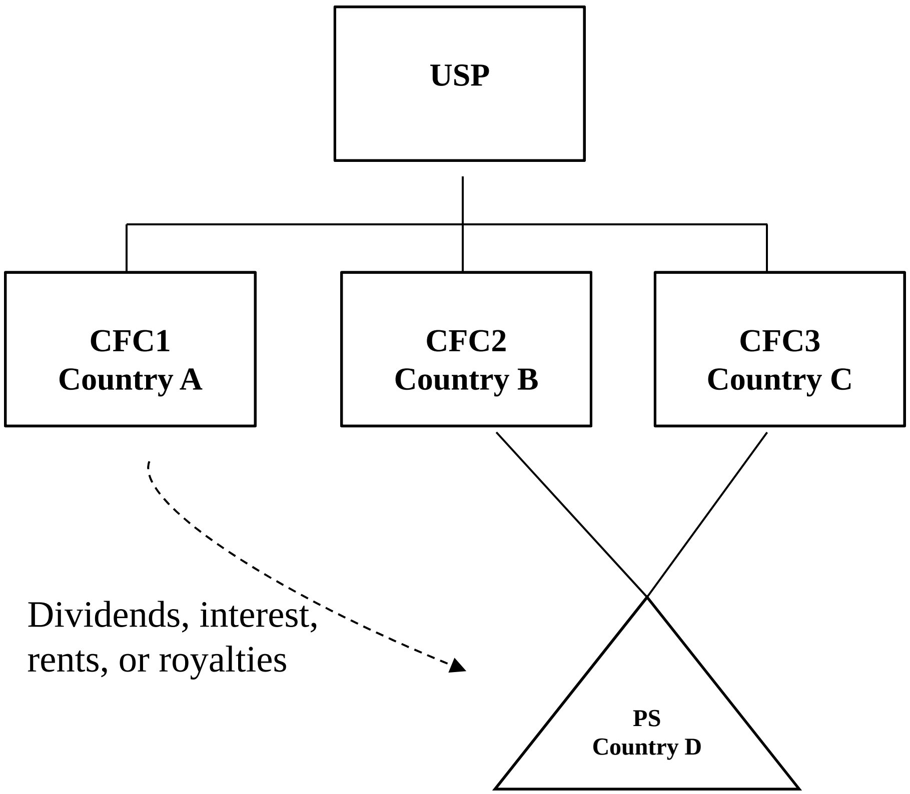
Subpart F Issues – CFC Status

- Because US PS is a domestic partnership and, therefore, a U.S. person under §7701(a)(30), it is a US shareholder for purposes of §951(b) and 957(a)
- Consequently, F Sub is a CFC despite the fact that USCo owns only 5% indirectly (*cf. Textron v. Commissioner*, 117 T.C. 67 (2001) (regarding ownership through a grantor trust)
- USCo must include its distributive share of US PS's subpart F inclusions in income



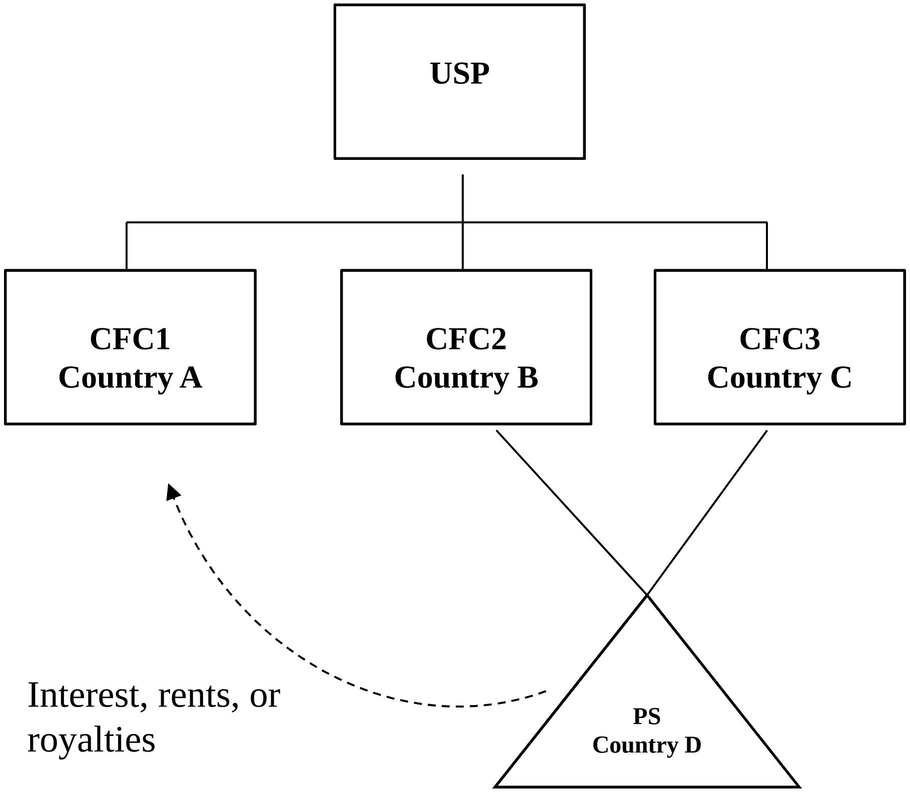
Subpart F Issues – Section 954(c)(6) Look-Through Rule

- §954(c)(6) generally excepts from FPHCI dividends, interest, rents, or royalties paid by related CFC to the extent not attributable to subpart F income of payer CFC
- Payments received by partnership treated as received by CFC partners (Notice 2007-9)
- CFC2's and CFC3's distributive shares of income exempt under §954(c)(6) to the extent payment not attributable to subpart F income of CFC1



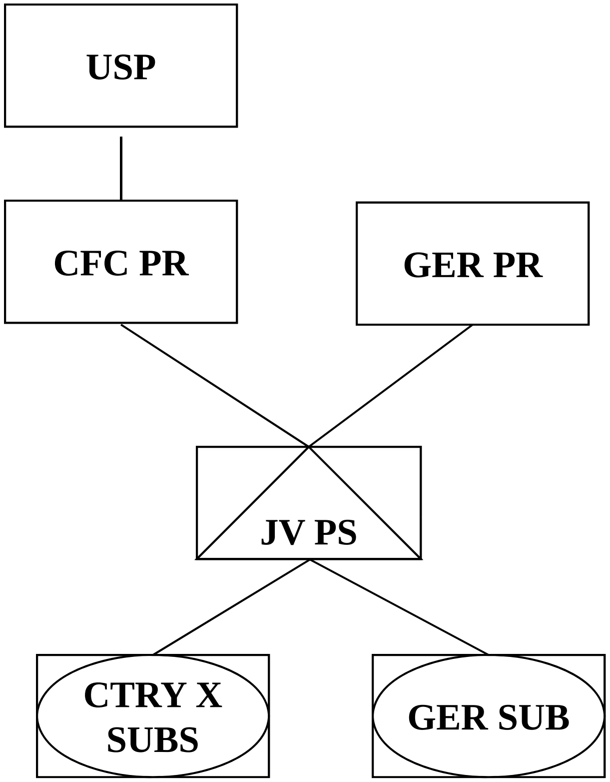
Subpart F Issues – Section 954(c)(6) Look-Through Rule

- Payments made by partnership treated as made by CFC partners (Notice 2007-9)
- Payment to CFC1 treated as made by CFC2 and CFC3
- CFC1's income exempt under §954(c)(6) to the extent payment not attributable to subpart F income of CFC2 or CFC3



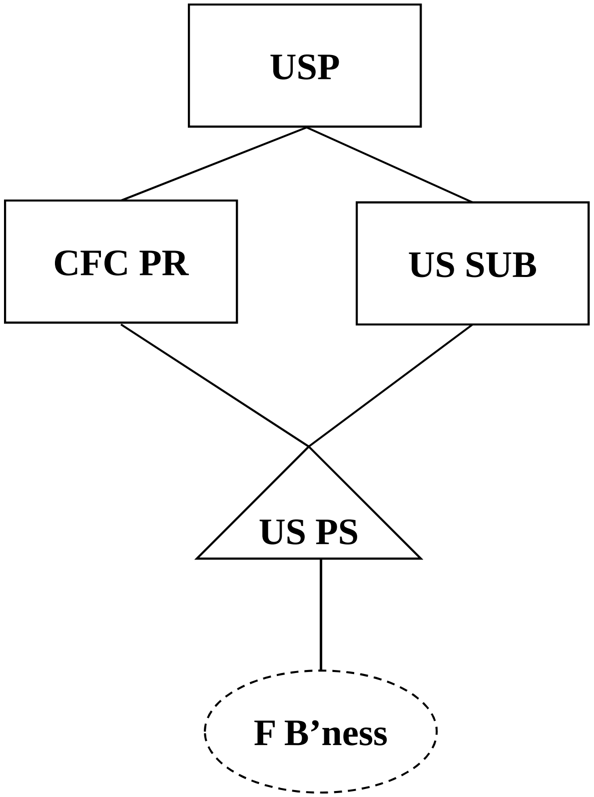
Subpart F Issues – Advantages of CFC Partner in Joint Venture

- If joint venture does not involve U.S. operations, using a CFC partner generally advantageous
- Transfers of intangible property
  - Intangibles owned by CFC PR can be contributed US tax-free
  - Intangibles owned by USP can be licensed to CFC PR, and CFC can contribute rights to JV
  - Avoids §367(d)
  - Maintain deferral on JV profits, subject to royalties paid by CFC PR to USP
- Provided all JV subsidiaries are disregarded entities, JV profits can be distributed to partners without US tax consequences
- If JV subsidiaries are passthroughs, subpart F rules must be considered regardless even if CFC PR is less than 50% partner in JV

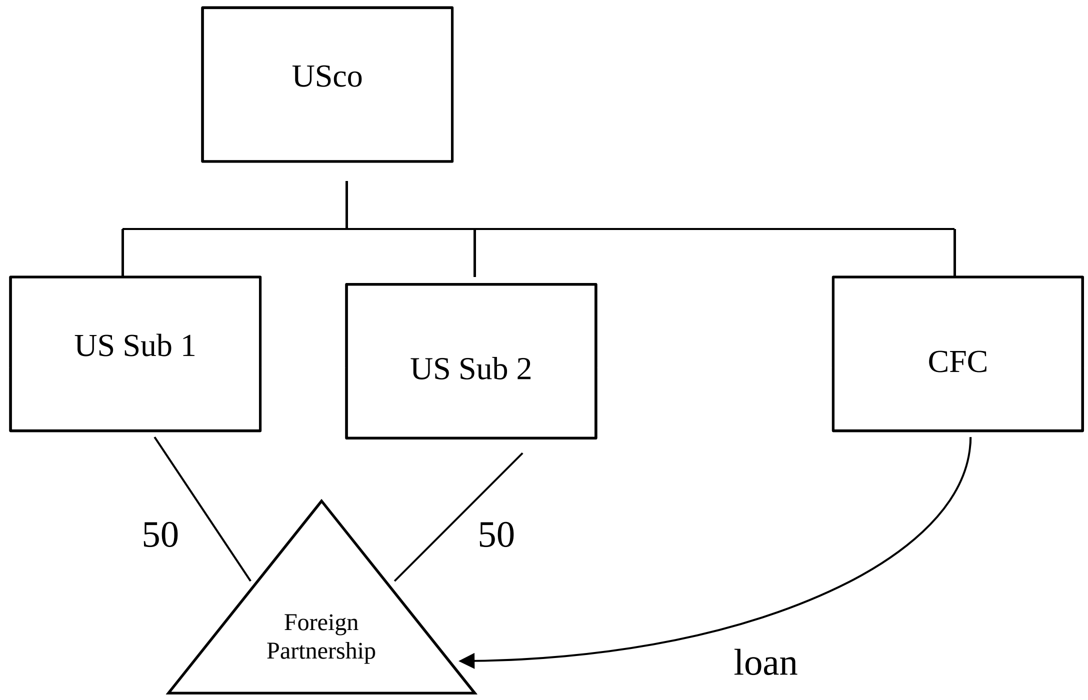


Subpart F Issues – Section 956

- Generally, section 956 causes US shareholder to have subpart F inclusion for share of CFC's investment in "U.S. property"
- Generally, look-through partnership interest to partnership's assets for purposes of section 956 (i.e., aggregate approach) (Reg. § 1.956-2(a)(3); Rev. Rul. 90-112)
- CFC PR would not be treated as holding U.S. property because US PS's assets used in foreign business

