Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances

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Co-Chairs
Stephen D. Rose
Eric B. Sloan
Clifford M. Warren
In Search of a Normative Theory of Partnership Taxation for International Tax (or How We Learned to Stop Worrying and Love Subchapter K)

Christopher Trump
Mark Graham
Deloitte Tax LLP
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Chris Trump is a Principal in the International Tax Service Line in Deloitte’s Washington National Tax Office.

Mark Graham is a Senior Manager in the International Tax Service Line in Deloitte’s Washington National Tax Office.

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The use of partnerships in the international context has become more prevalent. As a result, the international issues inherent in subchapter K have taken on increased importance. Christopher Trump and Mark Graham identify a few key provisions in which the application of the international rules to partnerships has been specifically considered by the IRS, Treasury, or Congress, use those provisions to illustrate the problem with the current approach, and ask the question as to whether a more coherent approach is possible.

The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance of the tax consequences.¹

Over the past 60 years, since the promulgation of subchapter K of the Internal Revenue Code,² published regulations, statutory modifications, revenue rulings, private guidance, court cases and countless articles have been written on the taxation of partnerships. In most cases, the guidance and commentary has helped to alleviate much of the confusion that existed prior to the Revenue Act of 1954. However, one area where a substantial amount of confusion still exists is in the context of international taxation. Although this is in part the result of the increased utilization of partnerships in cross-border transactions and the complexity of the overlapping rules, a more direct and proximate cause is the piecemeal approach adopted by the IRS and the Treasury in promulgating rules to address partnerships in the international context.

In many cases this guidance has been preceded with the following, which is used to justify both a piecemeal and what is often characterized as a largely “aggregate” approach to partnerships:

[b]oth the House provisions and the Senate amendment provide for the use of the “entity” approach in the treatment of the transactions between a partner and a partnership ... No inference is intended, however, that a partnership is to be considered a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.³

Even if one were to accept that an “aggregate” approach to partnerships in the international context is appropriate, what becomes clear from even a cursory reading of the guidance is that an aggregate approach has in fact not been adopted. Instead, the published rules largely adopt what this article will describe below as a “modified conduit” approach.

Under this “modified conduit” approach, the income (or loss) recognized by a partnership is characterized as if recognized by the partner directly (as opposed to by the partnership). In the case of the disposition
of an interest in a partnership, the gain or loss is calculated as if the asset being sold is an interest in an entity, but the character of the gain or loss is determined by reference to the partnership’s assets or activities. Finally, in cases where the nature of the assets held by a partnership are relevant (for example, in the context of Code Sec. 956), the amount of the investment is determined by reference to the partner’s basis in the partnership interest (i.e., an entity approach), but the character of that asset is determined by reference to the underlying assets of the partnership.

In the opinion of this article, it is time to move beyond this piecemeal approach and ask: Shouldn’t we have a generally coherent theory of partnership taxation in the international context?

It is necessary to note a few things that this article is not. First, it is not an attempt to assess the broader policies underlying aggregate versus entity within subchapter K as a whole. In addition, it is not a survey of all the various international provisions that implicate subchapter K (or vice versa). Instead, what this article will do is identify a few key provisions in which the application of the international rules to partnerships has been considered by the IRS, Treasury or Congress, use those provisions to illustrate the problem with the current approach and ask the question as to whether a more coherent approach is possible.

In Part I of the article, we will define the vocabulary that is used (and sometimes misused). In particular, although practitioners, the IRS and Treasury regularly use the term “aggregate” or “entity,” it is often without a clear articulation of what those terms are intended to mean. Thus, the article will start by defining those terms. In addition, the article will offer some other terms that are useful for this discussion, such as “conduit.”

In Part II of the article, we will consider a series of provisions in which a substantial overlap between subchapter K and the international rules exists. First, we will discuss Code Sec. 954 and the Brown Group regulations, which provide rules for the characterization of income recognized by a partnership. The article will then move to a discussion of Rev. Rul. 91-32 and the treatment of gain on the sale or exchange of a partnership interest that carries on a trade or business in the United States. The third area will be the application of Code Sec. 956, both in situations in which the partnership holds assets and where a partnership is the issuer of an obligation. Using this analysis as a springboard, Part II will then offer an answer to the question of whether a single coherent approach for the treatment of partnerships in the international context is appropriate. In addition, we will see whether it is possible, as the authors surmise, to adopt an entity approach to partnership taxation in the international context, which can be more easily integrated into the fabric of
subchapter K while preserving the policies of the various international provisions as a whole.

In Part III, the article will summarize the discussion and recommendations outlined in Part II.

I. THE VOCABULARY

Much has been written about the treatment of a partnership as an entity separate from its partners or as an aggregate, where the partners are treated as co-owners of property. Although the literature, including the Revenue Act of 1954, utilizes these terms when discussing transactions between a partner and a partnership, the terms themselves when used in the context of our discussion have a much broader meaning. Thus, as used in this article, an “aggregate approach” is an approach whereby the partnership is not viewed as an entity separate from its partners, and any transactions among and between the partners, the partnership and third parties are transactions that are treated as occurring between and among the partners and the third parties directly. In addition, under a pure aggregate approach, any transactions between a partner and the partnership would either be disregarded or viewed as a transaction directly between the partners themselves. Finally, any assets or liabilities held by the partnership would be treated as assets and liabilities of the partners.

Alternatively, under an entity approach, all transactions between the partnership and its partners and third parties would be treated as transactions directly with the partnership. Thus, for example, when analyzing whether a transaction between a person and a partnership is a related-party transaction (particularly relevant in the context of Code Sec. 954, discussed below), one would look to the relationship between the person and the partnership, as opposed to the relationship between the person and the partner. Similarly, under an entity approach, the transfer of a partnership interest would be viewed as the transfer of the interest in the entity, as opposed to the transfer of the underlying assets of the partnership.

Regardless of which camp one adheres to (aggregate or entity), it is necessary to characterize the income derived and expenses incurred by the partnership. In general, subchapter K treats the partnership as a “conduit,” where the character of any item of income, gain, loss, deduction or credit included in a partner’s distributive share is determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Thus, the partnership’s items retain “their original character in the hands of the partner as if they were realized directly by him from
the same source from which realized by the partnership and in the same manner." As will become clear through the discussion below, it is the application of this conduit approach (and the level at which the characterization should occur) that arguably drives much of the confusion surrounding the treatment of partnerships in the international context.

In addition to the modified conduit approach discussed earlier, commentators have also pointed out a fifth approach to the taxation of partnerships and partnerships: the "attributonal approach." Under this approach, the partner is not merely treated as owning its share of the assets of the partnership, but is also treated as carrying on the activities of the partnership. This principle, most clearly incorporated into the Internal Revenue Code (hereinafter, the "Code") in Code Sec. 875(1) and by the courts when analyzing partnerships in the income tax treaty context (for example, in Donroy Ltd. and Unger), treats a partner as engaged in a trade or business in the United States to the extent the partnership is engaged in a trade or business in the United States, and treats the partner as having a permanent establishment in the United States if the partnership has a permanent establishment in the United States.

II. CASE STUDIES

1. Brown Group: A Detour into Subpart F

A. Subpart F: In General

A majority of the guidance published by the IRS and Treasury on the application of partnerships in the international context has been focused on the anti-deferral rules promulgated in subpart F of the Code. As a result, a brief discussion of subpart F is necessary before moving forward.

a. A Brief History of the Enactment of Subpart F

The subpart F provisions of the Code stem from the Kennedy Administration's proposal in 1961 to eliminate deferral of earnings derived overseas by American investors amid concerns that American taxpayers were utilizing foreign investments to defer, and sometimes completely avoid, U.S. and foreign tax in both developed and "tax haven" jurisdictions. While Congress agreed that tax havens provided an inappropriate tax incentive, it did not share the President's view that deferral as a result of non-tax-motivated structures and transactions in
developed countries was problematic.\textsuperscript{13} Thus, when subpart F was enacted in 1962, it targeted deferral with respect to certain types of activities that were considered by Congress to be of the type that would take place within tax haven jurisdictions (such as trading, licensing and insurance), but not with respect to business activities in developed foreign countries.\textsuperscript{14}

As originally enacted, subpart F was also intended to ensure that passive income earned by U.S.-owned foreign corporations was also subject to U.S. tax, regardless if earned through a tax haven. While Congress recognized the importance of keeping American businesses competitive abroad, it “saw no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income.”\textsuperscript{15} Thus, while subpart F intended to promote equity and economic efficiency, Congress believed taxing passive and tax haven-earned income was an overriding policy concern that at the same time avoided undue harm to the competitiveness of U.S. multinationals. Since its enactment in 1962, subpart F has been amended numerous times.\textsuperscript{16}

The subpart F regime applies to income of, and assets held by, a controlled foreign corporation (CFC).\textsuperscript{17} In such a case, and provided that a foreign corporation is a CFC for an uninterrupted period of 30 days or more during the tax year, every person who is a U.S. shareholder and owns the stock on the last day of the year must include in gross income its \textit{pro rata} share of the CFC’s subpart F income for such year and the amount determined under Code Sec. 956 (related to investments in U.S. property, discussed further below) for the tax year.

A “U.S. shareholder” is a U.S. person who owns (within the meaning of Code Sec. 958(a)) or is considered to own (within the meaning of Code Sec. 958(b)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.\textsuperscript{18}

The term “U.S. person” is defined by reference to Code Sec. 7701(a)(30)(B) to include a domestic partnership and exclude a foreign partnership.\textsuperscript{19} Accordingly, and as discussed further below, a foreign corporation wholly owned by a domestic partnership will always be a CFC, regardless of who owns the domestic partnership.\textsuperscript{20}
Subpart F income is composed of several types of income, including foreign base company income (FBCI).\textsuperscript{21} Code Sec. 954(a) states that FBCI is the sum of foreign personal holding company income (FPHCI), foreign base company sales income (FBCSI), foreign base company services income (FBCSVI) and foreign base company oil related income (FORI), in each case reduced by properly allocable deductions as provided in Code Sec. 954(b)(5).

b. FPHCI

FPHCI consists of dividends, interest, the excess of gains over losses from the sale or exchange of certain types of property, royalties, rents and annuities.\textsuperscript{22} With respect to dividends, interests, rents and royalties, the Code and regulations provide three exceptions. The first, the “same country exception,” requires that, among other things, the recipient of the income is organized in the same jurisdiction as the payor, the payor is a foreign corporation and the recipient is related to the payor.\textsuperscript{23} It is noteworthy that with respect to FPHCI, the Code provides that “to the extent provided in regulations, payments made by a partnership with 1 or more corporate partners shall be treated as made by such corporate partners in proportion to their respective interests in the partnership.”\textsuperscript{24}

Under the second exception, “the active trade or business exception,” FPHCI does not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person.\textsuperscript{25}

The final exception, the “look-through rule,” requires that the income be received from a CFC that is a related person and that the income be attributable to income that itself is not subpart F or effectively connected with a U.S. trade or business.\textsuperscript{26} Thus, under the look-through rule, dividends, interest, rents and royalties received or accrued from a CFC that is a related person are not treated as FPHCI to the extent attributable or properly allocable to income of the related person that is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.\textsuperscript{27}
c. **FBCSI**

Code Sec. 954(d)(1) defines FBCSI as income (whether in the form of profits, commissions, fees or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person, where: (1) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the CFC is created or organized, and (2) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside of such foreign country.

However, FBCSI does not include income from the sale of property that (1) the CFC itself manufactured or produced,²⁸ (2) was manufactured or produced by another party in the same country that the CFC is organized, or (3) is sold for use, consumption or disposition in the same country as the CFC is organized.

In addition to the general rule of Code Sec. 954(d)(1), Code Sec. 954(d)(2)²⁹ provides a rule that applies in situations in which the CFC carries on manufacturing or sales activities through a branch or similar establishment outside its country of incorporation.³⁰

d. **FBCSVI**

Finally, FBCSVI means income derived in connection with the performance of services that are performed (1) for, or on behalf of, any related person; and (2) outside the country under the laws of which the CFC is created or organized. The regulations provide that “services performed for or on behalf of a related person” include cases in which (1) the CFC is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;³¹ (2) the CFC performs services (whether or not with respect to property sold by a
related person) which a related person is, or has been, obligated to perform;\(^3\) (3) the CFC performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale;\(^3\) or (4) substantial assistance contributing to the performance of such services has been furnished by a related person or persons.\(^4\)

**B. Brown Group, Inc.\(^{25}\)**

Although the IRS, Treasury and practitioners gave substantial thought to the treatment of partnerships in the international context for a number of years, much of the published guidance involving partnerships in the international arena originates from the case *Brown Group Inc. v. Commissioner*.

Brown Group, Inc., a domestic corporation and the common parent of an affiliated group of corporations filing a consolidated return (together, “Brown Group”), was in the business of manufacturing, importing and selling shoes. Brown Group International, a domestic subsidiary and member of the consolidated group, owned 100 percent of the issued and outstanding stock of Brown Cayman, a Cayman Island CFC. Brown Cayman formed a partnership, Brinco, with two individuals, to act as the Brown Group’s purchasing agent in Brazil. Brown Group paid Brinco a 10-percent commission for the sourcing of Brazilian footwear. The IRS determined that Brown Cayman’s distributive share of the commission income should be includible as subpart F income in the consolidated gross income of Brown Group. Brown Group disagreed. See Diagram 1, below.

![Diagram 1](diagram.png)

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As in effect for the tax years at issue in *Brown Group*, a person was related with respect to a CFC if (1) such person was an individual, partnership, trust or estate that controlled the CFC; (2) such person was a corporation that controlled, or was controlled by, the CFC; or (3) such person was a corporation that was controlled by the same person or persons that controlled the CFC. For this purpose, “control” means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. Therefore, at the time, a partnership controlled by a CFC (or controlled by the same person that controlled the CFC) was *not* a related person with respect to that CFC.

Following consideration and rehearing by the Tax Court, the case ultimately made its way to the Eighth Circuit where the court, citing Code Sec. 702(b), held that the income derived by Brinco was not included in the definition of FBCSI.36 Simply stated, the court ruled that income should be characterized at the partnership level, and the income should retain its character when included in the partner’s distributive share of partnership income such that Brinco “earned its commission income on behalf of an unrelated person.”37

With respect to the application of the related party requirement of Code Sec. 954(d), the court concluded:

> Although our holding may result in a tax windfall to the Brown Group due to the particularized definition of “related person” under the pre-1987 version of section 954(d)(3) of the Internal Revenue Code, such a tax loophole is not ours to close but must rather be closed or cured by Congress ... Indeed, Congress has done just that. It closed this loophole the following year, in 1987, when it amended section 954(d)(3) to broaden the definition of “related person” to include not only partnerships that *control* CFC’s, but also those that *are controlled* by CFC’s or their parents.38

Thus, under Code Sec. 954(d)(3) (as modified by Congress), a person is related with respect to a CFC if (1) such person is an individual, corporation, partnership, trust or estate that controls or is controlled by the CFC; or (2) such person is a corporation, partnership, trust or estate that is controlled by the same person or persons that control the CFC.39 As a result, under the amended statutory definition of a related party, the income derived by Brinco would be treated as commission income received by Brinco from a related person.40
C. The Brown Group Regulations

In response to its loss in Brown Group, the IRS and Treasury promulgated regulations under Code Sec. 954 for purposes of determining whether a CFC partner’s distributive share of partnership income runs afoul of the subpart F anti-deferral regime.41

The Brown Group regulations adopt a mix of entity, aggregate and conduit approaches to partnership taxation. As explained in more detail below, the aggregate and conduit provisions of the regulations are applied together with a modified conduit approach, under which the attributes of the partner, as opposed to the partnership, are considered when applying Code Sec. 954.

a. Treatment of Partnerships and the Brown Group Regulations

i. Modified Conduit Approach

Under the modified conduit approach applied by the regulations, in order to determine the extent to which a CFC’s distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly where a provision of subpart F requires a determination of whether an entity is a related person (within the meaning of Code Sec. 954(d)(3)) or whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, the determination is made at the partner level (and not by reference to the partnership).42

The regulations also provide a rule for purposes of identifying the payor or payee of amounts when the amount is paid or earned by the partnership. In such a case, the corporate partner is treated as making the payment, or earning the income, to the extent of its distributive share of the partnership’s income or expense.43

For example, if a partnership with one or more corporate partners makes an interest payment, a corporate partner will be treated as the payor of the interest if (1) the payment gives rise to a partnership item of deduction under the Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under Code Sec. 704(b); or (2) the payment...
does not give rise to a partnership item of deduction under the Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to Code Sec. 704(b)).

