# DOMESTIC PARTNERSHIPS TREATED AS ENTITIES AND AGGREGATES: NEW APPROACH FOR G.I.L.T.I. AND SUBPART F

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The effect of the T.C.J.A. continues to be encountered in unexpected ways during the second year after its enactment. Examples are the final and proposed G.I.L.T.I. regulations (the "2019 Final G.I.L.T.I. Regulations" and the "2019 Proposed G.I.L.T.I. Regulations") issued by the I.R.S. earlier this year in an attempt to bring order out of the chaos created by proposed G.I.L.T.I. regulations released in September 2018 (the "2018 Proposed G.I.L.T.I. Regulations").

This article discusses the approaches to be followed when determining those U.S. Persons that are considered to be U.S. Shareholders for G.I.L.T.I. and Subpart F purposes when a domestic partnership is a shareholder in a controlled foreign corporation. For those who follow the debate of whether a partnership is an aggregate of the partners or an entity that is separate from the partners, chalk up a victory to the proponents of the aggregate approach.

## PARTNERSHIPS: AGGREGATE OR ENTITY FOR SUBPART F INCLUSION PRIOR TO THE T.C.J.A.

Depending on the operative Code section, a partnership can treated either as an entity that is distinct and separate from its partners ("entity approach") or as an aggregate of all partners, meaning that each partner takes into account a *pro rata* share of each tax item on the tax return filed by that partner ("aggregate approach").

Prior to the newly proposed G.I.L.T.I. regulations, the approach to identify a U.S. Shareholder of a controlled foreign corporation ("C.F.C.") in the context of an investor partnership depended on whether the investor partnership was domestic or foreign. For Subpart F purposes, a domestic partnership was treated as an entity separate and distinct from its partners, and the partnership – not the partners – was treated as the owner of partnership assets including the stock in a foreign corporation. As a result, each partner of the partnership included a distributive share of the partnership's Subpart F inclusion, even if the partner held less than a 10% indirect interest in the C.F.C. Each U.S. member of the domestic partnership would pay tax on the amount included in that member's distributive share of the Subpart F Income. Each foreign member of the partnership would be taxed only in the rare event that the Subpart F Income constituted effectively connected income.[1]

Entity treatment was consistent with several provisions of U.S. tax law that are the foundations of the C.F.C. rules. These include (i) the characterization of a domestic

[1] Subpart F Income of a C.F.C. owned by a partnership is foreign-source income. As such, most items of Subpart F Income would not be taxed in the U.S. for a partner that is not a U.S. Person, such as an individual who is neither a U.S. citizen nor a U.S. resident for income tax purposes.

partnership as a “U.S. Person” in Code §§7701(a)(30) and (ii) the definition of the term “U.S. Shareholder” for purposes of Subpart F under Code §957(c). It is also consistent with the legislative history of Code §951, which included domestic partnerships within the definitions of the terms “U.S. Person” and “U.S. Shareholder.”

Under this view, if a domestic partnership were to own more than 50% of the stock of a foreign corporation, the foreign corporation would be considered a C.F.C. even if the holders of a majority of the capital and income interests in the domestic partnership are not U.S. Persons.

In comparison, a foreign partnership has been treated historically as an aggregate of its partners for purposes of ascertaining the C.F.C. status of a foreign corporation principally owned by the foreign partnership. Therefore, the partners of the foreign partnership are treated as owning the partnership’s assets.

In this fact pattern, Code §958(a)(2) looks through a foreign partnership to determine:

- Whether a U.S. partner is a U.S. Shareholder of the foreign corporation under Code §951(b) because, through the foreign partnership, the U.S. partner owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10% or more of the total value of shares of all classes of stock of such foreign corporation, and
- whether one or more U.S. partners that are U.S. Shareholders own, in the aggregate, shares representing more than 50% voting power or value of the foreign corporation.