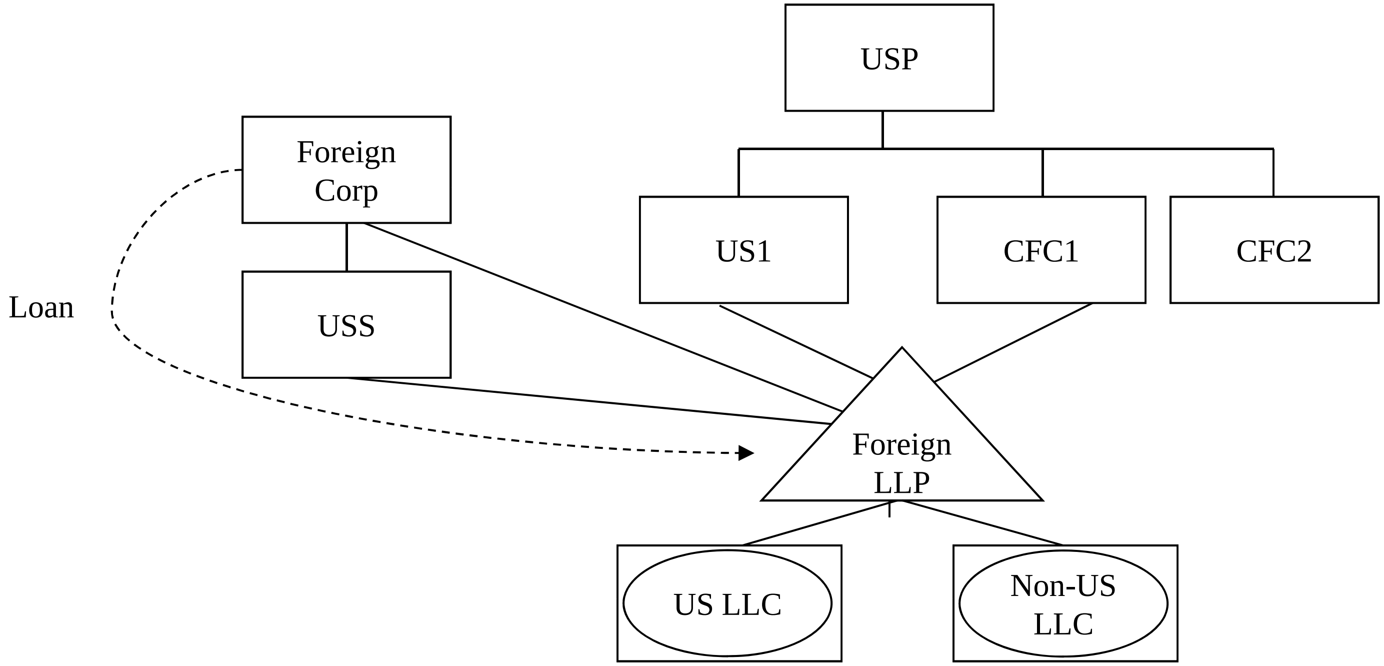


Subpart F Issues – Section 956; Loan by CFC to Partnership



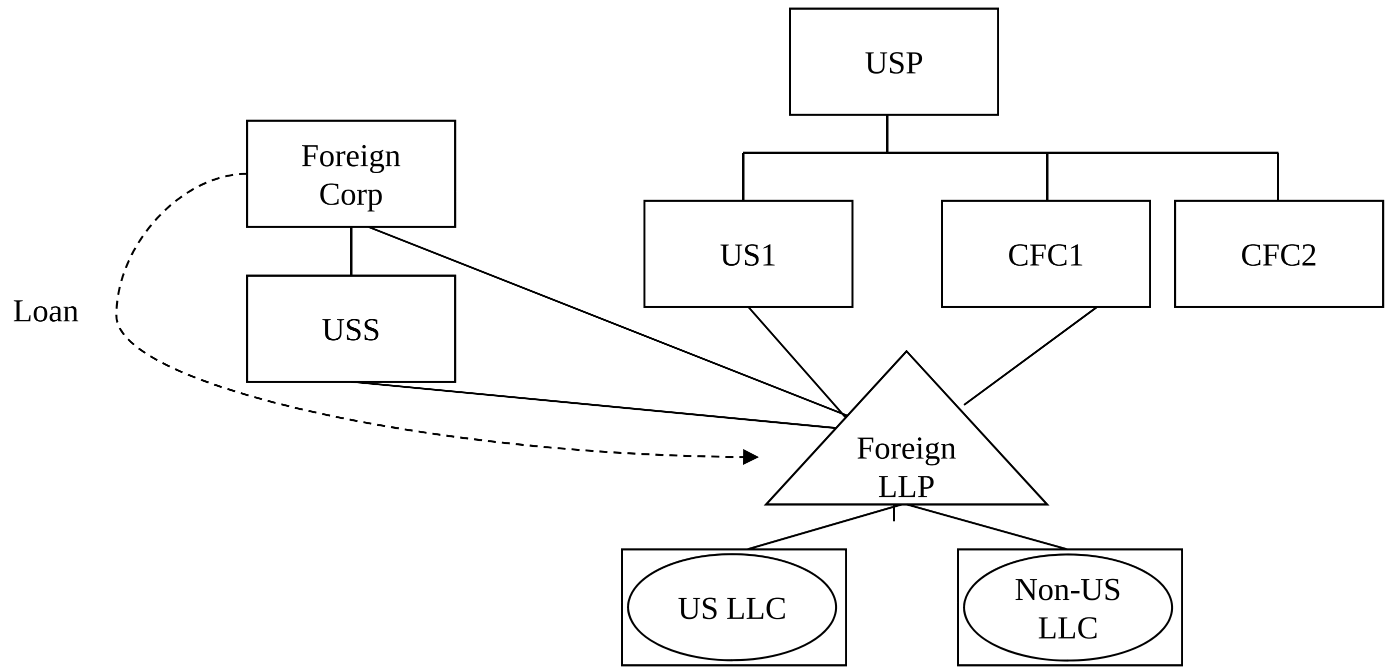
- Comment by IRS official indicates IRS is working on issues raised by partnerships and §956. Regs planned?
- Issues include: automatic aggregate rule? Liability for debt under foreign law? Use of funds by partnership?

Subpart F Issues – Section 956 Cont'd; PLR 200832024



- US1, CFC1, and unrelated Foreign Corp contribute cash to Foreign LLP, which acquires U.S. business from USP and non-U.S. business from CFC2.
- Non-US LLC holds no U.S. property. No fund transfers between U.S. LLC and Non-U.S. LLC.
- CFC1 has no interest in any items or assets of US LLC.

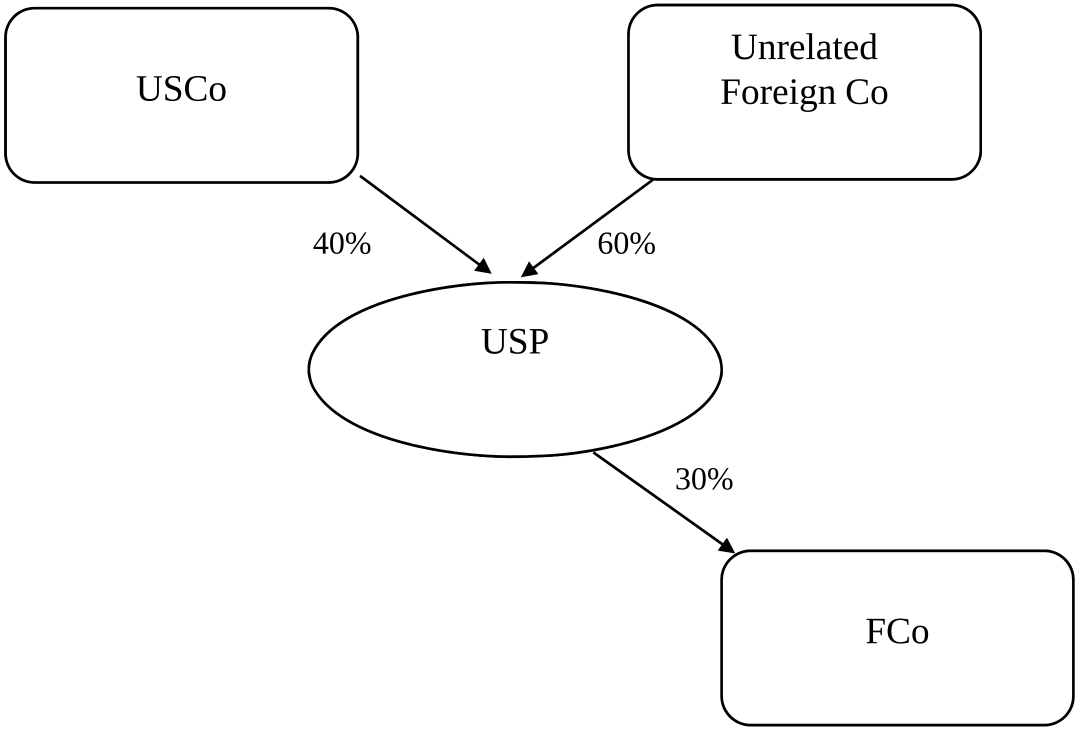
Subpart F Issues – Section 956 Cont'd; PLR 200832024



- IRS held no investment in U.S. property for CFC1. (Also CFC1 and USS should not be engaged in U.S. trade or business.)
- Tough reps (e.g., business "will be conducted in substantially the same manner" going forward)
- Possible reasons Loan is OK/ not deemed in part made to US1 and indirect support from CFC1's Non-US LLC assets: (1) not obligation of a US person w/i §956(b)(1)(C); entity treatment strong since no owner liability and 3rd party partner; (2) LLC is analogous to a corp for §956 and no 66-2/3% pledge.

Some Background Observations on Foreign Tax Credits via Partnerships

§902 Credits Through a Partnership



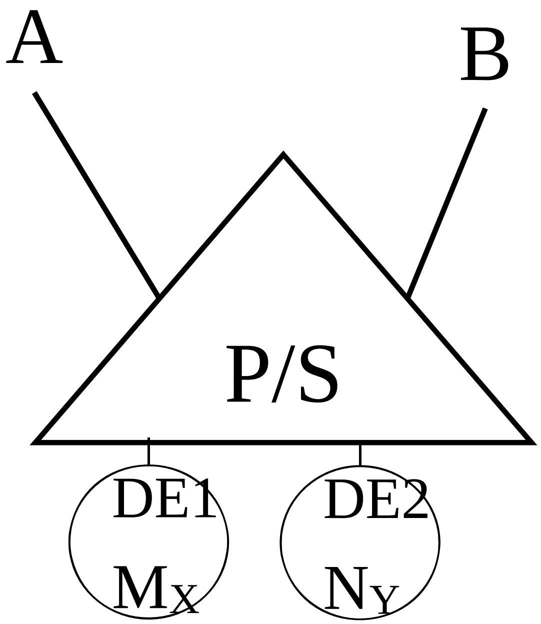
•§902(a) requires a US corp to own a minimum of 10% of the vote of a foreign corp to qualify for the §902 deemed paid credit.

•§902(c)(7) allows constructive ownership through the P/S, whether the corp is a limited or general partner and whether the P/S is foreign or domestic.

•§904(d)(3) look-through rule for the basket for the §904(d) limiting fraction.

§704(b) Rules Governing Allocation of Taxes Imposed on P/S (Creditable Foreign Tax Expenditures - CFTEs)

Assume P/S, with and B partners, conducts 2 businesses, M in country X in DE1 and Y in Country Y in DE2, and allocates M profits 75-25 and N profits 50-50; and M and N each tax the entity.



	US Net Inc.	Tax	A-B Split
M_X	\$100	\$40	75%-25%
N_Y	\$50	\$10	50%-50%

A: \$75 Inc, \$30 Tax (M); \$25 Inc, \$5 Tax (N)
B: \$25 Inc, \$10 Tax (M); \$25 Inc, \$5 Tax (N)

For SEE, allocated in proportion to distributive shares of income. §1.704-1(b)(4)(viii), and Ex. 21 (simple case). See Ex. 24, discussed infra, where splitter issues due to interbranch expense disregarded for US but not foreign purposes.

"Baskets" for P/S Income for Calculating §904(d) Foreign Source Income FTC Limit

- FTC foreign source income (FSI) limitation fraction (§904(a)) for FTCs--must be applied separately to <u>§904(d) baskets</u> (generally <u>"passive" and "general"</u>).

- Generally, determine §904(d) <u>baskets at the P/S level</u>. §1.904-5(h).

  - A "partner's distributive share of P/S income. . . [is] income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category."

  - <u>Interest, rent or royalties</u> that are paid to a partner in a non-partner capacity are income in a separate category to <u>the extent allocated</u> to the P/S's income in that category if the partner owns 10% or more of the P/S's capital and profits and look-through rule would apply if the P/S were a foreign corporation. §1.904-5(h)(1).

- For the treatment of a sale of a P/S interest, see §1.904-5(h)(3) (passive, except on look-through basis if 25% or greater owner).

- For allocation of interest <u>expense</u> in calculating FSI limit where a P/S, see §1.861-9T(e).

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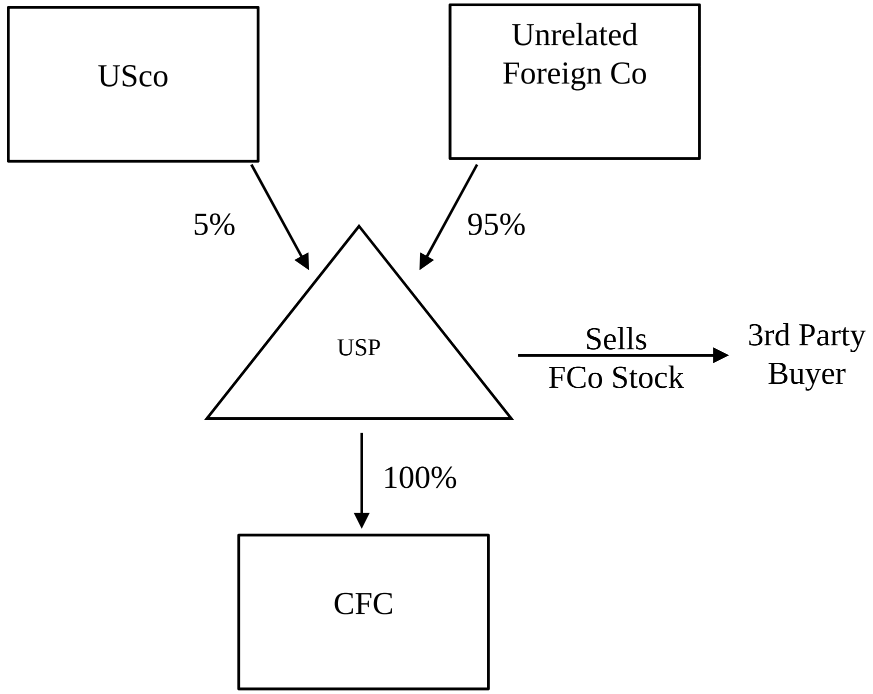
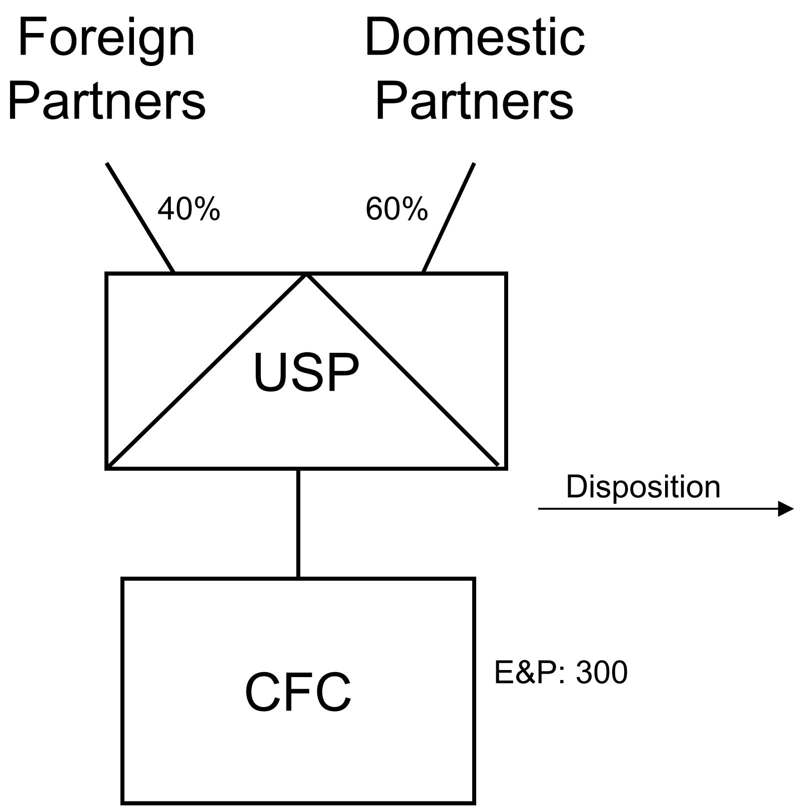
Select Section 1248 Issues Involving Partnerships

§1248 Sale by U.S. Partnership



- §1248 treats gain from sale of CFC by a 10% voting stock owner as a dividend with FTCs to extent of relevant E&P of the CFC.
- If USco had held 5% of FCo stock directly, it would not qualify for §1248(a) treatment.
- However, under the partnership structure, U.S. Partnership is a U.S. person holding 100% of FCo stock, and accordingly, §1248(a) applies to the sale. §7701(a)(30)(B), §1.1248-1(a)(1); Rev. Rul. 69-124.

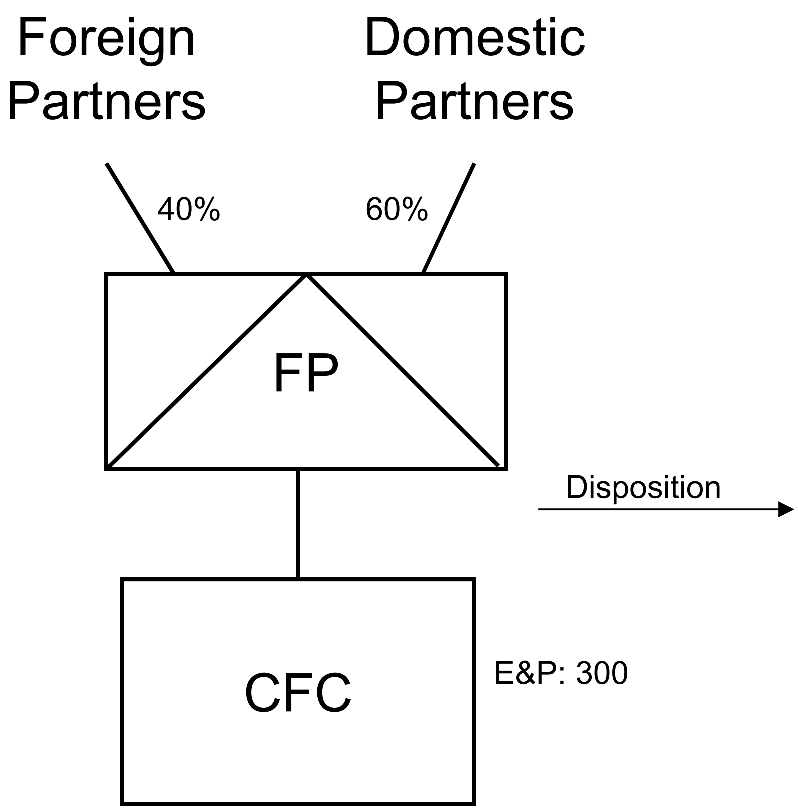
§1248 and Partnerships: Sale of CFC by Domestic Partnership



CFC FMV	600
Partnership Basis in CFC	100
Gain on Sale	500
§1248:	300
Capital Gain:	200

- Disposition treated as a sale of CFC stock by a US person to which §1248 applies.
- Each domestic partner allocated its respective share of §1248 dividend income and capital gain.
- Credits allowable to ≥10% domestic partners under Rev. Rul. 71-141 and §902(c)(7).
- If lower tier CFCs as well, §1248 dividend amount would reflect their E&P.

