Affirmative Use of Partnerships in U.S. International Tax Planning

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Jeffrey Rubinger
Bilzin Sumberg

CFCs, in General

- A “U.S. shareholder” of a controlled foreign corporation is required to include in its gross income its pro rata share of a CFC’s “subpart F” income, regardless of whether such income is distributed.
- In general, a CFC is a foreign corporation that is more than 50 percent owned (directly, indirectly or constructively) by “U.S. shareholders.”
- Subpart F income includes most forms of passive income (e.g., interest, dividends, royalties, capital gains, etc.), as well as income from related party sales and service transactions that have little, if any, connection with the CFC’s country of incorporation.

Definition of U.S. Shareholder

- Under Sections 951(b), 957(c), and 7701(a)(4) of the Internal Revenue Code (the "Code"), a U.S. partnership (including a U.S. LLC taxed as a partnership) is treated as a "U.S. shareholder" for subpart F purposes, even if all of its partners are foreign persons that are not subject to U.S. federal income tax.
- The IRS has acknowledged this position.
- In fact, the IRS has indicated on more than one occasion that no consideration has ever been given to requiring a foreign person to include in its income any portion of subpart F income passing through a U.S. partnership.
  - *See* 1995 FSA Lexis 496 (March 17, 1995) and 1995 FSA Lexis 131 (March 17, 1995).

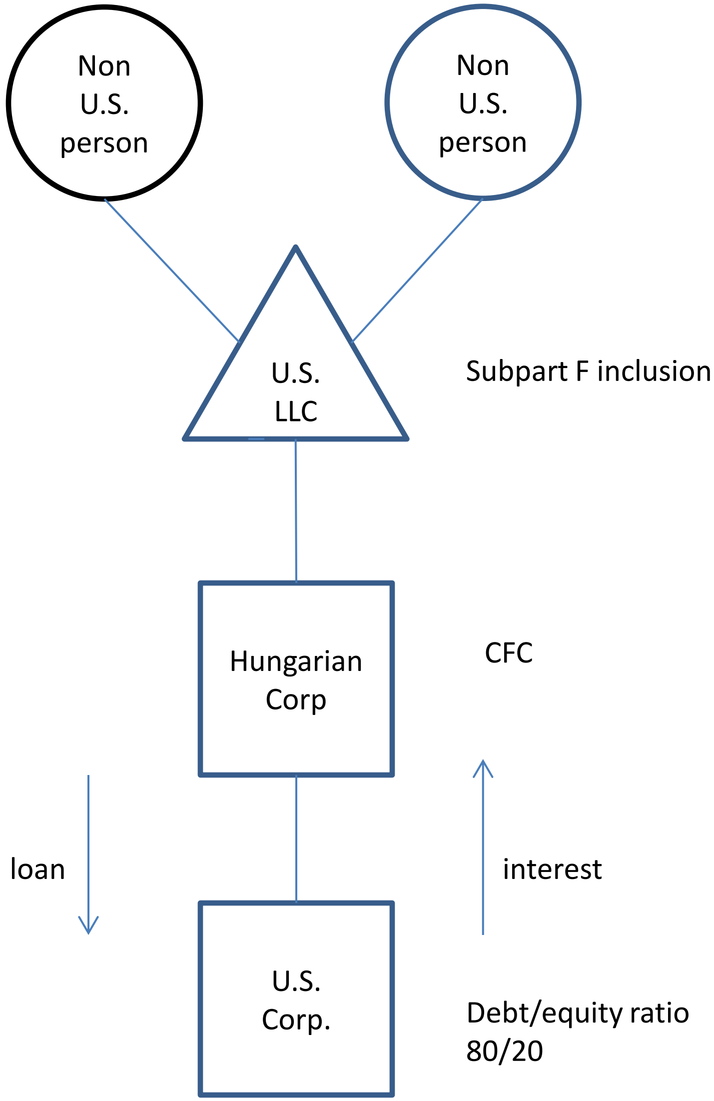
Consequences of Treating U.S. Partnership as a U.S. Shareholder

- Therefore, the receipt of passive income (e.g., interest) by a foreign corporation that is more than 50 percent owned by a U.S. partnership, will give rise to subpart F income that is includible in the gross income of a U.S. shareholder of a CFC (i.e., the U.S. partnership), even though no U.S. person actually will be subject to U.S. federal income tax on that income.

Planning Opportunities

Section 163(j) Interest Stripping Rules

- If a U.S. corporation's debt-to-equity ratio exceeds 1.5 to 1, Section 163(j) limits a U.S. corporation's interest deductions to 50 percent of its taxable income where, (i) the interest is paid to a related foreign person and (ii) no (or reduced) U.S. withholding tax is imposed on such payment.
- Under Proposed Regulation Section 1.163(j)-4, however, a payment of interest that is exempt from U.S. withholding tax (e.g., by treaty or portfolio interest) is deemed to be subject to tax, and therefore not subject to Section 163(j), to the extent the interest results in an inclusion in the gross income of a U.S. shareholder of a CFC for subpart F purposes.
- Therefore, interest paid by a U.S. corporation to a foreign corporation that is owned by a U.S. partnership that has exclusively foreign partners, all of which are exempt from U.S. federal income tax, will not be subject to Section 163(j).