A similar rule applies for purposes of determining whether a CFC’s distributive share of any item of gross income of a partnership is FBCSI when the item of income is derived from the sale by the partnership of personal property purchased by the partnership from (or sold by the partnership on behalf of) the CFC, or the sale by the partnership of personal property to (or the purchase of personal property by the partnership on behalf of) the CFC. In such cases, the transaction will be treated as a transaction with an entity that is a related person if: (1) the CFC purchased the personal property from (or sold it to the partnership on behalf of) a person related to the CFC; (2) the CFC sells personal property to (or purchases it from the partnership on behalf of) a person related to the CFC (other than the partnership); or (3) the branch rule of Code Sec. 954(d)(2) applies to treat as FBCSI the income of the CFC from selling to the partnership (or a third party) personal property that the CFC has manufactured, in the case where the partnership purchases personal property from (or sells personal property on behalf of) the CFC.

ii. Entity Approach

In addition to the modified conduit approach, the Brown Group regulations also include provisions that treat the partnership as an entity. For example, to determine the extent to which a CFC’s distributive share of an item of income of a partnership is FPHCI, the active trade or business exceptions apply only if the exception would have applied to exclude the income from FPHCI if the CFC had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the CFC or any other person.44
A similar rule applies for purposes of determining whether certain exceptions under Code Sec. 954(d) apply. In particular, Reg. §1.954-3(a)(6) provides that in order to determine the extent to which a CFC’s distributive share of any item of gross income of a partnership would have been FBCSI if received by it directly, under Reg. §1.952-1(g), the property sold will be considered to be manufactured, produced or constructed by the CFC, only if the manufacturing exception would have applied to exclude the income from FBCSI if the CFC had earned the income directly, determined by taking into account only the activities of the employees of, and property owned by, the partnership.

The Brown Group regulations also adopted two provisions addressing the application of Code Sec. 954(h) and Code Sec. 954(i). Thus, a CFC’s distributive share of partnership income will be excluded from FPHCI under the exception contained in Code Sec. 954(h) if (1) the CFC is an eligible CFC within the meaning of Code Sec. 954(h)(2) (taking into account the income of the CFC and any partnerships or other qualified business units, within the meaning of Code Sec. 989(a), of the CFC, including CFC’s distributive share of partnership income); and (2) the partnership, of which the CFC is a partner, generates qualified banking or financing income within the meaning of Code Sec. 954(h)(3) (taking into account only the income of the partnership). This provision may be the clearest example of the hybrid approach of the Brown Group regulations, where a single rule has both an entity and aggregate flavor which, although entirely justifiable from a policy perspective leads to uncertainty as to how a partnership should be treated when applying other provisions of the same regulation.

Finally, the partnership is treated as an entity for purposes of Code Sec. 954(e). This provision provides that a CFC’s distributive share of a partnership’s services income will be deemed to be derived from services performed for or on behalf of a related person if the partnership is a related person with respect to the CFC and, in connection with the services performed by the partnership, the CFC, or a person that is a related person
with respect to the CFC, provided assistance that would have constituted substantial assistance contributing to the performance of such services.

b. The Unanswered Questions

Although the Brown Group regulations provide guidance on the treatment of partnerships under Code Sec. 954, there are a number of issues that were left unresolved. In addition, because of the mixed approach adopted in the regulations, it is not possible to glean a single standard that can be applied when addressing these unanswered questions.48

i. The Regulations Only Address the Distributive Share of Partnership Income

In some ways, the most problematic area that is unaddressed by the Brown Group regulations is how the partnership should be treated when testing income derived by a partner from its dealings with the partnership. In short, because the scope of the regulations is limited to characterizing a partner’s distributive share of partnership income, they fail to answer the question of what happens when a partner derives income from its dealings with the partnership, other than as a distributive share, or how to treat the partnership more generally under the provisions of subpart F. A number of examples illustrate this issue. A few, arising in the context of Code Sec. 954(d), are discussed later. The following example illustrates this in the context of Code Sec. 954(c) under the same county exception to FPHCI.

Example 1. Assume that U.S. parent owns CFC1, organized under the laws of Country X; CFC2, organized under the laws of Country X; and CFC3, organized under the laws of Country Y. CFC2 and CFC3 own 60 percent and 40 percent, respectively, of an interest in FP, a Country X partnership. FP carries on an active trade or business in Country X. In year 1, FP makes a $150 interest payment to CFC1. See Diagram 2, below.
As discussed above, because the payment gives rise to a partnership item of deduction, for purposes of applying the same country exception, CFC2 will be treated as the payor with respect to $90 (60 percent of $150), and CFC3 will be treated as the payor with respect to $60 (40 percent of $150). For purposes of determining whether the payor of the interest is organized in the same country as the recipient, that determination is made at the partner (and not the partnership) level. Thus, with respect to the portion of the payment that is allocated to CFC3, because the payor (CFC3) is organized in Country Y and the recipient is organized in Country X, the same country exception cannot apply.

However, to the extent of the interest allocable to CFC2, this interest is treated as paid by CFC2, a related party that is organized in the same country as CFC1. In such a case, and provided the other requirements of the same country exception are met, this payment could qualify for deferral under the same country exception.

Under the same country exception, the term FPHCI does not include interest received from a related person that is a corporation created or organized under the laws of the same foreign country under the laws of which the CFC is created or organized, and has a substantial part of its assets used in its trade or business located in such same foreign country. The regulations under Code Sec. 954 (c) provide detailed guidance on how to determine whether a corporation (in this case CFC2) has a substantial part of its assets used in its trade or business located in the
same country in which it is organized. However, those regulations are completely devoid of any guidance related to the treatment of a partnership interest when such interest is held by the CFC payor.

Thus, the questions in the instant case are: Is CFC2’s interest in FP an active asset or a passive asset? Do we look-through the partnership interest to make this determination? Do we look to the manner in which CFC2 directly controls the activities conducted by the partnership?

Although these questions are unanswered in the Code Sec. 954(c) regulations, the regulations do provide an express rule for situations in which the payor owns a 50-percent-or-greater interest in the stock of a lower-tier CFC that is organized in the same country as the CFC payor. In such a case, the stock is considered located in the payor’s country of incorporation and, solely for purposes of the same country exception, used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. Thus, although it is completely reasonable (and likely the appropriate way) to treat CFC2’s interest in FP as an asset used in CFC2’s trade or business, this rule is not adopted by the regulations with respect to partnerships. In addition, because of the hybrid approach of the regulations, discussed above, it is difficult to point to any guiding principle to directly support this analysis.

ii. The Brown Group Approach Is Inconsistent with the Code Sec. 904 Rules

The provisions in the Brown Group regulations do not adopt an aggregate approach. Under a “pure” aggregate approach, if there is a payment between a partner and the partnership, then to the extent the deduction is allocated to the payee partner, the transaction should be disregarded. To the extent of the deduction allocable to the other partners, the partnership itself should play no role, thus requiring the partner to look solely to the attributes of the other partner. Even if one were to argue that this was the appropriate approach, such an approach
becomes particularly problematic when applying the provisions of Code Sec. 904 and the regulations thereunder for purposes of determining the foreign tax credit limitation basket of the income.\textsuperscript{58}  

**Example** 2. U.S. parent owns CFC1, organized under the laws of Country X; CFC2, organized under the laws of Country X; and CFC3, organized under the laws of country Y. CFC2 and CFC3 own 60 percent and 40 percent, respectively, of an interest in FP, a Country X partnership. FP carries on an active trade or business in Country X. In year 1, FP makes a $150 interest payment to CFC1 X. Please refer to Diagram 2, above.

The income and expenses of CFC2, CFC3 and FP are shown in Table 1.

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<td>CFC1</td>
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<td>FP</td>
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<td>$150 of interest income from FP</td>
<td>$250 of general basket non-subpart F income</td>
<td>$250 of general basket non-subpart F income</td>
<td>$120 general basket non-subpart F income</td>
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<td>$60 of passive FPHCI</td>
<td>$30 of passive FPHCI</td>
<td>&lt;$150&gt; of Interest Expense Paid</td>
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As discussed above, for purposes of applying the provisions of subpart F and Code Sec. 954(c), including determining whether the interest income is treated as gross FPHCI in the hands of CFC1, the regulations treat the interest as paid by the partners, CFC2 and CFC3, respectively. Thus, and assuming Code Sec. 954(c)(6) is applicable to the payments,\textsuperscript{59} the following would occur:

Under Code Sec. 954(c)(6) and Notice 2007-9, §4, if “interest is received or accrued from a partnership with one or more partners that are CFCs, such interest will be treated as received or accrued from a CFC for purposes of section 954(c)(6) to the extent that such CFC partner would be treated as the payor of the interest under Treas. Reg. §1.954-2(b)(4)(i)(B).” Accordingly, $90 of interest (60 percent of the 150) is treated as paid by CFC2 and $60 of interest (40 percent of the 150) is treated as paid by CFC3.

For purposes of apportioning CFC2’s $90 of interest expense, the gross income of CFC2 would include its distributive share of FP’s income, which consists of $72 of non-subpart F income and $18 of passive FPHCI. In
addition, CFC2 earns $250 of non-subpart F income directly. Accordingly, CFC2’s $90 of interest expense is allocated $18 to passive FPHCI under the passive-first rule and $72 to non-subpart F income. With respect to CFC3, for purposes of apportioning its $60 of interest expense, it would have $72 of passive FPHCI ($60 earned directly and $12 included as a distributive share of the income of FP). Accordingly, the entire $60 of payment to CFC1 would appear to be FPHCI. Consequently, for purposes of Code Sec. 954(c)(6), CFC1’s $150 of interest income is characterized as $78 of FPHCI and $72 non-FPHCI.

However, for purposes of determining the basket of the interest in the hands of CFC1, the regulations under Code Sec. 904 apply an entity approach. According to the regulations under Code Sec. 904(d)(3) and Reg. §1.904-5, a payment to a partner described in Code Sec. 707(e.g., payments to a partner not acting in capacity as a partner), or a payment to a member of the controlled group, is characterized as income in a separate category to the extent that the payment is attributable under the principles of Reg. §1.861-8 and Code Sec. 904 to income earned or accrued by the partnership in such category. Accordingly, interest paid by a partnership to 10-percent-or-greater CFC partners or to related look-through entities is characterized based upon the income of the partnership under an entity approach.

As a result of this entity approach applicable for Code Sec. 904, as compared to the modified conduit approach of Code Sec. 954, significant discontinuity can occur.

Returning to the facts of our example above, when the various provisions are applied, we would have the following results: The first $30 of CFC1’s interest income would be passive because FP has $30 of passive gross income. The remaining $120 is general limitation income because FP’s remaining gross income is entirely general basket.
Accordingly, we presumably end up with a mismatch in FPHCI and passive basket income, as illustrated in Table 2.

<table>
<thead>
<tr>
<th>TABLE 2.</th>
<th>Computation of Subpart F Income</th>
<th>CFC2</th>
<th>CFC3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Income</strong></td>
<td></td>
<td>$250 General Basket Non-Subpart F</td>
<td>$250 General Basket Non-Subpart F</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$72 Non-Subpart F from FP</td>
<td>$60 Passive FPHCI</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$18 Passive FPHCI from FP</td>
<td>$48 Non-Subpart F from FP</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$12 Passive FPHCI from FP</td>
</tr>
<tr>
<td><strong>Expense</strong></td>
<td></td>
<td>&lt;$90&gt; Distributive Share of Interest Expense Paid by FP</td>
<td>&lt;$60&gt; Distributive Share of Interest Expense Paid by FP</td>
</tr>
<tr>
<td><strong>Income to CFC1</strong></td>
<td></td>
<td>$18 FPHCI (&quot;Passive First&quot;)</td>
<td>$60 FPHCI (&quot;Passive First&quot;)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$72 Non-Subpart F Income</td>
<td>$0 Non-Subpart F Income</td>
</tr>
</tbody>
</table>

Computation of Basket

| | | $120 General Basket Non-Subpart F Income | $120 General Limitation Income |
| **Gross Income** | | $30 of Passive FPHCI | $30 of Passive FPHCI |
| **Expense** | | <$150> of Interest Expense Paid to CFC3 | |
| Passive Income to CFC1 | | $30 of Passive FPHCI | |
| General Limitation Income to | | $120 General Limitation Income | |

iii. The Regulations Are Silent on the Branch Rule for Code Sec. 954(d)

In addition to the issues raised under Code Sec. 954 (c) above, there are also issues under Code Sec. 954(d). These issues arise because it is unclear as to whether the
partnership should be treated as an entity or an aggregate when characterizing a partners’ income derived from dealings with the partnership.

**Example 3.** Take, for example, the situation where a CFC owns a 55-percent interest in FP, a partnership that manufactures property and sells to the CFC. The remaining 45-percent interest is owned by an unrelated third party. The CFC then sells the property to unrelated customers. See Diagram 3, below.

In this situation, if the partnership were treated as a pure aggregate, then for purposes of determining whether the gain recognized by the CFC itself on the sale to third party customers would be FBCSI, the CFC would be viewed as engaging in a transaction directly with itself and also with the unrelated third party. With respect to this transaction, the CFC should not be treated as deriving any FBCSI under Code Sec. 954(d)(1), as it is both manufacturing the property it sold and neither selling the property to nor acquiring the property from a related party (e.g., the sale is in part a transaction whereby the CFC is treated as buying from itself and in part a transaction where the CFC is treated as buying from its unrelated partner).

Unfortunately, that does not appear to be the result under current law. Instead, it would appear that 100 percent
of the income derived by the CFC would be subpart F income. In particular, it appears that the CFC would be treated as purchasing the property from a related party (i.e., the partnership) and selling to an unrelated customer. In addition, as discussed further below, it is unclear whether the manufacturing exception would apply since the partnership, and not the CFC itself, is manufacturing the property sold.65

**Example 4.** Alternatively, assume that the CFC owns a 35-percent interest in a partnership that manufactures property as shown in Diagram 4, below.

![Diagram 4](image)

In this situation, if the partnership was an aggregate, then the CFC would be viewed as engaging in a transaction directly with itself and also with the unrelated third party with whom it is a partner. As discussed above, with respect to the unrelated third party the CFC should not be treated as deriving any FBCSI under the general rule under Code Sec. 954(d)(1) and with respect to the transaction that the CFC is engaging with itself, it would also not have any FBCSI because in such a case there is not a related party transaction and the CFC is manufacturing the property sold.

