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Pursuing Justice

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TAXATION
A Section of the American Bar Association

January 16, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 951A in Relation to Passthrough Entities and their Owners

Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations related to Section 951A of the Internal Revenue Code in relation to passthrough entities and their owners. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Douglas L. Poms, International Tax Counsel, Department of the Treasury
Brian Jenn, Deputy International Tax Counsel, Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations under Section 951A in Relation to Passthrough Entities and their Owners

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ari S. Berk and Morgan K. Hann. Substantial contributions were made by Jennifer H. Alexander. These Comments were reviewed by Joan C. Arnold of the Committee on Government Submissions and Eric B. Sloan, Vice-Chair for Government Relations for the Tax Section.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 16, 2019

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I. Executive Summary

These Comments address the Proposed Regulations[1] regarding global intangible low-taxed income ("GILTI") under section 951A[2] and related provisions and the interaction of the Proposed Regulations with partnerships and their partners. Section 951A was enacted by Public Law 115-97 (the "Act") on December 22, 2017.[3] The Proposed Regulations have an effective date that generally applies to the taxable years of foreign corporations that begin after December 31, 2017, and to taxable years of U.S. shareholders[4] in which or with which such taxable years of foreign corporations end.[5]

Below is a summary of our recommendations. Part II of these Comments provides certain background information on the adoption of section 951A, and Part III provides a more detailed discussion of the recommendations.

We recommend that the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issue the following guidance:

1. Provide a special rule for a foreign passthrough entity to make basis adjustments to directly-held controlled foreign corporation ("CFC")[6] stock (or property by reason of which the foreign passthrough entity is treated as owning CFC stock under section 958(a)) with regard to the GILTI inclusion of a domestic partner of the foreign passthrough entity, similar to the specified basis adjustments prescribed by the proposed regulations under section 965.

    a. We respectfully request that such basis adjustments be made with respect to the appropriate partner and be treated as section 743(b) adjustments for all purposes of the Code.

    b. In addition, we recommend rules to coordinate the application of section 961(b) with these basis adjustments and the rules of section 743(b).

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[1] 83 Fed. Reg. 51,072 (October 10, 2018).

[2] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Regulation section" references are to the Treasury regulations promulgated under the Code, all as in effect on the date of these Comments.

[3] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054.

[4] A United States shareholder ("U.S. Shareholder") is a United States person who owns, within the meaning of section 958(a) or (b), 10 percent of the stock of the foreign corporation, measured by vote or value. I.R.C. § 951(b).

[5] 83 Fed. Reg. 51,072, at 51,084.

[6] A CFC "means any foreign corporation if more than 50 percent of 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 as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation." I.R.C. § 957(a).

2. Adopt a pure aggregate approach with respect to domestic partnerships that are U.S. Shareholders of controlled foreign corporations. To effectuate the aggregate approach, the domestic partnership would be treated as a foreign partnership for purposes of GILTI. Alternatively, if the pure aggregate approach is not adopted, we recommend a pure entity approach under which a domestic partnership is respected as a U.S. Shareholder.

3. If, contrary to our suggestion immediately above, neither the pure aggregate nor pure entity approach is adopted, we recommend an alternative approach to the hybrid methodology of the Proposed Regulations with respect to domestic partnerships that is intended to:

    a. Avoid the distortions to the economic arrangements of such partnerships that may occur under the approach prescribed by the Proposed Regulations (because of the interaction of the Proposed Regulations with the partnership capital accounting rules);

    b. Reach the appropriate partner-level results with respect to basis adjustments and exclusions of previously taxed income under sections 961 and 959, respectively; and

    c. Reduce the administrative burden on Treasury, the Service, and taxpayers with regard to compliance with the GILTI provisions for these domestic partnerships and their partners.

4. Clarify that any domestic corporation that owns the stock of a CFC through a partnership, whether domestic or foreign, qualifies for the section 250 deduction to the extent the domestic corporate partner either has a direct inclusion of GILTI under section 951A or receives a distributive share of a domestic partnership's GILTI inclusion under section 951A.

5. Clarify that, with respect to a controlled domestic partnership that is treated as a foreign partnership for purposes of sections 951 through 964 under Proposed Regulation section 1.951-1(h), the partnership is treated as a foreign partnership with respect to all of its partners.

6. Clarify that certain partnership basis adjustments, such as section 743(b) adjustments, are taken into account for purposes of determining the disqualified basis of certain property resulting from disqualified transfers by CFCs during the disqualified period.

7. Clarify the computation of the amounts of disallowed deductions attributable to disqualified basis with respect to property that has disqualified basis and basis other than disqualified basis.

8. Clarify that the partnership qualified business asset investment ("QBAI")[7] ratio is determined with respect to the gross taxable income, rather than the gross section 704(b) income, of a partnership that is included in a CFC partner's tested income.

9. Clarify whether the partnership QBAI ratio takes into account allocations under section 704(c), including allocations of remedial income.

10. Provide a special rule that takes into account a tested income CFC partner's partnership QBAI with respect to a partnership that is owned by the CFC during the CFC's taxable year but not on the last day of such taxable year.

11. Clarify that the partnership QBAI rules apply to the adjusted basis of specified tangible property of a partnership that is owned by a CFC indirectly through one or more other partnerships.

12. Clarify that section 743(b) basis adjustments that are allocated to items of partnership specified tangible property are included in partnership QBAI and provide special rules for including the adjusted basis of such section 743(b) basis adjustments in the QBAI of the CFC partner with respect to which the section 743(b) basis adjustment was made.

[7] QBAI "means, with respect to any controlled foreign corporation for any taxable year, the average of such corporation's aggregate adjusted bases as of the close of each quarter of such taxable year in specified tangible property used in a trade or business of the corporation, and of a type with respect to which a deduction is allowable under section 167." I.R.C. § 951A(d)(1).

II. Background

Prior to the Act, the United States generally subjected U.S. persons to taxation on a worldwide basis. Although income earned by a U.S. person was ultimately expected to be taxed by the United States, the inclusion of earnings for U.S. persons that engaged in business or investment through foreign subsidiaries was generally deferred until the earnings were repatriated or otherwise required to be included under anti-deferral regimes, such as Subpart F of the Code ("Subpart F").

The Act kept in place the Subpart F regime and introduced, among other things, taxation of a U.S. Shareholder's GILTI under section 951A. Similar to Subpart F, the GILTI regime operates to require the current inclusion of certain earnings of foreign subsidiaries in the income of U.S. persons who meet the relevant ownership test.

On October 10, 2018, the Proposed Regulations were published in the Federal Register providing rules for, among other things, the computation of GILTI and the application of the GILTI rules in the context of partnerships that own stock of a CFC. For a detailed discussion of the background of the Act with respect to GILTI and related provisions, see the Section of Taxation's Comments on the Proposed Regulations Concerning Section 951A submitted on November 21, 2018.[8]

Regarding partnerships specifically, the Proposed Regulations address certain partnership blocker structures,[9] the inclusion of certain tax basis of specified tangible property owned by a partnership in the QBAI of a CFC partner,[10] and special rules for determining the GILTI inclusions of domestic partnerships and their domestic partners.[11] These provisions, and our recommendations relating to these provisions, are discussed in detail below.

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[8] ABA Section of Taxation, *Comments on the Proposed Regulations Concerning Section 951A* (November 21, 2018), *available at* https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/112118comments.pdf (the "General GILTI Comments").

[9] Prop. Reg. § 1.951-1(h).

[10] Prop. Reg. § 1.951A-3(g).

[11] Prop. Reg. § 1.951A-5.

III. Discussion

A. Special Basis Adjustments for Foreign Partnerships

The GILTI provisions that relate to U.S. Shareholders who are treated as owning CFC stock indirectly through a foreign partnership under section 958(a) are generally consistent with the Subpart F provisions that apply to U.S. Shareholders, foreign partnerships, and CFCs in similar circumstances. This consistency is helpful as taxpayers adapt to the new and developing international tax framework established by the Act. However, it also causes uncertainties that exist under current law to be extended to the new GILTI provisions. For example, there is no provision in section 961 for adjusting the basis of stock or other property held by a foreign partnership, and practitioners disagree as to whether a foreign partnership, the outside basis of which is adjusted under section 961(a), may (or must) adjust the basis in stock of a CFC in which the partnership holds stock, although there is widespread agreement that it would, as a tax policy matter, be appropriate to make such adjustments.

The proposed regulations under section 965 acknowledge this uncertainty and provide specified basis adjustments for foreign passthrough entities in these circumstances.[12] We recommend that the regulations under section 951A provide for similar special basis adjustments to be made by foreign partnerships[13] with respect to CFC stock (or property by reason of which the foreign partnership owns CFC stock under section 958(a)(2)) by reference to the GILTI inclusion amount of a U.S. Shareholder, to the extent that the U.S. Shareholder's GILTI inclusion amount is attributable to the stock of the CFC owned by the U.S. Shareholder through the foreign partnership under section 958(a)(2). Such special basis adjustments would result in an increase[14] to the foreign partnership's basis of CFC stock to the extent that the U.S. Shareholder partner to which the basis adjustment is attributable (the "Relevant U.S. Partner") increases the basis of its interest in the partnership under section 961(a).

We further recommend that these special basis adjustments made by a foreign partnership be made using the framework of section 743(b).[15] Section 743(b) has an established and well understood framework for computing and managing basis

[12] Prop. Reg. § 1.965-2(h)(5)(ii). The final regulations under section 965 had been released (*available at* https://www.irs.gov/pub/irs-drop/td%20%28reg-104226-18%29.pdf) but not yet published in the Federal Register as of the date that these Comments were submitted; therefore these Comments will generally refer only to the proposed regulations under section 965 unless otherwise indicated.

[13] And other passthrough entities, as appropriate.

[14] These special basis adjustments are not expected to result in a decrease to the basis of CFC stock held by a partnership because they are correlative adjustments based on section 961(a), and section 961(a) provides only for an increase to basis. See our recommendation below regarding the application of section 961(b)(1), which provides for negative adjustments to basis.

[15] This secondary recommendation is identical to the recommendation we made for purposes of associating a specified basis adjustment under Prop. Reg. § 1.965-2(h)(5)(ii) with the owner of the foreign passthrough entity (that is a U.S. Shareholder of the CFC that is owned through the foreign passthrough entity under section 958(a)(2)) with respect to which the specified basis adjustment was made.

adjustments that are allocated to property owned by a partnership and that are only with respect to a certain partner.

Basis adjustments under section 743(b) are generally made only if there is a sale or exchange of an interest in a partnership.[16] Nevertheless, in 1986, Temporary Regulations under section 367(a) (the "Section 367(a) Temporary Regulations") adopted section 743(b) as a mechanism to associate basis adjustments with a partner who recognizes gain under section 367(a) (as a result of a partnership's transfer of property to a foreign corporation) even though there is no actual sale or exchange of an interest in the partnership.[17]

In order to provide a section 743(b) adjustment with respect to a partner that is treated as transferring a proportionate share of the property of a partnership to a foreign corporation, the Section 367(a) Temporary Regulations provide that (i) the partner's basis in the partnership is increased by the amount of gain recognized by the partner under section 367(a) and (ii) solely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the partner is treated as having a newly acquired interest in the partnership for an amount equal to the gain recognized.[18] Thus, the Section 367(a) Temporary Regulations make an adjustment to the basis of the partner's partnership interest and then allow an adjustment to be made to the partnership's basis in the stock of the foreign corporation under section 743(b) to account for the difference between the partner's basis in the (deemed newly acquired) partnership interest and the partner's share of the partnership's basis in the stock of the foreign corporation.

The long-standing basis adjustment rules under section 743(b) have provided an administrable method of computing and managing basis adjustments necessitated by section 367(a) in a manner consistent with the purposes of section 367(a) and Subchapter K of the Code ("Subchapter K"). We recommend that the regulations under section 951A apply the rules of section 743(b) for purposes of associating the recommended special basis adjustment made by a foreign passthrough entity with the Relevant U.S. Partner.[19] We further recommend that the rules of the Regulations, when finalized,

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[16] Section 743(b) adjustments may also be made upon the death of a partner.