§1248 and Partnerships: Sale of CFC by Foreign Partnership

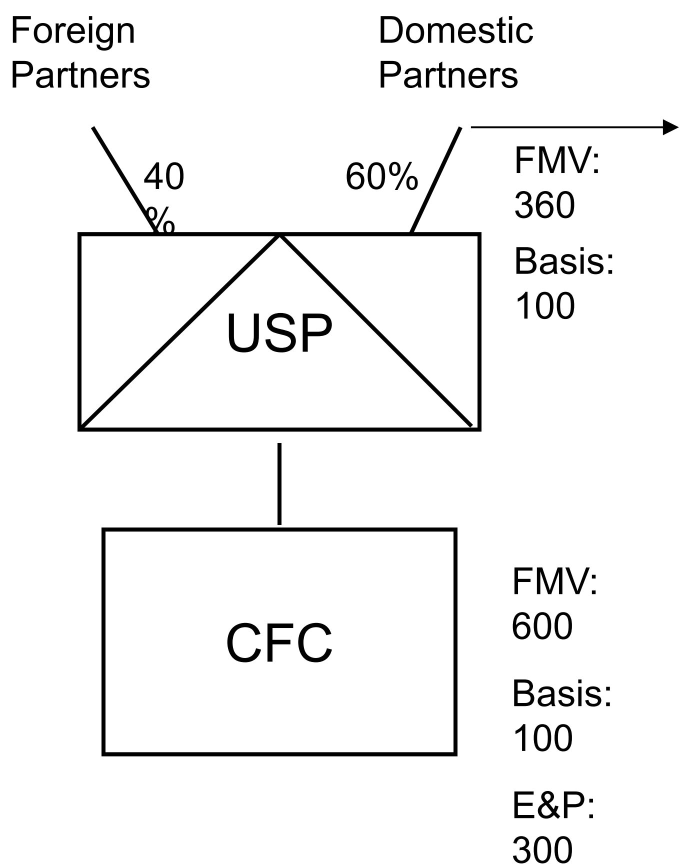


See Treas. Reg. §1.1248-1(a)(5), Ex. 4.

Partners of Foreign Partnership treated as selling or exchanging their proportionate share of the stock of CFC. Treas. Reg. §1.1248-1(a)(4).

CFC FMV	600
Partnership Basis in CFC	100
Gain on Sale	500
Gain Allocable to Domestic Partners (60% x 500)	300
E&P Allocable to Domestic Partners (60% x 300)	180
§1248 Amount	180
Capital Gain `	120

§1248 and Partnerships: Sale of Interest in Partnership Holding CFC Stock



<u>Issue</u>: Availability of FTCs?

- §751(c) treats stock of a CFC held through a partnership as a zero-basis unrealized receivable in an amount equal to the potential §1248 dividend amount.

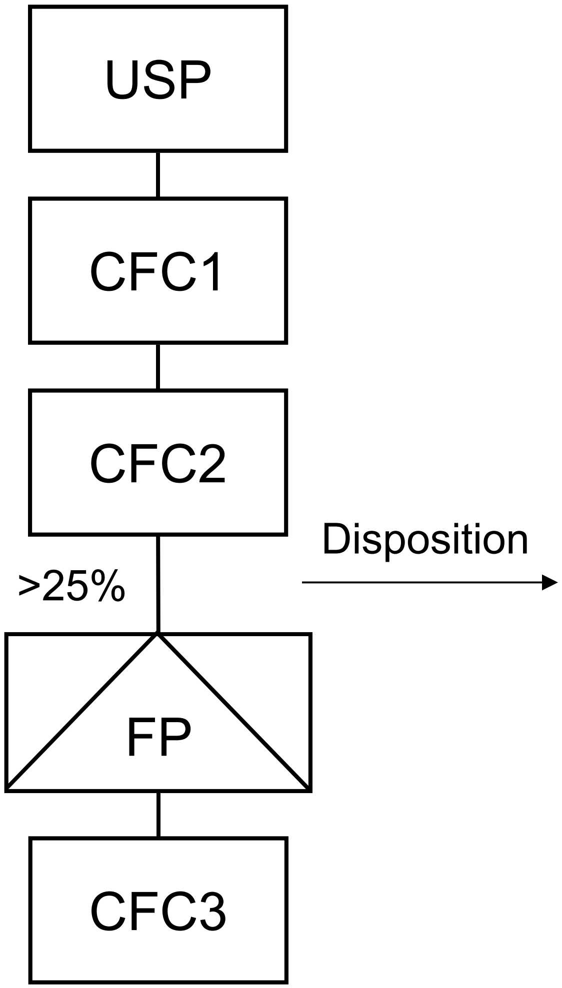
CFC FMV	600
Partnership Basis in CFC	<u>100</u>
Gain on Sale	500
Potential §1248 Dividend Amount	300

- A domestic partner of the partnership recognizes ordinary income to the extent of its share of any gain that would have been treated as a dividend under §1248 had the partnership sold the CFC stock directly. <u>§1.751-1(c)(4)(iv)</u>.

FMV Partnership Interest	360
Basis in Partnership Interest	<u>100</u>
Gain on Sale	260
§751(c) Ordinary Income (Allocable Share of Potential §1248 Amount)	(1<u>80</u>)
§741 Capital Gain	80

FTCs <u>not</u> available! §1248(g)(2) (§1248 yields). Trap!

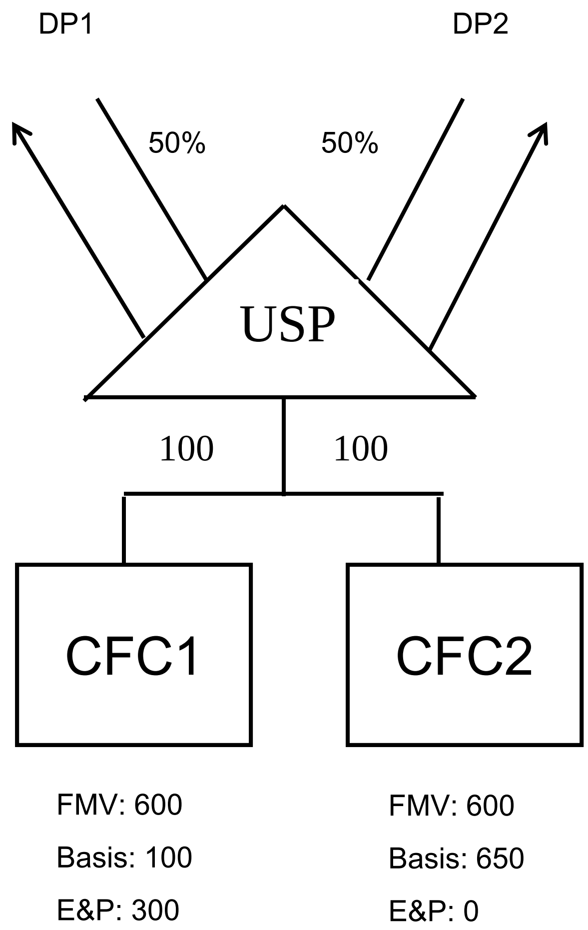
§1248 and Partnerships: Sale by CFC of Substantial Interest in Partnership Holding CFC Stock



- <u>Subpart F</u>: §954(c)(4) treats CFC2's sale of FP as a sale of CFC2's proportionate share of assets of FP (i.e., CFC3 stock).
- But only "for purposes of this subsection." So:
  - Not treated as a sale of CFC3 stock by CFC2 for purposes of §964(e) (which would treat as if §1248 applied)?
    - And if no 964(e)/1248, then no deemed dividend/FTCs to CFC2.
  - See §1248(g)(2) (§1248 yields to other OI provisions, and so 751 would apply if 964(e) does not).

Partnership Liquidation Issues in the International Context

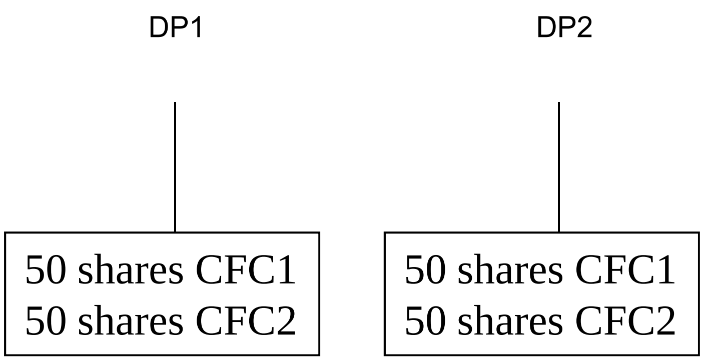
§1248 and Partnerships: Complete Liquidation of a Partnership Holding §1248 Stock



- DP1 and DP2 are U.S. citizens and are equal partners in the "straight-up" USP.
- USP owns two assets – stock of CFC1 and stock of CFC2.
- Assume no gain is recognized on the liquidating distribution under §731.
- §1248 only operates when gain is recognized. §1248(a) bottom flush language.
- When stock in a CFC is owned by a partnership, the amount of potential §1248 dividend income is treated as a zero-basis unrealized receivable under §751(c). §1.751-1(c)(4)(iv), 1.751-1(c)(5).
- If USP liquidates distributing 50 shares of CFC1 and 50 shares of CFC2 each to DP1 and DP2, then presumably each partner inherits part of the CFC1 stock with a zero basis and a $150 potential §1248 amount. *See* §751(c) (bottom flush language), §1.751-1(c)(4)(iv), §1.751-1(b)(5), and §732(c)(1)(A). (Note: the same should be true if a US partner received a tax-free liquidating distribution from a foreign partnership.)

§1248 and Partnerships: Complete Liquidation of a Partnership Holding §1248 Stock

Post Liquidation



- Issue 1: Does §1248 or §751 cause gain to be recognized to either DP1 or DP2? No.
- Issue 2: What happens to the inherent §1248 amount in the CFC1 stock upon liquidation? Does §735 apply? Yes.
  - §751(c) (bottom flush) – expanded definition of "unrealized receivable" (including §1248 stock) applies "[f]or purposes of *this section* and sections 731, 732, and 741 . . . ."
  - §735 – applies to gain or loss on the disposition by a distributee of unrealized receivables (*as defined in §751(c)*) distributed by a partnership.
- Issue 3: For purposes of §735, is the CFC1 stock received in liquidation of USP divided into two separate tranches – a §1248 tranche and a non-§1248 tranche? Presumably so. See §732(c).
  - If not, is a portion of each share of CFC1 stock treated as subject to §1248 (and another portion of each share treated as not subject to §1248)?
  - May the distributee partner specifically identify which share(s) of CFC1 stock contain the §1248 taint? See, e.g., §1.358-2, §1.1012-1(c) (allowing specific identification).
- Issue 4 (related to Issue 3): How does one track the §1248 amount into the future? Unclear.

§1248 and Partnerships: Complete Liquidation of a Partnership Holding §1248 Stock

DP1

50 shares CFC1
50 shares CFC2

50 shares CFC1 divided into tranches

§1248 Tranche:
AB = $0
FMV = $150

Non§1248 Tranche:
AB = $150
FMV = $100

DP2

50 shares CFC1
50 shares CFC2

- Post Liquidation Depreciation: What if DP1 sells the 50 shares of CFC1 stock for $100 (i.e., the price depreciated post distribution)? No gain or loss on sale. Does §1248 apply? Presumably no.
- What if DP1 sells the 50 shares of CFC1 stock for $150? $50 gain on sale. Does §1248 apply? Probably so, but it depends.
  - Is the §1248 amount a separate tranche?
  - Is each share of CFC1 partially hot and partially not?
  - Does the §1248 amount attach to some, but not all, shares of the CFC stock distributed to DP1?
    - If so, may DP1 specifically identify the shares DP1 sells?
- Post Liquidation Appreciation: What if DP1 sells 25 shares of CFC1 stock for $200 (because the price appreciated post-distribution)?
  - Does the sale trigger all of the §1248 amount?
  - If not, how much is triggered?

§1248 and Partnerships: Complete Liquidation of a Partnership Holding §1248 Stock

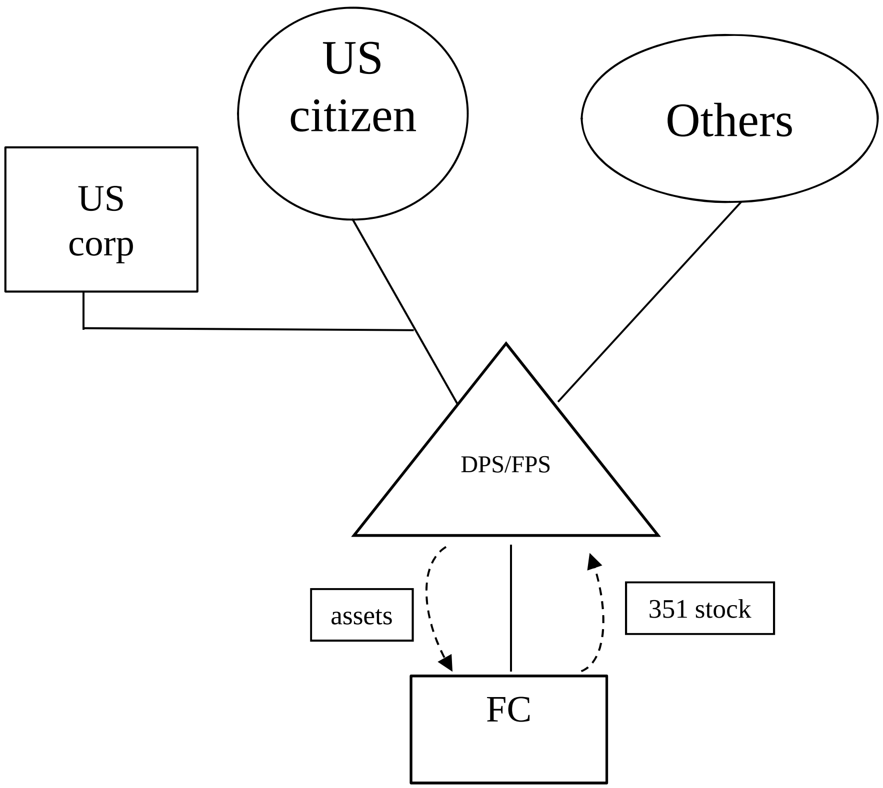
- Issue may also arise in nonliquidating partnership distributions.
- Issue may arise any time a partnership distributes a single asset with both a hot and a not hot component
  - 1245 recapture property
  - 1250 recapture property
  - 1253 oil, gas and geothermal property

§1248 and Partnerships: Complete Liquidation of a Partnership Holding §1248 Stock

- Possible Tracing/Identification Regimes for §1248 stock distributed by a partnership:
  - 1.1248-8
  - 1.367(b)-13
  - 1.358-2
  - 1.1012-1(c)
  - Others?

