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## IRS Issues Notice 2010-41 Outlining Regulations to be Issued That will Treat Domestic Partnerships as Foreign Partnerships Under the Controlled Foreign Corporation Rules

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### Introduction

**In December 2008, the IRS issued Notice 2009-7 to spotlight a transaction that it suspected was being used by U.S. taxpayers to avoid the current inclusion in gross income of certain income of “controlled foreign corporations” (“CFCs”) pursuant to § 951(a) of the Internal Revenue Code of 1986, as amended (the “Code”).<sup>1</sup> The IRS designated the transaction as a “transaction of interest” for purposes of Regulation § 1.6011-4(b)(6) and Code §§ 6111 and 6112.**

The transaction identified in Notice 2009-7 has the following basic fact pattern:

- A U.S. Taxpayer (the “Taxpayer”) wholly owns two controlled foreign corporations. (“CFC1” and “CFC2”);
- CFC1 and CFC2 together own 100% of the interests of a domestic partnership (the “Domestic Partnership”);
- The Domestic Partnership owns 100% of a third controlled foreign corporation (“CFC3”);
- CFC3 has “Subpart F income” (*i.e.*, income of the type that is subject to the current income regime of Code § 951(a)(1)) (collectively, the “Transaction” -- see Figure A)<sup>2</sup>

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Pursuant to the Transaction, Taxpayer was taking the position that there was no income inclusion under Code § 951(a) with respect to CFC3's Subpart F income. The rationale for this position appears to be that (i) Domestic Partnership is a "person"<sup>3</sup> and (ii) Domestic Partnership therefore can meet the requirements to be the first "United States shareholder" with respect to CFC3. As discussed below, current income inclusion of Subpart F income takes place with respect to the "United States shareholders" of a CFC. As a result, the argument would run, the Subpart F "taint" does not flow further up the chain to CFC1 and CFC2, and thence to Taxpayer (the "Taxpayer's Position"). The interposition of the Domestic Partnership, it was argued, had effectively "blocked" the Subpart F income.

The IRS, however, has concluded that the Taxpayer's Position is contrary to the purpose and intent of Code § 951. The IRS's solution to this problem is to treat the Domestic Partnership as a foreign partnership for purposes of Code § 951(a). Therefore the Domestic Partnership is *not* the first United States shareholder in the chain of ownership of CFC3, and current income inclusion related to CFC3 is not "blocked" by its insertion into the chain of ownership.

### **Statutory Background**

Under Code § 951(a), if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every "person" who is a "United States shareholder" of such corporation and who owns stock of such corporation on the last day of such year must include in gross income such person's *pro rata* share of the corporation's "Subpart F income" as well as any amount determined under Code § 956 with respect to such shareholder.<sup>4</sup>

A CFC is a foreign corporation in which "United States shareholders" together own more than 50% of the voting power or total stock value of the foreign corporation (the "50% Vote/Value Test").<sup>5</sup> A "United States shareholder" is a United States person that owns 10% or more of the voting power of the foreign corporation.<sup>6</sup> For purposes of applying the 50% Vote/Value Test and the United States shareholder test, both actual and constructive ownership are taken into account. Under Code § 958(a)(2), proportionate ownership of stock is attributed up through foreign entities to the first United States person in the ownership chain. Additionally, under Code § 958(b), Code § 318 constructive ownership rules are

applied, with certain modifications. Stock constructively owned under Code § 958(b), however, is not considered owned for purposes of Code § 951(a).

Code § 957(c) defines a "United States person" by reference to Code § 7701(a)(30). Under Code § 7701(a)(30)(B), a United States person includes a "domestic" partnership. Code § 7701(a)(4) provides that the term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by Regulations. Furthermore, Code § 7701(a) provides that any general definition included therein does not apply where such definition is "manifestly incompatible" with the intent of the relevant Code provision.

### **New Regulations**

The Regulations to be issued shall apply to taxable years of a domestic partnership ending on or after May 14, 2010 (the "Effective Date"). These Regulations generally will classify an otherwise domestic partnership as a foreign partnership solely for purposes of identifying the United States shareholders of a CFC required to include in gross income the amounts determined under Code § 951(a) with respect to such CFC. The Notice specifically provides that the new Regulations will cause a reclassification if the following conditions are met:

The partnership is a United States shareholder of a CFC; and  
If the partnership were treated as foreign,

- i) That foreign corporation would continue to be a CFC; and
- ii) At least one United States shareholder of the CFC,
  - a) Would be treated under Code § 958(a) as indirectly owning stock of the CFC owned by the partnership that is indirectly owned by a foreign corporation; and
  - b) Would be required to include an amount in gross income under Code § 951(a) with respect to the CFC.

### **Scope and Application of The New Regulations**

The reclassification of a domestic partnership as a foreign partnership in accordance with the Regulations will be used solely for the purpose of identifying "United States shareholders" of a CFC

who, as a result of such reclassification, would be required to include in gross income the amounts determined under Code § 951(a) with respect to an applicable CFC.

