International Issues Inherent in Subchapter K

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 clarify the treatment of partnerships and 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, in this author’s opinion, is the piecemeal approach adopted by the Internal Revenue Service (“IRS”) and the Department of the Treasury (“Treasury”) in promulgating rules to address partnerships in the international context.

In many, if not almost all cases, this guidance is preceded with the following citation which is used to justify both a piecemeal approach and an “aggregate” view of partnerships:\(^3\)

\[\text{Both 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….
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\(^{1}\) H.R. REP. NO. 83-1337, at 59 (1954).
the concept of the partnership as a collection of individuals is more appropriate for such provisions.4

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 what has been adopted is not in fact an aggregate approach at all, but something close to a “modified conduit approach”, where transactions with the partnership are respected as having occurred with a separate entity, with an overlay of anti-abuse rules. In this author’s opinion, 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 (and 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 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.

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

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article will offer some other terms which are useful for this discussion, such as “pass-through” and “conduit”.

In Part II of the article, we will consider a series of provisions in which there is a substantial overlap between subchapter K and the international rules. First, we will discuss section 954 and the Brown Group regulations,\(^5\) which provide rules for the characterization of income recognized by a partnership. The article will then move to a discussion of Revenue Ruling 91-32 and the treatment of gain on the sale or exchange of a partnership that carries on a trade or business in the United States. The third area will be the application of section 956, both in situations in which the partnership holds assets and where a partnership issues an obligation (and whether that obligation should be treated as an obligation of the partners). Finally, we will discuss a few additional provisions, including Notice 2010-41\(^6\) which have provided more targeted guidance to address specific transactions.

In Part III the article will revisit some the provisions discussed in Part II and using these as a springboard, attempt to answer 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 this author surmises, to adopt an entity approach to partnership taxation in the international regime, which can be more easily integrated into the fabric of subchapter K while preserving the policies of the various international provisions as a whole.

**Part I: The Vocabulary**

\(^5\) Although the Brown Group Regulations generally address the application of sections 954 and 956 to partnerships, the focus of this article will be primarily on some of the issues specifically presented in the Brown Group case, which relate solely to section 954(d) and the application of the foreign base company income rule provisions.

\(^6\) Notice 2010-41, 2010-22 IRB 715 (May 14, 2010).
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 much of 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 this discussion have a much broader meaning. Thus, as used in this paper, an “aggregate approach” is an approach whereby the partnership is not viewed as a separate entity from its partners, and any dealings among and between the partners, the partnership, and third parties, are transactions that are viewed as occurring between and among the partners and the third parties directly. In addition, under a pure aggregate view, any dealings between a partner and the partnership would either be disregarded, or viewed as a transaction directly between the partners themselves. Finally, under a pure aggregate approach, any assets or liabilities owned by the partnership would be treated as assets and liabilities of the partners.

Alternatively, under an entity approach, all dealings between the partnership and its partners and third parties would be treated as dealings 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 section 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

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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.\(^9\)

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 by the partnership, or incurred in the same manner as incurred by the partnership.\(^10\) 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.”\(^11\)

Commentators have also pointed out a potential fourth approach to the taxation of partnership and partnerships: the “attributional principle”.\(^12\) 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 “attribution of activities” concept, most clearly incorporated into the Code in section 875(1), and by the courts when analyzing partnerships in the income tax treaty context (for example, in Donroy Ltd. v. United States,\(^13\) and Unger v.

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\(^9\) See also, Treas. Reg. § 1.367(a)-1T(c)(3)(i) and (ii), which apply an aggregate approach in the case of transfers by partnerships and of partnership interests, respectively. A detailed discussion of the regulations under section 367 are outside the scope of this article.


\(^11\) 1984 ALI Report, at 114. See also, Gary R. Huffman & Barksdale Hortenstine, Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships, 86 Tax Mag. 179, 186 (2008). This conduit approach has also been referred to as a “pass thru” principle or approach. 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.

\(^12\) See Kimberly S. Blanchard, Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Attributes to Partners, 76 Tax Notes 1331, 1332 (1997).

\(^13\) 301 F.2d 200 (9th Cir. 1962).
Comm’r,\textsuperscript{14}) 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 treating the partner as having a permanent establishment in the United States if the partnership has a permanent establishment in the United States.\textsuperscript{15}

**Part II: Case Studies**

A. A Detour into Subpart F

Much 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 Internal Revenue Code (hereinafter, the “Code”).\textsuperscript{16} As a result, a brief detour into Subpart F is necessary before moving forward with our discussion.

