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Subpart F and Domestic Partnerships: One More Time, With Feeling

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From time to time over many years, I have expressed the view that the government's approach to domestic partnerships in the context of subpart F is wrong, both as a matter of textual interpretation and as a matter of policy.[1] The new proposed regulations under GILTI[2] (§951A)[3] illustrate the lengths to which the government will go to preserve its erroneous rule. As we will see, the government has twisted itself into a pretzel in an attempt to reconcile its basic subpart F approach to domestic partnerships with the dictates of GILTI. This is not the first time this kind of thing has happened.[4] The only surprise was that practitioners seem to have been surprised by the proposed regulations.

First let's summarize the state of the law as it existed prior to the enactment of GILTI with the 2017 tax act (the ''Act'').[5] Under subpart F, a foreign corporation is a CFC if more than 50% of its stock, by vote or by value, is owned by persons that are ''U.S. shareholders'' within the meaning of §951(b) (hereinafter, ''USSHs''). To qualify as a USSH for this purpose, under prior law one had to be a U.S. person that owned at least 10% of the voting stock of the foreign corporation, directly or indirectly. After the Act, it is enough to own at least 10% of the stock by vote or by value — but nothing in this short article turns on that change.

The government has long taken the view that a partnership formed under U.S. law should be treated as a separate entity for subpart F purposes. Its reasoning proceeds from the fact that a domestic partnership is a ''U.S. person.'' Section 957(c) provides that the term ''United States person'' when used in subpart F has the meaning ascribed to it in §7701(a)(30). Section 7701(a)(30) defines the term ''United States person'' to include a domestic partnership, and §7701(a)(4) defines the term ''domestic,'' when applied to a partnership, to mean a partnership formed under U.S. law, unless the IRS provides otherwise by regulation.

The government's conclusion is that because a domestic partnership is a U.S. person, it must be treated as owning stock at the entity level. It follows that if a domestic partnership owns at least 10% of the stock of a foreign corporation, the partnership itself is a USSH. Under this view, if the domestic partnership owns more than 50% of the stock, then the foreign corporation will be a CFC. This would be true even if 100% of the partners of the partnership were non-U.S. persons. We'll be referring to this view as the ''domestic partnership as entity'' rule.

As a corollary to the domestic partnership as entity rule, the government has long taken the view that if a domestic partnership is a USSH of a CFC, then *any* U.S. person who is a partner of the partnership must include in income its distributive share of the partnership's subpart F income. Because this approach is based on the application of the distributive share rules of §702, it would be true even if the U.S. partner did

[1] *See, e.g.,* Blanchard, *Notices 2010-41 and 2009-78: Thoughts on the Scope of IRS Authority*, 51 Tax Mgmt. Memo. 355 (Oct. 11, 2010); Blanchard, *Notice 2010-41: Schrodinger's Cat*, 39 Tax Mgmt. Int'l J. 402 (July 9, 2010); Blanchard, *Guidance Needed on CFC Lending Transactions*, 126 Tax Notes 201, at 211–212 (Jan. 11, 2010); Blanchard, *Cross-Border Tax Problems of Investment Funds*, 60 Tax Lawyer 583, at 605–607 (Spring 2007).

[2] Global Intangible Low-Taxed Income, REG-104390-18, released Sept. 13, 2018.

[3] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[4] *See* Notice 2010-14.

[5] Pub. L. No. 115-97 (Dec. 22, 2017).

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not own anywhere near 10% of the CFC stock directly or indirectly through the partnership or otherwise. This extension of the domestic partnership as entity rule will be referred to as the "small U.S. partner" rule.

Where a partnership is formed under non-U.S. law, it is clearly a foreign person and thus cannot itself contribute to the CFC status of a foreign corporation. In that case, §958(a) requires looking through the foreign partnership to determine whether some combination of its partners are USSHs. Section 958(a)(2) provides that stock owned indirectly through a foreign entity, including a foreign partnership, is treated as owned by the partner. The government labels this treatment "aggregate" treatment. This distinction between the way domestic and foreign partnerships are treated under subpart F, which extends to §956 as well,[6] is the reason that most partnerships that invest in the stock of foreign corporations are formed under non-U.S. law, usually the law of the Cayman Islands. In effect, the choice between partnership-as-entity and partnership-as-aggregate is elective.[7]

So long as the consequences of a partnership's place of formation were limited to those arising under pre-Act subpart F — that is, under §951, §956 and §1248 — some partnerships were formed under U.S. law and simply lived with the consequences. These rules constitute an anti-deferral regime, not a true worldwide regime. Section 951 and §956 often would not apply if the CFC had no subpart F income or investments in U.S. property. Section 1248 applied only on an exit.