If both conditions are satisfied, each U.S. Person that is a U.S. Shareholder of the C.F.C. through a foreign partnership must include in gross income the *pro rata* share of Subpart F Income generated through that partnership.

## THE ENACTMENT OF THE G.I.L.T.I. PROVISIONS

The T.C.J.A. 2017 introduced a global minimum tax for U.S. Shareholders of C.F.C.’s. Under Code §951A, tax is levied in the current period on G.I.L.T.I. that is allocated to a U.S. Shareholder. In broad terms, G.I.L.T.I. income includes all income of a C.F.C. in excess of a certain base amount[2] that is otherwise not taxed in the U.S. either as effectively connected income at the level of the C.F.C. or as Subpart F Income at the level of a U.S. Shareholder, unless otherwise specifically exempted under the G.I.L.T.I. provisions of U.S. tax law.[3]

Typically, anti-tax deferral regimes prevent unlimited deferral of tax on income that may arise from an abusive plan or tax structure or are relatively passive and

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[2] The base amount is determined by multiplying the C.F.C.’s investment in tangible depreciable property by 10% and reducing the product by interest expense that is not allocable to income characterized as tested income for G.I.L.T.I. purposes. By structuring the base amount in this way, a taxpayer cannot obtain a double G.I.L.T.I. benefit, once from interest expense arising from loans incurred to acquire assets and then from using the assets to compute the base amount.

[3] Among the items that are specifically excluded are (i) income that would be foreign base company income but for the high tax exclusion, (ii) dividend income received from a related person, and (iii) foreign oil and gas extraction income.

notoriously placed in no-tax jurisdictions. However, tax planning among major U.S. based multinationals that mostly operated in the cloud became so sophisticated that the term "stateless income" applied to the income from global operations. By introducing U.S. tax on G.I.L.T.I. of C.F.C.'s, Congress adopted a rule to impose a minimum tax on operations outside the U.S., especially where operations that do not require major investment in depreciable tangible property.

It took the Treasury Department and the I.R.S. almost one full year to determine how the general G.I.L.T.I. rules would be applied in the context of a domestic partnership owning shares of a C.F.C. The balance of this article explains the approach adopted in the Proposed G.I.L.T.I. Regulations.

## COMPUTATION OF THE G.I.L.T.I. INCLUSION

### Computation Under the 2018 Proposed G.I.L.T.I. Regulations

A U.S. Shareholder of a C.F.C. is required to include its G.I.L.T.I. in gross income for a taxable year in a manner generally similar to the computation of an inclusion of Subpart F Income.[4] Code §951A itself does not contain specific rules regarding the treatment of domestic partnerships and their partners for purposes of G.I.L.T.I. The I.R.S. released the 2018 Proposed G.I.L.T.I. Regulations, which adopted a hybrid approach to the G.I.L.T.I. inclusions received through domestic partnerships.

Under the hybrid approach, a domestic partnership was treated as an aggregate of the partners for those partners who were U.S. Shareholders with regard to a particular C.F.C. and as an entity for those partners who were not U.S. Shareholders as to the same C.F.C.[5] Partners who were U.S. Shareholders when looking through the domestic partnership computed their G.I.L.T.I. inclusion in a manner that was similar to ownership through a foreign partnership, by being allocated a distributive share of the C.F.C.'s tested items.[6] Conversely, partners of a domestic partnership who were not U.S. Shareholders would have been allocated a net G.I.L.T.I. inclusion in a two-step process. First the domestic partnership, as an entity, would compute its G.I.L.T.I. inclusion from the C.F.C. That amount would be allocated through distributive shares to partners who were not U.S. Shareholders.

This hybrid approach was intended to balance the policies underlying G.I.L.T.I. with the relevant statutory provisions. As mentioned above, a domestic partnership is a U.S. Person and a U.S. Shareholder. On the other hand, if a domestic partnership were treated strictly as an entity, a domestic partnership with a G.I.L.T.I. inclusion amount would be ineligible for foreign tax credits under Code §960(d) or a deduction under Code §250 with respect to its G.I.L.T.I. inclusion amount.