[17] T.D. 8087, 1986-1 C.B. 175.

[18] Temp. Reg. § 1.367(a)-1T(c)(3)(i)(B) ("If a U.S. person is treated under the rule of this paragraph (c)(3)(i) as having transferred a proportionate share of the property of a partnership in an exchange described in section 367(a), and is therefore required to recognize gain upon the transfer, then (1) [t]he U.S. person's basis in the partnership shall be increased by the amount of gain recognized by him; (2) [s]olely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the U.S. person shall be treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754; and (3) [t]he transferee foreign corporation's basis in the property acquired from the partnership shall be increased by the amount of gain recognized by U.S. persons under this paragraph (c)(3)(i).").

[19] If the Relevant U.S. Partner owns the foreign passthrough entity indirectly through another foreign passthrough entity (an "upper-tier foreign passthrough entity"), section 743(b) and the principles of Temp.

applying section 743(b) for this purpose follow the framework established by Temporary Regulation section 1.367(a)-1T(c)(3)(i)(B).[20]

If Treasury and the Service adopt our recommendations to provide special basis adjustments to CFC stock owned by a foreign partnership and associate such adjustments with partners under section 743(b), we also recommend that the final regulations provide that section 961(b) applies only at the partnership level. Section 961(b)(1) provides that "the adjusted basis of stock or other property with respect to which a U.S. shareholder or a U.S. person receives an amount which is excluded from gross income under section 959(a) shall be reduced by the amount so excluded." Where a distribution of previously taxed income ("PTI") is made by a CFC through a foreign partnership to a U.S. Shareholder that previously included income of the CFC in gross income (*e.g.*, under Subpart F or GILTI), the basis adjustment under section 961(b)(1) may apply to "the adjusted basis of stock" of the CFC. If the section 961(b)(1) basis reduction is applied to the partnership's basis in the stock of the CFC, a corresponding negative adjustment to the partner's basis in the partnership is expected to be made under section 705(a)(2)(B) because the basis reduction constitutes a non-deductible expense of the partnership.[21] Likewise, we believe that the amount of the distribution that was excluded from gross income under section 959(a) would be treated as tax exempt income of the partnership, increasing the partner's basis in the partnership under section 705(a)(1)(B). Because section 705(a) operates to naturally decrease and increase the basis of the partnership interest in an amount corresponding to the partnership's basis reduction under section 961(b)(1), we believe that section 961(b)(1) should not be applied again at the partner level (*i.e.*, it should not apply to reduce the partner's basis in the partnership interest).[22] This result is consistent with the language of section 961(b)(1) applying the basis reduction to "stock *or* other property."[23]

Reg. § 1.367(a)-1T(c)(3)(i)(B) should apply to associate the specified basis adjustment of a foreign passthrough entity with the upper-tier foreign passthrough entity that owns an interest in the foreign passthrough entity.

[20] We recommend that similar rules be applied with regard to subpart F inclusions of U.S. Shareholders that own stock of CFCs (within the meaning of section 958(a)(2)) through foreign partnerships and, in the case of transition tax, we have recommended that similar rules be applied with regard to the specified basis adjustments under Prop. Reg. § 1.965-2(h)(5)(ii). *See* ABA Section of Taxation, *Comments on the Proposed Regulations Addressing Section 965* (October 29, 2018)*, available at* https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/102918comments1.pdf.

[21] *See* Rev. Rul. 96-10, 1996-1 C.B. 138, and Rev. Rul. 96-11, 1996-1 C.B. 140. *See also* Reg. §§ 1.358-7(b) and 1.362-4(e)(1) (both relating to the treatment of a decrease in the basis of stock owned by a partnership as a noncapital, nondeductible expenditure for purposes of section 705(a)(2)(B)).

[22] *See* Example 3 in II.B.4. below for an illustration of the results of this approach to making basis adjustments with respect to a distribution of PTI through a domestic partnership.

[23] Emphasis added.

B. U.S. Shareholder Partnerships and their Partners

The Proposed Regulations adopt a blended framework for a domestic partnership that is a U.S. Shareholder of a CFC (a "U.S. Shareholder Partnership"). With respect to a partner of the U.S. Shareholder Partnership that is itself a U.S. Shareholder of a CFC, the stock of which is owned by the U.S. Shareholder Partnership within the meaning of section 958(a) (a "U.S. Shareholder Partner"), an aggregate approach applies. An entity approach applies, however, with respect to a partner who is not a U.S. Shareholder Partner.

Specifically, a U.S. Shareholder Partnership determines its GILTI inclusion amount under the general rules applicable to U.S. Shareholders for GILTI purposes (the "General Partnership Rule").[24] Then, each partner of the domestic partnership that is not a U.S. Shareholder Partner takes into account its distributive share of the partnership's GILTI inclusion amount (if any) (the "Small Partner Rule").[25] A U.S. Shareholder Partner, on the other hand, (1) is treated as owning the section 958(a) stock[26] of the CFC that is owned by the U.S. Shareholder Partnership in the same manner as if the partnership were a foreign partnership, (2) determines its pro rata share of the CFC tested items of the CFC by reference to the section 958(a) stock of the CFC that is treated as owned by the U.S. Shareholder Partner, and (3) determines its distributive share of the partnership's GILTI inclusion amount without regard to any CFC tested item of a CFC with respect to which the U.S. Shareholder Partner is a U.S. Shareholder (the "Special U.S. Shareholder Partner Rule").[27] The Proposed Regulations clearly provide that a single domestic partnership can be subject to both the Small Partner Rule and the Special U.S. Shareholder Partner Rule if (1) a partner is a U.S. Shareholder of at least one, but not all, CFCs owned by the partnership or (2) at least one partner is a U.S. Shareholder of a CFC owned by the partnership and at least one partner is not a U.S. Shareholder of the CFC.[28]

As explained in the preamble, the purpose of the proposed blended framework is to "harmoniz[e] the treatment of domestic partnerships and their partners across all provisions of the GILTI regime (sections 250, 951A, and 960(d))."[29] We agree with Treasury and the Service that the goal of special rules for domestic partnerships should be harmonization of the rules, specifically among domestic partnerships, their partners, and the provisions and purposes of the GILTI regime within the context of the existing worldwide system of taxation and the Act's amendments thereto. Our comments primarily relate to concerns and recommendations that are intended to further harmonize

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[24] Prop. Reg. § 1.951A-5(b)(1).

[25] Prop. Reg. § 1.951A-5(b)(2).

[26] Section 958(a) stock, as defined at Prop. Reg. § 1.951A-1(e)(3), means stock of a CFC owned (directly or indirectly) by a U.S. Shareholder within the meaning of section 958(a).

[27] Prop. Reg. § 1.951A-5(c).

[28] *See* Prop. Reg. § 1.951A-5(g), Ex. (3).

[29] 83 Fed. Reg. 51,072, at 51,079.

(or decrease the degree of conflict) of the Proposed Regulations with the rules applicable to domestic partnerships and their partners.

Our comments are organized to first describe the consequences and issues of the Proposed Regulations in relation to Subchapter K and then provide recommendations, including an alternative framework, to address these concerns.

1. <u>Capital Accounts</u>

Under the General Partnership Rule, a U.S. Shareholder Partnership that owns section 958(a) stock of a CFC determines its GILTI inclusion amount at the partnership level. Under the general rules of Subchapter K, an item of income that is recognized by a partnership is allocated to one or more partners and the aggregate amount of the allocations to the partners with respect to that item of partnership income equals the amount of the item of income at the partnership level.[30]

In general, a partner's capital account in a partnership is increased to the extent that the partnership allocates income to that partner.[31] However, where the Special U.S. Shareholder Partner Rule applies, it appears that the U.S. Shareholder Partner may not have an allocation of a U.S. Shareholder Partnership's GILTI that increases the partner's capital account.

The Proposed Regulations do not provide any rules coordinating the special rules for U.S. Shareholder Partnerships with the adjustments that are made to partners' capital accounts. While the capital accounting framework of Subchapter K generally accommodates special rules for the recognition of partnership income and/or allocation of partnership income to partners, there are potential distortions to the partners' capital accounts of a U.S. Shareholder Partnership if both the Small Partner Rule and the Special U.S. Shareholder Partner Rule apply to the U.S. Shareholder Partnership. The following example illustrates the uncertainties and latent consequences of the potential capital accounting issues posed by the Proposed Regulations.

> <u>Example 1.</u> <u>Facts.</u>[32] A domestic partnership, PRS, has two domestic corporate partners, US1 and US2, owning 5 percent and 95 percent of PRS, respectively. PRS owns 100 percent of the single class of stock of FC1, a CFC with tested income for purposes of GILTI of $100 in Year 1. US1 is not a U.S. Shareholder Partner, and US2 is a U.S. Shareholder Partner, with respect to FC1.

[30] *See, in general,* §§ 702, 703(a), 704(b), and 706(a).

[31] *See* Reg. § 1.704-1(b)(2)(iv)(*b*) providing that, *inter alia*, a partner's capital account is "increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section…"

[32] The facts of this example are similar to those of the example in I.F. of the preamble to the Proposed Regulations. *See* 83 Fed. Reg. 51,072, at 51,080.

US2 also owns 100 percent of the single class of stock of FC2, a CFC with tested loss of $20 in Year 1. All entities have taxable years ending December 31.

Analysis. PRS has a GILTI inclusion amount of $100 (equal to $100 of tested income from FC1).[33] US1 has a distributive share of PRS's GILTI inclusion amount equal to $5 (5% of PRS's $100 GILTI inclusion amount).[34] In the absence of the Special U.S. Shareholder Partner Rule, "US2's distributive share of PRS's GILTI inclusion amount would be $[95]" (95% of PRS's $100 GILTI inclusion amount) and US2's pro rata share of FC2's tested loss "would be unused."[35] However, taking into account the Special U.S. Shareholder Partner Rule, (i) US2's distributive share of PRS's GILTI inclusion amount is zero because its distributive share is determined without regard to PRS's pro rata share of tested items from FC1, and (ii) US2's GILTI inclusion amount is $75 (equal to $95 pro rata share of tested income from FC1, less $20 of tested loss from FC2).

In Example 1, the $5 of the GILTI inclusion amount that is allocated to US1 increases US1's capital account in PRS.[36] Normally, PRS would also allocate $95 of the GILTI inclusion amount to its 95% partner, US2. However, under Proposed Regulation section 1.951A-5(c)(1), US2 determines its distributive share of PRS's GILTI inclusion amount "without regard to [PRS's] pro rata share of any CFC tested item" of the CFCs owned by PRS with respect to which US2 is a U.S. Shareholder. Thus, US2 has no distributive share of GILTI from PRS, and it appears that no adjustment would be made to US2's capital account in PRS to reflect the GILTI with respect to FC1 under the Proposed Regulations.

A partnership that intends to be within the substantial economic effect safe harbor provided by the Regulations under section 704(b) generally maintains capital accounts in accordance with such Regulations and makes liquidating distributions to partners in accordance with positive capital account balances.[37] If US1's capital account was increased by $5 and US2's capital account was increased by $95, the economic arrangement of the partners would be reflected in the capital accounts and, upon liquidation of the partnership, distributions would be made to each partner in a manner consistent with that economic arrangement.

[33] Prop. Reg. § 1.951A-5(b)(1).

[34] Prop. Reg. § 1.951A-5(b)(2).

[35] 83 Fed. Reg. 51,072, at 51,080 (explaining that treating the domestic partnership as an entity would foreclose the opportunity for a partner to utilize a tested loss from a CFC owned without the domestic partnership to offset tested income of a CFC owned through the domestic partnership).

[36] Reg. § 1.704-1(b)(2)(iv)(*b*).

[37] *See* Reg. § 1.704-1(b). The other requirements for satisfying substantial economic effect are not discussed herein.