Section 367 and Partnership Transfers

Section 367 and Partnership Transfers



Example assumes section 7874 is not implicated

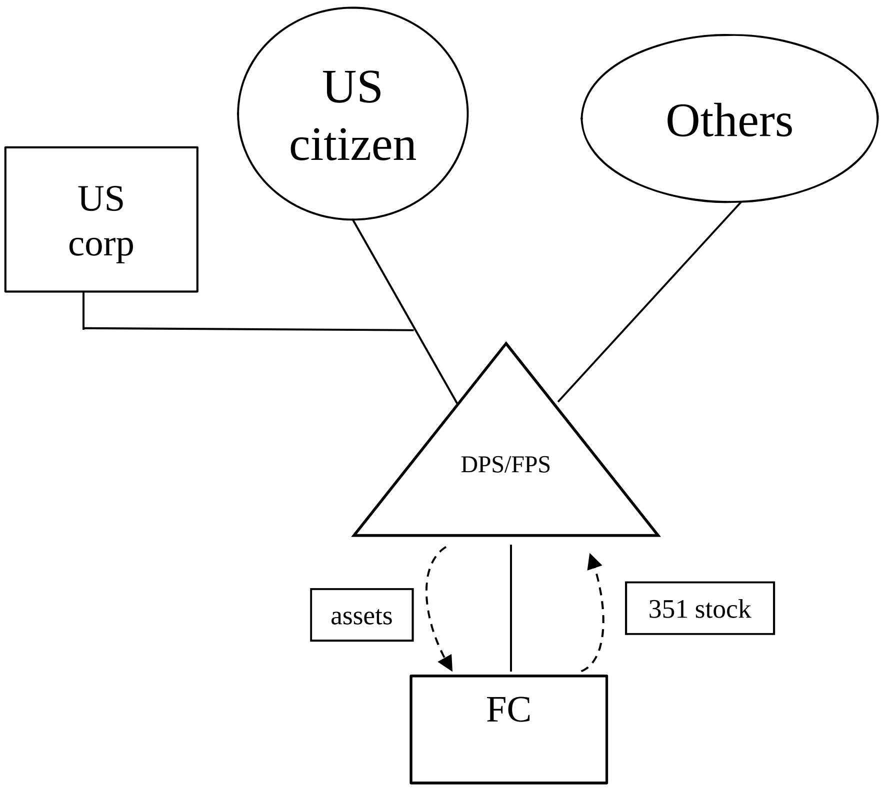
- U.S. persons that are partners in the partnership treated as having transferred a proportionate share of the property in an exchange described in section 367(a)(1).

-Aggregate approach. See Treas. Reg. 1.367(a)1T(c)(3)(i)

- A U.S. person's proportionate share of partnership property is determined under the rules and principles of sections 701 through 761 and the regulations thereunder.

-Do you look to at partners' capital accounts or interest in partnership income (net or gross)? Do you just look to the year of transfer?

Section 367 and Partnership Transfers



Example assumes section 7874 is not implicated

- If U.S. person is required to recognize gain upon the transfer (i.e., no exception to gain recognition under section 367(a) applies), then—

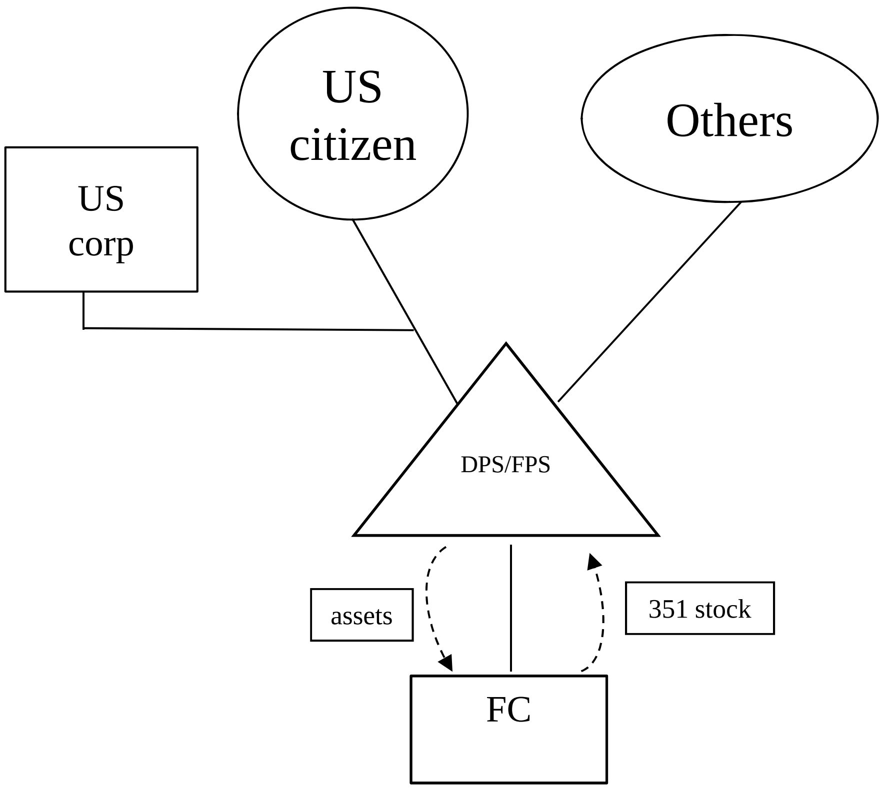
-U.S. person's basis in the partnership shall be increased by the amount of gain recognized by him;

-Solely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the U.S. person is treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754; and

-Transferee foreign corporation's basis in the property acquired from the partnership is increased by the of gain recognized by U.S. persons.

- *For transfers of partnership interests, see Treas. Reg. 1.367(a)-1T(c)(3)(ii).*
- Section 367(d) provides that for purposes of determining whether a U.S. person has made a transfer of intangible property that is subject to section 367(d), the rules of Treas. Reg. 1.367(a)-1T(c) apply. See Treas. Reg. 1.367(d)-1T(a).

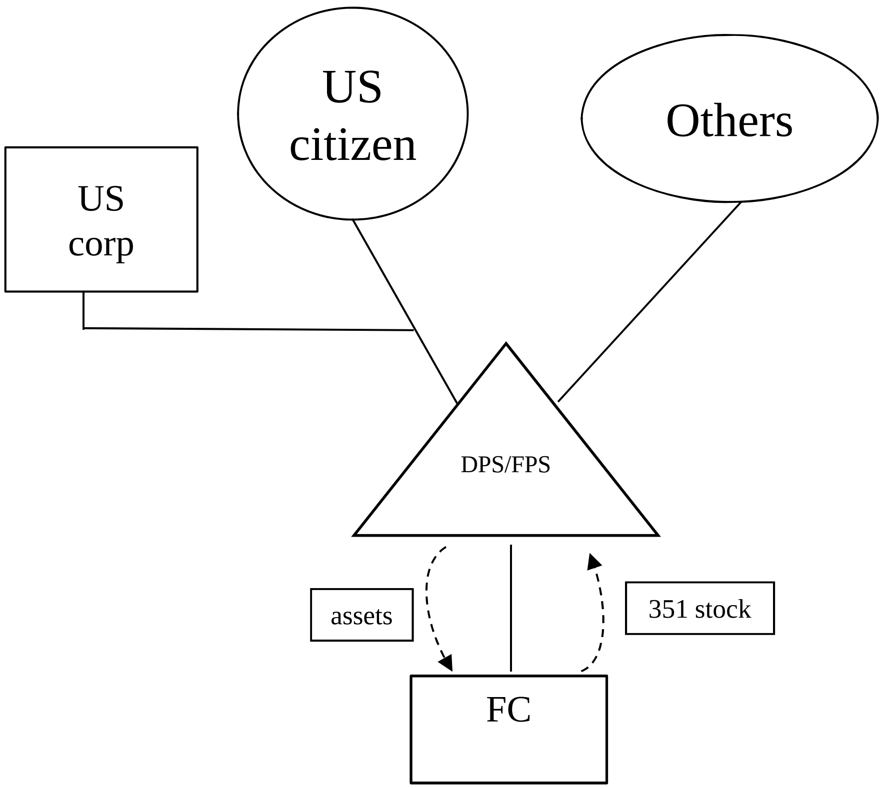
Section 367 and Partnership Transfers



Example assumes section 7874 is not implicated

- In this example, if a domestic partnership (DPS) transfers stock of a CFC (or, in some cases, a former CFC) to FC, in applying Treas. Reg. 1.367(b)-4, DPS generally is treated as a section 1248 shareholder (entity approach).
- Treas. Reg. 1.367(b)-2(k) provides that stock of a corporation that is owned by a *foreign* partnership is considered as owned proportionately by its partners under the principles of Treas. Reg. 1.367(e)-1(b)(2). (e.g., US corp is treated as owning its proportionate share of stock owned by FPS). Aggregate approach

Section 367 and Partnership Transfers



Example assumes section 7874 is not implicated

- Given the language of Treas. Reg. 1.367(b)-2(k), if one of the U.S. partners of FPS is a section 1248 shareholder of a CFC (or, in some cases, a former CFC) that is being transferred by FPS to FC, is such partner treated as engaging in a section 351 exchange for purposes of Treas. Reg. 1.367(b)-4 ?

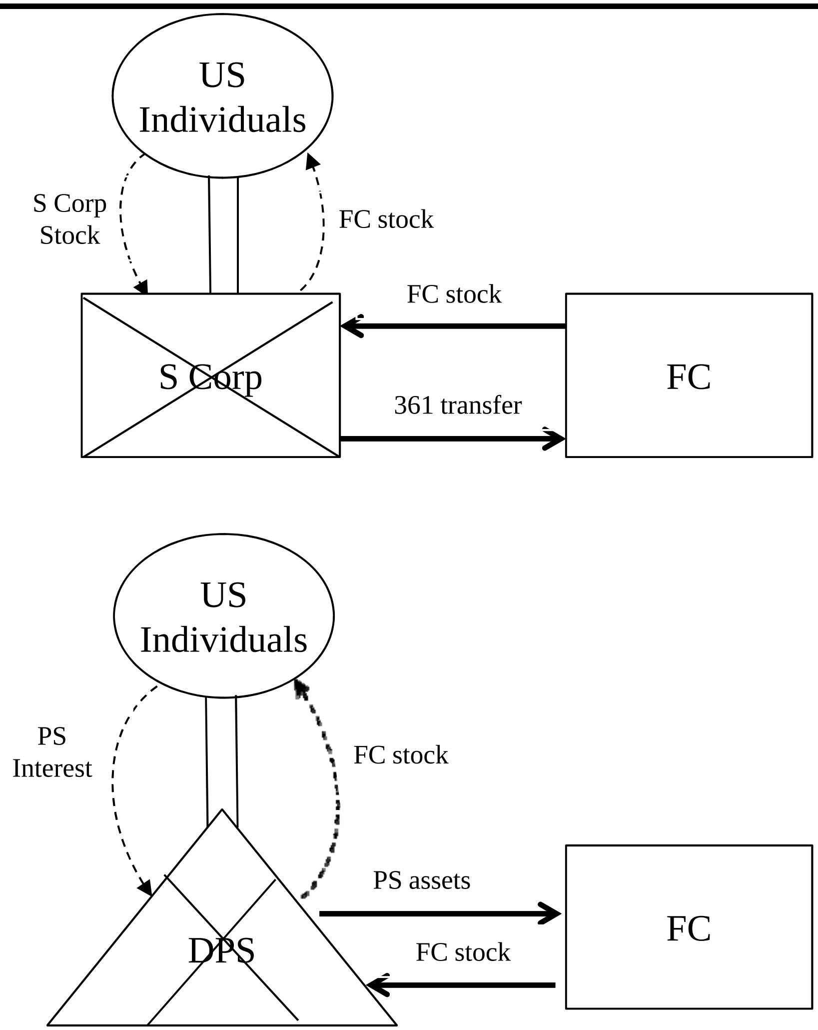
  -Note: Treas. Reg. 1.1248-1(a)(4) provides that, for purposes of applying section 1248, if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated as exchanging their proportionate share of stock of such corporation.

- Depending on the particular facts, other international tax issues may need to be considered as a result of the transfer (DCL issues, 987 issues, etc.)

Section 367(a)(5) Partnership v. S Corporation Considerations*

***These slides were prepared on January 19th prior to the issuance of any final regulations under section 367(a)(5)**

Section 367(a)(5)
S Corp vs. Partnership

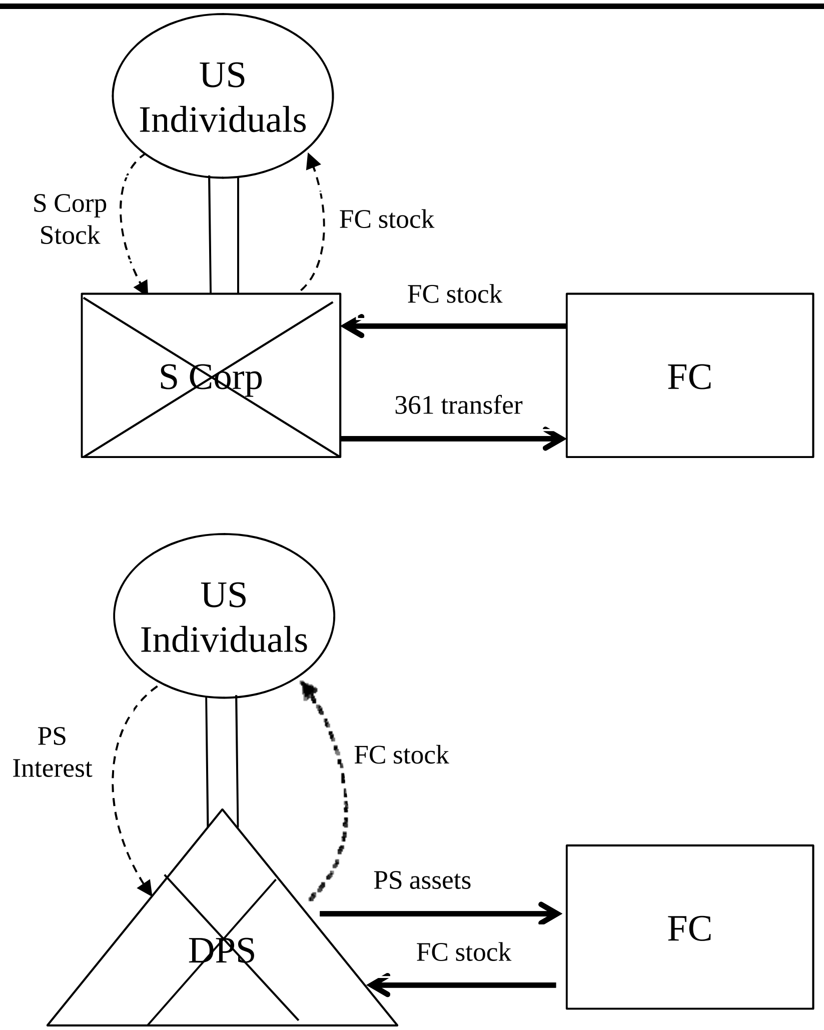


*** Assume neither transfer is subject to section 7874**

- Section 367(a)(5) provides that section 367(a)(2) and (3) [certain exceptions to the general gain recognition rule of section 367(a)(1)] shall not apply in the case of an exchange described in section 361(a) or (b) exchange. Subject to such basis adjustments and such other conditions as shall be provided in regulations, the preceding sentence shall not apply if the transferor corporation is controlled (within the meaning of section 368(c)), by 5 or fewer domestic corporations. For purposes of the preceding sentence, all members of the same affiliated group (within the meaning of section 1504) shall be treated as 1 corporation.

- IRS has broad authority under section 367(a)(6) to exempt certain transaction from section 367(a)(1) in order to carry out the purposes of section 367(a).