### Comments to 2018 Proposed G.I.L.T.I. Regulations

During the comment period for the 2018 Proposed G.I.L.T.I. Regulations, two comments received from the private sector raised concerns with the hybrid approach that was adopted.

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4 Code §951A(f)(1)(a).

5 Prop. Treas. Reg. §1.951A–5(b)(1).

6 Prop. Treas. Reg. §1.951A–5(c).

First, domestic partnerships would be required to identify those partners that are U.S. Shareholders of a C.F.C. and those that are not. The determination would be easier for those partners that do not own shares of the C.F.C. directly and more difficult if shares are owned directly by a partner. Without that determination, a partnership is not able to properly calculate a partnership-level G.I.L.T.I. inclusion for its partners. In addition, the proposed hybrid approach raised administrability concerns under the centralized partnership audit regime. Finally, the disparate treatment of partners who are U.S. Shareholders and those that are not affects various provisions regarding basis step-ups for inclusion of G.I.L.T.I. under Code §961 and the interplay of inclusions of income and previously taxed income rules of Code §959. It also affects the computation of capital accounts.

## Computation Under the 2019 Final G.I.L.T.I. Regulations

Consequently, the 2019 Final G.I.L.T.I. Regulations adopt a new simplified hybrid approach. Hybrid treatment based on the status of the partner is eliminated and hybrid treatment based on the provision of U.S. tax law being applied is adopted.

### *Entity Approach to Determine U.S. Shareholders*

The 2019 Final G.I.L.T.I. Regulations adopt the entity approach for domestic partnerships for purposes of determining whether a U.S. Person is a U.S. Shareholder or whether a foreign corporation is a C.F.C.[7] Hence, the regulations are consistent with the definitions of a U.S. Person and U.S. Shareholder and are consistent with the entity treatment of domestic partnership under Subpart F.

### *Aggregate Approach to Compute the Amount of the G.I.L.T.I. Inclusion*

The 2019 Final G.I.L.T.I. Regulations provide that in order to determine the amount of the G.I.L.T.I. inclusion, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of Code §958(a).[8] Rather, the partners of a domestic partnership are treated as owning proportionately the stock of the C.F.C. owned by the partnership in the same manner as if the partnership were a foreign partnership under Code §958(a)(2).

Thus, the aggregate approach applies for purposes of Code §951A (inclusion in income), its regulations, and any other provision that applies by reference to Code §951A or its regulations. It also applies to Code §§959 (previously taxed income), 960 (indirect foreign tax credit), and 961 (adjustments to basis for inclusions of income under G.I.L.T.I.). Applying an aggregate approach to the foregoing provisions was determined to be necessary to ensure that a single G.I.L.T.I. inclusion amount is determined for each taxpayer based on its economic interests in all of its C.F.C.'s.

### *Change to Treatment of Subpart F Inclusions*

To ensure consistent treatment across the G.I.L.T.I. and Subpart F regimes, the 2019 Proposed G.I.L.T.I. Regulations extend the aggregate approach to Code §951, noting that Congress intended for the Subpart F and G.I.L.T.I. regimes to work in tandem. Accordingly, for purposes of determining the Subpart F inclusions of partners of a domestic partnership that is a U.S. Shareholder of a C.F.C., an aggregate

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[7] Treas. Reg. §1.951A-1(e)(2).