Unfortunately, under the approach of the *Brown Group* regulations, although the CFC would not appear to have FBCSI under Code Sec. 954(d)(1), as it is purchasing from an unrelated party (i.e., the partnership), we now must determine how to apply the branch rule. In this
situation, it appears that the better read of the regulations should be that the CFC does not have a manufacturing branch. In particular, if we are specifically precluded from taking into account the CFC partner’s activities for purposes of determining whether the income derived from the sale of property by the partnership qualifies for the manufacturing exception, we should also be precluded from having to take such activities into account for purposes of treating the CFC as having a branch under the branch rule.\textsuperscript{66}

This approach is also consistent with the “substantial contribution” regulations. Under those regulations, a CFC cannot take into account activities conducted by a separate entity for purposes of qualifying the CFC’s own income as income derived from “manufactured” property.\textsuperscript{67} Instead, the CFC must itself engage in certain nonphysical manufacturing activities through its own employees in order to be the manufacturer.\textsuperscript{68} Given that the partnership is a separate operating company under local law over which the CFC likely has little (if any) control, this appears to be the more appropriate result.\textsuperscript{69}

Unfortunately, this result could be seen as contrary to a series of recent Private Letter Rulings (LTRs) issued by the IRS, in which it adopted an aggregate view of partnerships for purposes of the branch rule. For example, in LTR 201002024, the IRS applied the provisions of Code Sec. 954(d)(2) to a supply chain conducted by a partnership owned by a CFC. Although the facts of the letter ruling are complicated, what is clear is that the IRS did not treat the partnership as an entity for purposes of Code Sec. 954(d) and applied the provision of Code Sec. 954(d)(1) and 954(d)(2) at the partner, and not the partnership, level.

With this LTR in mind, and returning to example 3, we might conclude that under current law the IRS has adopted a “heads we win, tails you lose” approach to FBCSI in the partnership context. In particular, if the partnership is treated as an aggregate (and we apply the branch rule), then arguably 100 percent of the sales income derived by the CFC on its sale to third-party customers in both examples is FBCSI. In example 3, all of the gain
is FBCSI under Code Sec. 954(d)(1), because CFC purchased the property from a related party and sold to an unrelated party. In addition, even if the manufacturing exception might apply, we would be forced to apply the branch rule, and under Code Sec. 954(d)(2), the gain could remain FBCSI. In example 3, although there is no FBCSI under Code Sec. 954(d)(1) applying an entity approach, we are again left to consider whether the branch rule applies, in which case 100 percent of the gain would potentially be FBCSI under Code Sec. 954(d)(2).

c. An Alternative Approach

Given the complexity of the provisions discussed above, and the myriad of competing policies at play, it is not surprising that the approach adopted by the IRS and Treasury has left unanswered questions. However, a basic premise of this article is that without a guiding framework as to the taxation of partnerships in the international arena, there is no way to determine the appropriate treatment of partnerships when faced with such questions.

Thus, we will reconsider the examples above and ask: What would be the result if the partnership were treated as an entity such that the transactions were characterized at the partnership level (as opposed to the partner level)? In addition, we need to consider whether this approach both more consistent with the policies of Code Sec. 954 and the economic realities of the current business environment?70

i. Code Sec. 954(d)

The court in Brown Group held that Brown Cayman’s distributive share of commission income did not constitute subpart F income. It should be noted that from the time the IRS challenged Brown Group to today, one very important change in law has occurred: Code Sec. 954(d)(3) was amended to include CFC-controlled partnerships as related persons. Given this change, it would now be quite simple for the IRS and Treasury to issue regulations providing that the commission income would constitute subpart F income to Brown Cayman in Brown Group. In light of this change and Code Sec. 702(b),
consider the consequences if Brinco were treated as an entity receiving commission income from a related party.

Code Sec. 702(b) provides that the character of any item of income, gain, loss, deduction or credit included in a partner’s distributive share under Code Sec. 702(a) is determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Regulations under Code Sec. 702(b) provide an example to illustrate how gain on the sale by a partnership of depreciable property or deductions for charitable donations retain their character when allocated to a partner. If we simply applied Code Sec. 702(b) as drafted, the income derived by Brinco would retain its character when Brown Cayman recognized such income and included it in income as part of its distributive share. In such case, Brown Cayman would be treated as receiving a distributive share of commission income. In addition, this income was derived by the partnership from a related party. Accordingly, the commission income would constitute FBCSI.

Following this approach, we return to our examples discussed above. Please refer to Diagram 3, above.

In this situation, if the partnership is treated as an entity, 100 percent of the gain recognized by the CFC on the sale to its customers would be subpart F income, but none of CFC’s distributive share of the income would be FBCSI.

In particular, CFC would be treated as purchasing the property from a related party (i.e., the partnership) and the manufacturing exception should not apply, as CFC is not substantially contributing to the manufacture of the property it purchased. With respect to CFC’s distributive share of partnership income, this income would have been derived by FP from the sale of property to a related party. Under Code Sec. 702(b), this income would be characterized at the partnership level as gain from the sale of property to a related party. However, because the partnership is itself manufacturing the property it sold, this gain would qualify for an exception to Code Sec. 954(d) and thus would not be FBCSI in the hands of CFC.
Further, consistent with the treatment of separate taxable entities for Code Sec. 954(d)(2), the branch rule would have no application.\textsuperscript{73} See Diagram 4.

If instead, CFC owned a 35-percent interest in FP, then none of the income would be FBCSI. This result is entirely appropriate under the policies of Code Sec. 954(d). As an initial matter, as a 35-percent partner in a partnership, CFC has no more control over the partnership’s activities than it would if the partnership were a separate corporation. In addition, it is hard to imagine that Congress envisioned that the anti-deferral rules of Code Sec. 954(d)(1) should apply to a situation, where, as here, neither CFC nor FP are acting as a base company to allow for the deferral of income derived from a related-party transaction.\textsuperscript{74}

With respect to CFC’s distributive share of FP’s income, this too would not be treated as FBCSI, because the gain, when characterized at the partnership level, is from a sale to an unrelated party. In addition, FP’s gain, as the manufacturer of the property sold, should not be taken into account immediately by the U.S. shareholder of CFC. Finally, by treating FP as an entity, we avoid the uncertainty inherent with the application of the branch rule and Code Sec. 954(d)(2). In this situation, this result is consistent with the existing case law and policies of Code Sec. 954(d)(2), given that FP is a separate unrelated operating company under local law over which the CFC has likely little if any control.

\textbf{ii. Code Sec. 954(c) Examples Revisited}

Different foreign jurisdictions tax what the United States would view as a partnership as an association and the United States might tax what a foreign jurisdiction would view as an association as a partnership. As a result, there is an element of electivity in the application of the Brown Group regulations, where the provisions are applied at the partner level in situations where the CFC is a partnership under local law and the U.S. partnership is a local country taxable entity. This electivity would be relieved by creating a uniform U.S. tax rule for treating
foreign partnerships as entities when determining the taxability of a CFC.

Under this approach, a partnership will be treated as a related party in all cases where Code Sec. 954(d)(3) ownership is found, and will be treated as owning its own assets and operations. In such a case, a rule would be required (much like in the case of Reg. §1.904-5) to treat the partnership as an entity for purposes of provisions like Code Sec. 954(c)(6) and 954(c)(3).

Under such an approach, for purposes of determining whether a partner’s distributive share of income is subpart F, the same country exception would apply by looking solely to the assets, activities and income of the partnership. In addition, for purposes of testing the same country (or other FPHCI rules) with respect to dividends, interest, rents or royalties received by a partnership, the income would be characterized at the partnership level and then flow through to the partner retaining such character.

**Example 5.** A CFC is a partner in a partnership (FP) that in turn owns 100 percent of the shares of CFC2, which pays a dividend to the partnership as shown in Diagram 5, below.

![Diagram 5](image)

In determining whether or not CFC’s distributive share of the dividend to FP is subpart F income, we would apply Code Sec. 702(b) and characterize the income at the partnership level as a dividend from a CFC that is a related party with respect to the partnership. Following
this initial characterization, the source and character of the payment would retain its character and flow through to the partner where qualification for the same country exception could be determined. This does not necessarily require the testing of same country to be made at the partnership level, and would not be a significant divergence from the current rules set forth for purposes of Code Sec. 954(c)(3) and Code Sec. 954(c)(6), but would be consistent with the entity treatment of the partnership as the single guiding principle espoused herein.75 This would, admittedly, require a broad interpretation of Code Sec. 702(b). However, this “super-application” of Code Sec. 702(b) would also provide appropriate answers in the context of situations where the partnership is the payor.

For example, in determining whether interest paid by a partnership to a CFC constitutes subpart F, the country of organization and location of business assets of the partnership only would be considered. This rule does not only provide for simplicity of application, but also appears to have the policy benefit of dissuading taxpayers from cherry-picking jurisdictions in which it might be favorable to use a partnership that is organized in a country that neither the CFC nor the partners have activities.

Example 6. U.S. parent owns CFC1, organized under the laws of Country X; CFC2, organized under the laws of Country X; and CFC3, organized under the laws of Country Y. CFC2 and CFC3 own 60 percent and 40 percent, respectively, of an interest in a FP, a Country X partnership. FP carries on an active trade or business in Country X. In year 1, FP makes a $150 interest payment to CFC1. Please refer to Diagram 2, above.

Under the suggested approach, CFC2 and CFC3 would be allocated their distributive share of the expense paid by FP. The determination of whether the payment is from a related party would be made at the partnership level and that expense would be taken into account by the partners as a payment to a related person. Consistent with the regulatory authority granted by Congress in Code Sec. 954(c)(3), the payment (otherwise characterized at the partnership level) could then be viewed as being made by each of the partners for purposes of determining under Code Sec. 954(c) whether it is made by a corporation.
Admittedly, one might argue that this is in essence no different than the modified conduit approach applied in the current Brown Group regulations; however, unlike those regulations the suggested approach does not in any way require us to disregard the partnership as being the entity engaging in the transaction and merely applies Code Sec. 702(b) to pass-through the item of expense to the partner.

The remaining requirements for meeting the same country exception would then be applied looking solely at the partnership. Thus, under this approach the payment received by CFC1 would qualify for the same country exception because FP is related to CFC1, FP is organized in the same country as CFC1, and FP meets the substantial assets test.

This approach appears entirely consistent with the underlying policies of the same country exception. In particular, it is only by looking to the activities and assets of FP that we can determine whether there is a redeployment of income derived in an active trade or business in that same country. In addition, this prevents the avoidance of these policies by forming a CFC in a country solely to qualify under the same country exception. Such a rule would also provide a normative approach for the treatment of partnerships when the CFC conducts other activities and merely holds a partnership interest. In such a case, the partnership would be treated as an entity, and, subject to a look-through rule similar to that currently found in Code Sec. 954(c) and Reg. §1.954-2(b)(4)(x), discussed above, would be treated in accordance with the CFC partner’s treatment if such partnership were a corporation (i.e., as either a passive or active asset).76

Finally, utilizing an entity approach would provide parity between the foreign tax credit limitation and subpart F rules. Thus, in the instant case, and assuming we were applying either Code Sec. 954(c)(6) or 954(c)(3), CFC1 would have $120 of general limitation non-subpart F income and $30 of passive subpart F income. Thus, the subpart F character and basket of FP’s income would be retained in the hands of CFC1, as opposed to the “blended” approach that would result if Code Sec. 954
(c) applies a modified conduit approach and Code Sec. 904 applies an entity approach. 77

2. Rev. Rul. 91-32

A. In General

The existing Brown Group regulations address a CFC partner’s distributive share of income and expense of a partnership and thus only apply to a U.S.-based multinational corporation operating outside the United States (i.e., outbound investment). However, the same entity and aggregate considerations occur with respect to foreign persons investing in the United States (i.e., in the inbound context) where the commentary and guidance is largely focused on characterizing gain on the sale or exchange of a partnership operating in the United States (as opposed to characterizing income derived by the partnership from activities conducted in the United States). 78

a. Taxation of Income Effectively Connected with a U.S. Trade or Business

A foreign corporation or nonresident alien individual is subject to U.S. income tax if it engages in a trade or business in the United States (a “U.S. trade or business”) and the income that it earns is effectively connected with the conduct of that U.S. trade or business. Such income is commonly referred to as “effectively connected income” or “ECI.”

If a foreign corporation or nonresident alien individual is found to be engaged in a U.S. trade or business during a tax year, it must then be determined the extent to which income of the foreign corporation constitutes income that is effectively connected with the U.S. trade or business (i.e., ECI), which is subject to U.S. federal income taxation on a net basis using graduated rates. Under Code Sec. 864(c)(2), any U.S. source gain from the sale or exchange of a capital asset will be treated as ECI only if either: (1) the income, gain or loss was derived from assets used or held for use in the conduct of a U.S. trade or business; or (2) the activities of such U.S. trade or business were a material factor in the realization of the income, gain or loss. All types of income, gain or loss from U.S. sources other than those described in Code Sec. 864(c)
(2) are treated automatically as effectively connected with the conduct of a U.S. trade or business (the so-called “force of attraction” rule).

In addition to U.S. source income, three categories of foreign source income may be effectively connected with a U.S. trade or business and thus subject to U.S. taxation. Those categories are: (1) rents, royalties or gains from the sale of intangible property; (2) dividends, interest and gains from the sale of securities; and (3) gains from the sale of inventory property.

Hence, in determining if gain is ECI, there is generally a two-part test. First, the source of the gain must be determined under the principles of Code Sec. 865. Second, the gain must be tested under Code Sec. 864(c)(2) and (3) (if the gain is U.S. source) and under Code Sec. 864(c)(4) and (5) (if the gain is foreign source), to determine if it is ECI.

Under the general rule of Code Sec. 865(a), income from the sale of personal property is generally sourced by reference to the residence of the seller. Accordingly, income from the sale of personal property by a United States resident is generally considered domestic source, and income from the sale of personal property by a nonresident (e.g., a foreign corporation) is generally considered foreign source. However, Code Sec. 865 includes a variety of exceptions to this general rule, including exceptions for inventory, depreciable personal property, and intangibles. In addition, Code Sec. 865(e)(2) provides that if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business is sourced in the United States.

For purposes of the Code, and subject to a limited set of exceptions, a partnership is treated as an entity for purposes of determining and characterizing the gain on the sale or exchange of the partnership interest. As a result, when a partner in a partnership sells its partnership interest, the gain is generally characterized as gain from the sale or exchange of a capital asset, except to the extent of the partner’s share of assets that give rise to ordinary income (“hot assets”).

With respect to gain on the sale of a partnership interest, the statute and regulations provide very limited guidance on
how to apply the provisions of Code Sec. 865. Although Code Sec. 865(i)(5) provides that in the case of a partnership, except as provided in regulations, Code Sec. 865 is applied at the partner level, this provision only addresses the taxation of the partner’s distributive share of income. Thus, there is very little if any direct guidance on the treatment of the gain or loss recognized at the partner level on the sale or exchange of the partnership interest.

As discussed further below, Rev. Rul. 91-32’s resolution to this issue, which is that the partnership interest itself is an asset held in the trade or business of the partnership that the partner is deemed to be engaged in by reason of Code. Sec. 875(1), is not entirely satisfying.

b. Rev. Rul. 91-32

Although Rev. Rul. 91-32 presented three alternative fact patterns, the fact pattern that illustrates its application is quite basic.