Section 367(a)(5)
S Corp vs. Partnership



*** Assume neither transfer is subject to section 7874**

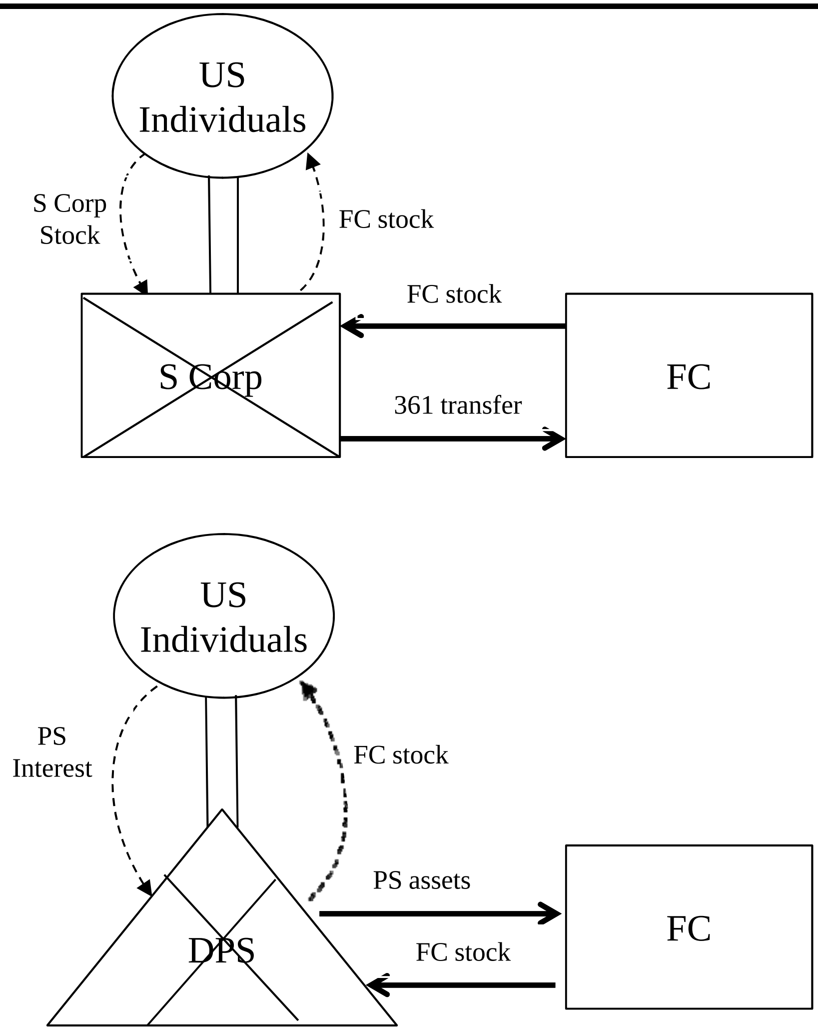
- IRS has issued proposed regulations under section 367(a)(5) in 2008 providing guidance on the application of section 367(a)(5).

  -Section 367(a)(5) applies to exchanges that are section 351/361 overlap transactions

  -The preamble to the proposed regulations clarifies that Section 367(a)(5) applies to S corporations that make section 361 transfers [An S corporation generally is treated as a domestic corporation that can make a section 361 transfer to a foreign corporation in an asset reorganization]

  --S corporations cannot satisfy section 367(a)(5) requirements (S corporations are not controlled by 5 or fewer domestic corporations)

Section 367(a)(5)
S Corp vs. Partnership



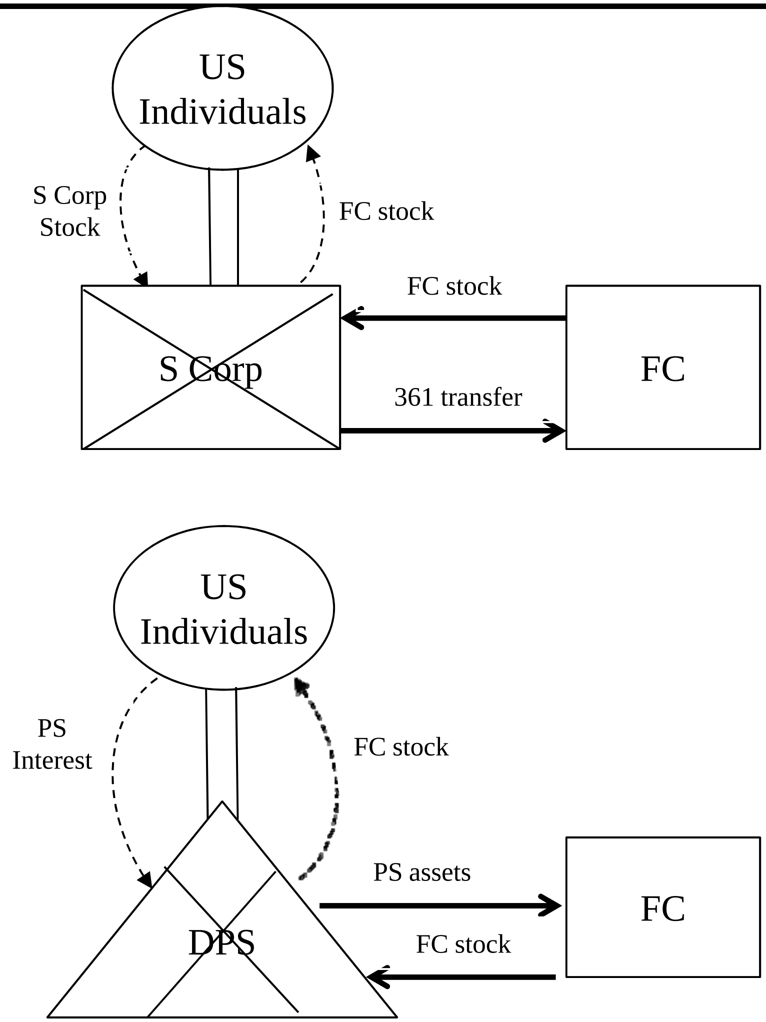
*** Assume neither transfer is subject to section 7874**

- This should be compared to the transfer by DPS in this example of its assets to FC [DPS is not a domestic corporation that can make a section 361 transfer of its assets to FC in an asset reorganization]

  --Although U.S. persons (U.S individuals) that are partners in the partnership are treated as transferring their proportionate share of the assets for purposes of section 367(a), such a deemed transfer should not be a section 361 transfer (assume this exchange is a section 351 exchange).

  -Thus, section 367(a)(5) N/A to this exchange and exceptions to general gain recognition rule of section 367(a)(1) available if requirements for such exceptions otherwise satisfied.

Section 367(a)(5)
S Corp vs. Partnership



*** Assume neither transfer is subject to section 7874**

- Is this different treatment of S corporations and partnerships warranted?

  -Major focus of section 367(a)(5) is preservation of corporate-level tax

  -Subject to certain exceptions (e.g., section 1374), S corporations generally are not subject to corporate level tax and are treated as a flow thru entity.

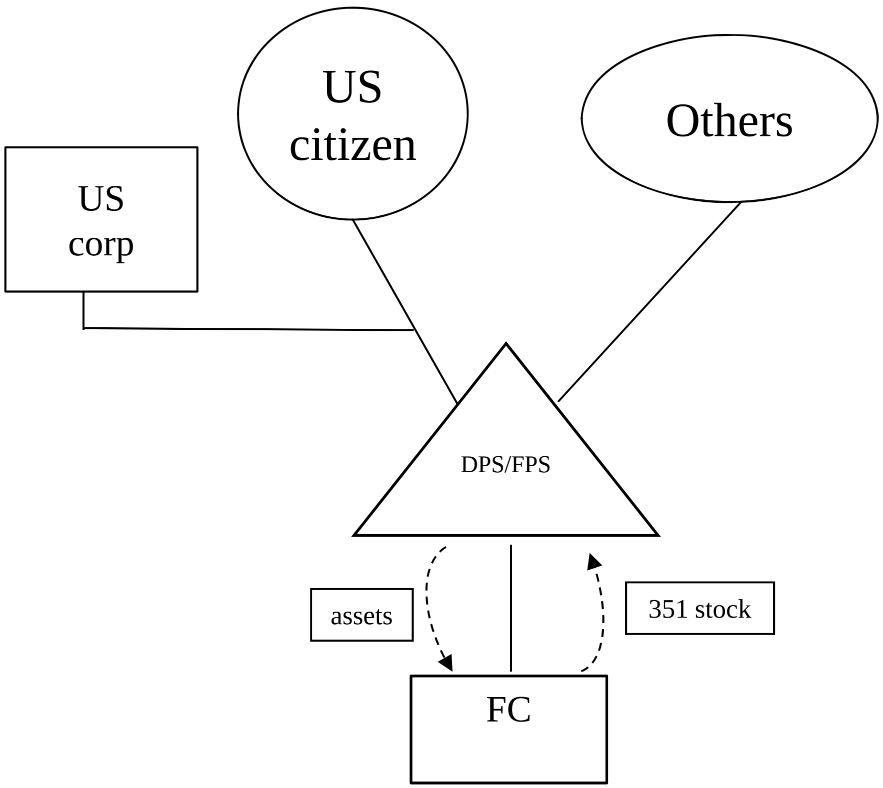
  -Proposed regulations recognize that S corporations generally are not subject to corporate level tax for purposes of the control group requirement because proposed regulations do not treat S corporations that own stock in other domestic corporations making a section 361 transfer to a foreign corporation as domestic corporations for purposes of satisfying the requirement of section 367(a)(5) that the transferor domestic corporation be controlled by 5 or fewer domestic corporations.

  -Nevertheless, S corporation subject to section 367(a)(5) when it makes a section 361 transfer .

  -Will the final section 367(a)(5) regulations retain this approach?

Section 6038B and Partnership Transfers

Section 6038B and Partnership Transfers



Example assumes section 7874 is not implicated

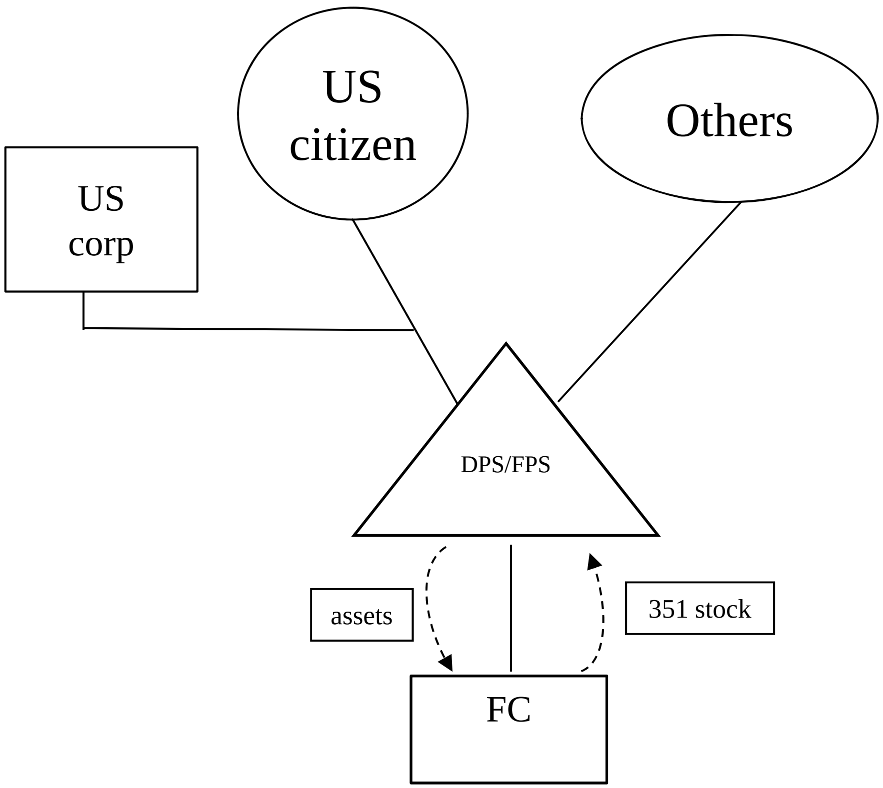
- Code Sec. 6038B(a)(1)(A) generally requires that each U.S. person who transfers property to a foreign corporation in a section 351exchange (among other exchanges) to furnish to the Secretary such information regarding the exchange as the Secretary may require in regulations

- Treas. Reg. §1.6038B-1(b) provides that Form 926 must be used for reporting certain transfers pursuant to section 6038B

  -Special rules for transfers of cash

  -Certain exceptions to filing and special rules may need to be considered (see section 6038B regulations and instructions to Form 926)

Section 6038B and Partnership Transfers



Example assumes section 7874 is not implicated

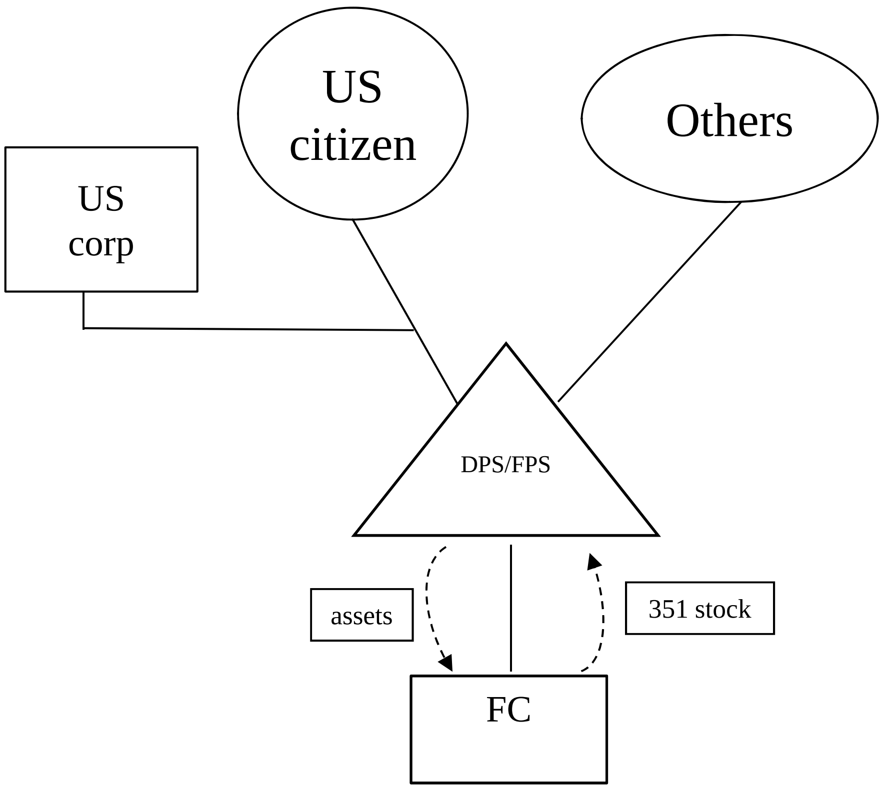
- If the transferor is a partnership (domestic or foreign), the domestic partners of the partnership, not the partnership itself, are required to comply with section 6038B and file Form 926 (Aggregate approach).

-Treas. Reg. 1.6038B-1(b) states that for purposes of determining if a U.S. transferor is subject to section 6038B, the rules of Treas. Reg. 1.367(a)-1T(c) and 1.367(a)-3(d) apply with respect to a transfer described in section 367(a) and the rules of Treas. Reg. 1.367(a)-1T(c)(3) apply with respect to a transfer described in section 367(d).

-Each domestic partner is treated as a transferor of its proportionate share of the property

-See AM 2008-006 for analysis of issue; compare treatment under section 6038B when S corporation transfers property to a foreign corporation in a section 351 transfer

Section 6038B and Partnership Transfers



Example assumes section 7874 is not implicated

- Potential consequences for failure to file Form 926 may include:

-Ineligibility for active trade or business exception under section 367(a).

-A penalty in the amount equal to 10% of the fair market value of the property at the time of the transfer.

--Penalty is limited to $100,000 unless the failure to comply was due to intentional disregard.

-Reasonable cause exception

-Extension of Statute of Limitations. See section 6501(c)(8).