However, as noted above, US2's capital account may not be adjusted because US2 has no distributive share of GILTI from PRS.[38] In this case, the aggregate increase in the partners' capital accounts would be only $5 (with respect to US1) and would not equal the partnership's GILTI inclusion amount of $100. This disparity, unless corrected, would distort the economic arrangement of the partners if the partnership maintains capital accounts and makes liquidating distributions in accordance with the substantial economic effect safe harbor under Regulation section 1.704-1(b).[39] In addition, there are no rules of general application in the Regulations under section 704(b) or the Proposed Regulations that would operate to correct this disparity. Thus, this disparity in the capital accounts between US1 and US2, and the resulting impairment of the economic deal underlying the partnership, would persist indefinitely.

Fundamentally, the potential for the Proposed Regulations to cause a material distortion to the economic arrangement of the partners of a U.S. Shareholder Partnership is present in any case where (i) at least one partner of the partnership applies the Special U.S. Shareholder Partner Rule with respect to a CFC owned by the partnership and at least one partner applies the Small Partner Rule with respect to a CFC owned by the partnership (a "Hybrid GILTI Partnership"),[40] or (ii) the partnership agreement provides for preferred interests or special allocations.[41]

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[38] Prop. Reg. § 1.951A-5(c)(1). Reg. § 1.704-1(b)(2)(iv)(*q*) provides a special rule for adjusting capital accounts where guidance is lacking. Adjustments made in accordance with this special rule are generally made in manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based on federal tax accounting principles. It is uncertain whether the amount that would be allocated to the U.S. Shareholder Partner in the absence of the Special U.S. Shareholder Partner Rule could be treated as a positive basis adjustment under Reg. § 1.704-1(b)(2)(iv)(*q*). In certain cases, the partnership agreement could provide for certain other allocations or revaluations to be made in a manner that mitigates the distortionary impact to the partners' capital accounts, but not all of the concerns with the hybrid entity/aggregate approach of the Proposed Regulations may be addressed with provisions of a partnership agreement.

[39] Similar issues regarding the distortion of the economic arrangement among the partners are present for partnerships that use distribution-driven partnership agreements (because, for example, the hypothetical distribution required by most distribution-driven partnership agreements could result in a portion of the book value attributable to the partnership's GILTI inclusion with respect to a non-U.S. Shareholder Partner's GILTI being allocated to a U.S. Shareholder Partner, and such allocations could become circular because any amount of GILTI allocated to a U.S. Shareholder Partner would not be taken into account under the Special U.S. Shareholder Partner Rule).

[40] As illustrated by Prop. Reg. § 1.951A-5(g), Example 3, a single partner may apply the Special U.S. Shareholder Partner rule with respect to one CFC owned by the U.S. Shareholder Partnership and the same partner may apply the Small Partner Rule with respect to another CFC owned by the same U.S. Shareholder Partnership.

[41] Even if the Special U.S. Shareholder Partner Rule is applied with respect to all partners and all CFCs of the partnership, the approach of the Proposed Regulations may distort the economic arrangement of a partnership with preferred interests or special allocations (because, for example, the U.S. Shareholder Partnership would not have any GILTI to allocate to any partner and the lack of allocations for one item of partnership income could impair the partnership's ability to specially allocate other partnership items).

Treasury and the Service have expressed compelling reasons to apply both the Special U.S. Shareholder Partner Rule and the Small Partner Rule to a Hybrid GILTI Partnership for purposes of computing the GILTI inclusion amounts of the partnership and partners, and Proposed Regulation section 1.951A-5(c) indicates a clear intention to limit the application of the Special U.S. Shareholder Partner Rule "for purposes of section 951A and the section 951A regulations." However, giving effect to the Special U.S. Shareholder Partner Rule also has adverse impacts on the partners' capital accounts and, by extension, the economic arrangement that the partners intend to achieve by engaging in business together through a partnership. We recommend that the Proposed Regulations should be modified to avoid the potential distortion of economic realities among a domestic partnership and its partners. Our recommended approach to addressing these issues is described in detail below in Part III.B.4.

2. Basis Adjustments

In general, a partner's basis in its partnership interest is increased to the extent that the partner receives an allocation of taxable income from the partnership.[42] In addition, section 961 generally provides for adjustments to the basis of certain property held by a U.S. Shareholder that has a subpart F income inclusion with respect to a CFC. Section 951A(f)(1)(A) and Proposed Regulation section 1.951A-6(b)(1) provide that a GILTI inclusion amount is treated as an amount included under section 951(a)(1)(A)[43] (*i.e.*, subpart F income) for purposes of, *inter alia*, applying the PTI rules under section 959 and the special basis adjustment rules under section 961 (the "Subpart F Equivalency Rule").

As described above, under the Special U.S. Shareholder Partner Rule, the U.S. Shareholder Partner has a GILTI inclusion amount determined by reference to the CFC tested items of the CFC owned through the domestic partnership and the U.S. Shareholder Partner does not take into account its distributive share of the U.S. Shareholder Partnership's GILTI inclusion amount. There are no provisions coordinating the Subpart F Equivalency Rule with the Special U.S. Shareholder Partner Rule. Thus, it is not clear whether the Subpart F Equivalency Rule applies at the level of a U.S. Shareholder Partnership or, in a situation where the Special U.S. Shareholder Partner Rule applies, at the level of a U.S. Shareholder Partner. The application of the basis adjustment rules under section 961 necessarily follows the level at which the GILTI inclusion is treated as a subpart F inclusion because the basis adjustment rules are operative with respect to the subpart F income of a U.S. Shareholder.

Similarly, the Proposed Regulations have the potential to distort the economic arrangement of a partnership the allocations of which change between the time of the inclusion and the time of the distribution of the earnings associated with the inclusion.

[42] I.R.C. § 705(a)(1)(A); Reg. § 1.705-1(a)(2)(i).

[43] Section 951(a)(1)(A) generally provides that a U.S. Shareholder includes in income its pro rata share of a CFC's subpart F income.

The first part of the Special U.S. Shareholder Partner Rule provides that, "for purposes of section 951A and the section 951A regulations, section 958(a) stock of a partnership CFC owned by a U.S. Shareholder Partnership is treated as section 958(a) stock owned proportionately be each U.S. Shareholder Partner…in the same manner as if the U.S. Shareholder Partnership were a foreign partnership under section 958(a)(2) and § 1.958-1(b)."[44] However, there is no rule providing that the U.S. Shareholder Partnership is treated as a foreign partnership for other purposes. For instance, it appears the U.S. Shareholder Partner treats the U.S. Shareholder Partnership as a U.S. person through which it is considered to own CFC stock under section 958(b) for purposes of sections 958, 959, and 961. As a result, if the Subpart F Equivalency Rule and section 961 are applied at the level of the U.S. Shareholder Partner, it appears that the U.S. Shareholder Partner's interest in the partnership may not be considered property of a type that is eligible for an increase in basis under section 961(a) (*i.e.*, "property of a [U.S.] shareholder by reason of which [the U.S. Shareholder Partner] is considered under section 958(a)(2) as owning stock of a [CFC]") because section 958(a)(2) refers specifically to "foreign entities" and the domestic partnership is not a foreign entity.

Alternatively, if the U.S. Shareholder Partnership's GILTI inclusion amount is the appropriate amount to be treated as subpart F income for purposes of section 961, there is no rule indicating whether the partnership's GILTI inclusion amount should be adjusted to take into account the amount, if any, of the U.S. Shareholder Partnership's GILTI inclusion amount that is disregarded by a U.S. Shareholder Partner under the Special U.S. Shareholder Partner Rule.

Similarly, there are no provisions coordinating the Special U.S. Shareholder Partner Rule with adjustments to the basis of a partner's partnership interest under section 705(a). Thus, it is not clear whether any adjustment should be made to a U.S. Shareholder Partner's basis in a U.S. Shareholder Partnership with respect to the amount that would be the U.S. Shareholder Partner's distributive share of the U.S. Shareholder Partnership's GILTI inclusion amount in the absence of the Special U.S. Shareholder Partner Rule.

The following example illustrates the uncertainties and potential consequences of basis adjustments that are present when applying the Subpart F Equivalency Rule at the level of the U.S. Shareholder Partner in a situation in which the Special U.S. Shareholder Partner Rule applies.

> <u>Example 2.</u> <u>Facts.</u>[45] A domestic partnership, PRS, has two domestic corporate partners, US1 and US2, owning 5 percent and 95 percent of PRS, respectively. PRS owns 100 percent of the single class of stock of FC1, a CFC with tested income for purposes of GILTI of $100 in Year 1. US1 is not a U.S. Shareholder Partner, and US2 is a U.S. Shareholder Partner, with respect to FC1.

[44] Prop. Reg. § 1.951A-5(c).

[45] The facts are the same as Example 1.

US2 also owns 100 percent of the single class of stock of FC2, a CFC with tested loss of $20 in Year 1. All entities have taxable years ending December 31.

Analysis. PRS has a GILTI inclusion amount of $100 in Year 1.[46] US1 has a distributive share of PRS's GILTI inclusion amount equal to $5 (5% of PRS's $100 GILTI inclusion amount).[47] In the absence of the Special U.S. Shareholder Partner Rule, US2 would have a distributive share of PRS's GILTI inclusion amount equal to $95. However, taking into account the Special U.S. Shareholder Partner Rule, US2 has no distributive share of GILTI from PRS and has a pro rata share of tested income from FC1 ($95) and tested loss from FC2 ($20) for a GILTI inclusion amount of $75.

US1 increases its basis in its interest in PRS by $5, the amount of its distributive share of PRS's GILTI inclusion amount.[48] US2 has no distributive share of income from PRS because US2 does not take into account its distributive share of PRS's GILTI inclusion amount attributable to FC1, a CFC with respect to which US2 is a U.S. Shareholder. Accordingly, US2 makes no adjustment to its basis in its interest in PRS under section 705(a).

PRS has a GILTI inclusion amount of $100 before application of the Special U.S. Shareholder Partner Rule. After the application of the Special U.S. Shareholder Partner Rule, it is not clear, under the Subpart F Equivalency Rule, whether PRS should increase its basis in the stock of FC1 by the $95 of PRS's GILTI inclusion that is allocated to neither US1 nor US2. Thus, it is unclear whether, in Year 1, PRS (a U.S. Shareholder) increases the basis of its stock in FC1 (a CFC) by $5 or $100 under section 961(a).

Applying the Subpart F Equivalency Rule to the U.S. Shareholder Partner (US2) results in US2 treating its GILTI inclusion amount ($75) as an inclusion under section 951(a)(1)(A). Generally, as a U.S. Shareholder that includes in gross income the subpart F income of a CFC that it owns indirectly, US2 would make an adjustment to the basis of the property by reason of which US2 is treated as owning CFC stock under section 958(a)(2).[49] However, there is no rule in the Proposed Regulations providing that US2 treats PRS as a foreign partnership for any purposes other than "section 951A and the section 951A regulations."[50] If PRS is not treated as a foreign partnership for purposes of section 961, it appears that US2 would not be able to make any adjustment under section 961(a) because

[46] Prop. Reg. § 1.951A-5(b)(1).

[47] Prop. Reg. § 1.951A-5(b)(2).

[48] I.R.C. § 705(a)(1)(A).

[49] I.R.C. § 961(a).

[50] Prop. Reg. § 1.951A-5(c).

it would not directly own FC1 stock and it would not own any property by reason of which it would be treated as owning FC1 stock under section 958(a)(2).[51]

In summary, PRS has likely increased its basis in the stock of FC1 by only \$5 under section 961(a), US1 has increased its basis in PRS by \$5 under section 705(a), and US2 has made no adjustment to the basis of its direct interest in PRS or its indirect interest in the stock of FC1.