The introduction of GILTI fundamentally changed these dynamics. The new GILTI tax applies to USSHs of CFCs, and those terms are defined in exactly the same way as they are for all other subpart F purposes. GILTI is a worldwide regime, meaning that GILTI is taxed to a USSH currently without exception. The base for GILTI is extremely broad, picking up almost all income earned by a CFC other than subpart F income and U.S. ECI. Coupled with the repeal of §958(b)(4), which dramatically expanded the number of foreign corporations that are CFCs,[8] GILTI considerably raises the stakes involved in the government's domestic partnership as entity approach.[9]

The treatment of domestic partnerships in the GILTI context presented the government with difficult choices. As noted in the preamble to the proposed regulations, pre-Act subpart F did not require any calculations to be performed at the partner level. A partnership could calculate its subpart F income at the CFC level, which then passed through to its partners as such under §702. GILTI, however, requires significant calculations to be made at the level of the CFC's shareholder. A USSH is required to combine the net tested income and net tested loss of all of its CFCs, to determine the QBAI of all of its tested income CFCs, and to perform other calculations on a combined basis across all of its CFCs.

The shareholder-level approach does not mesh well with an approach that treats a domestic partnership as a separate entity for tax purposes, because the shareholder-level approach assumes that the shareholder is the actual taxpayer in question, which a partnership is not. The most critical problem identified by the government was the case where a U.S. partner owned stock of one CFC through the partnership and stock of another CFC outside the partnership. The preamble states:

> Under a pure entity approach, the domestic partnership would determine its own GILTI inclusion amount, and each partner would take into gross income its distributive share of such amount. In the case of a partner that is a U.S. shareholder of CFCs owned by the partnership and other CFCs outside the partnership, a pure entity approach would effectively fragment the shareholder's GILTI inclusion amount into multiple GILTI inclusion amounts by separating the items of the CFCs owned by the shareholder through the partnership from the items of the CFCs owned by the shareholder outside the partnership, including through other domestic partnerships. An approach that dramatically alters a U.S. shareholder's inclusion under section 951A for a taxable year depending on the legal structure by which the shareholder owns each CFC presents both an inappropriate planning opportunity as well as a trap for the unwary. Such an approach is also inconsistent with the structure of section 951A, which requires an aggregation of all relevant items of a shareholder's CFCs in order to compute a single GILTI inclusion amount for a U.S. shareholder.

It is obvious, even to the government, that this problem is easily solved simply be treating a partnership as an aggregate. But the proposed regulations did not go there. And the reason they did not go there is that the government does not want to admit that its small U.S. partner rule (never mind its threshold domestic partnership as entity rule) is wrong. Here is what the government wrote:

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[6] Reg. §1.956-4, T.D. 9792 (Nov. 2, 2016).

[7] This has been confirmed by Reg. §1.701-2(f) *Ex.* (3). See also the discussion of this electivity in New York State Bar Association Tax Section Report No. 1124, "Report on Differences in Tax Treatment of Domestic and Foreign Partnerships" (Jan. 3, 2007).

[8] *See* Blanchard, *Top Ten Reasons to Limit §958(b)(4) Repeal*, 47 Tax Mgmt. Int'l J. 405 (June 8, 2018).

[9] The stakes are further raised where there are non-corporate partners not entitled to the 50% deduction under §250 or to foreign tax credits under §960(d).

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> A pure aggregate approach to the treatment of domestic partnerships and their partners would treat the partnership as an aggregate of its partners, so that each partner would calculate its own GILTI inclusion amount taking into account its pro rata share of CFC items through the partnership. However, a pure aggregate approach might also be interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely, a result that is not clearly contemplated in section 951A or its legislative history and is inconsistent with section 951.

To get around the problem of the partner (or at least some partners, as we shall see) who owns CFCs both inside and outside a domestic partnership, while maintaining the fiction of the small U.S. partner rule, the proposed regulations invented a hybrid construct that treats the same domestic partnership as both an aggregate and an entity with respect to different classes of partners. As to any partner who would be a USSH even if he owned the partnership's CFC shares directly — such partner defined in the proposed regulations as a ''U.S. shareholder partner''[10] — the proposed regulations would treat a domestic partnership as an aggregate, ''in the same manner as if the U.S. shareholder partnership were a foreign partnership under section 958(a)(2).''[11] But for small partners who would not be USSHs if they owned the stock directly, the government's current entity view would apply, with the result that such partners could not aggregate the income and attributes of a partnership-owned CFC with those of a CFC owned directly.[12]

The preamble to the proposed regulations does not state why the problem of combining a directly owned CFC with a CFC owned through a domestic partnership did not also have to be solved for the small U.S. partner. Given the fact that such a partner is required to take into account its share of subpart F and GILTI of the partnership, to deny it the benefit afforded to larger partners is illogical.