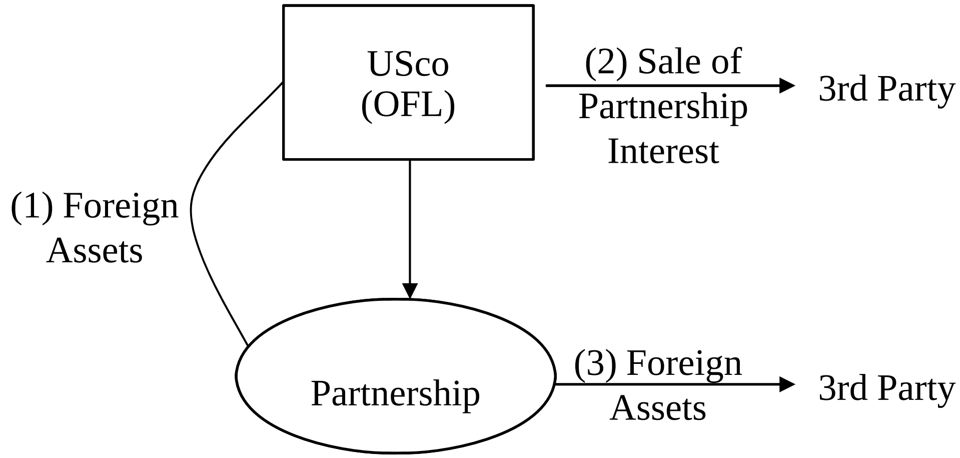
-See also Offshore Voluntary Disclosure Initiative and IRS FAQ 18 relating to missed Forms 926

A Few Classic Traps for which to Watch

§901--Allocation of Year's FTCs if Midyear Sale of P/S Interest or DE or Status Change

- In general, foreign taxes of foreign P/S or DE accrue on last day of its foreign tax year.
- Sale by partner terminates P/S year for US tax purposes for that partner (§706) or, if §708 termination, for all partners.
- Issue was whether only the remaining partners (or purchaser of DE) were entitled to FTCs for year of sale.
- Reg. §1.901-2(f)(4) (added by TD 9576, 2/9/12) provides for allocation between the terminating partnership (or owner of DE) and the new partnership (or owner of DE), as per principles of §1.1502-76(b).
  - Eliminates a planning opportunity (or trap)

§904(f) OFL Recapture Events



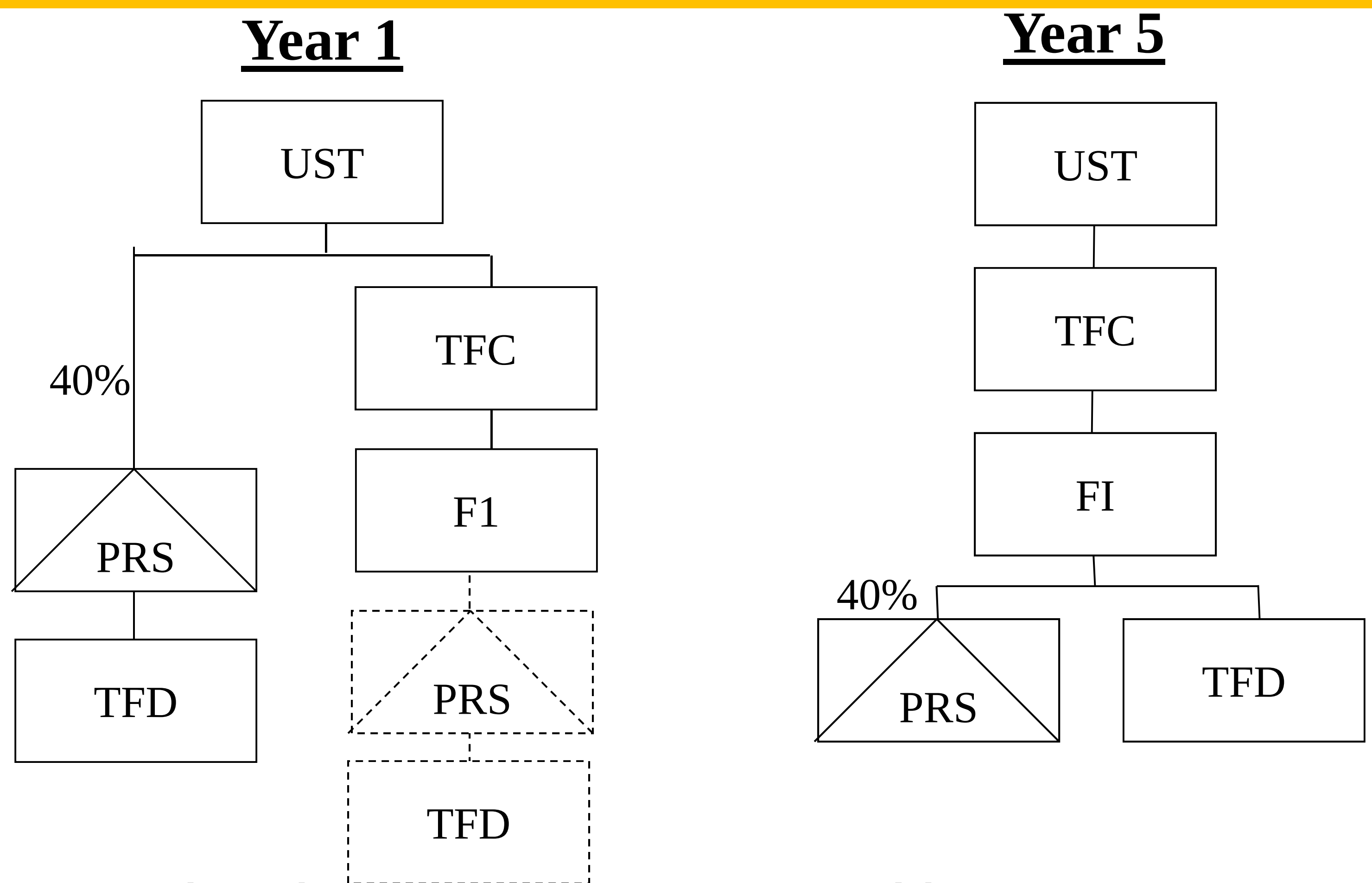
- Assume Foreign Assets were used in generation of OFL; now consider the following alternative transactions:

(1) Contribution of Foreign Assets to Partnership: treated as taxable under §904(f)(3) despite §721. §1.904(f)-2(d)(5)(i). Recapture OFL (income treated as domestic).

(2) Sale of interest in Partnership holding Foreign Assets: treated as a disposition of the proportionate share of the Foreign Assets. OFL Recapture. §1.904(f)-2(d)(5)(ii).

(3) Transfer of Foreign Assets by Partnership: OFL recapture. If assets = CFC Stock, no current guidance but likely to be treated as a "disposition" for OFL purposes and therefore subject to recapture.

§367(a) GRAs and Triggering Events

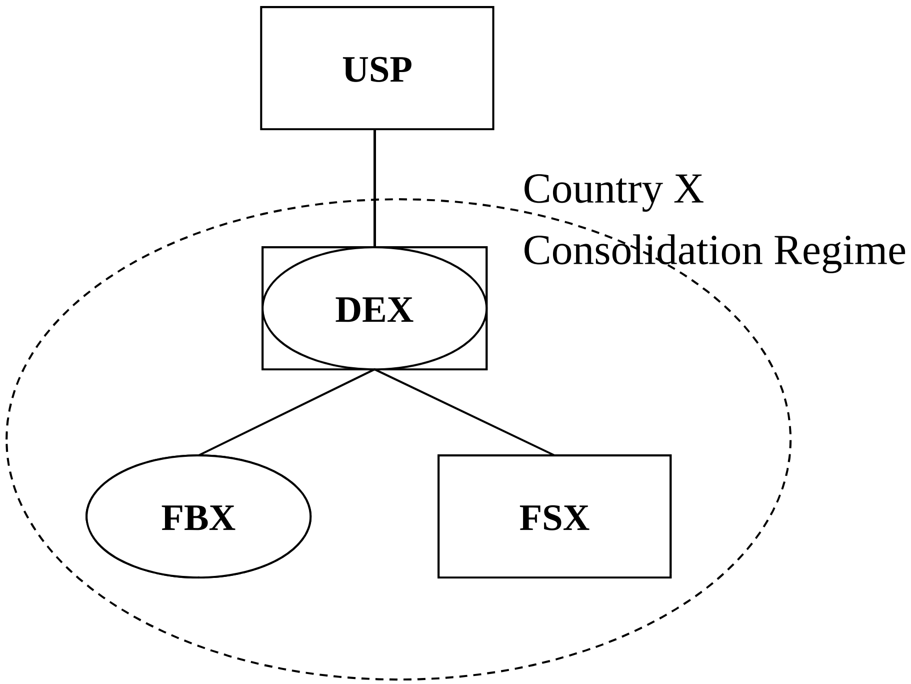


- Assume Yr 1 contribution by UST of interest in PRS to TFC and then F1. Entry into GRA.
- Assume Yr 3. §301(c)(1), (2) and (3) distributions by TFD to PRS. Last is TE for GRA.
- Assume Yr 5. PRS distributes TFD to F1. TE avoidable per §1.367(a)-8(k)(14) if new GRA is entered. §1.367(a)-8(q), Ex. 17.

Dual Consolidated Loss Issues Involving Partnerships

Dual Consolidated Loss Issues Involving Partnerships - Background

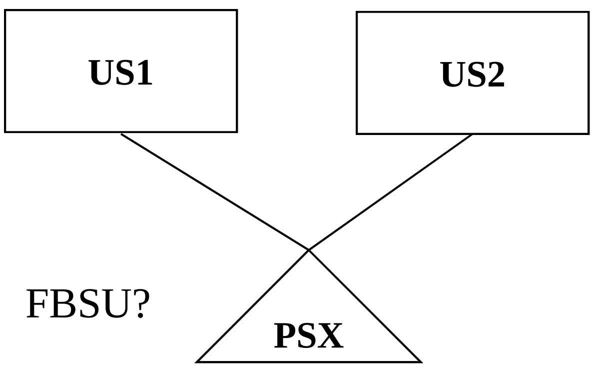
- Purpose of DCL rules is to prevent the use of single economic loss to offset two income streams, one of domestic corporation for US tax purposes and other of foreign corporation for foreign tax purposes
- DCL rules apply to DCLs of "separate units" of domestic corporations (section 1503(d)(3)), including foreign activities conducted through a partnership
  - Foreign branch separate unit (FBSU) – non-US business activities that if carried on by a US person would constitute a foreign branch under Reg. § 1.367(a)-6T(g)(1)
  - Hybrid entity separate unit (HESU) – an interest in an entity that is taxed as a passthrough (partnership or DRE) for US tax purposes and is subject to tax as a corporation on a worldwide or residence basis in a foreign country

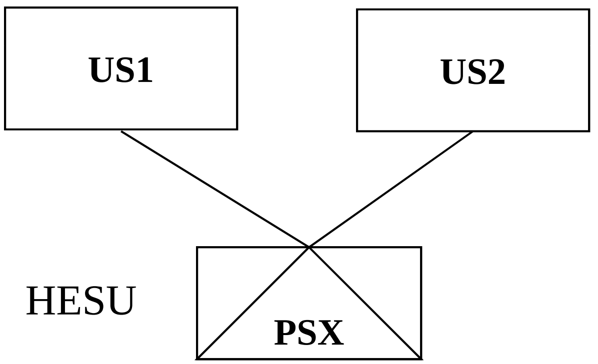


- In diagram, USP's ownership interests in DEX is a HESU and DEX's activities conducted through FBX is a FBSU
- The HESU and FBSU are combined and treated as single separate unit under separate unit combination rule (Reg. § 1.1503(d)-1(b)(4)(ii))

Dual Consolidated Loss Issues Involving Partnerships – Existence of Separate Unit and Computation of DCL

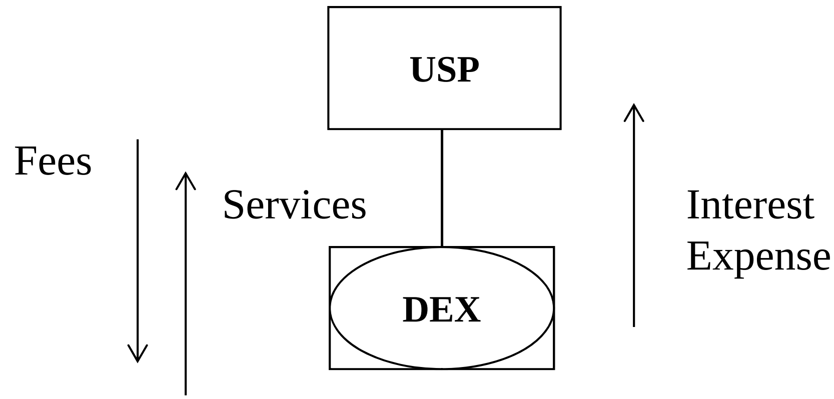
- Different standards applicable to determine whether different types of foreign partnerships constitute separate units
- Higher threshold if foreign partnership is also a passthrough for foreign tax purposes. Only will constitute a separate unit if activities of partnership constitute a foreign branch (FBSU). Relevant factors include:
  - Separate books and records
  - Office or fixed place of business used by employees of US person for foreign activities
  - Permanent establishment → FBSU
- If foreign partnership is fiscally regarded for foreign tax purposes, automatically constitutes separate unit (HESU)
- Different rules applicable to FBSUs and HESUs for determining whether separate unit incurs a DCL. Reg. § 1.1503(d)-5(c). Can lead to different results for similar activities.
  - Inverted ECI rules for FBSUs
  - Books and records approach for HESUs

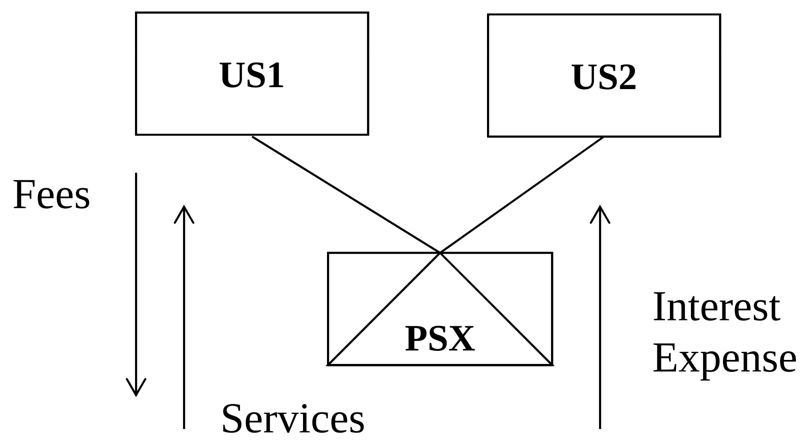




Dual Consolidated Loss Issues Involving Partnerships – Disregarded Payments

- Whether a separate unit incurs a DCL generally is determined by taking into account "only those existing items of income, gain, deduction, and loss of the separate unit's … domestic owner (or owners, in the case of certain combined separate units), as determined for US tax purposes." Reg. § 1.1503(d)-5(c)(1)(ii).
- Potentially different treatment of DEX's and PSX's items for purposes of determining whether separate units incur DCLs. PSX is viewed as separate entity for US tax purposes, so transactions and related items not disregarded.
- *But see* Reg. § 1.1503(d)-5(c)(3)(i) (requiring adjustments to conform items on DEX's books and records to conform to US tax principles).



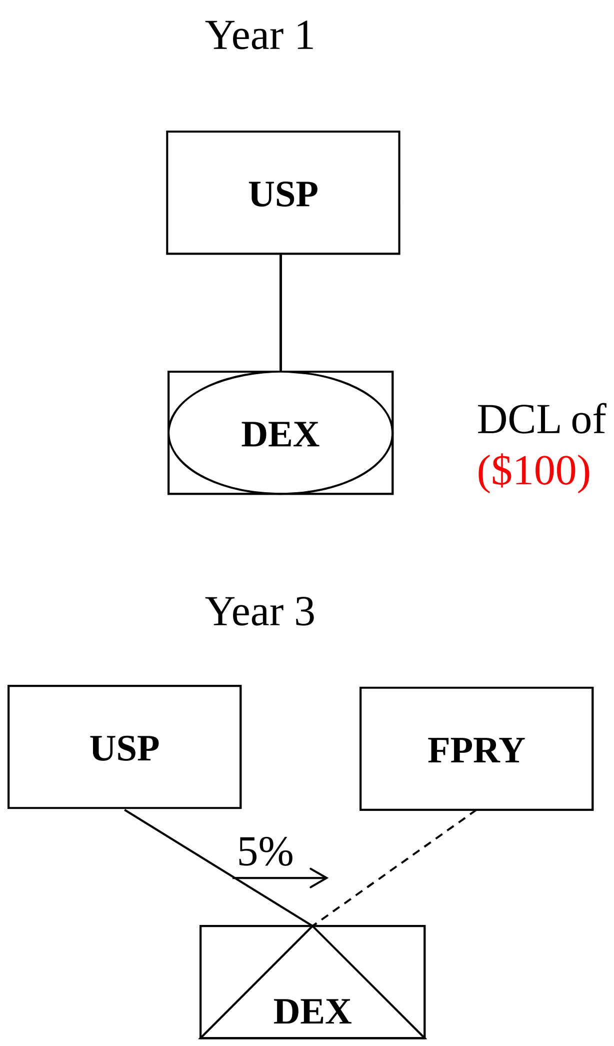


Dual Consolidated Loss Issues Involving Partnerships – Domestic Use Election and Triggering Events

- General rule is that unless taxpayer can show no possibility of "foreign use," "domestic use limitation" rules apply. Reg. § 1.1503(d)-4(b).
- Domestic use limitation rules limit amount of DCL that can be taken into account in US to amount of income generated by separate unit taken into account in US, determined on cumulative basis. Reg. § 1.1503(d)-4.
- Exception if taxpayer makes "domestic use election" (DUE). Reg. § 1.1503(d)-6(d). Under DUE, if "triggering event" occurs within 5-year certification period, taxpayer generally must recapture DCL.
- Triggering events include foreign use of DCL, which occurs if *any portion* of deduction or loss composing DCL is *made available* directly or indirectly under foreign tax law to offset income of foreign corporation or direct or indirect owner of interest in hybrid entity that is not a HESU. Reg. § 1.1503(d)-3(a)(1).
- Triggering events also include transfer of 50% or more of separate unit's assets within 12-month period or transfer of 50% or more of taxpayer's interest in separate unit within 12-month period. Reg. § 1.1503(d)-6(e)(1)(iv) and (v). *But see* Reg. § 1.1503(d)-6(e)(2)(ii) (rebuttal of asset transfer triggering event if taxpayer can show that asset transfer did not result in carryover of deductions or losses under foreign law).

