June 20, 2019

Final and Proposed Regulations on Certain Income Inclusions Under the CFC Rules Related to Domestic Partnerships

On June 14, 2019, the Internal Revenue Service (the "IRS") and the Department of the Treasury ("Treasury") released final regulations (the "Final Regulations") under Section 951A of the U.S. Internal Revenue Code of 1986, as amended (the "Code")[1] and proposed regulations (the "Proposed Regulations" and together with the Final Regulations, the "New Regulations") under Section 958 that would, among other things, address the treatment of domestic partnerships for purposes of determining amounts included in gross income of their partners with respect to a controlled foreign corporation (a "CFC") under Sections 951 and 951A.

As discussed in more detail below, while these rules are favorable in many regards with respect to domestic partnerships owning CFCs, we do not expect that they will change the market practice of private equity funds using foreign partnerships to invest in CFCs.

Controlled Foreign Corporations or "CFCs" Generally

A controlled foreign corporation, or a "CFC," is a foreign corporation more than 50 percent of the vote or value of the stock of which is owned by "United States Shareholders." A United States Shareholder is generally a shareholder of a foreign corporation that owns 10 percent or more of the vote or value of the stock of the foreign corporation, determined taking into account complicated constructive ownership rules. In general, if a domestic partnership owns more than 50 percent of the stock of a foreign corporation, the foreign corporation will be a CFC under existing law and under the New Regulations.

The rules relating to CFCs (the "Subpart F Rules" and, after the 2017 tax act, also the "GILTI Rules") generally prevent United States Shareholders of a CFC from earning passive income or low-taxed income in foreign corporations and avoiding current U.S. tax on that income. These rules generally create income inclusions that are treated as income to United States Shareholders on a current basis even if the CFC does not make a corresponding cash distribution.

[1] All Section references in this memorandum are to the Code.

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CFCs and Partnerships – Before the New Regulations

Domestic Partnership owning CFCs. Under existing law, if a domestic partnership owns 10 percent or more of the stock (by vote or value) of a CFC, the domestic partnership is required to include in its income its pro rata share of the CFC's subpart F income and, generally, global intangible low-taxed income ("GILTI") and to allocate its share of such income to its partners, regardless of whether the partners themselves would be United States Shareholders if they owned the proportionate shares of the stock of the CFC directly.

In addition, if the domestic partnership sold a CFC, a portion of the gain (generally attributable to the CFC's historic undistributed earnings as determined under U.S. tax principles) would be recharacterized as dividend income under Section 1248. In many cases, this could turn what would be long-term capital gain into ordinary dividend income.[2]

Foreign Partnerships Owning CFCs. In contrast, if a foreign partnership owns all of the stock of a foreign corporation, whether the foreign corporation is a CFC depends on the identity and ownership of the partners of the partnership. Even if a foreign corporation owned by a foreign partnership is a CFC, there would be no income inclusion under the rules described above for partners that own less than 10 percent of the vote and value of a CFC on an indirect or constructive basis. Moreover, there would be no recharacterization under Section 1248 of gain on a sale as dividend income, except with respect to any partner that would otherwise be a United States Shareholder of the CFC.

Market Practice for Investment Funds. Because of the "look-through" rules for foreign partnerships, using a foreign partnership to own a CFC may mitigate or completely avoid the "phantom income" and recharacterization issues that would be present with a domestic partnership owning a CFC. In part for this reason, it is common for many private equity funds that invest in foreign corporations to be organized as foreign partnerships or to use foreign alternative investment vehicles to invest in foreign corporations.

CFCs and Partnerships – After the New Regulations

Domestic Partnership Owning CFCs. Under the Proposed Regulations, a domestic partnership would not be treated as owning stock of a CFC for purposes of determining income inclusions under the Subpart F rules; instead, its partners would be treated as owning stock of the CFC in proportion to their respective interests in the partnership. Similarly, under the Final Regulations, a domestic partnership will not be treated as owning stock of a CFC for purposes of determining income inclusions under the GILTI Rules,

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[2] In some cases, however, the dividend income Section 1248 created could be eligible for treatment as "qualified dividend income" taxed at long-term capital gains rates, generally where the CFC was resident in a jurisdiction with which the United States has a tax treaty (and certain other requirements were satisfied) or was publicly traded.

and its partners will be treated as owning stock of the CFC in proportion to their respective interests in the partnership.

Accordingly, under the New Regulations, domestic partnerships would effectively be treated in the same manner as foreign partnerships, for purposes of these income inclusions, and even if a domestic partnership owns 10 percent or more of the stock (by vote or value) of a CFC, only partners that are themselves United States Shareholders on an indirect or look-through basis would be required to include in their gross income their shares of subpart F income and GILTI of the CFC.

Neither the Final Regulations nor the Proposed Regulations, however, would extend the new look-through rules for purposes of determining whether any United States person is a United States Shareholder or whether a foreign corporation is a CFC, or for purposes of the recharacterization rules under Section 1248. Accordingly, under the New Regulations, if a domestic partnership owns directly, indirectly or constructively 10 percent or more of stock (by vote or value) of a foreign corporation, the domestic partnership would continue to be treated as a United States Shareholder for purposes other than determining income inclusions under Sections 951 and 951A (including Section 1248).

The Final Regulations apply to taxable years of foreign corporations beginning after December 31, 2017 and to taxable years of United States Shareholders in which or with which such taxable years of foreign corporations end. The Proposed Regulations would apply to taxable years of foreign corporations beginning on or after the date of publication of Treasury decision adopting these rules as final regulations in the Federal Register and to taxable years of United States persons in which or with which such taxable years of foreign corporations end. A domestic partnership, however, may apply the look through rules under the Proposed Regulations to taxable years of a foreign corporation beginning after December 31, 2017 and to taxable years of the domestic partnership in which or with which such taxable years of the foreign corporation end, subject to certain conditions.

Observation

While the New Regulations take some of the sting out of a domestic partnership owning a CFC by removing the phantom income for U.S. partners that indirectly own less than 10 percent of the vote or value of a CFC, they do not change one of the important features of existing law with respect to the recast rule of Section 1248. For that reason, we expect that typical private equity fund structuring will continue as under current law with funds organized as foreign partnerships or using foreign alternative investment vehicles for investments in foreign corporations. It is possible that the IRS and Treasury will consider changing the rules as a result of comments received, but until then, and until the regulations are finalized, we expect there will not be much of a change in market practice in this regard.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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