The basis adjustments made in Example 2 do not reflect the general principles of section 705(a) (under which a partner's basis in its partnership interest is generally increased for the amount of the partner's income derived from the partnership) and section 961(a) (under which a U.S. Shareholder's basis in CFC stock, or an interest in a foreign entity through which a U.S. Shareholder is treated as owning CFC stock under section 958(a)(2), is generally increased by the amount of the U.S. Shareholder's subpart F inclusion derived from the CFC).

3. Previously Taxed Income[52]

In general, a distribution of the earnings and profits ("E&P") of a CFC that is attributable to amounts that have been included in the gross income of a U.S. Shareholder under section 951(a) is excluded from gross income to the extent the distribution is made (directly or indirectly) to the U.S. Shareholder with respect to which the inclusion was made under section 951(a).[53] In addition, as described above, the Subpart F Equivalency Rule of section 951A(f)(1)(A) and Proposed Regulation section 1.951A-6(b)(1) provides that a GILTI inclusion amount is treated as an amount included under section 951(a)(1)(A) for purposes of applying the PTI rules under section 959.

As noted above, the Proposed Regulations do not provide rules to coordinate the Special U.S. Shareholder Partner Rule with the Subpart F Equivalency Rule. Thus, it is not clear whether the Subpart F Equivalency Rule applies at the level of a U.S. Shareholder Partnership or, in a situation in which the Special U.S. Shareholder Partner Rule applies, at the level of a U.S. Shareholder Partner. The application of the PTI rules necessarily follows the level at which the GILTI inclusion is treated as a subpart F inclusion because the PTI rules are operative with respect to the subpart F income of a U.S. Shareholder.

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[51] If PRS is treated as a domestic partnership for purposes of section 961, US2 would be treated as owning the stock of FC1 under section 958(b), not section 958(a)(2). Alternatively, if PRS is treated as a foreign partnership for purposes of section 961, it appears that US2 would increase its basis in its PRS interest for the amount of subpart F income included in US2's income with respect to FC1 (\$75) because the PRS interest would be treated as property by reason of which US2 owns stock of FC1 under section 958(a)(2) as required by section 961(a).

[52] The interactions of PTI with the E&P and tested income (or loss) of a CFC are beyond the scope of these Comments. Rather, these Comments focus primarily on the interaction of the PTI rules with the hybrid entity/aggregate approach to U.S. Shareholder Partnerships.

[53] I.R.C. § 959(a).

For instance, if a U.S. Shareholder Partner has a GILTI inclusion amount under the Special U.S. Shareholder Partner Rule, under one approach the U.S. Shareholder Partner would treat that GILTI amount as an amount included under section 951(a)(1)(A) pursuant to the Subpart F Equivalency Rule. Following this approach, the amount so treated would be classified as E&P under section 959(c)(2) because the amount is included in the gross income of that U.S. Shareholder Partner under section 951(a)(1)(A). In addition, a distribution by the CFC to the U.S. Shareholder Partnership and a distribution by the U.S. Shareholder Partnership to the U.S. Shareholder Partner would then be subject to the potential exclusion from income for PTI distributions under section 959(a).[54]

Specifically, section 959(a) provides that certain amounts "distributed to…[the U.S.] shareholder…directly or indirectly through a chain of ownership described under section 958(a)" shall not "be again included in the gross income of such [U.S.] shareholder." However, a distribution by a CFC, through a U.S. Shareholder Partnership, to a U.S. Shareholder Partner would be made through a chain of ownership described under section 958(a) (with respect to the partnership's ownership of the CFC stock) *and* section 958(b) (with respect to the stock owned by the partnership that is constructively owned by the partner). In the absence of a special rule allowing for (1) the distribution through a chain of ownership described under section 958(b) or (2) the treatment of the U.S. Shareholder Partnership as a foreign partnership with respect to the U.S. Shareholder Partner for purposes of section 959, there may be no exclusion of the distribution from the income of the U.S. Shareholder Partner under the terms of section 959(a). That is, if the Subpart F Equivalency Rule is applied at the U.S. Shareholder Partner, meaning that the GILTI (*i.e.*, subpart F) inclusion is at the partner level and not at the U.S. Shareholder Partnership, the distribution by the CFC to the U.S. Shareholder Partnership would not excluded from the U.S. Shareholder Partnership's gross income because the U.S. Shareholder Partnership may not be the U.S. Shareholder that previously included the subpart F income in its gross income for purposes of section 959(a) (because not all of the U.S. Shareholder Partnership's GILTI inclusion was included in the gross income of a partner).

Applying the PTI and basis adjustment rules of sections 959 and 961 at the level of the U.S. Shareholder Partner (in situations where the Special U.S. Shareholder Partner Rule applies) can create uncertainty as to the taxable income and allocations of the U.S. Shareholder Partnership through which distributions of PTI are made. The following example illustrates issues presented by applying the Subpart F Equivalency Rule at the level of a U.S. Shareholder Partner in situations where the Special U.S. Shareholder Partner Rule applies.

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[54] Many practitioners do not believe a distribution by a CFC to a *foreign* partnership must be further distributed to a U.S. Shareholder Partner in order for the distribution to qualify for the exclusion under section 959(a). However, in the case of a distribution by a CFC to a *domestic* partnership, a distribution by the U.S. Shareholder Partnership to the U.S. Shareholder Partner may be necessary for the reasons described in this Part III.B.3.

Example 3. Facts.[55] A domestic partnership, PRS, has two domestic corporate partners, US1 and US2, owning 5 percent and 95 percent of PRS, respectively. PRS owns 100 percent of the single class of stock of FC1, a CFC with tested income for purposes of GILTI of $100 in Year 1. US1 is not a U.S. Shareholder Partner, and US2 is a U.S. Shareholder Partner, with respect to FC1. US2 also owns 100 percent of the single class of stock of FC2, a CFC with tested loss of $20 in Year 1. In addition, in Year 2, FC1 and FC2 have no tested income or loss, FC1 distributes $100 to PRS, and PRS distributes $5 and $95 to US1 and US2, respectively. All entities have taxable years ending December 31.

Analysis. It appears that $80 of FC1's E&P should be considered to be described by section 959(c)(2) because PRS is treated as having a subpart F inclusion of $5 and US2 is treated as having a subpart F inclusion of $75 with respect to FC1.[56] Accordingly, in Year 2, FC1 distributes $80 of E&P described in section 959(c)(2) and $20 of E&P described in section 959(c)(3).

PRS excludes $5 of the distribution from income under section 959(a) because PRS is a U.S. Shareholder that receives a direct distribution of PTI E&P from FC1, a CFC. In addition, PRS's distribution of $5 to US1 does not result in gain under section 731(a) because US1 has at least $5 of basis in its PRS interest before the distribution (as a result of the allocation of GILTI to US1 in Year 1 and the application of section 705(a)).[57]

However, it is not clear whether PRS also excludes from income the $75 of section 959(c)(2) E&P distributed by FC1 because that PTI is attributable to US2 and therefore it may be that PRS is not the U.S. Shareholder to which section 959(a) applies. PRS presumably recognizes $20 of dividend income under section 301(c)(1) with respect to the distribution of E&P described in section 959(c)(3).[58]

The purposes of section 959(a) suggest that the distribution of $75 of E&P described in section 959(c)(2) should be excluded from US2's gross income because US2 previously included $75 of GILTI with respect to FC1. However, if PRS is respected as a domestic partnership for purposes of section 959 (with respect to US2), section 959(a) may not apply to the distribution because the distribution by PRS to US2 is made in a chain of ownership described, in part,

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[55] The facts are the same as Example 1 except that there is a distribution made in Year 2.

[56] *See* I.R.C. § 951A(f) and Prop. Reg. § 1.951A-6(b).

[57] *See* Example 2, supra, for a discussion of the adjustments to US1's basis in its interest in PRS. It is assumed, but not entirely clear, that the $5 of excluded income and the corresponding amount of the distribution is attributable to US1. It is also assumed that there are no adjustments made to US1's basis in its PRS interest other than those related to the partner's distributive share of GILTI and the distribution of cash.

[58] The dividend may be eligible for the section 245A participation redemption to the extent it is allocated to US2, which is a U.S. Shareholder of FC1.

under section 958(b). If PRS is also respected as a domestic partnership for purposes of section 961 (with respect to US2), US2 may not increase the basis of its PRS interest under section 961(a).[59] In this case, assuming that PRS allocates all of its Year 2 taxable dividend income to US2 (*i.e.*, the sum of the $75 distribution of section 959(c)(2) E&P and the $20 distribution of section 959(c)(3) E&P), US2 would recognize $95 of taxable income in Year 2 because the amount of the distribution of section 959(c)(2) E&P ($75) may not be excluded from US2's income under section 959(a).[60] As a result, with respect to its share of FC1's Year 1 income ($95), US2 would have recognized total taxable income of $170 (equal to $75 of GILTI in Year 1, plus $95 of dividend income in Year 2).

Alternatively, the taxable income distortion to US2 may be corrected if US2 applies an aggregate approach to PRS, for example, by treating PRS as a foreign partnership for purposes of GILTI and related provisions.[61] If US2 treats PRS as a foreign partnership for purposes of sections 959 and 961, US2 would recognize only $20 of taxable income in Year 2 because US2 would receive an allocation of $95 of dividend income from PRS in Year 2, $75 of which would be excluded from US2's income under section 959(a) (because that amount would be treated as distributed through a chain of ownership described in section 958(a)).[62] In addition, the distribution by PRS to US2 would not give rise to any section 731(a) gain to US2 because the amount of the distribution ($95) would be equal the sum of (1) US2's increase to the basis of its PRS interest in Year 1 ($75) under section 961(a) as a result of US2's GILTI inclusion attributable to the stock of FC1 owned through PRS, plus the increase to the basis of its PRS interest in Year 2 ($20) under section 705(a)(1)(A) as a result of the allocation of the dividend income from PRS.[63] As a result, with respect to its share of FC1's Year 1 income ($95), US2 would have recognized total taxable income of $95 (equal to $75 of GILTI in Year 1, plus $20 of dividend income in Year 2).

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[59] *See* Example 2, supra, for a discussion of why US2 may not be able to make any adjustment under section 961(a) if US2 does not treat PRS as a foreign partnership for purposes of section 961.

[60] The basis of US2's interest in PRS is increased (by $95) under section 705(a)(1)(A) for its distributive share of PRS's dividend income in Year 2 before the cash distribution (of $95) is taken into account for purposes of section 731(a) because it is assumed that the cash distribution constitutes an advance or draw within the meaning of Reg. § 1.731-1(a)(1)(ii).

[61] See the *Recommended Approach* section in Part II.B.4. of these Comments for further discussion of treating a U.S. Shareholder Partnership as a foreign partnership as a means of applying an aggregate approach to domestic partnerships for purposes of GILTI.

[62] In addition, US2 may be eligible for the section 245A participation exemption with respect to the amount of the distribution that is treated as a dividend ($20).

[63] The basis adjustments (under sections 961(a) and 705(a)(1)(A)) to US2's interest in PRS are taken into account before the cash distribution for purposes of section 731(a) because it is assumed that the cash distribution constitutes an advance or draw within the meaning of Reg. § 1.731-1(a)(1)(ii). It is further assumed that the decrease to US2's basis of its interest in PRS under section 961(b)(1) is taken into account after section 731(a) and that US2's basis of its interest in PRS at such time exceeds $75.

4. Recommended Approach

As outlined in these Comments, the approach of the Proposed Regulations with regard to U.S. Shareholder Partnerships creates issues and uncertainties. Critically, the application of the Special U.S. Shareholder Partner Rule creates the potential for materially distorting the economic arrangement and basis of the partners and the partnership because there are no rules for making appropriate adjustments to the partners' capital accounts and bases. Accordingly, we recommend the following approach to applying section 951A to U.S. Shareholder Partnerships.[64]

One of the principal reasons for conflict between the Proposed Regulations and Subchapter K is that a U.S. Shareholder Partnership is, in part, treated as an entity with regard to its partners that are not U.S. Shareholder Partners and, in part, treated as an aggregate with regard to its U.S. Shareholder Partners. To address this dissonance, the following primary and secondary recommendations are intended to reduce the number of situations in which a U.S. Shareholder Partnership is subject to the application of the hybrid entity/aggregate rules.