[8] Treas. Reg. §1.951A-1(e)(1).

approach will apply such that the partners will be treated as proportionately owning the C.F.C. stock that is held by the domestic partnership. As in the G.I.L.T.I. context, this rule does not apply for purposes of determining U.S. Shareholder or C.F.C. status, or whether the U.S. Shareholder is a controlling domestic shareholder.[9]

*"Taxpayers initially must determine whether a corporation is a C.F.C. and then must determine which partners will be taxable under Code §§951 and 951A when a domestic partnership is a U.S. Shareholder."*

One effect of this change in the treatment of domestic partnerships is that, for U.S. Persons owning capital and profits interest of less than 10% in a domestic partnership, the overlap rule between P.F.I.C.'s and C.F.C.'s that treated a U.S. partnership as a U.S. Shareholder no longer will be applicable when a foreign corporation is a C.F.C. and a P.F.I.C.[10] Because these partners will no longer have an inclusion in income under Code §951, the overlap is inapplicable. The P.F.I.C. rules will apply. On the other hand, for purposes of reporting on Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, the reporting obligation for these partners will be reduced.

*Effective Date*

These rules are effective for tax years of foreign corporations beginning on or after the finalization date.[11] However, taxpayers may apply and rely on the 2019 Proposed G.I.L.T.I. Regulations for tax years beginning after December 31, 2017, provided they do so consistently.

## ILLUSTRATIONS

The examples in the 2019 Proposed G.I.L.T.I. Regulations[12] explain how the stock ownership rules for domestic partnerships apply to determine C.F.C. and U.S. Shareholder status and calculate partner inclusions under Code §§951 and 951A.

In a two-step process, taxpayers initially must determine whether a corporation is a C.F.C. and then must determine which partners will be taxable under Code §§951 and 951A when a domestic partnership is a U.S. Shareholder.

### Example 1

*Facts*

A U.S. parent corporation ("U.S.P.") and Individual A, an unrelated U.S. citizen, respectively own 95% and 5% of a domestic partnership ("P.R.S."). P.R.S. wholly owns a foreign corporation ("F.C.")

*Analysis*

**Determination of U.S. Shareholders: Entity Approach**

- Under Prop. Treas. Reg. §1.958-1(d)(2), determining whether P.R.S., U.S.P., and A (all U.S. Persons) are U.S. Shareholders and whether F.C. is a C.F.C. is accomplished without regard to the general rule in Treas. Reg.

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[9] Prop. Treas. Reg. §1.958-1(d)(2).

[10] Code §1297(d).

[11] Treas. Reg. §1.958-1(d)(4).

[12] Prop. Treas. Reg. §1.958-1(d)(3).

§1.958-1(d)(1) that a domestic partnership is treated in the same manner as a foreign partnership, *i.e.*, as an aggregate. Therefore, the entity treatment applies.

- P.R.S. owns 100% of the voting power and value of F.C. under Code §958(a), so P.R.S. is a U.S. Shareholder under Code §951(b) and F.C. is a C.F.C. under Code §957(a).
- U.S.P. is a U.S. Shareholder of F.C. because it owns 95% of F.C.'s vote and value under Code §958(b) applying Code §318(a)(2)(A).
- A is not a U.S. Shareholder because A owns only 5% of F.C.'s vote and value. A does not meet the 10% ownership requirement under Code §951(b).

**Computation of the G.I.L.T.I. Inclusion Amount: Aggregate Approach**

- The general rule in Prop. Treas. Reg. §1.958-1(d)(1) applies. P.R.S. is treated as an aggregate of its partners.
- P.R.S. is not treated as an entity owning the F.C. stock for the purpose of determining the Subpart F and G.I.L.T.I. inclusion amount. Instead, P.R.S. is treated in the same manner as a foreign partnership within the meaning of Code §958(a)(2).
- Consequently, when determining income inclusions, U.S.P. is treated as owning 95% of the F.C. stock under Code §958(a), and A is treated as owning 5% of the F.C. stock under Code §958(a).
- U.S.P. is a U.S. Shareholder of F.C. and determines its income inclusions under Subpart F and G.I.L.T.I. based on its ownership (95%). A is not a U.S. Shareholder. A does not have income inclusions under Code §§951 and 951A.

