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CLIENT ALERT

Treasury and IRS Issue New Regulations Regarding Treatment of Domestic Partnerships for Purposes of GILTI and Subpart F

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AUTHORS

Hillel N. Jacobson | Christopher J. Peters | Russell Pinilis | Yaniv Maman

On June 14, 2019, the Treasury Department and Internal Revenue Service issued (a) final regulations providing for the aggregate treatment of a domestic partnership for purposes of determining the global intangible low-taxed income ("GILTI") of its U.S. partners (the "Final GILTI Regulations") and (b) proposed regulations extending such aggregate treatment of a domestic partnership for purposes of determining the Subpart F income of its U.S. partners (the "Proposed Regulations").

General Background

In general, a U.S. Shareholder of a controlled foreign corporation ("CFC") must include in gross income its pro rata share of the CFC's Subpart F income for a taxable year. A U.S. Shareholder is a U.S. person that owns (or is considered to own through attribution) at least 10% of the combined voting power or value of the stock of a CFC. A CFC is any foreign corporation whose U.S. Shareholders own, in the aggregate, stock representing more than 50% of its combined voting power or value. Subpart F income generally consists of earnings of a CFC that are passive and certain other types of income.

The GILTI regime was introduced as part of the U.S. Tax Cuts and Jobs Act in 2017 and is intended to supplement a U.S. Shareholder's inclusion of Subpart F income discussed above. Similar to the inclusion of Subpart F income, new Internal Revenue Code ("Code") Section 951A requires a U.S. Shareholder of a CFC to include in gross income its GILTI for each taxable year. A U.S. Shareholder's GILTI inclusion generally equals its share of the CFC's non-Subpart F income earnings less 10% of the CFC's tax basis in its tangible assets. In the case of a corporate U.S. Shareholder, a deduction is available equal to 50% of such corporation's GILTI inclusion. In addition, a corporate U.S. Shareholder may also credit a portion of any non-U.S. income taxes paid by the CFC against its GILTI (subject to certain limitations).

Treatment of Domestic Partnerships

Under existing law, a domestic partnership is treated as a separate entity for purposes of determining if (a) U.S. Shareholders own more than 50% of the combined voting power or value of a foreign corporation and (b) such domestic partnership has an inclusion of Subpart F income with respect to a CFC and, if so, the extent of such inclusion. As a result, a domestic partnership that constitutes a U.S. Shareholder of a CFC must include in income its share of the CFC's Subpart F income, which it then must allocate among its partners in accordance with their distributive shares, regardless of whether each such partner is itself a U.S. Shareholder with respect to such CFC.

In contrast, one generally looks through a foreign partnership for purposes of making the aforementioned determinations. Whether a foreign corporation owned by a foreign partnership is a CFC is determined based on the proportionate amount of stock owned by the domestic partners of the foreign partnership and, if the foreign corporation is a CFC, only a partner of the foreign partnership that is itself a U.S. Shareholder will have an inclusion of Subpart F income to the extent of its proportionate ownership.

In the case of GILTI, proposed regulations from October 2018 adopted a hybrid approach to the treatment of a domestic partnership. Under that approach, a domestic partnership that is a U.S. Shareholder with respect to a CFC is treated as a separate entity with respect to its partners that are not U.S. Shareholders of such CFC, but is looked through with respect to its partners that are U.S. Shareholders of such CFC. The ultimate effect of such approach is to impose an inclusion of GILTI on all taxable U.S. partners of a domestic partnership treated as a U.S. Shareholder: either through a distributive share of the domestic partnership's GILTI (in the case of taxable U.S. partners that are not U.S. Shareholders of the underlying CFC) or directly (in the case of partners that are themselves U.S. Shareholders of the underlying CFC).

The Final GILTI Regulations and Proposed Regulations simplify the treatment of partnerships by extending the look-through treatment that applies to a foreign partnership to a domestic partnership for purposes of determining inclusions of Subpart F income and GILTI. A domestic partnership, however, will continue to be treated as a separate entity for purposes of determining whether a foreign corporation is a CFC. Thus, for example, under the new regulations, a foreign corporation that is wholly-owned by a domestic partnership will continue to be treated as a CFC by virtue of the domestic partnership's stock ownership. However, only those partners of the domestic partnership that are themselves U.S. Shareholders with respect to the CFC will be required to take into account their pro rata share of the CFC's Subpart F income and GILTI, which will be determined in accordance with their indirect ownership of the foreign corporation.

It is important to note that a domestic partnership will, however, continue to be treated as a separate entity for purposes of determining any deemed dividends upon the sale of a CFC under Code Section 1248. Therefore, in the previous example, the domestic partnership may still be required to re-characterize a portion of its gain on the sale of the CFC's stock as dividend income, which would then be allocated among its partners in accordance with their distributive shares, regardless of the indirect ownership percentages of such partners with respect to the foreign corporation.

Overall, the Final GILTI Regulations and Proposed Regulations will benefit many partners of domestic partnerships that hold investments in CFCs, either directly or indirectly through other pass-through entities. Specifically, in the case of private equity funds that invest in CFCs through a pass-through structure, there are less likely to be significant inclusions of Subpart F income and GILTI with respect to the fund's ownership in such CFCs, as the ultimate ownership of each CFC is likely fractured enough to prevent most limited partners from constituting a U.S. Shareholder.

Applicability Dates

The rules regarding the aggregate treatment of a domestic partnership for purposes of determining the GILTI of its U.S. partners apply to taxable years of a foreign corporation beginning after December 31, 2017, while the rules regarding the aggregate treatment of a domestic partnership for purposes of determining the Subpart F income of its U.S. partners will generally apply to taxable years of a foreign corporation beginning on or after the date on which the Proposed Regulations become final. However, the Proposed Regulations permit a domestic partnership to apply aggregate treatment for Subpart F purposes to taxable years of a foreign corporation beginning after December 31, 2017 as well, as long as it applies such treatment consistently across all of its ownership in foreign corporations.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Hillel N. Jacobson	**Christopher J. Peters**	**Russell Pinilis**	**Yaniv Maman**
212 728 8655	212 728 8868	212 728 8242	713 510 1762
hjacobson@willkie.com	cpeters@willkie.com	rpinilis@willkie.com	ymaman@willkie.com