The third section below, *Recommendations to Improve the Hybrid Approach Adopted by Proposed Regulations*, includes proposals that are intended to enhance the coordination of the GILTI rules with Subchapter K if a hybrid approach is retained in the final Regulations. In general, under the recommendations to the hybrid method, the general GILTI rules are applied to partnerships that are U.S. Shareholders of CFCs and then adjustments are made, at the partner level, to take into account the U.S. Shareholder aggregation principles that apply to the computation of GILTI. The recommendations for the hybrid approach address some, but not all, of the issues identified in these Comments regarding the framework of the Proposed Regulations.

i. Primary Recommendation – Adopt an Aggregate Approach by Treating Domestic Partnerships as Foreign Partnerships

Our primary recommendation is for the regulations under section 951A to adopt an aggregate approach with respect to U.S. Shareholder Partnerships. To accomplish the aggregate approach, we recommend treating U.S. Shareholder Partnerships as foreign partnerships for all purposes of GILTI (and related provisions, such as section 958, 959, 960, and 961, to the extent those provisions are applied for GILTI purposes) (the "Primary Recommendation").[65] Treating a domestic partnership as a foreign partnership

[64] Our recommended approach does not address all aspects of applying all provisions of Subchapter K in concert with section 951A and other key provisions of GILTI (*e.g.*, sections 250, 959, 960, and 961). Our recommendations are intended to enhance the harmony, and reduce the dissonance, of the current framework of the Proposed Regulations with key provisions of Subchapter K. We would be happy to work with Treasury and the Service to develop these recommendations into a more comprehensive set of rules to be implemented in the final Regulations.

[65] To the extent that a U.S. Shareholder Partnership is treated as a foreign partnership under this primary recommendation, it would be treated as a foreign partnership with respect to all of its partners.

to accomplish the aggregate approach allows taxpayers to rely on the existing framework of Subpart F.

We believe this aggregate approach is appropriate for all U.S. Shareholder Partnerships. However, if this aggregate approach is not adopted for all U.S. Shareholder Partnerships, we recommend that the aggregate approach is at least applied to U.S. Shareholder Partnerships with respect to which U.S. Shareholder Partners own a certain percentage interest in the partnership's capital or profits. For instance, the Regulations may adopt a rule under which a U.S. Shareholder Partnership is treated as a foreign partnership if at least 80 percent[66] of the interests in partnership capital or profits are owned (directly or indirectly) by U.S. Shareholder Partners (a "Controlled U.S. Shareholder Partnership").[67] Under this rule, a domestic partnership that is not a Controlled U.S. Shareholder Partnership, would be treated as an entity (*i.e.*, treated as a U.S. Shareholder that allocates GILTI to its partners) for GILTI purposes. Alternatively, if Treasury and the Service do not adopt a threshold test for treating a domestic partnership as a foreign partnership, we recommend that, in cases where all partners of a U.S. Shareholder Partnership are U.S. Shareholder Partners with respect to all CFCs in which the U.S. Shareholder Partnership owns stock under section 958(a), the U.S. Shareholder Partnership be treated as a foreign partnership for GILTI purposes.[68]

Treating a Controlled U.S. Shareholder Partnership as a foreign partnership for GILTI purposes would resolve the capital accounting issues and many of the basis adjustment, PTI, and administrative concerns identified in these Comments. In addition, this approach would achieve many of the objectives highlighted in the preamble to the Proposed Regulations. For example, this approach would allow a U.S. Shareholder Partner "to determine a single GILTI inclusion amount by reference to all of its CFCs, whether owned directly or indirectly through a partnership."[69] Adopting the Controlled

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[66] We recommend an 80 percent threshold because that percentage balances the interests of applying an aggregate approach that is intended to achieve the appropriate partner-level GILTI results with the potential for distortions that may be present if there are too many partners that are not U.S. Shareholder Partners. An 80 percent ownership threshold is also used in the temporary regulations under section 721(c) for purposes of coordinating the relevant partnership and international rules. *See* Temp. Reg. § 1.721(c)-1T(b)(14). Other examples of 80 percent thresholds include long-standing provisions such as section 368(c) (defining "control" for many purposes of Subchapter C of the Code) and section 1504(a)(2) (defining affiliation of corporations). Other percentages may be considered, but the critical recommendation is to adopt some threshold at which the domestic partnership is treated as a foreign partnership for GILTI purposes.

[67] This recommendation for Controlled U.S. Shareholder Partnerships is similar to the rule in the Proposed Regulations for treating certain controlled domestic partnerships as foreign partnerships for purposes of sections 951 through 964. Similar approaches to applying aggregate principles to domestic partnerships by treating them as foreign partnerships for purposes of foreign anti-deferral provisions were adopted by: Notice 2009-7, 2009-1 C.B. 312; Notice 2010-41, 2010-1 C.B. 715; and Prop. Reg. § 1.965-1(e) (83 Fed. Reg. 39,514 (August 9, 2018)).

[68] In other words, the alternative recommendation is to apply the aggregate approach to U.S. Shareholder Partnerships with respect to which there is no opportunity for a minority interest partner to avoid including GILTI in its gross income.

[69] 83 Fed. Reg. 51,072, at 51,079.

U.S. Shareholder Partnership rule would also allow "a corporate U.S. shareholder to calculate a foreign tax credit under section 960(d) with respect to each CFC and to compute a section 250 deduction with respect to its GILTI inclusion amount determined by reference to each such CFC."[70] Furthermore, this approach would have the advantage of aligning GILTI, to the greatest degree possible, with the existing provisions for subpart F income which are operative with respect to many provisions of the new GILTI regime.

Although this approach does not result in a minority-interest partner receiving a distributive share of GILTI, such a partner would, in any case, have taxable income as a result of a dividend or gain[71] with respect to the CFC stock because a minority-interest partner would not be a U.S. Shareholder of the CFC and section 245A would not be available to the partner.[72] In other words, the Controlled U.S. Shareholder Partnership rule would not allow a non-U.S. Shareholder Partner to avoid taxation with respect to its accretion of wealth that is attributable to the tested income of a partnership CFC; rather, the non-U.S. Shareholder Partner would recognize income under other generally applicable provisions of the Code (*e.g.*, as dividend income, capital gain, or inclusions with respect to a passive foreign investment company[73]).

ii. <u>Secondary Recommendation – Entity Approach</u>

If Treasury and the Service do not adopt our Primary Recommendation, we alternatively recommend that the Regulations under section 951A apply a pure entity approach with respect to U.S. Shareholder Partnerships (the "<u>Secondary Recommendation</u>").[74] The two principal reasons for recommending the entity approach are that (i) it would conform to the treatment of domestic partnerships for purposes of Subpart F (which is relatively established and understood under existing law) and (ii) it would avoid much of the complexity and the Subchapter K issues that are present with a hybrid approach. The preamble to the Proposed Regulations provided several reasons for rejecting such an approach. However, the two reasons noted above, in our view, make a compelling case that the entity approach may be preferable to a hybrid approach.

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[70] *Id*.

[71] Gain may occur as a result of a taxable disposition or a distribution to which section 301(c)(3) applies.

[72] In addition, many non-U.S. Shareholder Partners are not domestic corporations and, for that reason, would not be eligible for the section 245A participation exemption.

[73] A passive foreign investment company is a foreign corporation, other than a CFC, if (1) 75 percent or more of the gross income of the foreign corporation for the taxable year is passive income or (2) the average percentage of assets held by the foreign corporation produce (or are held to produce) passive income for the taxable year is at least 50 percent. I.R.C. § 1297(a).

[74] Under the "pure entity" approach, a U.S. Shareholder Partnership would be treated as a domestic partnership (*i.e.*, a U.S. person that is a U.S. Shareholder and has a GILTI inclusion with respect to CFCs the stock of which the domestic partnership owns within the meaning of section 958(a)) for all purposes of GILTI.

iii. **Recommendations to Improve the Hybrid Approach Adopted by Proposed Regulations**

If the final Regulations under section 951A continue to apply a hybrid entity/aggregate approach to U.S. Shareholder Partnerships, we recommend an alternative framework for the application of section 951A to U.S. Shareholder Partnerships (the "Alternative Framework") to address many, but not all, of the issues identified earlier in these Comments. In general, the Alternative Framework would apply the general GILTI rules to partnerships that are U.S. Shareholders of CFCs and then makes adjustments, at the partner level, that take into account the U.S. Shareholder aggregation principles that apply to GILTI. The fundamental principles of the Alternative Framework are (1) treating a U.S. Shareholder Partnership as the U.S. Shareholder that has a GILTI inclusion, (2) having each partner take into account its distributive share of a U.S. Shareholder Partnership's GILTI inclusion (regardless of whether each partner is a U.S. Shareholder), and (3) adjusting the GILTI amount, at the partner level, for certain GILTI attributes that the partner has outside of the U.S. Shareholder Partnership to reflect the adjustments to the partner's GILTI amount that are attributable to the U.S. Shareholder Partnership. In other words, this framework essentially applies an entity approach at the partnership level and then applies an aggregate approach at the partner level in a manner that reflects the overall GILTI inclusion of that partner to the extent the overall GILTI inclusion of that partner is attributable to the U.S. Shareholder Partnership.

To implement the Alternative Framework, we recommend a three-part general rule (the "Recommended General Rule") providing that:

a. A U.S. Shareholder Partnership determines its GILTI inclusion amount under the general rules for U.S. Shareholders under section 951A (consistent with Proposed Regulation section 1.951A-5(b)(1));
b. All partners of the U.S. Shareholder Partnership take into account their distributive shares of the U.S. Shareholder Partnership's GILTI inclusion amount allocated to them under section 704; and
c. Each U.S. Shareholder Partner takes into account its distributive share of the U.S. Shareholder Partnership's GILTI inclusion amount and then makes adjustments to the partner's overall GILTI inclusion amount ("Recommended Partner-Level Adjustments").

The Recommended Partner-Level Adjustments would be made according to the following principles:

First, the U.S. Shareholder Partnership would determine its GILTI inclusion amount under the Recommended General Rule and allocates that GILTI to its partners under section 704.

Second, each partner would determine the aggregate amount of its distributive share of GILTI from all U.S. Shareholder Partnerships in which it is a direct partner (or an indirect partner through one or more other partnerships).

Third, each partner would determine its GILTI inclusion amount or its net CFC tested loss, as the case may be, under the general rules of the Proposed Regulations, without regard to any CFC tested items that were taken into account by any U.S. Shareholder Partnership in which it is a partner (the "Separate Non-Partnership GILTI Amount").[75] The partner's total GILTI inclusion amount would be equal to the sum of the amount of its distributive share of GILTI inclusion amounts from U.S. Shareholder Partnerships and the amount of the Separate Non-Partnership GILTI Amount (whether positive or negative).[76] If the Separate Non-Partnership GILTI Amount is negative, the amount by which the partner's aggregate distributive share of GILTI from all U.S. Shareholder Partnerships exceeds the partner's total GILTI inclusion amount would be the "Partner-Level GILTI Reduction."[77]

The Recommended General Rule would apply without regard to whether a partner of the U.S. Shareholder Partnership is a U.S. Shareholder of any CFC the stock of which is owned by the U.S. Shareholder Partnership under section 958(a). In addition, because the Recommended Partner-Level Adjustments are intended to be attributable to each partner in a manner that results in the appropriate amounts of basis adjustments and exclusions from gross income for distributions of PTI with respect to each partner, the Recommended General Rule would be coordinated with sections 959 and 961 by providing that the PTI and Basis adjustments are to be made by the U.S. Shareholder

[75] Stated differently, each partner would compute what its GILTI inclusion amount or net CFC tested loss would be if the partner only took into account its pro rata share of CFC tested items from CFCs owned directly or indirectly under section 958(a).