The reclassification will not have an impact on other areas of the Code including: 1) sourcing of income and expenses; 2) the definition of U.S. property under Code § 956(c)(1)(C), 3) the application of Code § 1248(a) and 4) information reporting obligations (Forms 1065 and 5471).

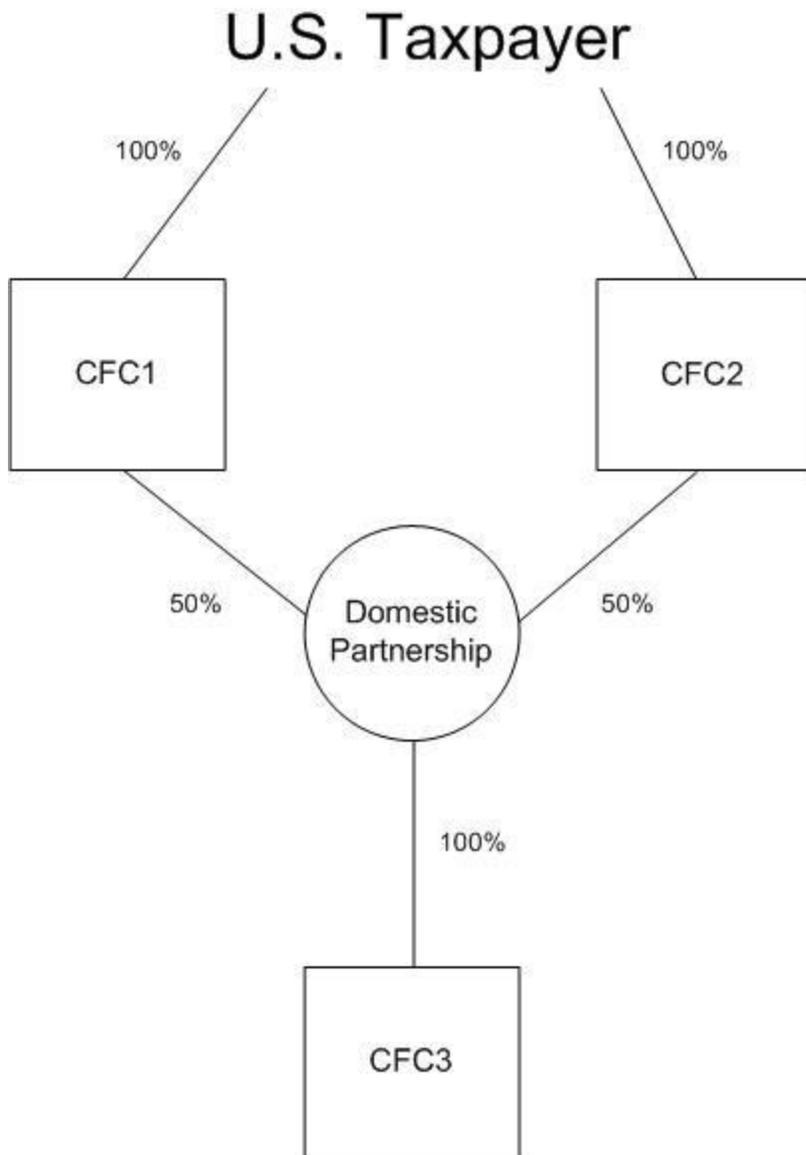
### **Additional Key Points**

The IRS has stated that no inference should be made by the issuance of the Notice for the treatment of a domestic partnership for a taxable year ending before the Effective Date. The IRS may still challenge the treatment of such domestic partnerships, including under the recently codified economic substance doctrine, the provisions of Subchapter K and F of the Code or under the judicial doctrines of "sham transaction" and "substance over form."<sup>7</sup>

The Regulations will likely capture any attempt to evade their application through the use of tiered partnerships.

### **Conclusion**

This is simply another example of the IRS's continued attempts to attack cross border transactions. With the current budget climate we expect such attempts to continue, if not increase in frequency. Taxpayers should exercise increased caution in the structuring of their international operations in this environment. Manatt, Phelps & Phillips, LLP's attorneys stand ready to assist you with any questions you may have.



**Figure A**

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<sup>1</sup>All section references contained herein are to the Code or the Treasury Regulations (the "Regulations") promulgated thereunder, unless otherwise specified.

<sup>2</sup> The Notice also covers transactions whose facts are "substantially similar" to those described herein.

<sup>3</sup> Code § 7701(a)(1) defines "person" to include a "partnership."

<sup>4</sup> See *also* Code § 951(a)(1)(A)(ii) and (iii) for other required

inclusions.

<sup>5</sup> § 957. Code § 7701(a)(5) defines the term foreign when applied to a corporation or a partnership as a corporation that is not domestic.

<sup>6</sup> Code § 951(b).

<sup>7</sup> This article does not address the potential validity of the Taxpayer's Position before the Effective Date of the Regulations.

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**For additional information on this issue, contact:**



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