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 completely eliminate deferral of earnings earned 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.\textsuperscript{17} While Congress agreed that tax havens provided an inappropriate tax incentive, it did not share the President’s view that deferral as a result on non-tax motivated structures and transactions in

\begin{footnotesize}
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\item[15] In addition to upward attribution, there are a few rulings which could be written 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. See TAM 200811019. \textit{C.f.), Sun Capital Partners, LP v. New England Teamsters & Trucking Industry Pension Fund}, 724 F.3d 129 (1st Cir. 2013); \textit{Dagres v. Commissioner}, 136 T.C. 12 (2011).
\item[16] Internal Revenue Code, Chapter 1 Subchapter N, Part III, Subpart F, being sections 951 – 954. Subpart F of the Code was adopted in 1962 in response to a debate about the “inappropriate” deferral of certain passive income and related party transactions.
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developed countries was problematic. 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.

As originally enacted, Subpart F was also intended to ensure passive income earned by U.S.-owned foreign corporations were 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.”

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 through several additions and subtractions to its provisions.

The Subpart F regime applies to income of, and assets held, by a controlled foreign corporation (“CFC”). In such a case, where a foreign corporation is a CFC for an uninterrupted

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18 Id.
19 Id. at 14.
21 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 from 30 percent to 10 percent. The Tax Reform Act of 1986 expanded the definition of a controlled foreign corporation 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, section 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, section 954(c)(6) is effective with respect to CFC’s with tax years beginning before January 1, 2014.
22 Under current section 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
period of 30 days or more during any taxable 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 pro-rata share of the CFC’s subpart F income for such year and the amount determined under section 956 (related to investments in U.S. property, discussed further below) for the taxable year.

A “U.S. shareholder” is a U.S. person who owns (within the meaning of section 958(a)) or is considered to own (within the meaning of section 958(b)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. The term “U.S. person” is defined by reference to section 7701(a)(30)(B) to include a domestic partnership, and exclude a foreign partnership. Accordingly, and as discussed further below, a foreign corporation wholly owned by a domestic partnership will always be a CFC, regardless of the composition of the domestic partnership’s ownership group.

Subpart F income is composed of several types of income including foreign base company income (“FBCI”). Section 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 section 954(b)(5).

b. FPHCI
FPHCI is gross income of a CFC which consists generally of dividends, interest, the excess of gains over losses from the sale or exchange of certain types of property, royalties, rents and annuities.\(^{27}\) With respect to dividends, interests, rents and royalties, the Code and regulations provide three exceptions, whereby these amounts are not treated as FPHCI when recognized by a CFC. The first (“same country exception”) requires that, among other things, the recipient of the income be organized in the same jurisdiction as the payor and the recipient is related to the payor.\(^{28}\) To the extent provided in regulations, payments made by a partnership with one or more corporate partners shall be treated as made by such corporate partners in proportion to their respective interests in the partnership.\(^{29}\)

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.\(^ {30}\)

\(^{27}\) In addition, FPHCI also includes the excess of gains over losses from sales and exchanges during the taxable 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. Section 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 (assuming, as explained below, that such assets are not included within the definition of “property that does not give rise to income”). 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, section 954(c)(4) provides that the case of any sale by a controlled foreign corporation of an interest in a partnership with respect to which such corporation is a 25-percent owner, such corporation shall be treated for purposes of this subsection as selling the proportionate share of the assets of the partnership attributable to such interest.

\(^{28}\) Under the same country exception the term FPHCI does not include: (i) dividends and interest received from a related person which (I) is a corporation created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation 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 (ii) 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 controlled foreign corporation is created or organized.

\(^{29}\) Section 954(c)(3) (flush language).

\(^{30}\) Section 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 [section 954(d)(3)]).”
The final exception (the “look-through rule”) requires that the income be received from 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 of the payor.  Thus, under the look-through rule, dividends, interest, rents, and royalties received or accrued from a CFC which is a related person is not treated as FPHCI to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.  

c. FBCSI

Section 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: (A) 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 (B) the

31 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).

32 Section 954(c)(6)(A) grants the Secretary the authority to prescribe regulations under section 954(c)(6). The IRS has published guidance under Notice 2007-9, which provides clarity on the applicability of section 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, 2007-5 IRB 401, at §4.
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: (i) the CFC itself manufactured or produced,33 (ii) was manufactured or produced by another party in the same country of organization as the CFC (the “same country manufacturing exception”), or (iii) is sold for use, consumption or disposition in the same country of organization as the CFC (the “same country consumption exception”).