Example 7. Assume a foreign person, FP1, is a nonresident alien individual that owns an interest in PRS1, a partnership. PRS1 is engaged in a U.S. trade or business. The assets of PRS1 are all used or held for use in its trade or business, but it owns no assets that would meet the definition of a FIRPTA asset under Code Sec. 897. FP1 sold the interest in PRS1 and recognizes gain of $100,000. See Diagram 6, below.

As has been pointed out by numerous commentators, the analysis in Rev. Rul. 91-32 is cursory at best. In particular, although the revenue ruling cites to Code Secs. 875(1) and 865(e)(2) (both discussed above), it fails to identify how, on even the most basic level, the gain recognized by FP1 is
“attributable” to the U.S. trade or business carried on by the partnership. In particular, the revenue ruling merely concludes, with no analysis that, “[i]ncome from the disposition of a partnership interest by the foreign partner will be attributable to the foreign partner’s fixed place of business in the United States.”

The revenue ruling continues:

Subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships. COMPARE section 751 of the Code WITH section 741. For purposes of applying provisions of the Code not included in subchapter K, a partnership may be treated as an aggregate of its partners or as an entity distinct from its partners, depending on the purpose and scope of such provisions. The treatment of amounts received by a foreign partner from a disposition of a partnership interest must therefore be considered in connection with the general purpose and scope of section 864(c) and section 865(e). Pursuant to section 865(e)(3) the principles of section 864(c)(5) are applied to determine whether gain or loss from a sale is attributable to an office or fixed place of business for purposes of section 865(e)(1) and (2), so the same analysis applies to both sections 864(c) and 865(e).

Thus, the gain is U.S. source and is also effectively connected to a U.S. trade or business.

The Revenue Ruling also provides guidance on how to compute the amount of gain that is ECI, where the partnership owns assets the gain (or loss) on which is ECI and assets the gain (or loss) on which is not ECI. Assume the same facts as above, that the partnership holds the assets and FP has a 25-percent interest in all the items of gain, loss, deduction and credit flowing through from the partnership as shown in Table 3.

<table>
<thead>
<tr>
<th>TABLE 3.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Value</td>
</tr>
<tr>
<td>Cash</td>
<td>$300,000</td>
</tr>
<tr>
<td>Non-U.S. Real Property</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Non-U.S. Machinery</td>
<td>100,000</td>
</tr>
<tr>
<td>ECI Property</td>
<td>500,000</td>
</tr>
<tr>
<td>Total:</td>
<td>$1,900,000</td>
</tr>
</tbody>
</table>

In such a case, the revenue ruling concludes that the ECI is an amount that bears the same ratio to the gain realized by FP1 from the disposition of his partnership interest as FP1’s
distributive share of partnership net ECI gain would have borne to his distributive share of partnership net gain if the partnership had disposed of all of its assets at fair market value on the date FP1 disposes of his partnership interest.

Thus, upon a disposition of its ECI asset, the partnership would realize U.S. source ECI gain of $300,000 (fair market value of FP’s ECI property of $500,000 less basis of $200,000), of which 25 percent, or $75,000, would represent FP1’s distributive share. Upon a disposition of all of its non-ECI assets, PRS1 would realize a net gain of $100,000 (fair market value of machinery and real property outside the United States of $1,100,000 less basis of $1,000,000), of which foreign person’s 25-percent distributive share would be $25,000. Thus, the gain from the disposition of the partnership interest that is attributable to ECI property of the partnership is an amount that bears the same ratio to $100,000 as $75,000 (the distributive share of the partnership’s ECI gain) bears to $100,000 (the distributive share of the partnership’s net ECI gain and net non-ECI gain). Accordingly, the portion of FP1’s gain from the disposition of his partnership interest that is attributable to the ECI property of PS1 equals 75,000/100,000 of $100,000, or $75,000.84

c. Unresolved Problems

i. The Gain Is Not Foreign Source

All would acknowledge that, from a policy perspective, the United States should be allowed to tax income that is effectively connected with a trade or business in the United States. However, Congress, in adopting the rules of Code Secs. 864 and 865 made very specific (and some would argue conscious) policy calls about the types of income that should be effectively connected. Accordingly, unless the gain recognized on the sale or exchange of the partnership interest falls within the specified categories of income that can be ECI, the gain should not be subject to net basis taxation.

On the facts of the revenue ruling, because the gain on the sale of a partnership interest, under current law, is not attributable to the U.S. office or fixed place of business of the partnership, it is not U.S. source and not ECI.
In particular, as discussed above, under Code Sec. 865 (a), the general rule is that the source of the gain is determined by reference to the residence of the seller. Thus, for purposes of Rev. Rul. 91-32, the starting point is that any gain is foreign source. A few exceptions could potentially apply in such situation, but as a general matter none of those exceptions apply in the case of the sale of a partnership interest under Rev. Rul. 91-32.

First, Code Sec. 865(d) should not apply because the partnership interest is not a patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise or other like property.85

Second, Code Sec. 865(c) could apply to override the general rule of Code Sec. 865(a) if, and only if, the partnership interest were treated as depreciable personal property.86 In such a case, the gain attributable to U.S. depreciation adjustments could be treated as U.S. source gain. In addition, any gain in excess of the U.S. depreciation adjustments could be treated as U.S. source gain if the partnership interest were sold in the United States.87 Interestingly, Rev. Rul. 91-32 does not address the potential application of this rule (and does not provide facts sufficient to determine whether the rule is potentially applicable).

Thus, we are left with the question of whether the gain on the sale or exchange of the partnership interest should be attributable to the U.S. office or fixed place of business carried on by the partnership under section 865 (e), and only deemed to be carried on by the partner by reason of the application of section 875(1). In the opinion of this article, the answer is clearly, “no.”

The exception set forth in section 865(e)(2) provides that a foreign seller’s gain on the sale of personal property is U.S. source if the nonresident maintains an office or other fixed place of business in the United States, and the income from the sale of personal property is attributable to such office or other fixed place of business. The rule goes on to provide that the principles of section 864 (c)(5) apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale
is attributable to such an office or other fixed place of business.88

As outlined in Rev. Rul. 91-32, factors considered in determining whether the gain or loss is ECI gain or ECI loss include whether the gain or loss is derived from an asset that is used or held for use in the conduct of a trade or business in the United States, or whether the activities of that trade or business were a material factor in the realization of the gain or loss. Reg. § 1.864-4(c)(2) applies for purposes of determining whether an asset is used or held for use in the conduct of a trade or business within the United States, while the rules of Reg. § 1.864-4(c)(3) apply to determine the character of gain or loss realized directly from the active conduct of the trade or business. In the instant case, because the gain was not gain from the conduct of a trade or business, the IRS and Treasury applied Reg. § 1.864-4(c)(2).

However, under Reg. § 1.864-4(c)(2), it is difficult to imagine how the office or other fixed place of business in the United States that is maintained by the partnership is a material factor in the production of the income, gain, or loss from the sale by the partner of its partnership interest. In addition, the tenuous link between the activities conducted in the United States (through the creation of the value and thus the built in gain in the partnership interest), appears insufficient to give rise to the connection necessary to treat the gain as U.S. source (or effectively connected), for U.S. federal income tax purposes. In fact, this “linkage” between the increase in value and gain, is frankly no different than the link that would occur if the partnership were a corporation for U.S. federal income tax purposes. In such a case (i.e., the case of a corporation), there is no colorable argument that the gain should be ECI, except in the case where FIRPTA could apply.

ii. Computational Issues

In addition to the revenue ruling being an incorrect application of the law, there are substantial issues with how the rule should be applied where there is ECI gain and non-ECI loss. Some of these issues are addressed in
Rev. Rul. 91-32, Situation 2, but even that example leaves open unanswered questions. For example, what if there is a built in loss to begin with in the partnership interest? Thus, assume the same facts as Example 7 above, except that the partnership interest is sold for a loss of $100,000, instead of a gain of $100,000 because the underlying assets of the partnership are as shown in Table 4.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Value</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Non-U.S. Real Property</td>
<td>1,000,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Non-U.S. Machinery</td>
<td>100,000</td>
<td>700,000</td>
</tr>
<tr>
<td>ECI Property</td>
<td>500,000</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>$1,900,000</strong></td>
<td><strong>$2,000,000</strong></td>
</tr>
</tbody>
</table>

In such a case, because there is no gain recognized on the sale or exchange of the partnership interest, there can be no gain to characterize as ECI.\(^89\) In essence, by treating the partnership as an entity for purposes of calculating the amount of gain or loss on the sale, the approach adopted in the revenue ruling allows for a netting of ECI gain with non-ECI loss.\(^90\)

### iii. No Collection Mechanism

Even assuming that the underpinnings of Rev. Rul. 91-32 are correct, the conclusion fails to consider how, if at all, the IRS and Treasury would collect the underlying tax due on the sale. As is made clear through both the FIRPTA regime and the regulations under Code Sec. 1446, the collection of gain recognized on the disposition of property by a foreign person is extraordinarily unlikely without the imposition of a withholding tax. Although such a regime has recently been proposed by the Obama administration, one does not currently exist.\(^91\) In addition, in order to implement such a withholding tax regime applying a pure aggregate approach would require substantial information, and complex and detailed information sharing.
rules that is simply unattainable by either the buyer or the seller in many cases. Thus, the administrative complexity of such a system would be unwieldly at best and completely unenforceable at worst.

iv. Ignorance Is Bliss

Finally, a rule that requires a foreign transferor of a partnership interest to report and pay U.S. tax, even if laudable from a policy perspective, makes little if any sense if it is impossible to apply. This is not a question of enforcement and collection; for the time being, let’s assume all taxpayers will report and pay tax on their income in appropriate amounts. This is an issue of information sharing. How would a selling partner determine the amount of ECI gain or loss on the sale? Because Rev. Rul. 91-32 does not contain a *de minimis* rule, presumably a minority partner would be required to determine the nature of the assets in a partnership (even if it is merely investing in that partnership as a passive investor) in order to apply and determine its tax liability under Rev. Rul. 91-32.

A similar issue exists in the context of Code Sec. 751 (a), where a partner sells an interest in a partnership. In such a case, a partner selling or exchanging any part of an interest in a partnership that has any Code Sec. 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information: (1) the date of the sale or exchange; (2) the amount of any gain or loss attributable to the Code Sec. 751 property; and (3) the amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest. In addition, the partnership is required to provide a statement to the partner setting forth each partner’s share of “hot assets.” This information reporting and sharing allows the partner to determine the amount of hot asset gain subject to Code Sec. 751(a). However, it is difficult to imagine in practice how a foreign partner with a small interest in a partnership, for example, which owns only a small percentage of its assets in a U.S. trade or business would
have knowledge of its requirement to provide such information (and from an enforcement perspective, it is difficult to imagine that the IRS could compel the cooperation of such partnership).\textsuperscript{93}

d. **Rev. Rul. 91-32 Revisited**

Rev. Rul. 91-32 represents the Treasury’s position that gain from the sale of a partnership interest by a foreign partner can constitute ECI to the extent that the partnership carries on a trade or business in the United States. It is questionable whether this position is supportable by current law. What if, instead, one were to adopt a rule consistent with Code Sec. 741 (a) and treat the partnership as an entity for this purpose?

It is important to note that such an approach would not be without precedent in the inbound context. For example, when FIRPTA was first proposed in 1980, Congress decided that a partnership should be treated as an entity and FIRPTA tax should be imposed if greater than 50 percent of the value of a partnership was attributable to U.S. real property. In such a case, the partnership was deemed to be a “United States real property holding organization” or “RPHO” and a sale of a “controlling interest” in the profits and capital of an RPHO gave rise to FIRPTA withholding.\textsuperscript{94} This entity approach was ultimately discarded in FIRPTA (and in its place Congress enacted section 897(g), which imposes tax on the sale or exchange of a partnership interest only to the extent the gain represented appreciation in U.S. real property held by the partnership).\textsuperscript{95}

However, a similar rule in the context of ECI would arguably be far simpler to apply and administer than the Rev. Rul. 91-32 approach discussed above. Indeed, with respect to minority passive investors, such an approach would treat the partnership as what it is: an equity investment in an entity. Therefore, under the suggested approach, if a threshold amount of the assets or income of a partnership is ECI, then the gain on the sale of the partnership interest would be treated as ECI. There would be no need to determine the amount of gain (or loss) from ECI property that would be allocated to a particular partner. Instead, if more than 50 percent of the value of the assets of the partnership consists of assets used or held for use in a U.S. trade or business, then all the gain
would be subject to tax in the United States. Alternatively, if less than 50 percent of the value consists of assets used or held for use in a U.S. trade or business, then the gain would not be ECI. In order to ensure collection, the regime would require withholding tax on the disposition of the partnership interest, consistent with the Obama Administration proposal and the FIRPTA provisions.

In adopting such an approach, it would be simple (and not without precedent) for the IRS and Treasury to adopt a *de minimis* rule for small minority owners who would not be subject to tax the sale or exchange, regardless of the potential quantum of U.S. assets. This approach has been adopted throughout the international tax provisions and would be equally appropriate in the instant case. Finally, it would be appropriate for the IRS and Treasury to consider a provision that would apply if the partnership was formed with a principal purpose of avoiding the application of the ECI rules to the contributing partner.

Accordingly, if such an entity approach were applied, one might resolve the issues discussed above by imposing withholding tax on the buyer of a partnership interest from a foreign person in a manner similar to the FIRPTA regime and adopting a reporting regime similar to FIRPTA. In addition, one could adopt a percentage requirement similar to FIRPTA and limit the application of the provisions to the sale or exchange of an interest in a partnership with a material amount of U.S. trade or business assets. Finally, if an entity approach were adopted with respect to determining whether the sale of a partnership interest constitutes ECI, much of the disagreement on the authority underlying Rev. Rul. 91-32 would be eliminated.

One potential issue that would need to be addressed if this approach was adopted is the ability for a buyer to avoid U.S. tax on the subsequent disposition of the assets of the partnership where the partnership has a Code Sec. 754 election in effect at the time of the purchase.

In general, under Code Sec. 743, when a partnership has a Code Sec. 754 election in effect, the partnership will increase (or decrease) the basis of its assets following a purchase to bring parity between the built in gain (or loss) in the buying partner’s partnership interest and the built in gain (or loss) in the partner’s share of the partnership assets. If such a rule
were allowed to apply when the selling partner’s gain is not subject to U.S. federal income tax, then the basis step up under Code Secs. 743 and 754 would effectively and permanently remove such gain from tax in the United States. In such a case, there would be two options.

Under the first option, the regime could simply deny the Code Sec. 743 adjustment in toto. Such an approach is not without precedent and was proposed as part of the Taxpayer Relief Act of 1997. However, in the opinion of this article, such an approach would serve as too blunt a weapon against abuse. Instead, the regime should allow the application of the Code Sec. 743 adjustment, but prevent any of the adjustment from increasing the basis in property used or held for use in the U.S. trade or business to the extent the seller did not pay U.S. federal income tax on the sale of the partnership interest. This result is entirely appropriate and would preserve the U.S. federal income tax on ECI assets.