**Example 2**

*Facts*

U.S.P., a domestic corporation, and Individual A, a U.S. citizen, own 90% and 10%, respectively, of P.R.S. 1, a domestic partnership. P.R.S. 1 and Individual B, a nonresident alien individual, own 90% and 10%, respectively, of P.R.S. 2, a domestic partnership. P.R.S. 2 owns 100% of the single class of stock of F.C., a foreign corporation. U.S.P., Individual A, and Individual B are unrelated to each other.

*Analysis*

**Determination of U.S. Shareholders: Entity Approach**

- Under Prop. Treas. Reg. 1.958-1(d)(2), the determination of whether P.R.S. 1, P.R.S. 2, U.S.P., and Individual A (each a U.S. Person) are U.S. Shareholders of F.C. and whether F.C. is a C.F.C. is made under the entity approach.
- P.R.S. 2 owns 100% of the total combined voting power or value of the F.C. stock within the meaning of Code §958(a). Accordingly, P.R.S. 2 is a U.S. Shareholder under Code §951(b), and F.C. is a C.F.C. under Code §957(a).

- Under Code §§958(b) and 318(a)(2)(A), P.R.S. 1 is treated as owning 90% of the F.C. stock owned by P.R.S. 2. Accordingly, P.R.S. 1 is a U.S. Shareholder under Code §951(b).
- For purposes of determining whether the F.C. stock is treated as owned by U.S.P. and Individual A under Code §318(a)(2)(A), P.R.S. 1 is treated as owning 100% of the F.C. stock by reason of Code §958(b)(2). Therefore, U.S.P. is treated as owning 90% of the F.C. stock under Code §958(b) (100% x 100% x 90%), and Individual A is treated as owning 10% of the F.C. stock under Code §958(b) (100% x 100% x 10%). Accordingly, both U.S.P. and Individual A are U.S. Shareholders of F.C. under Code §951(b).

**Computation of the G.I.L.T.I. Inclusion Amount: Aggregate Approach**

- Under Prop. Treas. Reg. §1958-1(d)(1), P.R.S. 1 and P.R.S. 2 are not treated as owning (within the meaning of Code §958(a)) the F.C. stock; instead, P.R.S. 1 and P.R.S. 2 are treated in the same manner as foreign partnerships for purposes of determining the F.C. stock owned by U.S.P. and Individual A under Code §§958(a)(2) and (b) of this section.
- Therefore, for purposes of determining the amount included in gross income under Code §§951 and 951A, U.S.P. is treated as owning 81% (100% x 90% x 90%) of the F.C. stock under Code §958(a), and Individual A is treated as owning 9% (100% x 90% x 10%) of the F.C. stock under Code §958(a). Because U.S.P. and Individual A are both U.S. Shareholders of F.C., U.S.P., and Individual A determine their respective inclusions under Code §§951 and 951A based on their ownership of F.C. stock under Code §958(a).

## CONCLUSION

The 2019 Final G.I.L.T.I. Regulations have modified the hybrid treatment afforded partnerships for purposes of Code §951A. No longer are certain partners treated one way and other partners another based on indirect ownership interests in a foreign corporation that is a C.F.C. Rather, a U.S. domestic partnership is treated as an aggregate for purposes of computing an income inclusion, but as an entity for other purposes, such as reporting annual information on the C.F.C.

Because a domestic partnership is not treated as owning Code §958(a) stock for purposes of Code §951A, a domestic partnership does not have a G.I.L.T.I. inclusion amount and thus no partner of the partnership has a distributive share of a G.I.L.T.I inclusion amount. Instead, the tax obligations are determined at the partner level. Consequently, a partner that is not a U.S. Shareholder of a C.F.C. owned by the partnership does not have a *pro rata* share of any tested item of the C.F.C.

Nonetheless, a domestic partnership is treated as a U.S. Person and a U.S. Shareholder for all obligations that are not related to the inclusion of income. Hence, the information gathering obligation under U.S. tax law will be imposed on the U.S. partnership, which is in position to obtain and disseminate information to its partners.

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