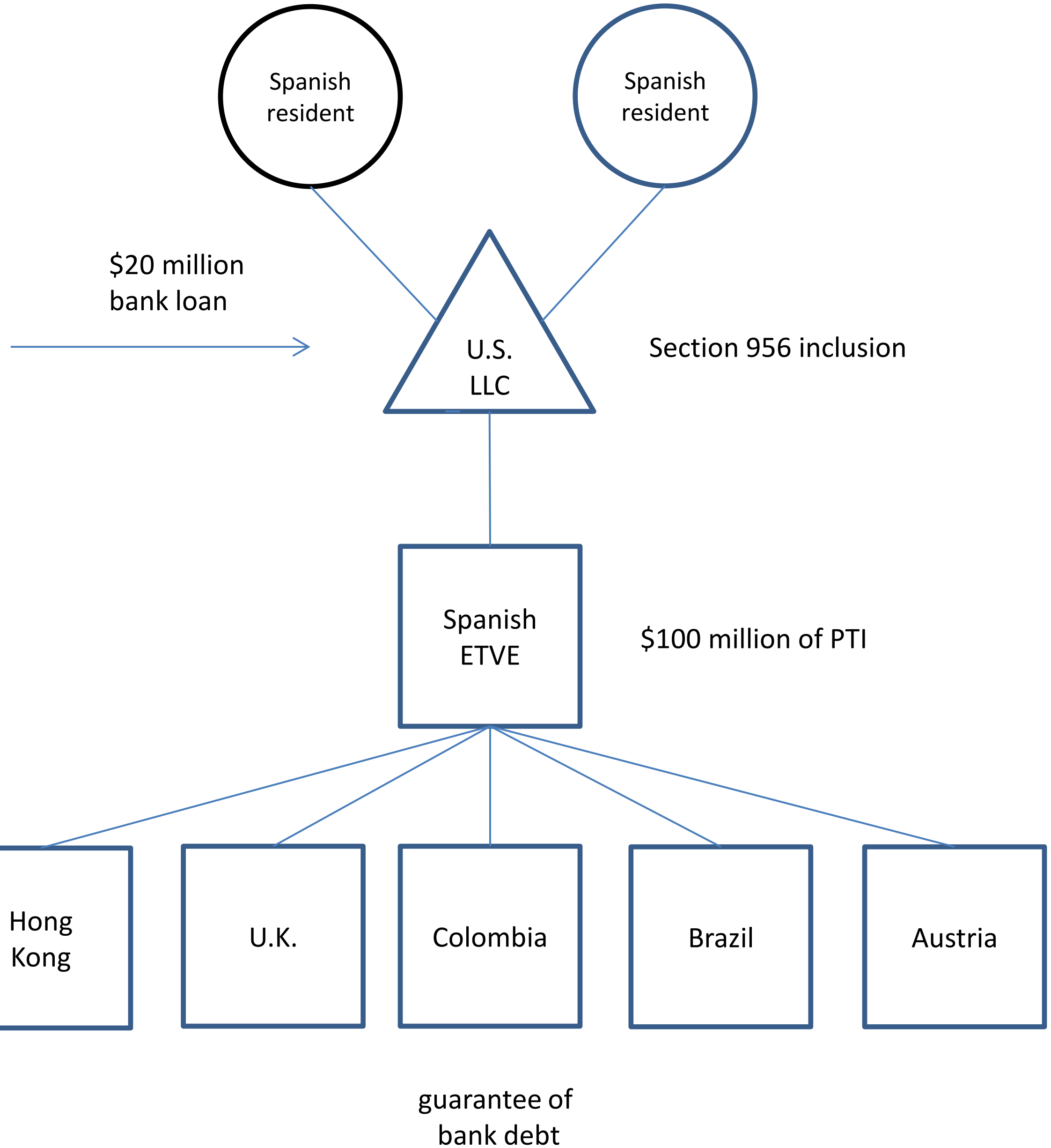

Non
U.S.
person
Non
U.S.
person
U.S.
LLC
Subpart F inclusion
Hungarian
Corp
CFC
loan
interest
U.S.
Corp.
Debt/equity ratio
80/20

Creation of Non-Taxed "Previously Taxed Income"

- Section 959(a) provides that the earnings and profits of a CFC attributable to amounts included in the gross income of a U.S. shareholder, otherwise known as “previously taxed income” or “PTI,” shall not be again included in the gross income of such U.S. shareholder.
- Distributions made by a CFC are considered to come first from PTI to the extent thereof.
- Because a U.S. partnership is considered to be a U.S. shareholder for purpose of the CFC rules, if a U.S. partnership includes in its gross income the earnings and profits of a CFC (i.e., Subpart F income or a Section 956 inclusion), the inclusion of the income creates PTI, even though none of the income may be subject to U.S. federal income tax.