3. Code Sec. 956

a. A Short Primer on Code Sec. 956

Much like the subpart F rules discussed above, Code Sec. 956 is intended to limit the ability of a taxpayer to defer its earnings and avoid immediate U.S. taxation. However, unlike subpart F, which was geared to identifying certain passive activities and related party activities for which Congress determined deferral to be inappropriate, the legislative purpose of Code Sec. 956 is to prevent the direct or indirect repatriation of income to the United States in a manner that avoids current U.S. federal income taxation. However, and importantly, Code Sec. 956 does not reach “every benefit derived from ownership of stock in a CFC,” but instead is implicated “only when the CFC’s earnings are invested in United States property” as defined by Code Sec. 956.

Under Code Sec. 956, a U.S. Shareholder of a CFC must take into account and include in income an amount equal to the U.S. property held by the CFC for any tax year, as limited by the amount earnings and profits of the corporation, and reduced by amounts previously included in income under Code Sec. 951 (i.e., amounts included by reason of Code Sec. 956 or generally under subpart F). The amount of U.S. property held by a CFC is either the
CFC’s adjusted basis in such property or, in the case of an obligation, the principal amount of such obligation.

U.S. property as defined in Code Sec. 956(c)(1), and subject to exceptions contained in Code Sec. 956(c)(2), includes the following: (1) tangible property located in the United States; (2) stock of a domestic corporation; (3) an obligation of a U.S. person; or (4) any right to the use in the United States of (a) a patent or copyright, (b) an invention, model or design (whether or not patented), (c) a secret formula or process, or (d) any other similar property right, which is acquired or developed by the CFC for use in the United States.

Notably absent from the list is any direct reference to partnerships or interests in partnerships. The only potential reference, similar to that discussed above with respect to U.S. shareholders of CFCs, is the reference to a United States person. As noted above, and as discussed in greater detail below, a U.S. person includes domestic partnerships but excludes foreign partnerships.

There are two primary issues that exist with respect to partnerships in the context of Code Sec. 956. The first is whether assets held by a partnership with a CFC partner should be treated as U.S. property of the CFC partner. This issue was addressed in the Brown Group regulations, which themselves built on preexisting guidance found in Rev. Rul. 90-112.105 The second issue is whether obligations issued by a partnership (foreign or domestic) and held by a CFC should be treated as an obligation of a U.S. person for purposes of determining whether an inclusion should result with respect to that CFC’s earnings and profits.106 This issue in large part hinges on the entity/aggregate nature of the partnership and the extent to which one believes that Congress understood the consequences of limiting Code Sec. 956 property to obligations of a U.S. person in the context of a partnership.

b. Property Held by a Partnership

As discussed above, under a pure aggregate approach, the partners in a partnership should be viewed as owning the partnership property as co-owners directly. In such a case, any property held by the partnership (including U.S. property as defined in Code Sec. 956(c)(1)) would be viewed as owned proportionately by the partners. This approach leads to a myriad of problems, including how one determines the amount of such property and the partner’s basis in such property for purposes of applying Code
Sec. 956. The IRS addressed this question directly in Rev. Rul. 90-112 and then again by “codifying” the revenue ruling in the Brown Group regulations. Subsequent to that, additional guidance in the form of an LTR has provided more insight into the IRS’s view of these provisions (and also added color to issues that may arise under these provisions).

In Rev. Rul. 90-112, the IRS and Treasury held that a CFC’s interest in a partnership which owned real property located in the United States should be treated as U.S. property for purposes of Code Sec. 956. In addition, the ruling concluded that the amount of such property should be the adjusted basis of the property in the hands of the partnership, limited by the partner’s adjusted basis in its partnership interest. Although the IRS and Treasury characterize this approach as an “aggregate” view of the partnership, it is in fact another hybrid approach, which respects the partnership as an entity and in essence characterizes the partnership interest as Code Sec. 956 property. The facts of Rev. Rul. 90-112 are as follows:

**Example 8.** S, a CFC, owned a 25-percent interest in PRS, a partnership. The remaining 75 percent of PRS was owned by unrelated parties. PRS’s assets included U.S. real estate, which constitutes U.S. property under Code Sec. 956. CFC’s adjusted basis in its partnership interest is $10, while the inside basis of the U.S. property is $80. As noted above, the revenue ruling concludes that the amount of CFC’s investment in U.S. property should be 25 percent of the basis in the U.S. property held by the partnership (or $20), as limited by CFC’s basis in its partnership interest ($10). See Diagram 7, below.
The fact that a hybrid approach is used was also made clear in the Brown Group regulations, which provide that for purposes of Code Sec. 956, if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC will be treated as holding an interest in the property equal to its interest in the partnership, and such interest will be treated as an investment in U.S. property.\textsuperscript{108} Thus, and in the words of the IRS and Treasury, “consistent with Rev. Rul. 90-112, the regulations would provide that, for purposes of section 956, a CFC’s investment in U.S. property includes the U.S. property held by a partnership to the extent of the CFC’s interest in the partnership.” The regulations requested comments as to whether the amount of such CFC partner’s interest should be computed by reference to capital, profits or a general facts and circumstances approach. No guidance as to the proper approach was provided in final regulations.

As should be clear by now, the approach adopted by the IRS and Treasury when applying the international rules to partnerships has been piecemeal and result-driven, and is not (as some have suggested) a pure aggregate approach. Indeed, even in Code Sec. 956, where the clearest indication would be for an aggregate flavor, such treatment has not been adopted. Accordingly, taxpayers have been left to decide for themselves how to determine a partner’s share of Code Sec. 956 property held by the partnership. In at least one case, a taxpayer requested guidance from the IRS and received a private letter ruling, LTR 200832024.

In LTR 200832024, the taxpayer was a U.S. shareholder of a CFC (“FC”) that conducted its business outside the United States. In order to expand its U.S. and non-U.S. business, FC and an unrelated third party planned to enter into a joint venture (“Pship”). Under the arrangement:

The US Business and the non-US Business, including any subsequently acquired assets, will be maintained in separate legal entities owned by the partnership, LLC1 and LLC2. LLC1 and LLC2 will maintain separate books and records and funds will not be loaned or transferred between the entities. LLC1 will conduct the US Business and LLC2 will conduct the non-US Business and will not acquire any US property. FC will lend capital to Pship to Fund the US and Non-US Business, but will only share in income, gains, deductions and losses from the Non-US Business and will only have liquidation rights with respect to the Non-US Business.
The ruling concludes that because FC will not have an “economic interest” in the U.S. Business after the formation of Pship; no economic interest in U.S. property is being shifted from a CFC to a non-CFC; and LLC1 will not receive any loans, other funds, or credit support from LLC2, FC should not be treated as holding an interest in the U.S. Business under Reg. §1.956-2(a)(3) and, accordingly, will not be treated as holding any U.S. property otherwise held by Pship. There are a few items worth noting about the private letter ruling.

First, it does not address the broader question of (and assumes away) whether FC is a partner in the partnership in which the U.S. business assets are held or whether, in substance, the arrangement in effect created multiple partnerships under a single holding vehicle. This issue has been addressed by the IRS, and it is unclear from the facts whether treating the arrangement as a single partnership is appropriate. In addition, the ruling does nothing to move away from the hybrid approach of the Brown Group regulations or Rev. Rul. 90-112 and arguably muddies the waters further by concluding that FC will not be treated as holding an interest in the U.S. Business under the partnership rules.

Notwithstanding this lack of clarity, what is clear is that under Code Sec. 956 an interest in a foreign or domestic partnership held by a CFC is not an interest in U.S. property (unlike an interest in a domestic corporation). Under the regulations, a CFC’s interest in a partnership may be treated as an interest in U.S. property (irrespective of whether that partnership is foreign or domestic), but only to the extent that interest represents an interest in U.S. property held by the partnership itself. Under an aggregate approach, this would be accomplished by comparing the relative economic interests of the partners to the assets of the partnership and treating those assets as held proportionately by each of the partners. Alternatively, under an entity approach, the interest in the partnership itself would arguably not be treated as Code Sec. 956 property under current law, because in such a case the interest would not be specifically listed in Code Sec. 956(c)(1) (unlike, for example, stock in a domestic corporation).

Regardless of the viewpoint of this article as to the need for a coherent theory of subchapter K in the international context, what seems clear and must be acknowledged is that it is necessary to treat, under some methodology, U.S. property held by a partnership as held by the CFC partners in order to prevent the avoidance
of Code Sec. 956. Without such a rule, a CFC with substantial earnings could merely invest that capital in a partnership that itself could invest in U.S. property.

One approach, which is the one adopted in Rev. Rul. 90-112 and the Brown Group regulations, would be to treat the CFC as holding indirectly its share of U.S. property held by the partnership. Alternatively, and consistent with the basic premise of this article, we could instead treat the partnership as an entity. This latter approach is discussed in further detail below.

c. Obligations of a Partnership

i. In General

In addition to attributing assets to a CFC partner that holds an interest in a domestic or foreign partnership, Code Sec. 956 should also be considered when a partnership issues a note to a CFC with untaxed earnings and profits. The question in such a case is whether the partnership is a U.S. person and, more specifically from a Code Sec. 956 perspective, whether the obligation is an obligation of a U.S. person.\(^\text{110}\)

For purposes of Code Sec. 956, the term “United States person” is specifically defined by reference to Code Sec. 7701 (a)(30) as (with exceptions not applicable to the instant situation) a citizen or resident of the United States, a domestic partnership, a domestic corporation, an estate (other than a foreign estate) and any trust if a court within the United States is able to exercise primary supervision over its administration or one or more United States persons has the authority to control substantial decisions of the trust.\(^\text{111}\) Thus, in the case of a foreign partnership with U.S. partners issuing debt to a CFC, because a foreign partnership is not a U.S. person, the loan by a CFC to a foreign partnership with U.S. partners is not an obligation of a U.S. person and should not give rise to a Code Sec. 956 inclusion.\(^\text{112}\)

Under current law, the treatment of a partnership as an entity (regardless of whether the partnership is domestic or foreign) for purposes of Code Sec. 956 seems clear. Thus, subject to the potential application of the various anti-abuse provisions, including the partnership anti-abuse rule, if a CFC makes a loan to a foreign partnership, under the current Code Sec. 956 rules, this appears to be a loan to a foreign person
and is not, on its face, an obligation of a U.S. person. Alternatively, if a CFC makes a loan to a domestic partnership, under the current Code Sec. 956 rules, this appears to be a loan to a U.S. person, and gives rise to an investment in U.S. property.

The broader question is whether this treatment is appropriate under the policies of Code Sec. 956 in the case of a foreign partnership with U.S. partners if the cash is repatriated to the United States, or otherwise invested in property located within United States. In addition, the opposite question arises when the loan is issued by a domestic partnership with foreign partners which invests solely in foreign assets. In either case, the question is whether the treatment of the partnership as an entity is appropriate and, more broadly, why the treatment of the partnership as either an entity, an aggregate, or a hybrid, is in any way more appropriate given the underlying policies of Code Sec. 956.

ii. The Issue

The potential concern, in cases where a partnership borrows from a cash rich CFC, is not necessarily due to the application of the international provisions. Instead, and as with much of the confusion in this area, the issue arises from the potential application of certain partnership provisions. In particular, the concern stems from the fact that a partnership may distribute cash to its partners without having that amount treated as either income (for example, in the form of a dividend which would be the case if the distribution was made from a corporation) or as capital gain. This results from an interaction of a number of provisions, including Code Sec. 707, 721 and 731. While a discussion of these provisions is outside the scope of this article, their operation can be illustrated with the following example:

Example 9. U.S. Parent is a domestic corporation. U.S. Parent owns 100 percent of the issued and outstanding stock of CFC, USS1 and USS2. USS1 and USS2 are partners in FP, a foreign partnership. CFC has $100 of earnings and profits. CFC makes a loan of $100 to FP. FP makes a distribution of $60 to USS1 and $40 to USS2. See Diagram 8, below.
Under existing law, the loan to FP should not give rise to a Code Sec. 956 inclusion with respect to the earnings of CFC. However, it is likely that this cash can be distributed to the partners without triggering immediate U.S. tax. In particular, under Code Sec. 752, a partner in a partnership will increase its basis in its partnership interest to the extent of its share of the partnership’s liabilities. This will allow for the partnership to potentially distribute the cash to its partners tax-free. In such a case, we must ask the question of whether such a transaction should, from a policy perspective, give rise to an immediate U.S. federal income tax inclusion. But first, compare the above example to the following:

**Example 10.** U.S. Parent is a domestic corporation. U.S. Parent owns 100 percent of the issued and outstanding stock of CFC, USS1 and USS2. USS1 and USS2 are partners in FP, a foreign partnership. CFC has $100 of earnings and profits. CFC makes a loan of $100 to FP. FP invests that cash in a foreign trade or business (or uses it to acquire stock of another CFC). See Diagram 9, below.
In contrast to the previous example, the cash loaned to FP in the present example was never redeployed in the United States. Therefore, the transaction arguably should not be violative of the policies of Code Sec. 956. Indeed, it may be argued that such a transaction should be *encouraged* by the United States, as the earnings derived from the trade or business would not be deferred with respect to USS1 and USS2. If instead CFC either purchased the business directly or loaned the cash to another CFC to purchase the business, the income of the foreign business would likely be tax-deferred.

In light of these examples, should the application of Code Sec. 956 hinge on whether the borrowing partnership is domestic or foreign? In at least one other situation (discussed below), and in the context of Subpart F, the IRS and Treasury made a determination that the answer should be “no.” In addition, this determination was made without disregarding the partnership as an entity. Instead, the IRS and Treasury decided to define (or redefine), the partnership as foreign or domestic for purposes of applying the subpart F provisions.

d. **Code Sec. 956 Revisited**

As should be clear at this point, a basic premise of this article is that it is possible to preserve the policies of the numerous international provisions by generally treating a partnership as an entity. Having described how this would be accomplished for Code Sec. 954 and as a replacement for Rev. Rul. 91-32, we can now turn to describing how it would be accomplished under Code Sec. 956 where a partnership is owned by a CFC, and where a partnership with U.S. partners issues an obligation to a CFC. In either case, it is the opinion of this article that the approach suggested is consistent with the key guiding principles of Code Sec. 956.

i. **Partnership Interest Is Treated as U.S. Property**

The existing Code Sec. 956 regulation that codified Rev. Rul. 90-112 was introduced in conjunction with the *Brown Group* regulations. As a result, and in order to be consistent with the premise of this article, the approach with respect to Code Sec. 956 should be consistent with the approach to partnerships under Code Sec. 954. In order to preserve that parity, the alternative approach proposed herein would be to treat the
partnership as an entity and treat the CFC partner as holding an interest in the partnership.

Similar to what was proposed above with respect to Rev. Rul. 91-32, a sensible approach to Code Sec. 956 would be to treat an interest in a partnership as section 956 property only where a threshold percentage of the partnerships assets were U.S. property. Although various percentages might be appropriate, it appears reasonable to adopt a rule that would only apply if 25 percent or more of the assets are U.S. property.\textsuperscript{117} If such an approach were adopted, one might argue that this proposal would invite opportunistic taxpayers to enter into a partnership solely to limit (or eliminate) its Code Sec. 956 inclusion. To combat this, it would be appropriate to rely on (or adopt) an anti-abuse rule.

A framework for such an anti-abuse rule already exists in the Code Sec. 956 regulations under Reg. §1.956-1T(b)(4), which would merely need to be expanded to include partnerships.\textsuperscript{118} Under Reg. §1.956-1T(b)(4), a CFC is considered to hold indirectly Code Sec. 956 property acquired by any other foreign corporation that is related to the CFC under Code Sec. 267(b), “if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the [CFC].”