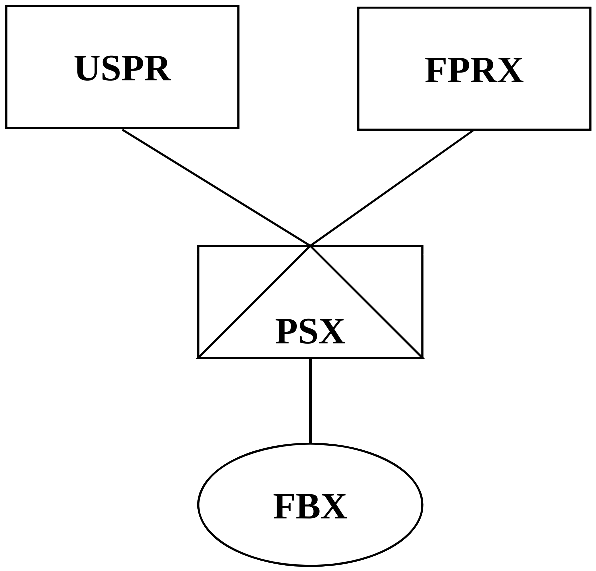
Dual Consolidated Loss Issues Involving Partnerships – DRE to PP (Rev. Rul. 99-5) Transactions

- In Year 1, USP owns DEX, which incurs a DCL of ($100). Assume that DEX incurs a Year 1 NOL for Country X tax purposes that is carried forward under Country X tax law.
- In Year 3, USP sells 5% of its interest in DEX to FPRX, a Country Y foreign corporation.
  - But for *de minimis* exception (Reg. § 1.1503(d)-3(c)(5)), foreign use would occur because DCL carries over under Country X tax law to offset income that is viewed under US tax principles as an item of an owner (FPRY) of an interest in a hybrid entity (DEX) that does not constitute a HESU (in FPRY's hands). *See* Reg. § 1.1503(d)-7(c), Ex. 5(iv).
  - De minimis exception not available if domestic owner's interest is reduced by either (i) 10% or more during any 12-month period or (ii) 30% or more at any time as compared to end of year DCL was incurred. Reg. § 1.1503(d)-3(c)(5)(ii).
- Under Rev. Rul. 99-5, sale treated as (i) asset sale, followed by (ii) contribution to newly formed partnership. Deemed contribution by USP would constitute asset transfer triggering event but for exceptions in Reg. §§ 1.1503(d)-6(f)(1) and (3).
- If, instead, USP sold 15% of interests, would result in foreign use and asset transfer triggering events because *de minimis* exception unavailable.



Dual Consolidated Loss Issues Involving Partnerships – Exceptions to Foreign Use

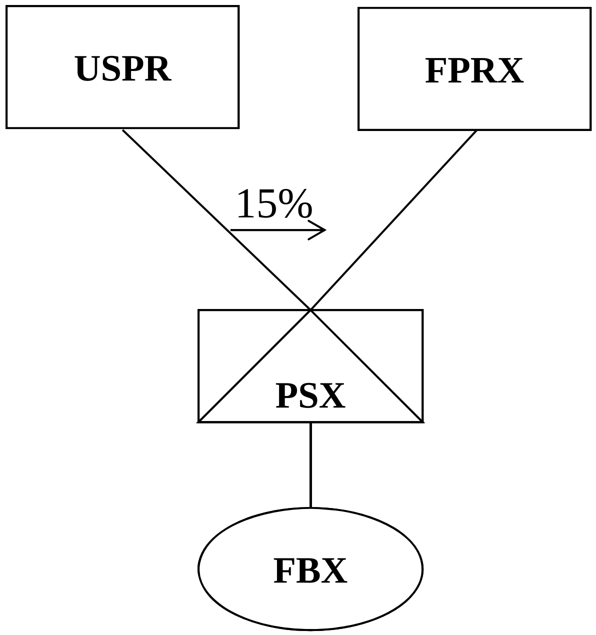
- Assume that an item of deduction or loss composing the Year 1 DCL is made available to offset income of FPRX in Year 1 under Country X tax law.
- Alternatively, assume an item of deduction or loss composing the Year 1 DCL is made available to offset income of FPRX in Year 2 under Country X tax law because PSX incurs a Year 1 NOL and the NOL can be carried forward.
- Generally, exception to foreign use if "solely the result of another person's ownership of an interest in the partnership … and the allocation or carry forward of an item of deduction or loss composing such dual consolidated loss as a result of such ownership." Reg. § 1.1503(d)-3(c)(4)(i).



Assume USPR's Country X separate unit incurs Year 1 DCL of ($100) because of losses incurred by PSX through activities of FBX

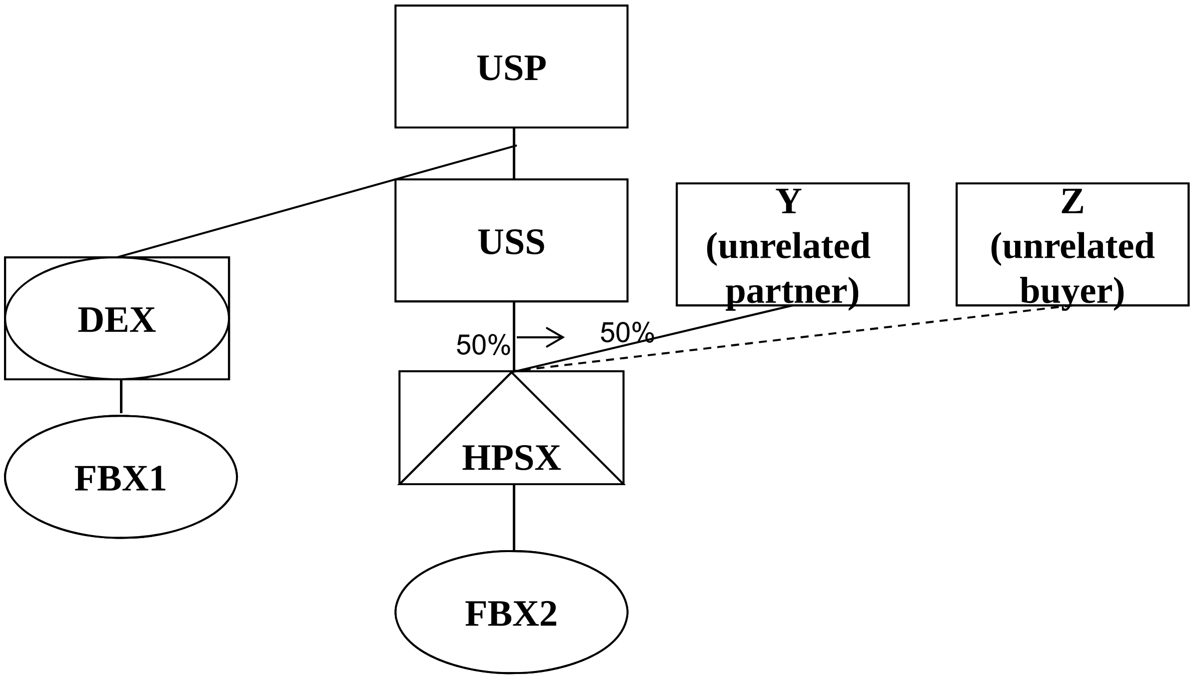
Dual Consolidated Loss Issues Involving Partnerships – Exceptions to Foreign Use

- Assume an item of deduction or loss composing the Year 1 DCL is made available to offset income of FPRX in Year 2 under Country X tax law because PSX incurs a Year 1 NOL and the NOL can be carried forward. Also assume that in Year 2, USPR sells 15% of its interest in PSX to FPRX.
- Foreign use occurs because -3(c)(4) exception does not apply if partner's interest is reduced by either (i) 10% or more during any 12-month period or (ii) 30% or more at any time as compared to end of year DCL was incurred. Reg. § 1.1503(d)-3(c)(5)(ii); -7(c) Ex. 13.
- How is USPR's interest in PSX measured? Similarly to partner's interest in partnership for section 704(b) purposes? What if partnership agreement calls for special allocations and income and loss allocations fluctuate from year to year?
- Foreign use can result from transactions not involving USPR (e.g., dilution from contribution by FPRX to PSX).
- No foreign use if FPRX were instead a US corporation.



Assume USPR's Country X separate unit incurs Year 1 DCL of ($100) because of losses incurred by PSX through activities of FBX

Dual Consolidated Loss – Triggering Event where Combined Separate Unit

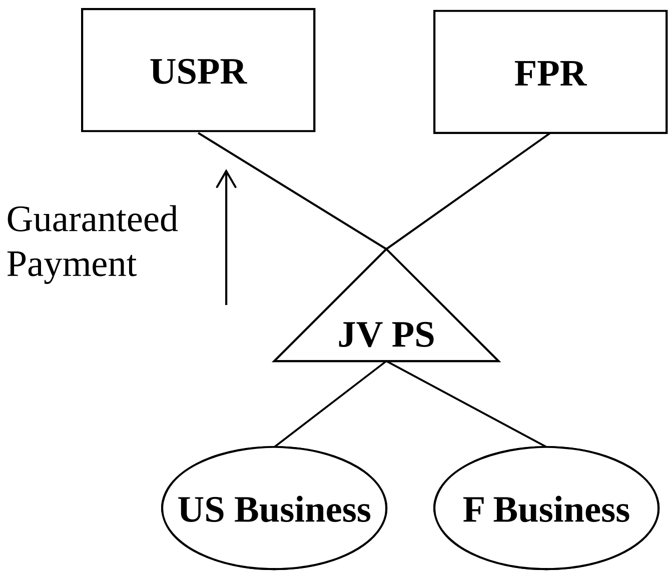


- USP's HESU interest in DEX and FBSU interest in FBX1 and USS's HESU interest in HPSX and FBSU interest in FBX2 are combined and treated as a single Country X separate unit. Reg. § 1.1503(d)-1(b)(4)(ii).
- Assume USS sells 100% of its interest in HPSX to unrelated Z. Application of partnership rule in Reg. § 1.1503(d)-3(c)(4)(i) is awkward because exception in Reg. § 1.1503(d)-3(c)(4)(iii) references reduction in "percentage interest in the partnership" but cross references limitation on *de minimis* rule set forth in Reg. § 1.1503(d)-3(c)(5)(ii), which references "percentage interest in separate unit."
- No triggering event provided interest represents less than 10% of combined separate unit. *See* AM 2008-007 (Scenario 1). If interest represents 10% or more of the combined separate unit, foreign use of DCL of combined separate unit. *See* AM 2008-007 (Scenario 2). Trap for unwary if transferred HESU or FBSU itself had no loss.

Source of Section 707(c) Guaranteed Payment

Source of Guaranteed Payments – Guaranteed Payments, Generally

- Section 707(c) guaranteed payment is a payment to a partner in its capacity as a partner for services or for use of capital, where payment is not dependent on the income of the partnership.
- Statute provides that payment is considered as "made to one who is not a member of the partnership," but only for purposes of section 61(a) and section 162(a). *Cf.* section 707(a). Guaranteed payment generally deductible to partnership under section 162 as business expense and constitutes ordinary income to partner, regardless of amount or character of income of partnership.
- Unclear when recipient partner treats guaranteed payment as distributive share of partnership income (aggregate approach) or services or interest income (entity approach) for other tax purposes.
- Conflicting legislative history, case law, and regulatory guidance. *Compare* Reg. § 1.707-1(c) (supporting aggregate approach) *with* Reg. § 1.704-1(b)(2)(iv)(o) (supporting entity approach).

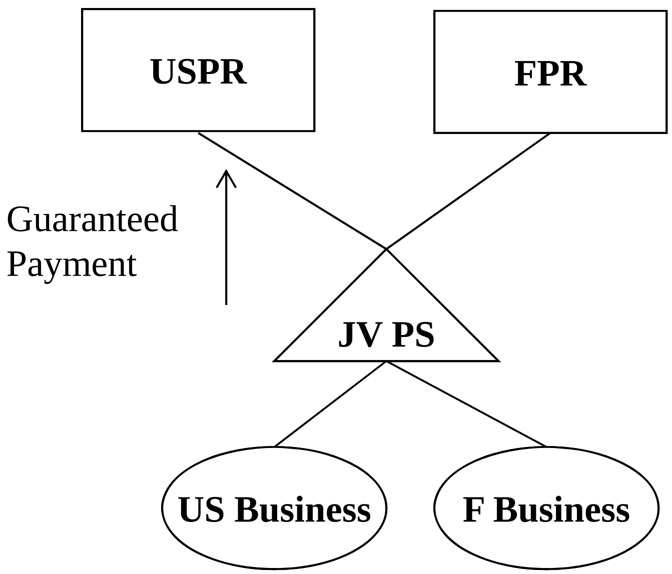


Source of Guaranteed Payments – Background on Sourcing Rules

- In outbound context, sourcing of guaranteed payment matters for purposes of determining USPR's foreign tax credit limitations under section 904. In inbound context (foreign partner is recipient), sourcing matters for purposes of applying ECI rules and FDAP withholding rules.
- Partner's distributive share of partnership income generally sourced at partnership level, and source passes through to partners. *See* section 702(a)(7); section 702(b); PLR 8802038 (Oct. 16, 1987). *Cf.* section 865(i)(5) (except as provided in regulations, source of gain from sale of personal peroperty determined at partner level).
- If no applicable sourcing rule, income sourced by analogy to other type or types of income for which there are explicit rules.
- Services income generally sourced by location where services are performed. Section 861(a)(3); section 862(a)(3).
- Interest income received from partnership generally sourced by partnership's place of residence. A partnership, whether foreign or domestic, generally considered a US resident for these purposes if engaged in US trade or business at any time during year. Reg. § 1.1861-2(a)(2). Exception provided, however, for interest paid by foreign partnership if (i) partnership predominantly engaged in foreign trade or business, (ii) interest not paid by US trade or business of partnership, and (iii) interest not allocable to ECI. Section 861(a)(1)(B).
- Under aggregate approach, guaranteed payment sourced as distributive share of partnership income. Under entity approach, likely sourced by analogy to service income or interest income, as appropriate.