In addition to the general rule of section 954(d)(1), section 954(d)(2) 34 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.35

d. FBCSVI

33 Treas. Reg. § 1.954-3(a)(2) and (3). For purposes of section 954(d), the definition of “manufacturing” is set forth in Treas. Reg. §1.954-3(a)(4)(ii) (i.e., substantial transformation of property), (iii) (i.e., “substantial in nature” manufacturing) and (iv) (i.e., substantial contribution to manufacturing).

34 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).

35 Under section 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 Secretary, 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.
Finally, FBCSVI means income derived in connection with the performance of services which 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: (i) 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;\(^{36}\) (ii) 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;\(^{37}\) (iii) 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;\(^{38}\) or (iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons.\(^{39}\)

B. *Brown Group, Inc. v. Commissioner*\(^{40}\)

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\(^{36}\) Treas. Reg. § 1.954-4(b)(1)(i).


\(^{38}\) Treas. Reg. § 1.954-4(b)(1)(iii).

\(^{39}\) Treas. Reg. § 1.954-4(b)(1)(iv). In 2007, the IRS released Notice 2007-13. Notice 2007-13 announced that the IRS will amend the substantial assistance regulations in several ways. First, whereas under the current regulations, substantial assistance could be rendered by any related person, the amended regulations will re-define substantial assistance to include only assistance rendered by a related United States person. Second, the amended regulations will both eliminate the distinction between the two categories of assistance described above and discontinue the use of the principal element test as a method for determining substantial assistance. Rather, assistance will be tested for substantiality using only the cost test. For purposes of the cost test, the term “assistance” will include, but will not be limited to “direction, supervision, services, know-how, financial assistance (other than contributions to capital) and equipment, material, or supplies provided directly or indirectly by a related United States person to a CFC.” Notice 2007-13 explains that the test will be satisfied if “the cost to the CFC of the services furnished by the United States person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.” The Notice explains that, instead of demonstrating that the assistance provided by the related person is less than 80 percent of the total cost, the taxpayer can also satisfy the test by demonstrating that the value of the services provided by the CFC itself exceeds 20 percent of the total cost of performing the services. In addition, the amended regulations will specify that, for purposes of determining substantial assistance, services provided by a CFC will not be considered to be services provided “indirectly” by a United States person that is related to that CFC. However, the amended regulations will also specify that, for any fiscal year of a CFC in which an officer, director, or employee of the CFC is also an officer, director, or employee of a related United States person, that officer, director, or employee will be considered to be only an officer, director, or employee of the related U.S. person. Finally, it is important to note that Notice 2007-13 specifies that, “until regulations reflecting these changes are issued, taxpayers may rely on this notice.”

\(^{40}\) 102 T.C. 616 (1994), withdrawn and reissued 104 T.C. 105, reversed 77 F.3d 217 (8th Cir. 1996).
Although the IRS, Treasury and practitioners were giving substantial thought to the
treatment of partnerships in the international context for a number of years, much of the recent
guidance involving partnership and section 954, originates from Brown Group Inc. v.
Commissioner.

Brown Group, Inc. was a domestic corporation and the common parent of an affiliated
group of corporations filing a consolidated return, which 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, which acted 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 includable as subpart F

A key point of contention between the IRS and Brown Group was whether the income
derived by Brinco and taken into account by Brown Cayman was FBCSI and in particular
whether Brinco (the “entity” deriving the commission income) was a related party to either
Brown Cayman or Brown Group

As in effect for the taxable years at issue, a person was a related person with respect to a
CFC if: (A) such person was an individual, partnership, trust or estate which controls the CFC;
(B) such person is a corporation which controls, or is controlled by, the CFC; or (C) such person
is a corporation which is controlled by the same person or persons which control 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.41

Accordingly, a key question presented was whether the income, when recognized by the partnership, should be FBCSI in the hands of the partner. Following consideration and rehearing by the Tax Court, the case ultimately made its way to the Eighth Circuit, where the court, citing section 702(b), held that the income derived by Brinco should not be included in the definition of FBCSI.42 Simply stated, the court ruled that income should be characterized at the partnership level, and that 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.”43

As 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 partnership that control CFC’s, but also those that are controlled by CFC’s or their parents.44

As noted by the Eighth Circuit Court of Appeals, the “loophole” taken advantage of by Brown Group was in fact closed by Congress through a modification to the definition of a related party. Thus, under section 954(d)(3) (as modified), a person is related with respect to a CFC if:

41 Section 954(d)(3) was subsequently amended and currently provides as follows: For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if-- (A) such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the controlled foreign corporation, or (B) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the controlled foreign corporation. The import of this change will be discussed further below.
42 Brown Group Inc. v. Comm'r 77 F.3d 217, 223 (8th Cir. 1996).
43 Id., at 221.
44 Id., at 222.
(a) such person is an individual, corporation, partnership, trust, or estate, which controls or is controlled by the CFC or (b) such person is a corporation, partnership, trust, or estate, which is controlled by the same person or persons which control the CFC. As a result, under the new statutory definition of a related party, the income derived by Brinco would be treated as commission income received by Brinco from a related person.