Use of Non-Taxed PTI in Pre-Immigration Context

- Assume residents of Spain own 100 percent of the shares of a Spanish ETVE that in turn owns 100 percent of five operating companies located in jurisdictions throughout Europe, Asia, and Latin America.
- The operating companies are consistently profitable and each one generates a large pool of current year earnings and profits.
- The Spanish owners plan to relocate to the United States in the future and will continue to hold these investments after the move. In advance of the move, the owners formed a U.S. partnership and transferred their interests in the ETVE to such partnership.
- Assume the U.S. partnership then takes out a $20 million bank loan to fund the business operations of the subsidiary entities. Assume that each of the five operating companies guarantees the bank loan in full. This income inclusion in turn should give rise to PTI in the same amount. Assuming that each guarantor has at least $20 million of current year earnings and profits, $100 million of PTI should be created by this transaction.
  - The IRS has taken this position with respect to taxable Section 956 inclusions. *See, e.g.,* FSA 200216022, in which the IRS argued that multiple guarantees by more than one CFC of the same US obligation could result in a Section 956 inclusion that exceeds the principal amount of the loan.
- Thus, once the Spanish owners relocate to the United States, it appears that they would be entitled to take $100 million of tax-free distributions from the underlying CFCs through the U.S. partnership.


Spanish resident
Spanish resident
$20 million bank loan
U.S. LLC
Section 956 inclusion
Spanish ETVE
$100 million of PTI
Hong Kong
U.K.
Colombia
Brazil
Austria
guarantee of bank debt

Section 267(a)(3) Related Party Accrual of Deduction

- Section 267(a)(3) prevents a U.S. corporation from currently deducting an amount accrued to a related foreign person until the amount actually is paid.
- An exception is provided, however, that allows a corporation to deduct the amount accrued in a taxable year prior to the year of payment where the amount accrued is includible in the gross income of a U.S. person who owns stock in a CFC.
- Therefore, similar to the opportunity mentioned above, a U.S. corporation potentially can deduct an amount accrued to a related foreign person in a taxable year prior to payment, where the related foreign person is a CFC solely because it is owned by a U.S. partnership that has exclusively foreign partners that are not subject to U.S. federal income tax.

Converting Foreign Source ECI into Subpart F Income

- While foreign corporations are generally not subject to U.S. federal income tax, they are subject to tax like a U.S. corporation on any income effectively connected to a U.S. trade or business (otherwise known as ECI).
- Although this rule typically applies only to U.S.-source ECI, there are certain categories of foreign-source income that can be treated as ECI under Section 864(c)(4)(B).
- If, however, the foreign corporation is a CFC and the foreign-source ECI also gives rise to subpart F income, the subpart F rules will trump the ECI rules, regardless of whether any amount is taxable in the hands of a U.S. person. Regulation Section 1.864-5(d)(2), example 1.
- Accordingly, it may be possible for a foreign corporation that is owned by foreign persons and that is subject to U.S. federal income tax on foreign-source ECI to interpose a U.S. partnership in between the corporation and its foreign shareholders to take advantage of the CFC trumping rule, without actually triggering any U.S. federal income tax.

Avoiding Dividend Treatment on Liquidation of Holding Company

- Under Section 332(d), a liquidating distribution to a foreign corporation of an "applicable holding company" is treated as a dividend (rather than non-taxable income) that generally will be subject to a 30 percent U.S. withholding tax.
- In general, an applicable holding company is a domestic corporation that (i) has been in existence for less than 5 years and (ii) substantially all of its assets consist of stock in other members of an affiliated group.
- An exception exists, however, if the foreign corporation is a CFC. In this situation, the liquidating distribution generally will be exempt from U.S. withholding tax.
- Therefore, it may be possible to convert taxable dividend income into a non-taxable distribution by interposing a U.S. partnership in between the foreign corporation and its shareholders to cause such foreign corporation to be characterized as a CFC.

Possible IRS Challenges

- If the IRS were to challenge the use of U.S. partnerships in these situations, the most likely basis would seem to be an attack under the partnership anti-abuse rules.
- Interestingly, however, in Notice 2010-41 the IRS decided against using the anti-abuse provisions in a similar context, instead choosing to treat the U.S. partnership as a foreign partnership to prevent the purported abuse.
- This may be because the partnership anti-abuse rules themselves contain an example that approves the interposition of a U.S. partnership between the shareholders and a foreign corporation for the sole purpose of converting the foreign corporation into a CFC, which would allow the shareholders to take advantage of more favorable foreign tax credit provisions.
  - See Treas. Reg. Section 1.701-2(f), example 3.
- Other possible avenues of attack include the use of common law doctrines, such as substance over form, sham transaction, and economic substance. Those arguments, however, typically are much more difficult to sustain and are used only as a last resort.

Possible IRS Challenges (cont.)

- In Notice 2009-7, the IRS identified a transaction of interest labeled the "Subpart F income partnership blocker."
- The 2009 notice was then followed with Notice 2010-41, which announced an intention to issue regulations which would treat domestic partnerships as foreign partnerships for the sole purpose of identifying the U.S. shareholders of a CFC that are required to include in gross income the amounts specified in Section 951(a). These regulations would have no impact on a CFC owned by a U.S. partnership that ultimately is owned by non-U.S. persons.