[76] If the sum of these amounts is negative, the partner's total GILTI inclusion amount would be limited to zero.

[77] It is intended that the Partner-Level GILTI Reduction would have the same effect in most cases as netting the net CFC tested loss of the partner, as determined without regard to the CFC stock owned by U.S. Shareholder Partnerships, with the net CFC tested income (and the QBAI and other CFC tested items) attributable to the CFC stock owned by U.S. Shareholder Partnerships, to the extent the taxpayer is a partner in such partnerships. However, in certain situations, the partner's GILTI inclusion amount after application of the Partner-Level GILTI Reduction may not be exactly the same as the results of the Special U.S. Shareholder Partner Rule of the Proposed Regulations. For example, if a partner owns two CFCs directly, one of which is a tested income CFC with tested income of $90 and QBAI of $100 and the other of which is a tested loss CFC with a tested loss of $100, and that partner owns 50% of a U.S. Shareholder Partnership that owns a CFC with tested income of $100, the partner's distributive share of GILTI ($50) would be reduced by the negative amount of the Separate Non-Partnership GILTI Amount (-$10) to arrive at a GILTI inclusion amount for the partner of $40. If the Proposed Regulations were applied to the same facts, the directly-held tested income CFC's QBAI would be taken into account and the partner's GILTI inclusion amount would be $30 (equal to $40 of net CFC tested income, minus $10 deemed tangible income return). Similarly, the partner's GILTI inclusion would have been $30 if the U.S. Shareholder Partnership was treated as a foreign partnership (as suggested in our primary recommendation above). Finally, the partner's GILTI inclusion would have been $50 if a pure entity approach were applied to the same facts. We believe that the limited cases of divergence between the results of the Proposed Regulations and the results of the Alternative Framework are justified in the context of both (1) the degree to which the recommended approach simplifies administration and information keeping and reporting and (2) the general principle that anti-deferral inclusions are different for U.S. persons that invest in foreign corporations through domestic, as opposed to foreign, partnerships.

Partnership in the same manner as such adjustments are made with respect to subpart F income included in the gross income of a domestic partnership.

For purposes of applying section 960(d), each partner would be required to determine the extent to which its GILTI inclusion amount is allocable to tested income CFCs owned by the U.S. Shareholder Partnership under the principles of section 951A(f)(2) and Proposed Regulation section 1.951A-6(b)(2). To provide the information necessary to make this determination, the U.S. Shareholder Partnership would be required to provide each partner with the partner's share of the partnership's amount of tested income from each tested income CFC owned by the partnership (the "Share of Partnership Tested Income").

We believe the Alternative Framework would achieve the government's goals because a non-U.S. Shareholder Partner of the U.S. Shareholder Partnership would include in income its distributive share of the U.S. Shareholder Partnership's GILTI even though the partner would have no such inclusion if the U.S. Shareholder Partnership were not a U.S. Shareholder of a CFC.[78] The Alternative Framework is also favorable because the particular adjustments that would be made to address the coordination of GILTI with the attributes of a partner would be made at the partner level rather than making adjustments at the partnership level that could frustrate the economic arrangement of the partners.

In addition, the Alternative Framework would be administrable in terms of (1) relying on the well-understood existing framework and mechanical rules for applying Subpart F to domestic partnerships and their partners, (2) reducing the need for novel and rigorous information keeping and reporting,[79] (3) reducing the need for complex rules to address capital accounts, basis adjustments, and previously taxed income for common domestic partnership scenarios in which there is little or no potential for abuse, and (4) avoiding the distortions to capital accounts maintained under section 704(b), basis adjustments made under section 705, basis adjustments made under section 961, and exclusions from income for previously taxed E&P under section 959 as noted elsewhere in these Comments.

One shortcoming of the Alternative Framework is that it does not allow a partner to utilize a net CFC tested loss of a U.S. Shareholder Partnership in which it is a partner. To address this, Treasury and the Service may want to consider a special rule under which (1) the U.S. Shareholder Partnership would report each partner's proportionate share of the amount of net CFC tested loss for the partnership taxable year to its partners

[78] The preamble to the Proposed Regulations indicated that one of the reasons for proposing a hybrid approach was to cause each non-U.S. Shareholder Partner to take "into income its distributive share of the domestic partnership's GILTI inclusion amount (similar to subpart F)." 83 Fed. Reg. 51,072, at 51,079.

[79] Under the Alternative Framework, the only attribute of the U.S. Shareholder Partnership that would be necessary to disclose to the partners would be the partner's Share of Partnership Tested Income, and the U.S. Shareholder Partnership would already be required to compute the components of that attribute (*i.e.*, the tested income of each CFC and the partner's distributive share of GILTI) for purposes of determining the GILTI inclusion amount of the U.S. Shareholder Partnership.

(a "Share of Partnership Tested Loss") and (2) the partner would reduce its amount of GILTI computed without regard to the U.S. Shareholder Partnership (but not below zero) by the partner's Share of Partnership Tested Loss.[80] Again, this rule would bring the results of the Alternative Framework closer to those achieved by the Special U.S. Shareholder Partner Rule in the Proposed Regulations, with the benefit of alignment with the principles and operating rules of Subchapter K and the simplified administration that comes from leveraging the existing rules for the interaction of Subpart F and partnerships.

As outlined above, the Alternative Framework is intended to enhance the alignment of section 951A with Subchapter K in general and the other key provisions of the GILTI regime if the final Regulations under section 951A do not adopt a pure aggregate or pure entity approach to U.S. Shareholder Partnerships.

5. Sections 250 and 960(d)

The Proposed Regulations do not address in detail the coordination of the provisions under section 951A with the deduction allowed to domestic corporations in respect of GILTI under section 250 or the foreign taxes deemed to be paid by a domestic corporation (that is a U.S. Shareholder) under section 960(d). As such, a detailed discussion of the coordination of these rules is not within the scope of these Comments. However, in the interest of harmonizing the treatment of U.S. Shareholder Partnerships with the key provisions of the GILTI regime, which include sections 250 and 960(d), these Comments offer observations on the approach of the Proposed Regulations and the approaches discussed in our recommendations.

We believe that a domestic corporation's ownership of CFC stock through a partnership, whether domestic or foreign, should not impair the domestic corporation's ability to claim the section 250 deduction or section 960(d) deemed paid foreign taxes with respect to the domestic corporation's GILTI attributable to the CFC. The conference report to the Act suggests that Congress intended for a domestic corporation to benefit from the section 250 deduction where the domestic corporation has a GILTI inclusion attributable to a CFC owned through a domestic partnership.[81]

i. Coordination with the Proposed Regulations

Under the Small Partner Rule, a domestic corporation that is a partner, but not a U.S. Shareholder Partner, of a U.S. Shareholder Partnership takes into account its distributive share of the partnership's GILTI inclusion amount.

[80] The special rule may consider a reasonable approach to determining each partner's share of the partnership's net CFC tested loss, such as following the same proportion in which the partners would receive a distributive share of GILTI if the partnership instead had a GILTI inclusion amount. In addition, special rules for adjusting the partner's basis in the U.S. Shareholder Partnership may be considered to apply the principles of the adjustments to the basis of CFC stock under Prop. Reg. § 1.951A-6(e).

[81] H.R. Conf. Rep. No. 115-466, at 623 fn. 1517 (2017).

To permit the partners to claim the deduction, the amount of GILTI allocated by a partnership to a domestic corporation should be a separately stated item under Regulation section 1.702-1(a)(8)(ii) because, if the distributive share of GILTI is separately stated and eligible for the section 250 deduction at the partner level, the partner's income tax liability "would be different from that which would result if that partner did not take the item into account separately." In addition, the separately stated item of GILTI allocable to the domestic corporate partner under the Small Partner Rule should be treated by that partner as GILTI "which is included in the gross income of such domestic corporation under section 951A" (as required by section 250(a)(1)(B)(i)) because section 702(b) determines the character of a partner's separately stated item of income "as if the item were realized directly from the source from which realized by the partnership" and the partnership realized the income as an inclusion under section 951A. Accordingly, we believe a domestic corporate partner's distributive share of a partnership's GILTI inclusion amount allocated to it under the Small Partner Rule should qualify for the section 250 deduction because, by application of section 702(b), the domestic corporate partner should be treated as having GILTI "which is included in the gross income of such domestic corporation under section 951A" (as required by section 250(a)(1)(B)(i)).[82]

Under the Special U.S. Shareholder Partner Rule, a domestic corporation that is a U.S. Shareholder Partner computes its GILTI inclusion amount by taking into account its pro rata share of the CFC tested items attributable to the CFC owned by the U.S. Shareholder Partner through the U.S. Shareholder Partnership. We believe the GILTI inclusion amount of such a domestic corporation qualifies for the section 250 deduction because the domestic corporation includes GILTI in its gross income under section 951A (which satisfies the requirement of section 250(a)(1)(B)(i)).

Under section 960(d)(3), tested foreign income taxes are defined by reference to a domestic corporation that is a U.S. Shareholder of a CFC. In addition, under the Proposed Regulations, any domestic corporation that (1) is eligible to be deemed to pay foreign taxes under section 960(d) with respect to a CFC and (2) is a partner of a U.S. Shareholder Partnership that owns stock of that CFC under section 958(a) is treated as a U.S. Shareholder Partner of the U.S. Shareholder Partnership with respect to that CFC.[83] Accordingly, if the Special U.S. Shareholder Partner Rule applies to the domestic corporation and the CFC, the domestic corporation's inclusion of the GILTI inclusion amount under section 951A should satisfy the requirements of section 960(d).[84]

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[82] This approach appears to be consistent with the proposed regulations under section 904, which provide, in part, that "section 951A category income means amounts included (directly *or indirectly through a pass-through entity*) in gross income of United States person under section 951A(a)." Prop. Reg. § 1.904-4(g)(1); emphasis added. 83 Fed. Reg. 63,200 (December 7, 2018).

[83] *See* I.R.C. §§ 951(b), 958(b), and 960(d)(3).

[84] This conclusion appears to be consistent with the proposed regulations under section 960 which include an example illustrating the computation of a U.S. Shareholder Partner's deemed paid tested foreign income taxes with respect to a CFC the stock of which is owned by the U.S. Shareholder Partner through a U.S. Shareholder Partnership. *See* Prop. Reg. § 1.960-2(c)(7), Ex. (2). 83 Fed. Reg. 63,200.

ii. Coordination with the Alternative Framework

As noted above, we believe that the section 250 deduction should be available to any domestic corporation that includes an amount in income by reason of section 951A, including as a result of an allocation of GILTI from a partnership. Our recommendations are consistent with allowing a domestic corporate partner to claim a section 250 deduction with respect to GILTI attributable to a CFC, the stock of which is owned by the partner through the partnership. Under our Primary Recommendation, a domestic corporation that is a partner of a Controlled U.S. Shareholder Partnership would have a direct inclusion of GILTI under section 951A that is attributable to the CFC tested items of a CFC owned by the U.S. Shareholder Partnership. In addition, a domestic corporation that is a partner to which the Secondary Recommendation or the Alternative Framework apply will have a distributive share of the U.S. Shareholder Partnership's GILTI inclusion amount and that item of income should be treated as a separately stated amount included by the domestic corporate partner under section 951A.[85]

We also believe that the deemed paid tested income foreign taxes under section 960(d) should be available to any domestic corporation that is a U.S. Shareholder of a CFC and includes GILTI with respect to that CFC in its income by reason of section 951A, including as a result of an allocation of GILTI from a partnership. Our recommendations are consistent with this belief because a domestic corporation that is a U.S. Shareholder of a CFC the stock of which the domestic corporate partner owns through a U.S. Shareholder Partnership (a "Corporate U.S. Shareholder Partner") would have a GILTI inclusion under section 951A by application of the rule for Controlled U.S. Shareholder Partnerships (by reason of computing and including GILTI in its income at the partner level) or the Secondary Recommendation or the Alternative Framework (by reason of including its distributive share of the partnership's GILTI inclusion amount in its income).