C. The *Brown Group* Regulations

In response to its loss in *Brown Group*, the IRS and Treasury promulgated regulations under section 954 for purposes of determining whether a CFC partner’s distributive share of partnership income runs afoul of the subpart F anti-deferral regime. As noted above, although many may view the *Brown Group* regulations as adopting an aggregate approach, the regulations themselves are in fact a mix of both aggregate and entity. In addition, in this author’s opinion, the “aggregate” rule of the regulations is really better understood to be a “modified conduit” approach, identifying certain situations in which the attributes of the partner, as opposed to the partnership, are relevant in applying section 954.

i. Modified Conduit Approach

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45 Section 954(d)(3). For this purpose, 954(d)(3) defines a related person with respect to a CFC as an individual, corporation, partnership, trust, or estate which 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.

46 Even under this new related party definition, a question might nonetheless exist as to whether the income could be subpart F income (given that it was derived by a partnership, and not a CFC. This argument was also posited by Brown Group during the litigation. However, given the comment by the Eighth Circuit, it does not appear that such an argument, in and of itself, would have been successful.

47 T.D. 9008, 67 Fed. Reg. 48,020 (7/23/02). 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, under section 954, set forth a framework for dealing with issues arising under subpart F (sections 951 through 964) that relate to the use of certain entities that are regarded as fiscally transparent for purposes of U.S. tax law.

48 *Id.*
Under the Brown Group 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, if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 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).49

The regulations also provide a rule for purposes of determining the payor of amounts, when the amount is paid or earned by the partnership. Accordingly, if a partnership with one or more corporate partners makes a payment, a corporate partner will be treated as the payor of the interest: (1) if 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 section 704(b); or (2) if 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 section 704(b)).50

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 (“CFC-partnership transaction”). In such cases, the transaction will be treated as a transaction with an entity that is

49 Treas. Reg. § 1.954-1(g)(1).
a related person if: (i) The CFC purchased the personal property from (or sold it to the partnership on behalf of) a person related to the CFC; (ii) 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 (iii) the branch rule of section 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 discussed above, 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 to the FPHCI provision, shall apply only if such 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.51

A similar rule to the rule applies for purposes of determining whether exceptions apply under section 954(d). In particular, Treas. 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 § 1.952-1(g), the property

51 In addition, a CFC’s distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(i) unless the controlled foreign corporation is a qualifying insurance company, as defined in section 953(e)(3), and the income of the partnership would have been qualified insurance income, as defined in section 954(i)(2), if received by the controlled foreign corporation directly. See § 1.952-1(g)(1).
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 special rules for purposes of section 954(h) and section 954(i). Thus, a CFC’s distributive share of partnership income will not be excluded from FPHCI under the exception contained in section 954(h) (related to active financing) unless the CFC is an eligible CFC within the meaning of section 954(h)(2) (taking into account the income of the CFC and any partnerships or other qualified business units, within the meaning of section 989(a), of the CFC, including CFC’s distributive share of partnership income) and the partnership, of which the CFC is a partner, generates qualified banking or financing income within the meaning of section 954(h)(3) (taking into account only the income of the partnership). This provision is may be the clearest indication of the mix of entity/aggregate concepts in the *Brown Group* regulations.

Finally, the partnership is treated as an entity for purposes of section 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 section 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.\textsuperscript{52} Although the problems with this approach and the lack of a single coherent framework will be discussed in detail below, it is worth a few pages to discuss the questions that were left unanswered.