Thus, if an entity approach to the treatment of partnerships was adopted, concerns regarding the misuse of partnerships could be eased by expanding the existing anti-abuse rule to apply both to foreign corporations and partnerships that were funded by a CFC.

If adopted in full, such an approach would protect the fiscal health of the United States, while respecting the partnership as an entity and respecting the CFC owner has holding an interest in a partnership, as opposed to an indirect share of the partnerships assets. In addition, such a rule would vastly simplify the discussion and analysis regarding the amount of property held by a CFC partner. To the extent there was concern with minority partners, the exception under Code Sec. 956 (c)(2)(F) could be expanded to only apply to the extent the partner owns a 25-percent interest in the partnership (applying the attribution rules of Code Sec. 958(a) and (b)). This would have the advantage of preserving parity between the partnership
and the treatment of domestic corporations, which would further discourage cherry picking of entity type to achieve different results.

**ii. Loans to Partnerships**

A similar result, consistent with the treatment of debt under the rules of subchapter K, can be achieved with loans to partnerships by CFCs as well. Returning to our example above, and treating the FP as an entity:

**Example 11.** U.S. Parent is a domestic corporation. U.S. Parent owns 100 percent of the issued and outstanding stock of CFC, USS1 and USS2. USS1 and USS2 are partners in FP, a foreign partnership. CFC has $100 of earnings and profits. CFC makes a loan of $100 to FP. FP makes a distribution of $60 to USS1 and $40 to USS2. Please refer to Diagram 8, above.

Under the suggested approach, the loan would not constitute an investment in U.S. property. Accordingly, such a loan would, in and of itself, not give rise to a Code Sec. 956 inclusion. This would be entirely appropriate because the mere lending of cash to a foreign partnership should not itself give rise to concerns under Code Sec. 956 since the cash represented by CFC’s earnings have not directly, or indirectly, been repatriated to the United States.

Similar to the discussion above with respect to property held by partnerships, however, the IRS and Treasury would have a valid concern that through the operation of the subchapter K provisions a CFC could achieve tax-free repatriation through a loan to a partnership and the distribution of cash to the partners. In order to preserve the policies of Code Sec. 956, the IRS and Treasury should adopt a rule that traces the cash that is otherwise loaned to the partnership. For example, a loan to a partnership followed by a distribution of cash to a partner that is a U.S. shareholder of the CFC or an investment in the partnership in U.S. property would give rise to a Code Sec. 956 inclusion to the CFC. In fact, the anti-abuse rule proposed above would likely be sufficient to address this concern.

In addition, in order to maintain parity with respect to the treatment of partnerships, regardless of where formed or organized, this article would also recommend that the IRS and Treasury adopt rules to treat a domestic partnership borrowing...
from a CFC as a foreign partnership for purposes of applying Code Sec. 956. A similar approach was taken by the IRS for purposes of subpart F in Notice 2010-41, discussed below.

e. **Notice 2010-41**

Under Code Sec. 957(a), a foreign corporation is a CFC if more than 50 percent of either the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of the stock of such corporation, is owned (within the meaning of Code Sec. 958(a)) or is considered to be owned (within the meaning of Code Sec. 958(b)) by U.S. shareholders on any day during the CFC’s tax year. Thus, where a domestic partnership owns a CFC, the domestic partnership can in fact be the U.S. shareholder of the CFC and the “person” required to include in income its proportionate share of subpart F income. This treatment is widely accepted and was even included in examples in the partnership anti-abuse regulations. Accordingly, in the case of a domestic partnership that owns stock of a CFC, subpart F income recognized by a CFC is taken into account by the U.S. partnership as the CFC’s U.S. shareholder.

The problem identified by the IRS in Notice 2010-41 was that a CFC partner’s distributive share of a U.S. partnership’s subpart F inclusion is arguably not itself subpart F income. Only CFCs can recognize subpart F income, not U.S. partnerships. Thus, the Treasury and the IRS were concerned that taxpayers were taking the position that income inclusions recognized by a partnership under Code Sec. 951(a) were allocated to CFC partners, and because the distributive share of a CFC’s Code Sec. 951(a) income inclusion is not itself subpart F income, there were no amounts ultimately subject to U.S. income tax. Let us consider the following:

**Example 12.** A United States taxpayer (U.S. Parent) wholly owns two CFCs (CFC1 and CFC2), each of which owns 50 percent of another CFC (CFC3) through a domestic partnership (USP). CFC3 earns subpart F income. See Diagram 10, below.
Under these facts, the IRS and Treasury were concerned that the U.S. Parent would take the position that it does not have an income inclusion under Code Sec. 951(a) with respect to CFC3 because USP is the first United States person in the chain of ownership of CFC3. As a result, and because such treatment was “inconsistent with the purpose and intent of section 951(a),” the IRS and Treasury intend to issue regulations that will treat a domestic partnership as a foreign partnership solely for purposes of Code Sec. 951(a) if:

1. the partnership is a U.S. shareholder of a foreign corporation that is a CFC (within the meaning of Code Sec. 957(a) or 953(c)); and

2. if the partnership were treated as foreign: (a) that foreign corporation would continue to be a CFC; and (b) at least one U.S. shareholder of the CFC: (i) would be treated under Code Sec. 958 (a) as indirectly owning stock of the CFC owned by the partnership that is indirectly owned by a foreign corporation; and (ii) would be required to include an amount in gross income under Code Sec. 951(a) with respect to the CFC.

Importantly, Notice 2010-41 does not adopt an aggregate theory of partnerships. In fact, the targeted fix of Notice 2010-41 merely treats a domestic partnership as a foreign partnership for purposes of computing a U.S. shareholder’s subpart F income.
Notice 2010-41 represents an example of a targeted anti-abuse rule addressing a specific transaction in a way that preserves the partnership’s treatment as an entity for U.S. federal income tax purposes. By not attempting to broadly adopt an aggregate or modified conduit approach, the collateral impact that Notice 2010-41 has on the broader provisions of the Code and regulations is refreshingly limited!

III. SUMMARY OF CONCLUSIONS

From even the foregoing cursory review of selected partnership guidance in the international arena, it should be clear that the current state of partnership taxation is mixed, muddied and unclear. The provisions that have been adopted have done little to provide broad clarity and instead has been a scattershot result-driven approach.

In addition, many of these international tax provisions favor an approach where partners are treated as directly earning income generated by the assets of a partnership. Thus, the international tax provisions seem to disavow the general rule of Code Sec. 702(b) that characterizes a partner’s distributive share of partnership income at the partnership level. These same provisions also treat the partners as holding a direct interest in the partnership’s assets for certain purposes and treat the partners as holding an interest in an entity for other purposes. In addition, the present approach to taxing partnerships in international tax, because it is not consistently aggregate or entity, means that in areas where direct guidance does not exist, practitioners and taxpayers are left to argue over the correct treatment.

Throughout this article we have reviewed the provisions promulgated under the Brown Group regulations, Rev. Rul. 91-32 and guidance under Code Sec. 956 and identified that each consistently adopts a tortured mix of aggregate, entity and conduit theories of partnership taxation. We then proposed an approach using what is almost entirely an entity theory to illustrate how doing so might reduce the uncertainty present today in this area of international tax and still get the taxpayer to a tax answer that makes sense from a policy perspective.

In particular, we analyzed how using an entity approach would clarify FBCSI questions unanswered by the Brown Group regulations: whether transactions between partnerships and partners would be subpart F, and whether the branch rule of Code Sec. 954(d)(2) should apply. We also illustrated how the FPHCI result could be applied using an entity
approach while at the same time creating parity between the foreign tax credit limitation and subpart F rules.

In the inbound context, we discussed how the questions left unanswered by Rev. Rul. 91-32 could be resolved by treating a partnership as an entity, and how collection, computation, and information sharing concerns might be assuaged by implementing rules similar to what was first proposed under FIRPTA.

Finally, we looked at how using an entity approach in the context of Code Sec. 956 guidance could be achieved by using targeted rules in cases where such approach would be problematic. By using targeted rules even for a provision where an aggregate approach might be supportable, we illustrated how Code Sec. 956 would apply with respect to CFCs owning interests in partnerships or to loans from CFCs to partnerships.

As acknowledged, this article did not propose to represent a complete survey of all the international provisions that might implicate (or be implicated by) subchapter K. However, what should be clear from the discussion is that the current approach leaves much to be desired, and the suggested approach would seem to solve many uncertainties, unanswered questions and alleviate much of the ambiguity. In addition, this approach seems consistent with the policies of the international provisions and does not appear to require a significant departure from the underlying provisions of subchapter K.

Thus, we should continue to ask the questions posed at the beginning of this article. Why diverge from subchapter K when doing so is unnecessary to apply the international provisions? What policy is served by treating the partnership as other than an entity, given that in many cases such treatment is more consistent with the business objectives and realities of the partners’ investment? The answer, in our opinion, is quite simple: When there is no obvious reason to diverge from the approaches to taxing partnerships found in subchapter K, we shouldn’t.

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6. 1984 ALI Report, at 114; see also Gary R. Huffman and Barksdale Hortenstine, Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships, Taxes, Mar. 2008, at 179, 186. This conduit approach has also been referred to as a “pass thru” principle or approach. See Kimberly S. Blanchard, Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Attributes to Partners, 76 Tax Notes 1331, 1333 (1997); see also McKee Treatise, at ¶ 9.01[4][a]. As will be discussed further below, the IRS and Treasury have departed from this general approach when applying certain provisions in the international context in a stated effort to preserve certain enumerated policies of the relevant provisions being applied.
10. In addition to upward attribution, there are a few rulings which could be read to imply a downward attribution, whereby a partnership is treated as engaged in a trade or business by reason of the activities of its partners (or alternatively, a partners independent activities related to the activities of the partnership could give rise to a trade or business to which partnership income could be effectively connected). See TAM 200811019 (Nov. 29, 2007); cf. Sun Capital Partners, LP, CA-1, 724 F3d 129; T.A. Dagres, 136 TC 263, Dec. 58,581 (2011).
11. Internal Revenue Code, Chapter 1 Subchapter N, Part III, Subpart F, being sections 951–954.
13. Id.
16. For example, the Tax Reduction Act of 1975 expanded the definition of subpart F to include certain shipping income. In addition, the 1975 Act also lowered the percentage of a CFC’s gross income necessary for an inclusion to a U.S. shareholder. 

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from 30 percent to 10 percent. The Tax Reform Act of 1986 expanded the definition of a CFC to dissuade taxpayers from transferring 50 percent of the vote of a CFC while retaining most of the value. Thus, under the 1986 Act, a CFC included a foreign corporation in which 50 percent or more of the voting power of all classes of stock entitled to vote or the total value of all shares of stock is owned by one or more U.S. persons (including U.S. corporations, partnerships, trusts, and estates). More recently, the Tax Increase Prevention and Reconciliation Act of 2005 enacted a temporary provision, Code Sec. 954(c)(6), which excepted from subpart F passive income received by one CFC from another CFC which is a related person. At the time of this writing, Code Sec. 954(c)(6) is effective with respect to CFC’s with tax years beginning before January 1, 2015.

17. Under current Code Sec. 957(a), a foreign corporation is a CFC if more than 50 percent of either the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of the stock of such corporation, is owned (within the meaning of Code Sec. 958(a)) or is considered to be owned (within the meaning of Code Sec. 958(b)) by U.S. shareholders on any day during the CFC’s tax year.

18. Code Sec. 951(b).

19. Code Sec. 957(c).

20. It is not entirely clear based on the legislative history to Code Sec. 951 why a domestic partnership should be included within the definition of U.S. shareholder regardless of whether its partners are U.S. persons. There is some evidence that the treatment of a domestic partnership as a U.S. shareholder could have been based on the presumption that, at the time subchapter K was adopted, only U.S. individuals would be partners in such a partnership. See Philip F. Postlewaite, *The Omnipresence of Subchapter K in the International Arena?*, TAXES, March 2015. Additionally, or alternatively, it may be that Congress viewed the partnership as providing certain legal or state law benefits, consistent with that of a corporation and thus concluded that treating the partnership as a U.S. shareholder was appropriate for this purpose. Regardless of the basis for its conclusion, the treatment of a U.S. partnership as a U.S. person appears to have been accepted as black letter law by the IRS and Treasury. See Reg. §1.701-2(e), Ex. 3; see also Notice 2010-41, 2010-1 CB 715.

21. Code Sec. 952(a) lists other types of income, such as insurance income, a portion of international income, the sum of the amounts of any illegal bribes, kickbacks or other payments paid on behalf of the CFC, and income derived from any foreign country for which Code Sec. 901(j) denies a foreign tax credit for taxes paid to such country.

22. In addition, FPHCI also includes the excess of gains over losses from sales and exchanges during the tax year of the following types of property: (1) property that produces FPHCI in the form of dividends, interest, royalties, rents or annuities; (2) property that is an interest in a trust, partnership, or real estate mortgage investment conduit; and (3) property that does not give rise to income. Code Sec. 954(a)(1)(B). However, gains on the sale of active business assets, including intangible property used in that trade or business, generally are not considered items of FPHCI. Further, gains from the sale of inventory or similar property, dealer property or property that gives rise to rents or royalties that are derived in
the active conduct of a trade or business from persons that are not related persons are specifically exempted from FPHCI under the regulations. With respect to gain from the sale or exchange of a partnership interest, Code Sec. 954(c)(4) provides that the case of any sale by a CFC of an interest in a partnership with respect to which such corporation is a 25-percent owner, such corporation shall be treated as selling the proportionate share of the assets of the partnership attributable to such interest.

23. Under the same country exception, the term FPHCI does not include: (1) dividends and interest received from a related person which is a corporation created or organized under the laws of the same foreign country under the laws of which the CFC is created or organized, and has a substantial part of its assets used in its trade or business located in such same foreign country, or (2) rents and royalties received from a corporation which is a related person for the use of, or the privilege of using, property within the country under the laws of which the CFC is created or organized. See Code Sec. 954(c)(3)(A).

24. Code Sec. 954(c)(3) (flush language). This language was added to Code Sec. 954(c)(3) with little additional discussion authorizing the IRS to issue regulations expanding the availability of the same country exception to FPHCI to CFCs receiving payments from partnerships with corporate partners that otherwise met the requirements in section 954(c)(3). H.R. REP. NO. 101-386, at 666 (1989).

25. Code Sec. 954(c)(2)(A) provides that FPHCI does not include “rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of [Code Sec. 954(d)(3)]).”

26. The House Report for what ultimately became the Tax Increase Prevention and Reconciliation Act of 2005 provides an explanation for the policy underlying the look-through rule:

Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States. H.R. REP. NO. 109-304, at 39 (2005).

27. Code Sec. 954(c)(6)(A) grants the Secretary the authority to prescribe regulations under Code Sec. 954(c)(6). The IRS has published guidance under Notice 2007-9, which provides clarity on the applicability of Code Sec. 954(c)(6) in certain transactions, including the applicability of the look-through rule to payments received by partnerships with corporate partners. Notice 2007-9, 2007-1 CB 401, at §4.

28. Reg. §1.954-3(a)(2) and (3). For purposes of Code Sec. 954(d), the definition of “manufacturing” is set forth in Reg. §1.954-3(a)(2)(ii) (substantial transformation of property), (iii) (“substantial in nature” manufacturing) and (iv) (substantial contribution to manufacturing).
29. The Conference Report to the 1962 Act describes the branch rule as follows:

The Senate amendment provides that foreign branches of a controlled foreign corporation shall, under certain circumstances, be treated as wholly owned subsidiary corporations for purposes of determining the foreign base company sales income of the controlled foreign corporation, and treats foreign base company sales income of the branch as foreign base company sales income of the controlled foreign corporation. H.R. REP. NO. 87-2508, at 31 (1962).