C. Partnership Blocker Structures

The Proposed Regulations provide a special rule that expands upon the reference in Notice 2018-26[86] to Notice 2010-41[87] and, if certain conditions are satisfied, treats a controlled domestic partnership described in Proposed Regulation section 1.951-1(h)(2) (a "CDP") as a foreign partnership for purposes of sections 951 through 964. The special rule is similar to the rule for CDPs in the proposed regulations under section 965. As described more fully below, we recommend that the final Regulations clarify that a CDP that is treated as a foreign partnership for purposes of sections 951 through 964 is treated as a foreign partnership with respect to all partners of the partnership.

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[85] As noted above, we believe that a domestic corporate partner's distributive share of a U.S. Shareholder Partnership's GILTI should be separately stated under Reg. § 1.702-1(a)(8)(ii) and treated as GILTI "which is included in the gross income of such domestic corporation under section 951A" pursuant to section 702(b). I.R.C. § 250(a)(1)(B)(i).

[86] 2018-16 I.R.B. 480.

[87] 2010-1 C.B. 715.

Included in the conditions that must be satisfied to treat a CDP as a foreign partnership, is a requirement that "[i]f the [CDP] (and all other [CDPs] in the chain of ownership of the [CFC] were treated as foreign—"[88]

> At least one United States shareholder of the controlled foreign corporation would be treated as owning (within the meaning of section 958(a)) stock of the controlled foreign corporation through another foreign corporation that is a direct or indirect partner in the controlled domestic partnership.[89]

The definition of CDP provides, in part:

> For purposes of paragraph (h)(1) of this section, the term controlled domestic partnership means, with respect to a United States shareholder described in paragraph (h)(1)(ii)(B) of this section, a domestic partnership that is controlled by the United States shareholder and persons related to the United States shareholder.[90]

Defining the term CDP "with respect to a U.S. shareholder described in [Proposed Regulation section 1.951-1(h)(1)(ii)(B)]" raises the question as to whether a domestic partnership is treated as a CDP with respect to all of its partners or solely with respect to the U.S. Shareholder described in Proposed Regulation section 1.951-1(h)(1)(ii)(B).[91] It appears the intent of the rule is to treat a CDP that satisfies all of the conditions in Proposed Regulation section 1.951-1(h)(1)(i) and (ii) as a foreign partnership with respect to all of its partners for purposes of "determining the stock of a [CFC] owned (within the meaning of section 958(a)) by a U.S. person." Treating a CDP as a foreign partnership with respect to all of its partners is also consistent with the announcement in Notice 2010-41 that Treasury and the Service intended to issue Regulations "treating certain domestic partnerships as foreign partnerships for purposes of identifying which U.S. shareholders are required to include amounts in gross income under section 951(a)."[92]

We recommend that the final Regulations clarify that a CDP that is treated as a foreign partnership for purposes of sections 951 through 964 is treated as a foreign partnership with respect to all partners of the partnership (and not solely with respect to

[88] Prop. Reg. § 1.951-1(h)(1)(ii).

[89] Prop. Reg. § 1.951-1(h)(1)(ii)(B).

[90] Prop. Reg. § 1.951-1(h)(2).

[91] If a CDP is treated as a foreign partnership with respect to only certain partners (*i.e.*, the U.S. Shareholder described in Prop. Reg. § 1.965-1(e)(1)(ii)(B) and related person) but is treated as a domestic partnership as to other partners, there could be various complexities associated with capital accounts, tax basis, and allocations for the same reasons as discussed in Part II.B. of these Comments.

[92] Notice 2018-26, section 2.13.

the United States shareholder described in Proposed Regulation section 1.951-1(h)(1)(ii)(B)).[93]

D. Disqualified Basis Transactions

The Proposed Regulations contain anti-abuse rules relating to the period, if any, with respect to which a CFC's earnings are not subject to inclusion under either section 965 or section 951A (the "Disqualified Period").[94] Generally, a fiscal year CFC has a Disqualified Period beginning on January 1, 2018, and ending on the last day of its last taxable year that began before 2018. The anti-abuse rules generally apply if there is a transfer of specified property by a CFC to a related person during the Disqualified Period and gain is recognized (in whole or in part) (a "Disqualified Transfer").[95] For purposes of determining whether a transaction is a Disqualified Transfer, "a transfer of an interest in a partnership is treated as a transfer of the assets of the partnership" (the "Disqualified Transfer Partnership Look-Through Rule").[96]

Under the anti-abuse rules, any disqualified basis with respect to specified tangible property ("STP") is not included in a CFC's QBAI.[97] In addition, "any deduction or loss attributable to disqualified basis of specified property allocated and apportioned to tested income…is disregarded for purposes of determining tested income or tested loss of a CFC."[98] With respect to STP, disqualified basis is "the excess (if any) of the property's adjusted basis immediately after a disqualified transfer, over the sum of the property's adjusted basis immediately before the disqualified transfer and the qualified gain amount with respect to the disqualified transfer" ("Disqualified Basis").[99]

1. Special Partnership Basis Adjustments

If a CFC transfers an interest in a partnership to a related person during the CFC's Disqualified Period and the CFC recognizes gain (in whole or in part), the transfer is a

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[93] We made a similar recommendation regarding the CDP rule in the proposed regulations under section 965. *See* ABA Section of Taxation, *Comments on the Proposed Regulations Addressing Section 965* (October 29, 2018), *available at* https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/102918comments1.pdf. In the final Regulations under section 965, Treasury and the Service adopted our recommendation and clarified that a domestic partnership that is treated as a foreign partnership under the CDP rule (for purposes of section 965) is treated as a foreign partnership with respect to all partners, and we believe that a similar clarification would be appropriate for the proposed CDP rule in Prop. Reg. § 1.951-1(h). The final regulations under section 965 had been released (*available at* https://www.irs.gov/pub/irs-drop/td%20%28reg-104226-18%29.pdf) but not yet published in the Federal Register as of the date that these Comments were submitted.

[94] Prop. Reg. § 1.951A-3(h)(2)(ii)(D).

[95] Prop. Reg. § 1.951A-3(h)(2)(ii)(C).

[96] *Id.*

[97] Prop. Reg. § 1.951A-3(h)(2)(i).

[98] Prop. Reg. § 1.951A-2(b)(5)(i).

[99] Prop. Reg. § 1.951A-3(h)(2)(ii)(A).

Disqualified Transfer to the extent the CFC is treated as transferring STP of the partnership under the Disqualified Transfer Partnership Look-Through Rule. The rules for determining the amount of Disqualified Basis do not make reference to section 743(b) adjustments (or any other adjustments made by a partnership with respect to partnership property). Rather, such rules refer only to the "property's adjusted basis."[100] We recommend that the Regulations, when finalized, clarify that a property's adjusted basis for purposes of determining the extent to which such property has Disqualified Basis includes any adjustment under sections 743(b) or 734(b) that is allocated to such property under section 755 for Disqualified Transfers that are subject to sections 743(b) or 734(b) and that take place during the Disqualified Period.[101]

2. Property with Disqualified Basis and Other Basis

In general, Disqualified Basis "may be reduced or eliminated through depreciation, amortization…and other methods."[102] Additionally, if STP has some basis that is Disqualified Basis and some basis that is not Disqualified Basis ("Hybrid Basis Property"), "the disqualified basis is reduced or eliminated in the same proportion that the disqualified basis bears to the total adjusted basis of the property" (the "Disqualified Ratio").[103]

The Proposed Regulations do not specify when the Disqualified Ratio is to be determined. If the Disqualified Ratio is measured immediately after the Disqualified Transaction and remains static over the recovery period of the Hybrid Basis Property (*i.e.*, the period relating to the recovery of the Disqualified Basis or the period relating to the recovery of the basis that is not Disqualified Basis, whichever is later), the total amount of deductions with respect to the Hybrid Basis Property that is excluded from the computation of tested income is equal to the amount of the property's Disqualified Basis. This result is consistent with the purposes of the Disqualified Basis rule and is also consistent with the amount of disallowed deductions attributable to STP that only has Disqualified Basis.[104] Accordingly, we recommend that the Regulations, when finalized, clarify that (1) the Disqualified Ratio is determined immediately after the Disqualified

[100] *Id.*

[101] A special rule should apply to avoid over-stating the amount of Disqualified Basis with respect to certain distributions of partnership property. For example, in the case of a positive basis adjustment under section 734(b), the amount of such adjustment that is treated as Disqualified Basis should exclude an amount equal to any corresponding negative adjustment to the basis of distributed property under section 732(a)(2) or (b).

[102] Prop. Reg. § 1.951A-3(h)(2)(ii)(A).

[103] *Id.*

[104] If the recovery period of the Disqualified Basis is different from the recovery period of the non-Disqualified Basis of Hybrid Basis Property, the fixed ratio may not result in the same amount of deductions that are disregarded from the computation of tested income or tested loss in a given year; however, the fixed ratio would ensure that the total amount of deductions (over the full recovery period) that are disregarded from the computation of tested income or tested loss is equal to the amount of the Disqualified Basis.

Transfer occurs and (2) the Disqualified Ratio does not change at any time thereafter (unless there is a subsequent Disqualified Transfer of the Hybrid Basis Property with respect to which there is an amount of Disqualified Basis computed under Proposed Regulation section 1.951A-3(h)(2)(ii)(A)).

E. Partnership QBAI

The Proposed Regulations generally provide that a tested income CFC that holds an interest in a partnership as of the close of the CFC's inclusion year increases its QBAI by the amount of the CFC's partnership QBAI ("Partnership QBAI") with respect to the partnership.[105] The CFC's Partnership QBAI is generally based on the CFC's share of the partnership's adjusted basis in partnership specified tangible property ("PSTP") as of the close of the partnership's taxable year that ends with or within the CFC inclusion year.[106]

In general, PSTP is tangible property of a partnership that is used in the partnership's trade or business, subject to depreciation under section 167, and used in the production of tested income.[107] For purposes of the Partnership QBAI rules, a partnership's adjusted basis in PSTP ("PSTP Basis") is generally based on the average of the partnership's adjusted basis in the property as of the close of each quarter in the partnership taxable year.[108]

A tested income CFC's share of the partnership's PSTP Basis with respect to an item of PSTP is equal to the product of the PSTP Basis and the partnership QBAI ratio ("Partnership QBAI Ratio") with respect to the item of PSTP ("Share of Partnership PSTP Basis").[109] With respect to an item of PSTP that produces "directly identifiable income," the Partnership QBAI Ratio is equal to the ratio of the tested income CFC's distributive share of the gross income produced by the PSTP that is included in the gross tested income of the CFC for the partnership taxable year to the total gross income produced by the PSTP for the partnership taxable year.[110] If the PSTP does not produced directly identifiable income, the Partnership QBAI Ratio is equal to the ratio of the tested income CFC's distributive share of all gross income of the partnership that is included in the gross tested income of the CFC for the partnership taxable year to the total gross income of the partnership for the partnership taxable year.[111]

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[105] Prop. Reg. § 1.951A-3(g)(1).

[106] Prop. Reg. § 1.951A-3(g)(2)(i).

[107] Prop. Reg. § 1.951A-3(g)(2)(iii).

[108] Prop. Reg. § 1.951A-3(g)(3).

[109] Prop. Reg. § 1.951A-3(g)(2)(i).

[110] Prop. Reg. § 1.951A-3(g)(2)(ii)(A).

[111] Prop. Reg. § 1.951A-3(g)(2)(ii)(B).