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

One key area that is unaddressed by the Brown Group regulations is that they fail to discuss how the partnership should be treated when testing income derived by a partner from its dealings with the partnership. Thus, because the scope of the regulations is limited solely 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.

ii. The Brown Group Approach is Inconsistent with the section 904 Rules

The provisions in the Brown Group regulations do not adopt an aggregate approach. Under a “pure” aggregate approach, to the extent the deduction is allocated to the partner receiving the income, this transaction should be disregarded. In addition, to the extent of the deduction allocable to the other partners, the partnership itself should play no role, thus requiring

\textsuperscript{52}\textit{See T.D. 9808 which provides that: }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 polices underlying subchapter K.
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 section 904, and the regulations thereunder, for purposes of determining the
basket to which to allocate the income.53

iii. Problem 2: The Regulations are Silent on the Branch Rule

In addition to the issues raised under section 954(c) above, there are also issues under
section 954(d), the very provisions the Brown Group regulations were intended to address. In
short, 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. Take, for example, the situation where a CFC owns a 55 percent interest in a
partnership that manufactures property and sells to the CFC. The CFC then sells the property to
unrelated third parties.

In this situation, if the partnership was an aggregate, then for purposes of determining
whether the gain recognized by the CFC itself on the sale to third parties would be FBCSI, the
CFC would be viewed as engaging in a transaction directly with itself and also with the unrelated
third party with which it is a partner. With respect to the unrelated third party, the CFC should
not be treated as deriving any FBCSI under the general rule. In addition, with respect to the
transaction that the CFC is engaging with itself, it should also not have any FBCSI; in such a
case, it would be treated as manufacturing the property that it sold. Unfortunately, that does not
appear to be the result under the modified conduit approach of the regulations. Instead, it would

53 Under Treas. Reg. §§ 1.904-5(h) and -5(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 section 904(d)(3)(C) and Treas. Reg. §1.904-
5(i)(1), interest paid by a partnership to 10 percent-or-greater CFC partners or to related look-through entities are
characterized based upon the income of the partnership under an entity approach.
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 it does not appear that the manufacturing exception would apply, as the CFC itself is not manufacturing the property sold.

Alternatively, assume that the CFC owns a 35 percent interest in a partnership that manufactures property. 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. With respect to the unrelated third party, the CFC should not be treated as deriving any FBCSI under the general rule under section 954(d)(1). In addition, with respect to the transaction that the CFC is engaging with itself, it would also not have any FBCSI because in such a case, it would be manufacturing the property that it sold.

Unfortunately, under the approach of the Brown Group regulations, although the CFC would not appear to have FBCSI under section 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 given Treas. Reg. § 1.954-3(a)(6) should be that the CFC does not have a manufacturing branch.54 In particular, if we are specifically precluded from taking into account the CFC partners activities for purposes of determining whether the income derived from the sale of property by the partnership qualifies for the manufacturing exception, we should equally be precluded from having to take into account such activities into account for purposes of treating the CFC as having a branch under the branch rule.

54 See Lowell D. Yoder, Final Regulations Apply Subpart F to a CFC’s Distributive Share of Partnership Income, 2003 TMII 32. (March 14, 2003)
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. Instead, the CFC must itself engage in certain non-physical manufacturing activities through its own employees in order to be the manufacturer. Given that the partnership in a separate unrelated operating company under local law, over which the CFC has likely little if any control, this appears to be the more appropriate result.\(^{55}\)

Unfortunately, this result could be seen as contrary to a series of recent Private Letter Rulings issued by the IRS, in which it adopted an aggregate view of partnerships for purposes of the branch rule. In particular, in Priv. Ltr. Rul. 2010-02-024, the IRS applied the provisions of section 954(d)(2) to a supply chain conducted by a partnership owned by a CFC. Although the facts of the Priv. Ltr. Rul. are somewhat complicated, what is clear is that the IRS took an “aggregate” view of the partnership for purposes of section 954(d) and applied the provision of section 954(d)(1) and 954(d)(2) at the partner, and not the partnership level.

We will return to these examples below and ask the question, what would the result have been if the partnership were treated as an entity and the transactions were characterized as the partnership level (as opposed to the partner level). In doing so, we will ask the further question,

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\(^{55}\) See also, *Ashland Oil, Inc. v. Commissioner*, 95 TC 348(1990), the Tax Court 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 dictionary 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*, *supra* (holding that a wholly-owned subsidiary could not be a “branch” of its parent corporation). “Our 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.
is this approach both more consistent with the policies of section 954 and the economic realities of the business climate.\textsuperscript{56}

D. Revenue Ruling 91-32

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

i. In General

A foreign corporation or non-resident alien individual is subject to U.S. income tax if it engages in 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.” Unless a foreign corporation is engaged in a U.S. trade or business, its gains on the sale of personal property generally are treated as income from sources outside the United States (“foreign source income”) and foreign source gain income is generally excluded from ECI.