30. Under Code Sec. 954(d)(2) (the “branch rule”), for purposes of determining FBCSI where the carrying on of activities by a CFC through a branch or similar establishment outside the country of incorporation of the CFC has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Treasury, the income attributable to the carrying on of such activities of such branch or similar establishment will be treated as income derived by a wholly owned subsidiary of the CFC and may constitute FBCSI of the CFC. If a CFC has a sales (or purchase) branch located outside of the CFC’s country of incorporation, then the sales branch and the “remainder” (i.e., non-branch activities) of the CFC may be treated as separate corporations for purposes of determining the FBCSI, if any, of the CFC. If a CFC has a manufacturing branch located outside of the CFC’s country of incorporation, then the manufacturing branch and the remainder of the CFC may be treated as separate corporations for purposes of determining the FBCSI, if any, of the CFC. See also, Reg. §1.954-3(b)(1) and (2).

37. Id., at 221.
38. Id., at 222.
39. Code Sec. 954(d)(3). For this purpose, Code Sec. 954(d)(3) defines a related person with respect to a CFC as an individual, corporation, partnership, trust or estate that controls, or is controlled by, the controlled foreign corporation, or such person which is controlled by the same person or persons which control the controlled foreign corporation. Control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation.
40. The taxpayer made an additional argument in support of its contention that the commission income should not be FBCSI. The taxpayer asserted that because the income was derived by a partnership, not a CFC, and only a CFC can earn FBCSI, the income derived in the instant case (as a distributive share of income from a partnership) cannot itself be FBCSI. It does not appear that either the Tax Court or the Eighth Circuit found this argument particularly compelling. Although the Eighth Circuit did note that this additional argument was made, based on the
conclusion and the comment regarding the “closing of the loophole,” it did not appear that the Court would have found in favor of Brown Group based on this argument alone. In addition, it does not appear that such an analysis adopts a correct reading of Code Sec. 702(b). In particular, Code Sec. 702(b) provides that the character of any item of income, gain, loss, deduction or credit included in a partner’s distributive share shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. This provision does not go so far as to say that the partnership becomes the taxpayer or otherwise shields the partner from a characterization (i.e., commission income derived from a related party) that would give rise to FBCSI. Compare Notice 2010-41, discussed below, in which the income derived by the partnership is “subpart F income” which when characterized at the partnership level arguably would not be treated again as subpart F income when taken into account by the CFC.

41. T.D. 9008, IRB 2002-33, 335 (2002). When originally proposed the Brown Group regulations also included a set of provisions which were not finalized and remain in proposed form, “the extraordinary transaction regulations.” These proposed regulations set forth a framework for dealing with issues arising under subpart F that relate to the use of certain entities that are regarded as fiscally transparent for purposes of U.S. tax law.

42. Reg. §1.954-1(g)(1).


44. In addition, a CFC’s distributive share of partnership income will not be excluded from FPHCI under the exception contained in Code Sec. 954(i) unless the CFC is a qualifying insurance company, as defined in Code Sec. 953(e)(3), and the income of the partnership would have been qualified insurance income, as defined in Code Sec. 954(i)(2), if received by the CFC directly. See Reg. §1.952-1(g)(1).

45. In general, Code Sec. 954(h) provides that FPHCI does not include qualified banking or financing income of an eligible corporation. For this purpose, the term “eligible corporation” means a CFC which is: (1) predominantly engaged in the active conduct of a banking, financing or similar interest, and (2) conducts substantial activity with respect to such business. See Code Sec. 954(h)(1) and (2).

46. Code Sec. 954(i) provides an additional exception to FPHCI and provides that FPHCI does not include qualified insurance income of a qualifying insurance company.

47. Interestingly, when originally proposed, the regulations addressing Code Sec. 954(h) appeared to adopt a pure entity approach to the partnership. However, in response to comments, the final regulations included a new rule that applies the “eligible controlled foreign corporation” requirement under Code Sec. 954(h)(2), including the 70-percent test of Code Sec. 954(h)(2)(B)(i), at the CFC partner level (by including in the gross income of the CFC partner any gross income earned by partnerships or other QBUs of the CFC partner), and applies the qualified banking and financing income test (the 30-percent test) under Code Sec. 954(h)(3) at the partnership level (by including only the gross income of the partnership). See T.D. 9008, IRB 2002-33, 335 (2002).
48. See T.D. 9008, IRB 2002-33, 335 (2002), which provides as follows:

To allow a CFC to avoid subpart F income through the simple expedient of receiving them as a distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F. Subpart F was intended to limit deferral of U.S. income tax on certain types of income received by CFCs. The IRS and Treasury believe that the approach set out in these regulations (which treats the partnership as an entity for certain purposes and as an aggregate for certain purposes) best achieves the purposes of subpart F and is consistent with the policies underlying subchapter K.

50. Reg. §1.954-1(g)(1).
51. As discussed above, this payment may fall within the look-through exception of Code Sec. 954(c)(6), which provides similar rules for purposes of determining the payor of interest for that provision. See Notice 2007-9, 2007-1 CB 401, at §4.
52. Code Sec. 954(c)(3).
56. Id.
57. Similar issues arise in other areas of the international tax provisions. As a general matter, in such cases the regulations appear to adopt an entity approach to the partnership (i.e., treating the partnership interest as the relevant asset) but characterizing its use by reference to the activities of the partnership. See Reg. §1.904-2(f)(5); Code Sec. 865; Rev Rul. 91-32, 1991-1 CB 107 (discussed below); Reg. §1.956-2(b)(4) (discussed below); see also NEW YORK CITY BAR, THE COMMITTEE ON TAXATION OF BUSINESS ENTITIES, REPORT OFFERING PROPOSED GUIDANCE REGARDING THE PASSIVE FOREIGN INVESTMENT COMPANY RULES (2009) (discussing a similar issue that arises in the context of PFICs).
58. Under Reg. §1.904-5(h) and (i), the partnership is treated as an entity for purposes of determining the source and basket of the income paid by the partnership. Thus, under Code Sec. 904(d)(3)(C) and Reg. §1.904-5(i)(1), interest paid by a partnership to 10-percent-or-greater CFC partners or to related look-through entities is characterized based upon the income of the partnership under an entity approach.
59. We have chosen to utilize the potential look-through exception of Code Sec. 954 (c)(6) (as opposed to the same country exception) in order to focus the analysis on the difference between the Brown Group regulations and the regulations under Code Sec. 904.
60. This article does not intend to offer a complete discussion of the nuanced and arguably contradictory rules applicable to payments made by a partnership under Code Secs. 904 and 954. Instead, the purpose of this example is to merely illustrate yet another area in which the hybrid and piecemeal approach to partnership taxation in the international arena has led to somewhat inexplicable results. For a comprehensive discussion of these provisions, see Seth Goldstein, Subpart F and Basket Look-Through for Partnerships: A Clash of Aggregate and Entity Treatments, 43 TAX MGMT’T INT’L J. 591 (2014).
61. The provision applies to payments made by a CFC or “other entity” otherwise entitled to look-through treatment (a “look-through entity”) to a “related look-through entity.” To meet the requirement of a related look-through entity, either: (1) one look-through entity must own more than 50 percent of the vote or value of the other look-through entity; or (2) the same U.S. shareholders must own, directly or indirectly, greater than 50 percent of the vote or value of both look-through entities. Reg. §1.904-5(i).

62. Under Reg. §1.904-5(a)(3), a member of the controlled group is any member of the affiliated group within the meaning of Code Sec. 1504(a)(1) except that “more than 50 percent” shall be substituted for “at least 80 percent” wherever it appears in Code Sec. 1504(a)(2).

63. Similarly, the source characterization of interest income received by the related look-through entity (as well as any other person) is determined under Code Sec. 861(a)(1)(C) by applying an entity theory of partnerships. Code Sec. 861(a)(1)(C) provides that interest received from a foreign partnership will be considered foreign-source if the foreign partnership is predominantly engaged in an active conduct of a trade or business outside the United States and the interest is not allocable to ECI. Interest paid by a U.S. partnership is foreign-source if the partnership does not have a U.S. trade or business at any time in the year in which the interest is accrued. Reg. §1.861-2(a)(2). But see, Code Sec. 904(h).

64. Under the general allocation rules of Code Sec. 904(d)(3) and Reg. §1.904-5(c), the gross income of the CFC in the applicable foreign tax credit baskets and in separate categories of foreign base company income within the foreign tax credit baskets must be determined. Next, expenses that are definitely related to certain classes of gross income under Reg. §1.861-8 or -10T are allocated and apportioned to the various categories of income. Third, related-person interest expense is allocated to passive FPHCI of the CFC. Fourth, related-person interest expense in excess of passive FPHCI is allocated under the asset method or modified gross income method. Finally, interest expense other than related-person interest expense is apportioned under the asset method or modified gross income method, and other expenses that are not definitely related, or that are definitely related to all gross income, are apportioned (Step 5). See Goldstein, supra note 60, at 2–12.

65. See Reg. §1.954-3(a)(4)(i) and (iv).

66. See also, Lowell D. Yoder, Final Regulations Apply Subpart F to a CFC’s Distributive Share of Partnership Income, 32 TAX MGMT. INT’L J. 99 (2003) (articulating an identical point immediately after the final Brown Group regulations were promulgated).


69. See Ashland Oil, Inc., 95 TC 348, Dec. 46,899 (1990). The Tax Court in Ashland Oil concluded that since the Code and regulations fail to address the definition of a branch, the term “branch” should receive its ordinary and customary meaning in an economic and accounting sense. The Tax Court adopted the definition from BLACK’S LAW DICTIONARY and from a specialized business which emphasized the existence of an office in a different location from the parent company and a branch being a division, office or other unit of business located at a different location from the headquarters. See also, Vetco Inc., 95 TC 579, 593, Dec. 47,001

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(1990) (holding that a wholly owned subsidiary could not be a “branch” of its parent corporation, providing further that “[o]ur examination of the structure of section 954(d), as well as its underlying history, leads us to agree with petitioner that the branch rule simply supplies the relationship required to bring an otherwise unrelated party within the spectrum of section 954(d)(1).”). Id., at 591–92.

70. It is worth noting that in many cases, the entity that is being treated as the corporation is in fact a flow through entity for local tax purposes, and the entity that is the partnership is in many cases a local country corporation. Thus, although the United States appears to be approaching these transactions as looking to the attributes of the partner, the local law tax or legal treatment of the entity results in the partner’s attributes being largely irrelevant for purposes of taxing the partnership’s income.

71. Reg. §1.702-1(b).

72. It should be noted that, under this approach, partners who owned small interests in Brinco, and were unrelated to Brown Group, could also recognize a distributive share of FBCSI. In such case, however, it seems completely reasonable to adopt a rule that would treat this income as subpart F income to a U.S. shareholder of a de minimis partner only to the extent that the partnership has subpart F income if it is a CFC. Accordingly, if the policy of subpart F is arguably not being achieved, a targeted exception or anti-abuse rule would be appropriate. For example, an ownership threshold test could be that if U.S. shareholder owned less than 10 percent of the capital or profits of the partnership (determined under Code Sec. 958(a) and (b)), then the distributive share of such income would not be treated as subpart F income to the U.S. shareholder of the CFC partner. This approach also has the advantage of providing parity between the treatment of partnerships and corporations in this context, such that there would be a limited impetus to choose to form a partnership merely to achieve a result different from that which would be achieved if a corporation were formed.

73. See note 69, discussing Ashland Oil and Vetco.


75. See Reg. §1.954-1(g)(1); see also Notice 2007-9, 2007-1 CB 401. Although this does not appear to be the result under existing law in other areas of the Code and Regulations, it would be possible to apply such a result. In the view of this article, such a result would provide for significant simplicity. Take for example Code Sec. 245 where the ownership thresholds could also be tested at the partnership level. In the context of the international provisions, Code Sec. 902 would provide an opportunity for a similar discussion. Under current law, Code Sec. 902(c)(7) provides that, for purposes of determining whether a partner in a partnership is eligible for a section 902 deemed paid credit, “[s]tock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by its partners. Stock considered to be owned by a person by reason of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.” Code Sec. 902(c)(7) provides that, for purposes of determining whether a partner in a partnership is eligible for a Code Sec. 902 deemed paid credit, “[s]tock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by its partners. Stock considered to be owned by a person by reason of the preceding sentence shall, for purposes of applying such sentence, be
treated as actually owned by such person.” Thus, for purposes of determining whether a domestic corporate partner owns the requisite 10-percent voting interest in a foreign corporation, a pure aggregate approach seems to be intended by Congress, where stock owned by a partnership is treated as actually owned “proportionately” by its partners. If instead of this “aggregate” approach, one were to apply Code Sec. 902 by reference to the partnership’s ownership interest in the foreign corporation paying the dividend and then subsequently “flow” that character through to the partners under Code Sec. 702(b), it is likely that much of the complexity surrounding the determination of a partner’s proportionate share would be alleviated. In addition, given that it is the partnership that ultimately has the requisite ownership interest in (and control of) the foreign corporation, such an approach does not seem inconsistent with the underlying policies of Code Sec. 902. See H.R. REP. No. 2087, 80th Cong., 2d Sess. (1948); H.R. REP. No. 1447, 875th Cong., 2d Sess. 76 (1962); H.R. REP. No. 148, 105th Cong., 1st Sess. 530 (1997); See also Eric Sloan & Dina A. Wiesen, The 80-Percent Dividends-Received Deduction Under Section 243: Does a Partnership Mess It All Up?, 64-7 USC LAW SCHOOL INSTITUTES ON MAJOR TAX PLANNING 7 (2012).

76. We will return to a similar discussion below in the context of Rev. Rul. 91-32 and Code Sec. 956, where this article will suggest that in both such cases the partnership be treated as an entity.

77. Introducing a rule that would treat a partnership as an entity for purposes of applying the subpart F provisions would bring much-needed clarity to an area that is not specifically addressed by the Brown Group regulations. Another area of the Brown Group regulations that is unsettled is the impact of payments between a partnership and its CFC partners. Under an aggregate approach, such payments might be disregarded to the extent of the CFC’s interest in the partnership, whereby a partner may be viewed as making a payment to itself. As discussed, for purposes of applying Code Sec. 904 an entity approach to partnerships is utilized, whereby the basket of the payment from FP is based on the income profile of FP. However, the Code Sec. 954 analysis with respect to the payment attributable to CFC1 is unclear (as CFC1 is treated as making a payment to itself). Although Reg. §1.954-1(g)(3), Example 2 seems to indicate that for purposes of Code Sec. 954(d), a CFC can be related to itself, the resolution of this issue is very unclear. Assuming the related-party provisions might otherwise apply, Reg. §1.954-1(c)(1) incorporating the principles of Reg. §1.904-5(k), would likely result in the interest income and deduction offsetting. Unfortunately, if CFC1 is not related to itself, then presumably 100 percent of this payment is gross FPHCI. If instead, FP is treated as an entity, then it is clear that the payment is between a related party (FP and CFC1). In addition, the deduction would be allocated to CFC1 and, under Code Sec. 702(b), retain its character as a related-party interest payment.

78. The latter question was largely answered statutorily through the promulgation of various provisions, including Code Secs. 865(i) and 875(1), discussed below.