Source of Guaranteed Payments – Relevant Authorities

- Some support for view that guaranteed payment sourced like services income or interest income, rather than as distributive share of partnership income.
  - *See* Reg. § 1.881-3(e), *Ex (15)* (implicitly applying entity approach to guaranteed payment for capital in withholding context); *Miller v. Commissioner*, 52 T.C. 752 (1969); *Carey v. United States*, 427 F.2d 763 (Ct. Cl. 1970) (applying entity approach for purposes of section 911); GCM 36702 (1976).
  - *But see Kampel v. Commissioner*, 72 T.C. 827 (1979), *aff'd* 634 F.2d 708 (2d Cir. 1980) (applying aggregate approach for purposes of section 1348); *Mallary v. United States*, 238 F. Supp. 87 (1965) (applying aggregate approach for purposes of section 613); PLR 8639035 (Jun. 27, 1986); PLR 8728033 (Apr. 13, 1987) (applying aggregate approach to determine whether recipients satisfied income requirements to qualify as REITs); GCM 34173 (1969).
  - Reg. § 1.1441-5(b)(2)(i)(A) ambiguously provides: "a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a U.S. partnership) are made." Does parenthetical modify "distributions" or "amounts subject to withholding"?



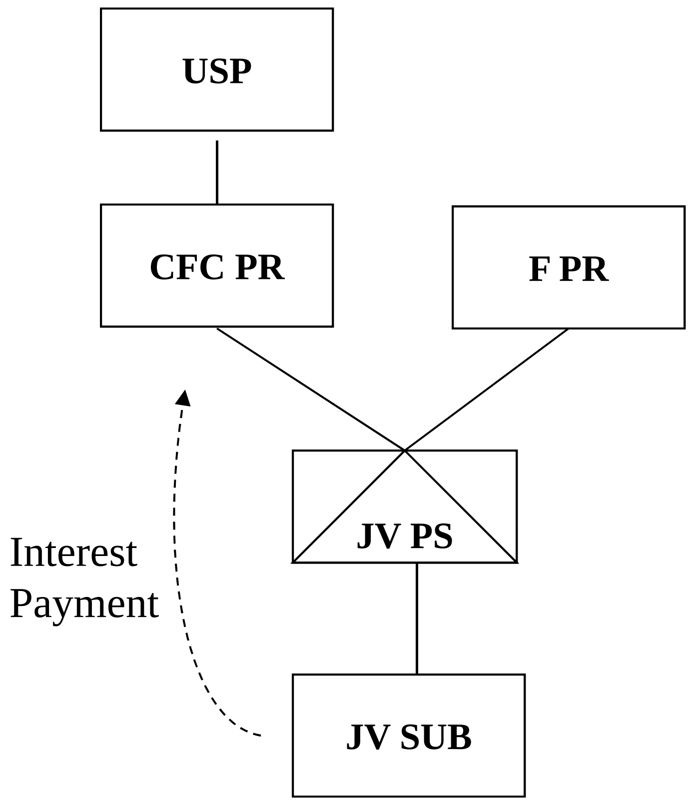
Brown Group Rules Relating to Income of Partnerships under Subpart F

Subpart F Issues – *Brown Group* Regulations

- Subpart F rules generally apply by testing income on a transactional basis (e.g., foreign personal holding company income)
- Generally, subpart F rules apply at CFC partner level as if CFC partner earned distributive share of partnership income directly (Reg. § 1.952-1(g)(1))
  - Country of organization determinations generally based on CFC partner country of organization (Reg. § 1.954-1(g)(1))
  - Related-party determinations generally based on CFC partner’s relationship to other party (Reg. § 1.954-1(g)(1))
- Some exceptions applied based only on activities and property of partnership (*e.g.*, Reg. § 1.954-2(a)(5)(ii)(A))

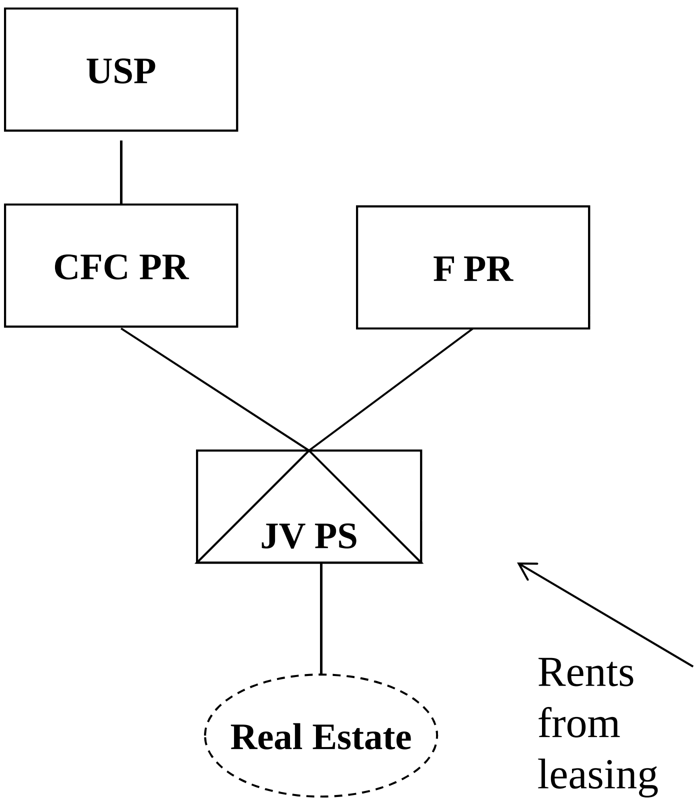
Subpart F Issues – Foreign Personal Holding Company Income

- Interest income generally not treated as FPHCI if payer (i) is corporation related to CFC, (ii) is organized in same foreign country as CFC, and (iii) uses substantial part of its assets in business in country of incorporation (Reg. § 1.954-2(b)(4))
- Same-country exception available only if:
  - JV Sub is "related" to CFC PR (not JV PS)
  - JV Sub organized in same country as CFC PR (without regard to country of organization of JV PS)



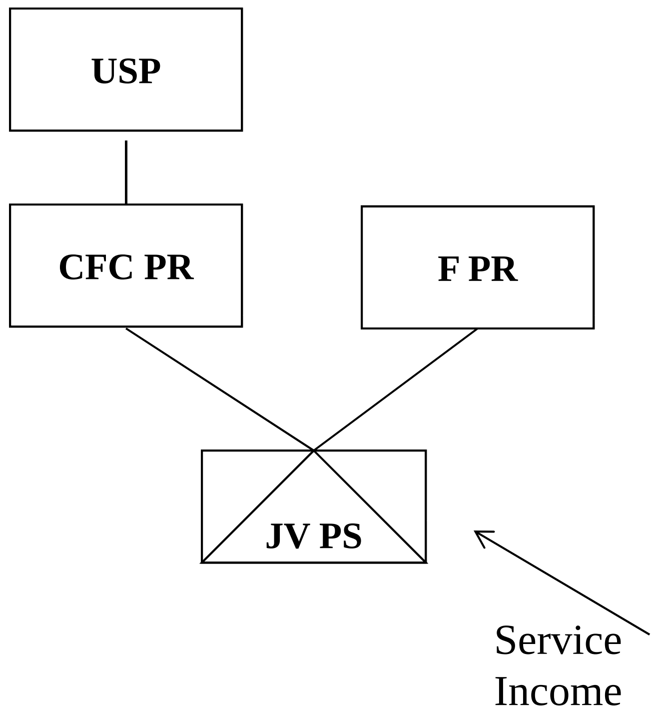
Subpart F Issues – Foreign Personal Holding Company Income Cont'd

- Rents from real property generally excepted from subpart F income if (i) derived in active trade or business of CFC, (ii) received from non-related person, and (iii) lessor conducts active management or operational functions through employees (Reg. §§ 1.954-2(b)(6), (c)(1))
- Active rents exception applied taking into account only activities of JV PS (not CFC PR or F PR) (Reg. § 1.954-2(a)(5)(ii))



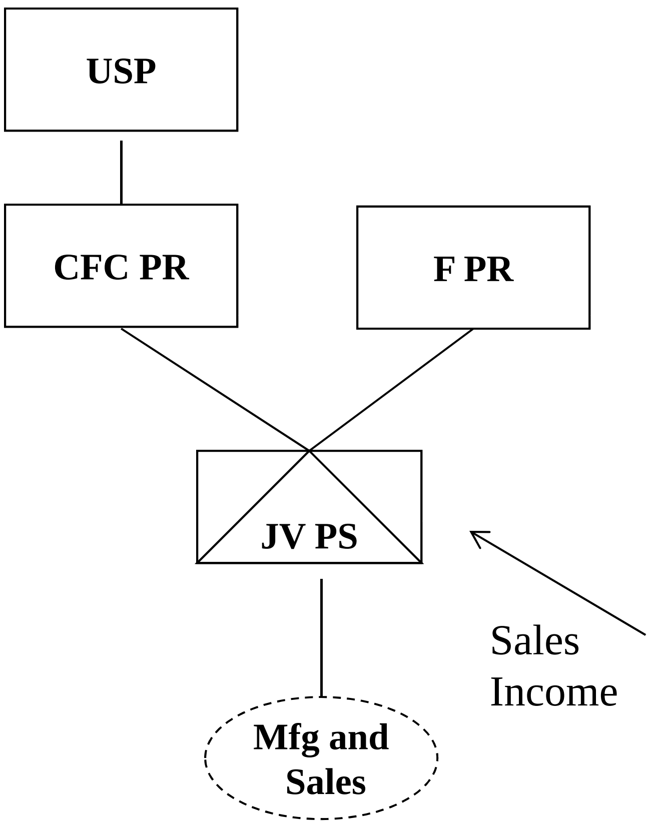
Subpart F Issues – Foreign Base Company Services Income

- Service income generally is FBC services income if performed (i) for or on behalf of related party (or with substantial assistance from U.S. related party) (ii) outside of CFC's country of organization (Reg. § 1.954-4(a); Notice 2007-13)
- Assume JV PS performs services for third parties directly and/or through its partners
- Application to CFC PR
  - Determined based on CFC PR's country of organization
  - Under Reg. § 1.954-4(b)(2)(iii), deemed for/on behalf of related party if JV PS related to CFC PR and CFC PR or related person provides substantial assistance



Subpart F Issues – Foreign Base Company Sales Income

- Sales income generally is FBC sales income if (i) product purchased from or sold to related party, (ii) not manufactured by CFC or third-party in CFC's country of organization, and (iii) sold for use or consumption outside CFC's country of organization (Reg. § 1.954-3)
- Assume JV PS manufactures produces and sells them to affiliates of CFC PR for resale
- Application to CFC PR (Reg. § 1.954-3(a)(6)
  - Related person sales or purchases tested by relationship to CFC PR (not JV PS)
  - Manufacturing exception applied taking into account only JV PS's activities (not CFC PR)



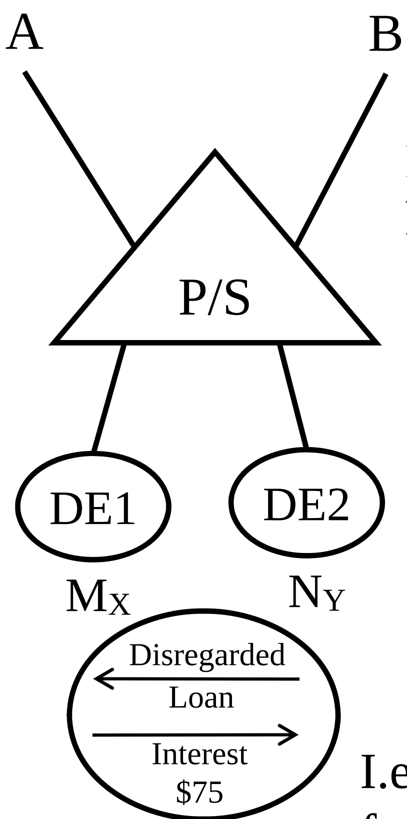
Selected Foreign Tax Credit Anti-Abuse Rules: Partnership Aspects of "Splitter" Rules and "Covered Asset Acquisition" Rules

Foreign Tax Credit Splitters

- §909 imposes a "matching" rule on FTCs**:** if the income to which a foreign tax relates is, or will be, taken into account by a person other than the taxpayer, the FTC is suspended until the income is taken into account by the taxpayer.
- §§704(b) and 909 Temporary Regulations (Feb. 9 2012)
  - Ex. 24 of §1.704-1(b)(5) revised to ensure that tax imposed on a P/S (CFTE) is allocated to the related income, as determined for US purposes. See next slide. Effective (if calendar year) 2012. Thus, §909 inapplicable.
  - Such a transaction is §909 splitter for 2011 under §1.909-5T(a)(2).
  - Grandfather rule for existing P/Ss, with certain exceptions and limitations. If grandfathered, splitter starting in 2012 unless tax reallocated in accordance with income. §1.909-2T(b)(4).

§704(b) Rules Governing Allocation of Creditable Foreign Tax Expenditures (CFTEs) to Avoid Splitter

Example 24: Same facts as Ex. 21, except for an inter-branch loan:



Prior Ex 21	US income	Ex. 21 Tax	A-B Split
M_X	$100	$40	75-25
N_Y	$50	$10	50-50

Now, due to the $75 disregarded interest, for local law purposes DE1 has $25 income and $10 tax, and DE2 has $125 income and $25 tax.

Ex. 24	US Net Inc.	Revised Tax	A-B Split
M_X	$100	$40-30= $10	75%-25%
N_Y	$50	$10+15=$25	50%-50%

A-B US Income and Taxes in Ex. 24 (as revised in Feb 2012)

A: $75 Inc, $7.5 Tax (M); $25 Inc, $5 Tax AND $11.25 Tax (N)

B: $25 Inc, $2.5 Tax (M); $25 Inc, $5 Tax and $3.75 Tax (N)

I.e., shifting $75 income from 40% M rate to 20% N rate saved $15 foreign tax. But to have SEE, the $15 N tax on that $75 must be allocated 75-25, as the US income for US didn't move from DE1.

Splitters: Reverse Hybrid Rule and Allocation of Tax Rule

- Final Regulations: §1.901-2(f)(3) and (4) (Feb. 2012)
  - To avoid possible splitting: If an entity is a P/S for US purposes but taxed as an entity for foreign ("reverse hybrid"), the entity considered to have legal liability under foreign law for tax on its income—so the tax stays with the income. Effective (if calendar year) 2013.
  - To avoid splitting in case of foreign tax imposed on P/S or DE if there is (i) termination of P/S year under §708 for all partners, (ii) a change in a partner's interest or (iii) a change in a DE's owner, the foreign tax is allocated under §1.1502-76(b) principles. Effective (if calendar year) 2013.

§901(m) – Covered Asset Acquisitions

- §901(m), in the case of a "covered asset acquisition" after 2010, denies an FTC (or deduction) for the portion of a foreign tax attributable to the excess of the basis of the assets for foreign tax purposes over the basis for US tax purposes
  - Unlike the splitter rules, which match credits with income, §901(m) permanently disallows a credit
  - Built-in losses in foreign assets reduce the basis difference (but not below zero)

§901(m) – Covered Asset Acquisitions

- Applies to
  - An acquisition of a foreign corporation or a US corporation with foreign assets if there has been a §338 election that steps up basis for U.S., but not foreign, tax purposes
  - The acquisition of a hybrid entity – P/S or disregarded entity in the US, corporation under foreign tax law – if the acquisition steps up basis for US but not foreign, tax purposes
  - The acquisition of an interest in a P/S that has foreign assets if a §754 election is in effect

§901(m) – Covered Asset Acquisitions

- Example (from the JCT explanation)
  - U.S. acquires FT, makes a §338(g) election and steps up basis for U.S. (but not foreign) tax purposes by 200.
  - If FT in the next year has 100 of income, and pays (25% rate) 25 in foreign tax, and the straight-line amortization of FT's assets for that year is 20, the disallowed credit is 5
    - determined by multiplying the foreign tax (25) by a fraction of which the numerator is the basis difference (20) and the denominator is the foreign income for foreign tax purposes (100)

§901(m) – Covered Asset Acquisitions

- In an acquisition involving a §754 election, reconstructing pre-acquisition asset bases under US tax principles could be needed to reduce FTCs that may be permanently disallowed.
- Could involve going back many years in the case of a foreign P/S that previously had only foreign partners/owners and that used only foreign tax or accounting rules.
  - Goal: identify past transactions that had resulted in a basis step up for US tax purposes, even though US tax rules were irrelevant at that time.
- Relevant P/S provisions/transactions in those past years could include, e.g., §§704(c), 732(b) and (d), 734, and 743(b).