If a foreign corporation is found to be engaged in a U.S. trade or business during a taxable 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 (\textit{i.e.}, ECI), which is subject to U.S. federal income taxation on a net basis using graduated rates. Under section 864(c)(2), any U.S. source gain from the sale or exchange of a capital asset will be treated as effectively connected with a U.S. trade or business 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,

\textsuperscript{56} 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 US is approaching these transactions as looking to the attributes of the partner, in many cases the local law tax or legal treatment of the entity results in the partner’s attributes being largely irrelevant for purposes of taxing the partnerships income.
gain, or loss. All types of income, gain, or loss from U.S. sources other than those described in section 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: (i) rents, royalties or gains from the sale of intangible property; (ii) dividends, interest, and gains from the sale of securities; and (iii) 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 section 865. Second, the gain must be tested under section 864(c)(2) and (3) (if the gain is U.S. source) and under Section 864(c)(4) and (5) (if the gain is foreign source), to determine if it is ECI.

ii. Source

Under the general rule of section 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, section 865 includes a variety of exceptions to this general rule, including exceptions for inventory, depreciable personal property, and intangibles. In addition, section 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 shall be sourced in the United States. The principles of section 864(c)(5) shall 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.

As a general matter, 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 section 865. Although section 865(i)(5) provides that in the case of a partnership, except as provided in regulations, section 865 shall be applied at the partner level, this provision only addresses the taxation of the partners 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, Revenue Ruling 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 partner, and that the partner is in a trade or business by reason of the activities of the partnership, is not entirely satisfying.

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57 Section 741(a).
58 See also, Treas. Reg. § 1.865-1 and -2, which provide
59 This is similar to the approach taken by the IRS in Priv. Ltr. Rul 91-42-023. In Priv. Ltr. Rul. 91-42-023, PRS, a U.S. limited, 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 section 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 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 section 864(c)(2), discussed further below, 1 attributable to that foreign office or other fixed place of business of PRS and, provided US pays to FC a ten percent effective rate of income tax on the gain from the sale.
b. Rev. Rul. 91-32

Although Revenue Ruling 91-32 presented three alternative fact patterns, the basic fact pattern that illustrates its application is quite basic. 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’s 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 section 897. FP1 sold the interest in PRS1 and recognizes gain of $100. The question addressed by the Revenue Ruling is whether the gain is subject to tax in the United States as ECI.

As has been pointed out by numerous commentators, the IRS analysis in Revenue Ruling 91-32 is at best cursory. In particular, although the Revenue Ruling cites to sections 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, what 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…. Accordingly, to the extent provided below, income from FP1's disposition of his partnership interest will be sourced in the United States.”

The Revenue Ruling goes on:

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

from its interest in FC PRS (computed by applying the principles of section 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 section 865(e)(1).
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, because the gain is U.S. source, it is also effectively connected to a U.S. trade or business.

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 sections 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, there is a strong policy argument that the gain should not be subject to net basis taxation.

On the facts of the revenue ruling, unless 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. In particular, as discussed above, under section 865(a) the general rule will be 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 Revenue Ruling 91-32.
First, section 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.\(^{60}\)

Second, section 865(c) could apply to override the general rule of section 865(a) if, and only if, the partnership interest were treated as depreciable personal property.\(^{61}\) In such a case, the gain attributable 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.\(^{62}\) Interestingly, Revenue Ruling 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.

### ii. Computational Issues

In addition 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 Revenue Ruling, Situation 2, but even that example leaves open unanswered questions.

### iii. No Collection Mechanism

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\(^{60}\) Section 865(d)(1). See McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶16.01 (3rd ed.) (“the [partnership] interest is treated as a separate intangible asset, detached from the assets of the partnership”); Treas. Reg. § 1.19702(c)(1) (excepting a partnership interest from the definition of intangible property); CGF Indus., Inc. v. Commissioner, 1999 Tax Ct. Memo LEXIS 44, 34 (1999) (“partnership interests, a type of property generally considered to be non-amortizable”).

\(^{61}\) Section 865(c). Based on the plain language of section 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 ARTICLE>

\(^{62}\) Section 865(a)(2) provides that any gain (in excess of the depreciation adjustments) from the sale of depreciable personal property shall be sourced as if such property were inventory property. Under section 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 Sections 861(a)(6), 862(a)(6) and 863. See also, Treas. Reg. § 1.861-7.
Finally, even assuming that the underpinnings of Revenue Ruling 91-32 were correct, the conclusion fails to consider how, if at all, the IRS and Treasury would proceed with collecting the underlying tax due on the sale. As made clear in the FIRPTA regime and the regulations under section 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 regime. Although such a regime has recently been proposed by the Obama administration, one does not currently exist. In addition, in order to implement such a withholding tax regime, applying a pure aggregate approach would require substantial information that is simply unattainable by either the buyer or the seller in many cases. Thus, the administrative complexity of such a system would be unwieldy at best and completely unenforceable at worst.

iv. Ignorance is Bliss

Finally, a rule that requires a foreign transfer 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 taxpayer’s will report and pay tax on their income in appropriate amounts. This is solely an issue of information sharing.