79. Code Sec. 741(a); see also Code Sec. 954(c)(4).
80. Code Sec. 751(a).
81. See also Reg. §§1.865-1 and -2.
82. This is similar to the approach taken by the IRS in LTR 9142023 (July 19, 1991). In LTR 9142023, PRS, a U.S. limited partnership whose owners were all U.S.
citizens or residents, domestic trusts or domestic corporations, owned an interest in FC, a foreign limited partnership. FC was formed for the purpose of constructing and leasing an asset in a foreign country. The asset was not depreciable personal property within the meaning of Code Sec. 865(c). FC had an office in FC from which it directs the construction and leasing of Asset. Following formation, PRS sold 85 percent of its limited partner interest in FC PRS to a non-U.S. entity. PRS was subject to an FC income tax on the gain from the sale of its interest in FC PRS at a rate in excess of a 10-percent effective rate of tax. With no analysis, the private letter ruling held that all the gain on the sale of the partnership interest was, applying the principles of Code Sec. 864(c)(2), discussed further below, attributable to that foreign office or other fixed place of business of PRS and, provided US pays to FC a 10-percent effective rate of income tax on the gain from the sale from its interest in FC PRS (computed by applying the principles of Reg. §1.954-1T(d)(2)), the share of each U.S. partner of the gain recognized by US PRS from the sale of Asset will be from sources outside the United States under Code Sec. 865(e)(1).

83. The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), enacted as Subtitle C of Title XI (the “Revenue Adjustments Act of 1980”) of the Omnibus Reconciliation Act of 1980 (P.L. 96-499), 94 Stat. 2599, 2682 (Dec. 5, 1980). Under the FIRPTA regime, gain or loss on the sale or exchange of certain real property located within the United States is treated as ECI, irrespective of whether the seller is actually engaged in a USTOB. In addition to interests in real property, the tax is also imposed on the sale or exchange of stock of certain domestic corporations (United States Real Property Holding Companies), if more than 50 percent of the corporation’s assets consist of interests in real property located within the United States. Code Sec. 897. The collection of the tax under the FIRPTA provisions is accomplished through a withholding tax regime set forth in detail under Code Sec. 1445 and the regulations thereunder. See also Feingold & Alpert, Observations on the Foreign Investment in Real Property Tax Act of 1980, 1 VA. TAX REV. 105 (1981); Austrian & Schneider, Tax Aspects of Foreign Investment in U.S. Real Estate, 45 TAX LAW. 385 (1992); Phillip Morrison, Is the FIRPTA Definition of “Inherently Permanent Structure” Inherently Not Permanent?, 40 TAX MGMT. INT’L J. 340 (2011); Milani & Wrappe, Dispositions of U.S. Real Property Interest by Foreign Partners-Tax Provisions, Pitfalls, and Planning Possibilities, 20 J. REAL EST. TAX’N 149 (1993).

84. The third fact pattern in the Revenue Ruling sets forth the application of the US-Model Treaty to the transaction at issue. Rev. Rul. 91-32, IRB 1991-20, 20. Consistent with the analysis discussed above with respect to the ECI/USTOB analysis, the Revenue Ruling concludes that the gain recognized is attributable to a permanent establishment and not protected under the treaty from taxation. Id.

85. Code Sec. 865(d)(1). See McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 16.01 (4th ed. 2007) (“the [partnership] interest is treated as a separate intangible asset, detached from the assets of the partnership”); Reg. §1.197-2(c)(1) (excepting a partnership interest from the definition of intangible property); CGF Industries, Inc., 77 TCM 1405, Dec. 53,249(M), TC Memo. 1999-45 (“partnership interests, a type of property generally considered to be non-amortizable”).
86. Code Sec. 865(c). Based on the plain language of Code Sec. 865(c)(4)(A), it would appear that a partnership interest could very easily be treated as depreciable personal property if depreciation deductions are reflected in the basis of the partnership interest. For a discussion of similar issues in the context of 1239, see Erich Hahn, Legislative Update Corner: Code Sec. 1239: An Extra Ordinary Proposal, 12 J. PASSTHROUGH ENTITIES 15 (2009).

87. Code Sec. 865(a)(2) provides that any gain (in excess of the depreciation adjustments) from the sale of depreciable personal property is sourced as if such property were inventory property. Under Code Sec. 865(b), the source of gain recognized on the sale or exchange of inventory property is determined, as a general matter, under the title passage rule. See Code Secs. 861(a)(6), 862(a)(6) and 863; see also Reg. §1.861-7.

88. See Reg. §1.864-4.

89. See Kimberly S. Blanchard, Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Attributes to Partners, 76 TAX NOTES 1331 (1997); see also, NEW YORK STATE BAR ASSOCIATION, TAX SECTION, REPORT ON GUIDANCE IMPLEMENTING REVENUE RULING 91-32 (2014) (discussing the current approach under Rev. Rul. 91-32 as a “hybrid approach”).

90. A similar issue arises in the context of Code Sec. 751(a), where a partnership holds ordinary income generating assets and also has non-ordinary income losses. In such a case, the regulations under Code Sec. 751(a) provide that a partner can recognize ordinary income on the sale of a partnership interest with a built in loss, with an offsetting increase in a capital loss on the sale. See Reg. §1.751-1(a)(2); see also, Reg. §1.751-1(g), Ex. 1. It is clear, however, that such an approach was not adopted in Rev. Rul. 91-32.


92. Reg. §1.751-1(a)(3); see also Reg. §1.6050K-1.

93. The issues raised by such a reporting and compliance regime are similar to those addressed in the context of withholding under Code Sec. 1446. However, the ability to compel compliance with any provisions in the instant case are quite distinct from those addressed in the Code Sec. 1446 context, given that in such a case Congress chose to impose liability on the partnership directly, the entity with the assets over which the IRS could assert collection authority and where were located in the United States. In the instant case, with gain on the sale or exchange of a partnership interest between two parties with potentially no direct ties to (or assets in) the United States, such a collection regime would likely be untenable.

94. See Code Sec. 897(c) (1980).


96. See Code Sec. 897(c)(3) (publicly traded exception to FIRPTA); Reg. §1.367(a)-3(b)(1)(i) (providing that a U.S. Person is not subject to immediate gain recognition on the outbound transfer of stock or securities of a foreign corporation if such U.S. person owns less than five percent of total vote and value of stock); Proposed Reg. §1.987-1(b)(ii) (de minimis rule for certain indirectly owned Code Sec. 987 QBUs).
97. It is the opinion of this article that specific rules, with targeted anti-abuse rules, provide a more appropriate mechanism for managing the risk of the avoidance of these provisions, as opposed to the opposite approach that seems to have been recently adopted by the IRS and Treasury, whereby rules of broad over application are instead adopted. As a result, a similar approach is suggested below in the context of Code Sec. 956.

98. In the event a partnership interest is transferred in a sale or exchange and a partnership has a “substantial built-in-loss” (as defined in Code Sec. 743(d)) or has a Code Sec. 754 election in effect, Code Sec. 743(b) requires an increase in the adjusted basis of property held by the partnership to the extent the partner’s interest in the partnership exceeds the partner’s proportionate share of the adjusted basis in the property. To the extent the partner’s proportionate share of the adjusted basis of partnership property exceeds the partner’s outside basis in the partnership interest, Code Sec. 743(b) requires a decrease in the adjusted basis of partnership property held by the partnership. For example, assume Partner A sells his interest in Partnership AB to incoming Partner C in Year 1. At the time of sale, Partner A’s proportionate share of Partnership AB’s adjusted basis in its partnership property is $100. Partner A’s outside basis is $200. Partnership AB has a Code Sec. 754 election in effect for Year 1. The partnership’s basis in its partnership property is increased by $100 under Code Sec. 743(b).


100. In addition, a provision addressing subsequent transfers of the partnership interests could also be adopted to ensure that the basis step up cannot later attach to the ECI property. See Proposed Reg. §1.743-1(f)(2).

101. It is worth noting that in such case the subsequent sale of the partnership’s assets if giving rise to gain, would increase the partner’s basis in its partnership interest. Thus, although we would have U.S. taxable gain, there would be an offsetting loss created in the partnership interest. However, under the approach suggested above, it is unlikely following the disposition of the U.S. trade or business assets, that the remaining loss would itself be ECI.


103. D.K. Ludwig, 68 TC 979, 988, Dec. 34,672 (1977); see FSA 1999794 (June 2, 1993) (holding that a purchased warrant did not constitute an investment in U.S. property with the IRS further advising “[h]owever, not every transaction between a United States shareholder and its controlled foreign corporation constitutes an investment of the controlled foreign corporation in United States
property. The term ‘United States property’ is statutorily defined under section 956(b) of the Code.”).

104. Code Sec. 956(a)(1); see also Code Sec. 956(b).


106. See NEW YORK STATE BAR ASSOCIATION, TAX SECTION, REPORT ON THE APPLICATION OF SECTION 956 TO PARTNERSHIP TRANSACTIONS (2006).

107. It is interesting to note that this “hybrid approach” is very similar to the approach taken by the IRS and Treasury when addressing the sale of a partnership interest under Rev. Rul. 91-32, which limits the potential gain recharacterized to the built in gain in the partnership interest, in lieu of adopting an approach more similar to Code Sec. 751(a) and the regulations thereunder.


109. See, e.g., Rev. Rul. 55-39, 1955-1 CB 403, holding that certain assets acquired by a partnership become assets of the partner at the time they are acquired for him by the partnership.

110. See NEW YORK STATE BAR ASSOCIATION, TAX SECTION, REPORT ON THE APPLICATION OF SECTION 956 TO PARTNERSHIP TRANSACTIONS (2006); see also Kimberly S. Blanchard, Guidance Needed for CFC Lending Transactions, 126 TAX NOTES 533 (2010).

111. Code Secs. 957(c) and 7701(a)(30).

112. The definition of U.S. person as utilized in the context of Code Sec. 956 is the same as that used above with respect to determining whether a foreign corporation is a CFC. As discussed below in the context of Reg. §1.701-2, the IRS and Treasury believe that the treatment of a domestic partnership as a U.S. person (and similarly the treatment of a foreign partnership as a foreign person), must be specifically intended by Congress. Accordingly, in the instant case it seems perfectly clear that the loan to a foreign partnership under current law should not give rise to a Code Sec. 956 inclusion.

113. An interesting issue, discussed more fully below, arises if the foreign partnership to which the loan is made is a general partnership (or a limited partnership with a U.S. person as a general partner). In such a case, under Code Sec. 956 the question arises as to whether a loan should be an obligation of a U.S. person, where there is not limited liability as between the actual borrower (the partnership) and the ultimate obligor (the partner). Under current Code Sec. 956 and the regulations thereunder, this appears to give rise to an investment in U.S. property, as it would legally be an obligation of a U.S. person. The question in such a case is whether such an approach would be inconsistent, or seemingly inconsistent, with a basic premise of this paper that significant simplicity could be achieved by treating the partnership as an entity for purposes of the international provisions of the Internal Revenue Code. See Reg. §1.956-2(d)(2) for a definition of an obligation for purposes of Code Sec. 956. See also, Kimberly S. Blanchard, Guidance Needed for CFC Lending Transactions, 126 TAX NOTES 533 (2010); Phillip Morrison, Section 956 Multiple Inclusions Due to Multiple CFC Guarantees-The Need for Clear Guidance From the IRS, 36 TAX MGMT. INT’L J. 283 (2007); Lee-Lim & Morgenstern, Guarantors and Co-Obligors in the Tax World, 36 INT’L TAX J. 45 (2010); Brewer, Open Questions Regarding Pledges and Guarantees by CFCs, 94 TAX NOTES INT’L 891 (Feb. 25, 2002);
New York State Bar Ass’n Tax Section, Controlled Foreign Corporations and Foreign Partnership Loan Transactions, 112 TAX NOTES 435 (July 31, 2006).

114. The NYSBA in its report effectively concedes that this is the result, irrespective of whether the policies of Code Sec. 956 are served by such a treatment. Given that this article is not bound by the current existing rules of law, we will not be burdened by such a limitation. In addition, and as discussed more fully below, it is the belief of this article that the IRS and Treasury have the authority to diverge from the treatment of a domestic partnership as a U.S. person when necessary to serve the purposes of the provisions at issue, without the need of ignoring the legal and practical realities of the partnership being the borrower on the debt.

115. Code Sec. 752; see also Reg. §§1.752-1 through -4. The rules for determining a partner’s share of partnership liabilities are detailed and beyond the scope of this article. Suffice it to say, however, with proper planning a partnership should be able to distribute the cash proceeds received in exchange for a newly issued note payable to its partners without immediate U.S. taxation. For a deeper discussion of Code Sec. 752, see McKee Treatise, supra note 6, at ¶¶7.01-7.06; Hagan, The Final Regulations under IRC Sections 704(b) and 752: Envisioning Economic Risk of Loss Through a Glass Darkly, 49 WASH. & LEE L. REV. 487 (1992); Eric B. Sloan & Jennifer H. Alexander, Economic Risk of Loss: The Devil We Think We Know, 84 TAXES 217 (2006); Steven C. Todrys, Recourse Debt is Usually Nonrecourse; A Comment, 84 Taxes 251 (2006).

116. In addition to Code Sec. 752, the distribution of cash by a partnership to a partner may also raise the potential for gain recognized under Code Sec. 707 (the “disguised sale” rules) if that partner has contributed property to the partnership. However, very generally, there is an exception to the disguised sale treatment for distributions of loan proceeds from a partnership. See Reg. §1.707-5. See also McKee Treatise, supra note 6, at ¶¶14.01–14.04; Marich & Horstenstine, A Comprehensive Guide to Interpreting and Living With the Rules Governing Disguised Sales of Property, 110 TAX NOTES 1421 (Mar. 27, 2006).

117. Such a percentage would be consistent with the ownership necessary to make a loan or a stock investment to be U.S. property. See Code Sec. 956(c)(2)(F).

118. Although by its terms Reg. §1.956-1T(b)(4) does not apply to partnerships, the IRS recently issued guidance applying the anti-abuse rule indirectly to a partnership transaction entered into by CFCs. See ILM 201420017 (May 16, 2014), in which the IRS held that a loan by one CFC to its U.S. parent corporation should give rise to a Code Sec. 956 investment with respect to the earnings and profits of other CFCs that held ownership interests in a partnership with the lending CFC under the argument that the partnership facilitated an indirect funding of the lending CFC by the other CFCs.

119. In the opinion of this article, this is more consistent with the treatment of partnerships under subchapter K, than for example an aggregate approach treating the loan to a partnership as a loan to the partners. In particular, under Code Sec. 752, a partnership liability is allocated to a partner for purposes of determining that partner’s basis in its partnership interest. However, under Code Sec. 752, the liability is nonetheless the liability of the partnership. Thus, the subchapter K rules generally adopt an entity theory with respect to partnership debt, and in fact the Code Sec. 752 rules are necessary because of this entity treatment to allow
the partner to obtain deductions (and avoid gain) consistent with the partnership being a separate taxable entity. See generally 26 U.S.C. §§ 701–777 (2014); see also Code Sec. 752; NEW YORK STATE BAR ASSOCIATION, TAX SECTION, REPORT ON THE APPLICATION OF SECTION 956 TO PARTNERSHIP TRANSACTIONS (2006) (suggesting a potential approach that would treat the loan to the partnership as a loan to the partners (and potentially giving rise to a Code Sec. 956 inclusion)).