The preamble to the proposed regulations takes pains to highlight the counterintuitive results that would occur if an entity approach were applied, at least to large partners. Yet the real basis of any counterintuitive result has existed for many years: the government's insistence that a domestic partnership be treated as a separate entity for distributive share purposes. So let's return to the original sin and ask, one more time with feeling, why the government believes that a domestic partnership must be treated as a separate entity for purposes of subpart F.

The original sin committed by the government was to conflate the defined term ''U.S. person'' with the common-law question of whether a partnership (domestic or foreign) should be treated as an entity or as an aggregate of its partners. There is no question that a domestic partnership is a U.S. person and not a foreign one, unless and to the extent that the government uses its authority under §7701(a)(4) to provide otherwise. But that fact is not relevant to the question whether the partnership should be treated as an aggregate for purposes of subpart F, any more than it is relevant for any other purpose of the Code. Conversely, just because a foreign partnership is not a U.S. person, there is no reason to suppose that it ought to be treated as an aggregate.

The fact that §958(a) incorporates a look-through rule for foreign entities, including foreign corporations, does not create any negative inference that a domestic partnership is not an aggregate. Section 958(a) is just an indirect ownership rule needed to find a U.S. person where he/she holds stock through a foreign entity of any kind. Section 958(b) contains constructive ownership rules that by cross-reference to §318 clearly require stock owned by a domestic partnership to be treated as owned by all of its partners, proportionately. It is axiomatic that two different people cannot both be USSHs with respect to the same share of stock. So which is it: the partnership, or the partners? There is simply nothing in the Code that prevents the government from reaching the theoretically correct answer here, which is that the partners (who are the real taxpayers), not the partnership, are the persons to be tested for their USSH status. In fact, almost everything in the Code screams out for an aggregate approach to be used in the context of distributive share income.[13]

In other words, a finding that a domestic partnership is *a* ''U.S. person'' does not end the inquiry, and does not preclude a conclusion that a domestic partnership is not *the* U.S. person that subpart F is attempting to tax. To the extent relevant, a U.S. single-member limited liability company that is disregarded for tax purposes is a ''U.S. person,'' but it seems beyond doubt that such company is not *the* U.S. person tested under subpart F. There is no reason why a different rule should apply to a domestic partnership. Neither a partnership nor a disregarded entity is a taxpayer.

Under the common law entity-aggregate distinction, it is normally supposed that the choice between entity and aggregate theory should turn on the purpose of the substantive provision sought to be applied.

[10] Prop. Reg. §1.951A-5(e)(3).

[11] Prop. Reg. §1.951A-5(c).

[12] Prop. Reg. §1.951A-5(b)(2).

[13] Examples include §875, §512(c), the so-called Brown Group regulations under subpart F, and the portfolio interest regulations.

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The preamble to the proposed regulations, cited above, stated that "An approach that dramatically alters a U.S. shareholder's inclusion under section 951A for a taxable year depending on the legal structure by which the shareholder owns each CFC presents both an inappropriate planning opportunity as well as a trap for the unwary." This is an admission that the entity approach to a domestic partnership is inconsistent with the policy and logic of GILTI. But, more broadly, the treatment of any partnership as an entity is simply inconsistent with the policy and logic of all of subpart F, and the government's traditional insistence upon entity treatment for domestic partnerships is erroneous.

Moreover, there is no basis in aggregate-versus-entity policy to treat a single partnership as an aggregate as to some partners but not others.[14] Especially in the context of GILTI, where shareholder-level calculations are required, the deficiencies of an entity approach are just as real for small partners as they are for larger ones. In fact, the situation of the small partner is more compelling for applying aggregate treatment, since many small partners are likely to be individuals ineligible for the §250 deduction for GILTI or to claim foreign tax credits.

The proposed GILTI regulations addressing partnerships should be withdrawn and reissued to adopt a pure aggregate approach to all partnerships. If the government insists on maintaining its position vis-à-vis small partners for §951 purposes, the inconsistency is no worse than the inconsistency embedded in these proposals.

[14] I made this argument in the articles cited at n.1, above, in connection with Notice 2010-41, which treats a domestic partnership as an aggregate for some purposes and as an entity for other purposes.

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