As will be discussed further below, in this author’s opinion, these problems could be addressed by the promulgation of a rule that would treat the partnership as an entity for this purpose. Thus, as a general rule, and under this approach, subject to certain exceptions, the gain on the sale of a partnership interest by a foreign partner would be foreign source and not ECI.

E. Section 956
As with the discussion of subpart F above, a brief primer on the general rules of section 956, along with a brief discussion describing the policies underlying the adoption of the provision is appropriate.

a. **A Primer on Section 956**

Much like subpart F, section 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 section 956 is to prevent the direct or indirect repatriation of income to the United States in such a way that avoids U.S. federal income taxation. Section 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 section 956.

In general, under section 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 taxable year, as limited by the amount earnings and profits of the corporation, and reduced by amounts previously included in income under section 951 (i.e., amounts included by reason of section 956 or generally under subpart F). The amount of U.S. property held by a CFC is either the CFC’s

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64 *Ludwig v. Commissioner*, 68 T.C. 979, 988 (1977). See FSA 1999-794 (June 2, 1993), in holding that a purchased warrant did not constitute an investment in United States property, the Service advised as follows: “However, 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.”
adjusted basis in such property or, in the case of an obligation, the principal amount of such obligation.

U.S. property as defined in section 956(c)(1), and subject to exceptions contained in section 956(c)(2), includes the following: (A) tangible property located in the United States; (B) stock of a domestic corporation; (C) an obligation of a United States person; or (D) any right to the use in the United States of (i) a patent or copyright, (ii) an invention, model, or design (whether or not patented), (iii) a secret formula or process, or (iv) 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 a domestic partnership but excludes foreign partnerships.

There are two primary issues that exist for partnerships in the context of section 956. The first is whether assets held by a partnership that is owned by a CFC should be treated as U.S. property of the CFC. This issue was addressed in the Brown Group regulations, which themselves built on preexisting guidance found in Revenue Ruling 90-112. 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. 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 section 956 property to obligations of a U.S. person.
b. Property Held by a Partnership

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 section 956(c)(1)) would be viewed as owned proportionately by the partners. Such an approach, which may arguably be correct from a policy perspective, 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 section 956. The IRS addressed this question directly in Revenue Ruling 90-112 and then again by “codifying” the revenue ruling in the Brown Group regulations. Subsequent to that, additional guidance in the form of a private letter ruling has provided more insight into the IRS’ view of these provisions (and also added more color to issues that may arise around these provisions).

In Rev. Rul. 90-112, the IRS and Treasury held that real property that was located in the United States and owned by a partnership should be treated as U.S. property held by a CFC partner for purposes of section 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 section 956 property.

The fact that this was a hybrid approach was made clear in the Brown Group regulations, which provides that for purposes of section 956, if a CFC is a partner in a partnership that owns property that would be United States 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 interest in United States property. 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 results-driven, and is not (as some have suggested) a pure aggregate approach. Indeed, even in section 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 section 956 property held by the partnership. In at least one case, a taxpayer requested guidance from the IRS and received a private letter ruling, Priv. Ltr. Rul. 2008-32-024.

In Priv. Ltr. Rul. 2008-32-024, the taxpayer was a U.S. shareholder of a CFC (“FC”) which conducted its business outside the United States. In order to expand its U.S. and non-U.S. business, the taxpayer, 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 form the

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65 Treas. Reg. § 1.956-2(a)(3)
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 US Business after the formation of Pship, no economic interest in US property is being shifting 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 US Business under Treas. Reg. §1.956-2(a)(3) and, accordingly, will not be treated as holding any US property otherwise held by PShip.

There are a few items worth noting about the Private Letter Ruling. First, it does not address the broader concept (and assumes away) whether FC is a partner in the partnership in which the US 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 in a handful of rulings 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.

As is clear in the Brown Group regulations, Rev. Rul. 90-112, and section 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). Thus, 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 a pure 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 a pure entity approach, the interest in the partnership itself could not be treated as section 956 property, because in such a case the interest would not be specifically listed in 956(c)(1) (unlike, for example, stock in a domestic corporation).

Regardless of the viewpoint of this author as to the need for a coherent theory of subchapter K in the international context, what seems reasonably clear and must be acknowledged is that it is necessary to attribute, under some methodology, the property held by a partnership to the CFC partners in order to prevent the simple avoidance of section 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. Arguably, however, this approach could be accomplished with a targeted anti-abuse. Thus, one could have a presumption that all the interest in a partnership is treated as U.S. property if the partnership holds a certain percentage (potentially 50 percent consistent with the FIRPTA rule discussed above). All other interests in partnerships would not be treated as U.S. property, unless the partnership was formed funded or availed of with a principal purpose of avoiding the application of section 956 to the CFC partner, in which case the entire partnership interest would be U.S. property. Such a rule would be similar to the provisions adopted in Treas. Reg. § 1.956-1T(b)(4).

c. Obligations of a Partnership

In addition to attributing assets to a CFC partner that holds an interest in a domestic or foreign partnership, section 956 can also apply when a partnership issues a note to a CFC with untaxed earnings and profits. The question is such a case is whether the partnership is a U.S.
person and, more specifically from a section 956 perspective, whether the obligation is an obligation of a U.S. person.

As discussed above, the term “United States property” is defined under section 956(c) to include the following:

(i) an obligation of a related U.S. person,
(ii) stock of a related U.S. person,
(iii) any right to use in the United States certain intangible property rights, or
(iv) tangible property located in the United States.

For purposes of section 956, the term “United States person” is specifically defined by reference to section 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. Thus, in the instant case, because the partnership is not a U.S. person, the loan to FP in the example above is not an obligation of a U.S. person and should not give rise to a section 956 inclusion.

Although under current law, the treatment of a partnership as an entity (regardless of whether the partnership is domestic or foreign) seems reasonably clear. The broader question is whether such treatment is appropriate under the policies of section 956 when the cash is repatriated to the United States, or otherwise invested in, property located within United States.

F. Notice 2010-41

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66 Sections 957(c) and 7701(a)(30).
67 The definition of U.S. person as utilized in the context of section 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 Treas. 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 section 956 inclusion.
As discussed above, under section 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 section 958(a)) or is considered to be owned (within the meaning of section 958(b)) by U.S. shareholders on any day during the CFC’s taxable 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, which is the CFC’s U.S. shareholder.

The problem identified by the IRS in Notice 2010-41 was that subpart F income of a partnership and, more specifically, a CFC partner’s distributive share such subpart F income is not itself subpart F income. In particular, the Treasury and IRS were concerned that taxpayers were taking the position that income inclusions recognized by a partnership under section 951(a) were allocated to the CFC partners, and because the distributive share of a CFC’s section 951(a) income inclusion is not itself subpart F income, there were no amounts ultimately subject to U.S. income tax.

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 section 951(a) if:
(1) The partnership is a United States shareholder of a foreign corporation that is a CFC (within the meaning of § 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 United States shareholder of the CFC: (i) would be treated under section 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 section 951(a) with respect to the CFC.

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. By not attempting to broadly adopt an “aggregate approach” or “modified conduit” approach, the collateral impact that the Notice has on the broader provisions of the Code and regulations is refreshingly limited. The Notice 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.\(^68\) In the opinion of this author, Notice 2010-41 represents a welcome guideline going forward as to how the IRS and Treasury could address issues inherent in the interaction between Subchapter K and the international provisions without creating undesirable complexity and confusion.

**Part III: Summary of Conclusions and Recommendations**

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, muddled and unclear. The provisions that have been adopted, and the guidance that we are

\(^{68}\) There are substantial issues with the ultimate distribution of the previously taxed income through tiers of partnerships which own CFC stock. This is another area where guidance is currently lacking in final regulations for the U.S. However, the 959/961 rules generally treat partnerships as an entity for purposes of those provisions.
awaiting, has done little to provide broad clarity and instead has been geared toward a scattershot result driven approach. With this in mind, let us now return to the selected issues discussed above and ask the question: what if we made clear that a partnership was an entity for these purposes. Would such an entity approach, utilizing the original conduit provisions of Subchapter K, reach the appropriate results in most cases and be substantially simpler for the IRS, Treasury and taxpayer’s to administer? Further, in those limited cases where the result would arguably be inappropriate, would it be possible to diverge from this general rule with targeted anti abuse provisions that would sufficiently protect the fiscal health of the United States and the policies of the underlying provisions without creating undue complexity and confusion?