Finally, the tested income CFC's Partnership QBAI is equal to the sum of the tested income CFC's Share of Partnership PSTP Basis with respect to each item of the partnership's PSTP.[112]

1. Partnership QBAI Ratio

The Partnership QBAI Ratio for each item of PSTP is determined by reference to the amounts of gross income produced by the property (or of the partnership) that are included in the gross tested income of the CFC and the amounts of total gross income produced by the property (or by the partnership). For purposes of determining each partner's distributive share of partnership items and maintaining capital accounts, partnerships often compute gross income for purposes of section 704(b) and for purposes of taxable income (under section 703). Determining the Partnership QBAI Ratio by reference to the amount of a partnership's gross taxable income (rather than gross section 704(b) income) appears consistent with determining whether all or a portion of that amount is included in the CFC partner's gross tested income because a CFC's tested income is based on the CFC's gross taxable income under section 951A(c)(2)(A) and Proposed Regulation section 1.951A-2(c)(1). We recommend that the Regulations under section 951A clarify that the Partnership QBAI Ratio is determined by reference to the gross taxable income, rather than the section 704(b) income, produced by the relevant item of partnership PSTP (or the partnership's total gross taxable income, as the case may be).

Allocations of gross taxable income from partnerships necessarily take into account allocations that are made under section 704(c) to address the built-in gains or losses of property contributed by a partner to a partnership (or built-in gains or losses that are attributable to a partner upon a revaluation of partnership property).[113] Therefore, if the Partnership QBAI Ratio is determined by reference to the gross taxable income of an item of PSTP (or of the partnership), we recommend that the Regulations under section 951A clarify that each partner's distributive share of gross income takes into account allocations under section 704(c) for purposes of computing the Partnership QBAI Ratio of an item of PSTP.

If Treasury and the Service adopt our recommendation to take into account section 704(c) allocations of gross taxable income for purposes of determining the Partnership QBAI Ratio, we recommend that the Regulations under section 951A address whether an item of remedial income with respect to an item of PSTP (or the aggregate amount of gross remedial income in the case of an item of PSTP that does not produce directly identifiable income) is taken into account when determining the gross income items that are used in the computation of the Partnership QBAI Ratio. In general, notional items of remedial income would be taken into account for purposes of computing the gross tested income and notional items of remedial deduction would be taken into account for purposes of determining the allowable deductions of a CFC under Proposed Regulation section 1.951A-2(c) because such remedial items are included in

[112] Prop. Reg. § 1.951A-3(g)(2)(i).

[113] *See, in general,* Reg. §§ 1.704-1(b)(1)(vi) and 1.704-3(a)(6).

taxable income. However, items of remedial income and remedial deduction are notional items that "the partnership creates" in offsetting amounts pursuant to Regulation section 1.704-3(d)(1). As a result, these remedial items are not derived from cost recovery of the basis of any property, no item of property actually produces remedial income, and the partnership does not actually produce any net remedial income. Furthermore, under Regulation section 1.704-3(d)(1), the remedial income and loss with respect to each item of property necessarily net to zero (and the aggregate of all remedial items of income and deduction of a partnership necessarily net to zero).

In light of the foregoing, we recommend that if Treasury and the Service adopt our recommendation to take into account section 704(c) allocations for purposes of determining the Partnership QBAI Ratio, the final Regulations provide that any items of remedial income are taken into account in determining the amount of gross income (from the PSTP or the partnership, as the case may be) included in gross tested income and the total amount of gross income for purposes of computing the Partnership QBAI Ratio.[114]

2. Transfers of Partnership Interests

The Proposed Regulations address an ambiguity in section 951A(d)(3) (referring to a partner's "distributive share of the partnership's adjusted basis")[115] with special rules for determining a CFC partner's Partnership QBAI by reference to the CFC partner's distributive share of gross income. The preamble to the Proposed Regulations notes that the special rule was motivated, in part, by a desire to avoid "the effect of decoupling the CFC partner's share of the basis of partnership property used to compute the CFC partner's QBAI from the CFC partner's distributive share of the partnership's income from the property that is taken into account in computing the CFC partner's tested income."[116]

There is another provision in section 951A(d)(3) that has the potential to separate a CFC partner's share of partnership basis in PSTP from the CFC's partner's share of partnership income that is included in the CFC partner's tested income. Specifically, the Code provides that "if a [CFC] holds an interest in a partnership at the close of [the] taxable year of the [CFC], such [CFC] shall take into account" its share of a partnership's

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[114] Although the adjusted basis of PSTP may be more appropriately associated with the cost recovery deductions with respect to the property (and the allocation thereof), Congress stated a clear intent in the Act to associate a partner's QBAI owned through a partnership with the income derived from the relevant property and taking into account remedial items of income with respect to the relevant property would be consistent with the legislative intent regarding Partnership QBAI. *See* section 951A(d)(3) (the Act included two paragraphs designated as section 951A(d)(3); this reference is made to the second such paragraph which is titled "Partnership Property") and H.R. Conf. Rep. No. 115-466, at 636 and 645 (2017).

[115] The Act included two paragraphs designated as section 951A(d)(3). This reference is made to the second such paragraph which is titled "Partnership Property."

[116] 83 Fed. Reg. 51,072, at 51,077.

adjusted basis in certain tangible property for QBAI purposes.[117] The Proposed Regulations similarly provide that a tested income CFC's QBAI is increased by its Partnership QBAI only if the tested income CFC "holds an interest in one or more partnerships as of the close of the CFC inclusion year."[118] Neither the Code nor the Proposed Regulations have a rule that would allow a tested income CFC to increase its QBAI for its share of Partnership QBAI if the CFC owns an interest in the partnership for a portion of the CFC's taxable year but does not own the interest at the close of that taxable year.

In contrast, a CFC's distributive share of income from a partnership is taken into account for purposes of computing the CFC's tested income under Proposed Regulation section 1.951A-2(c) regardless of whether the CFC owns an interest in the partnership as of the close of the CFC's taxable year. For example, if a CFC with a taxable year ending on December 31, 2018, owns a 10 percent interest in a partnership with a taxable year ending on November 30, 2018, and disposes of its entire interest in the partnership on November 30, 2018, the CFC's distributive share of partnership income for the taxable year of the partnership ending on November 30, 2018, would be included in the CFC's tested income[119] but the CFC would have no opportunity to take into account its Partnership QBAI with respect to the disposed partnership interest because it would not own an interest in the partnership as of December 31, 2018.

We believe it is appropriate for Regulations to address this apparent deficiency in the Code with respect to the timing of a CFC's ownership of a partnership interest and the inclusion of Partnership QBAI in the CFC's QBAI for the CFC's inclusion year because the result is clearly contrary to the policy of coupling a CFC's distributive share of partnership income and a CFC's share of Partnership QBAI. In this regard, we note that Treasury and the Service addressed a similar issue with the same provision of the Act in the Proposed Regulations.[120] Accordingly, we recommend that Treasury and the Service provide a special rule in the final Regulations under section 951A that a tested income CFC increases its QBAI for its CFC inclusion year for the sum of the tested income CFC's Partnership QBAI with respect to each partnership for which (1) an interest in the

[117] I.R.C. § 951A(d)(3) (the Act included two paragraphs designated as section 951A(d)(3); this citation refers to the second such paragraph which is titled "Partnership Property").

[118] Prop. Reg. § 1.951A-3(g)(1).

[119] This example assumes that the CFC partner's distributive share of income is not of a type that would be excluded from tested income under section 951A(c)(2)(A)(i).

[120] As noted above, the preamble to the Proposed Regulations explains that because "the statutory language 'distributive share of the partnership's adjusted basis' is ambiguous, the proposed rules for determining Partnership QBAI (in Prop. Reg. § 1.951A-3(g)) were drafted in a manner that determines a "CFC partner's share of the partnership's adjusted basis in specified tangible property by reference to the partnership's average adjusted basis in the property" and in proportion to the CFC partner's share of gross income from the property (or the partnership). 83 Fed. Reg. 51,072, at 51,076-7.

partnership was held by the CFC on at least one day of the CFC's inclusion year and (2) the partnership's taxable year ends with or within the CFC's inclusion year.[121]

3. <u>Partnership QBAI through Tiered Partnerships</u>

It is common for CFCs to invest in foreign operations through one or more tiered partnerships, including structures in which a foreign entity that is classified as a partnership for United States federal income tax purposes is a holding company for a lower-tier operating company (that may itself be classified as a partnership for United States federal income tax purposes). In such structures, the CFC receives allocations of operating income and loss, indirectly through tiers of partnerships, and generally takes into account such income or loss when determining the CFC's tested income or loss. As noted above, a fundamental principle of the computation of GILTI is that QBAI from a partnership is inherently related to the distributive share of income from the partnership that is included in tested income.[122] However, the Proposed Regulations do not make any explicit reference to tiered partnerships in the Partnership QBAI rules.

The mechanical rules of Proposed Regulation section 1.951A-3(g)(2) that take into account a CFC partner's distributive share of partnership income may be read broadly to include a CFC's distributive share of partnership income related to the underlying partnership property that generates gross income included in the CFC's tested income, whether allocated to the CFC by a partnership in which the CFC holds a direct interest or an indirect interest through one or more tiers of partnerships. Furthermore, the rules determining whether a partnership's property is included in PSTP do not explicitly require a CFC to be a direct partner of the partnership.[123]

As noted above, there is a requirement in the Code and the Proposed Regulations that a tested income CFC includes Partnership QBAI in its QBAI if the CFC "holds an interest in one or more partnerships as of the close of the CFC inclusion year."[124] There is no provision in Proposed Regulation section 1.951A-3(g)(1) allowing for the CFC to hold such an interest directly or indirectly through other partnerships. Accordingly, to be consistent with the purposes of the Partnership QBAI rules (*i.e.*, to link a tested income CFC partner's tested income derived from a partnership with its share of PSTP Basis from the partnership) and to reflect the common business and investment structures of

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[121] If this recommendation is adopted, we believe the mechanical rules in the Proposed Regulations for determining a tested income CFC partner's share of PSTP Basis, along with the rules of section 706, will take into account an appropriate amount of Partnership QBAI for a partnership whose taxable year ends with or within the CFC's inclusion year, even if the CFC does not own an interest (or the same proportion of the interest) for the entire CFC inclusion year, because the Partnership QBAI Ratio takes into account the CFC partner's distributive share of the partnership's income and the amount of a partner's distributive share generally reflects any variations in the partner's interest in the partnership as determined under section 706.

[122] *See* 83 Fed. Reg. 51,072, at 51,077.

[123] Prop. Reg. § 1.951A-3(g)(2)(iii).

[124] Prop. Reg. § 1.951A-3(g)(1).

U.S. investors, we recommend that the Regulations, when finalized, clarify that a tested income CFC's QBAI is increased for its Partnership QBAI with respect to partnerships the interests of which the CFC owns directly or indirectly through other partnerships.[125]

4. Section 743(b) Adjustments

As noted above, Proposed Regulation section 1.951A-3(g)(2)(iii) provides that:

> The term partnership specified tangible property means tangible property (as defined in paragraph (c)(2) of this section) of a partnership that is –
> (A) Used in the trade or business of the partnership,
> (B) Of a type with respect to which a deduction is allowable under section 167, and
> (C) Used in the production of tested income.

A section 743(b) adjustment is an adjustment to the basis of partnership property, made with respect to a particular partner, and allocated to items of partnership property under section 755.[126] In addition, Regulation section 1.743-1(j)(4)(i)(B) provides that, for purposes of section 168, an increase to the basis of partnership property that is subject to cost recovery is treated "as if it were newly-purchased recovery property placed in service when [the transfer of the partnership interest giving rise to the section 743(b) adjustment] occurs." To the extent a section 743(b) adjustment is allocated to a partnership's tangible property that satisfies the requirements of PSTP, the basis associated with the adjustment should be considered PSTP Basis of the partnership. Accordingly, we recommend that the Regulations, when finalized, clarify that a section 743(b) basis adjustment is taken into account for purposes of determining PSTP Basis of a partnership to the extent that the section 743(b) basis adjustment is allocated to an item of property that qualifies as PSTP.

We further recommend that the Regulations provide a special rule that the entire amount of the section 743(b) basis adjustment that is allocated to PSTP property (the "Section 743(b) PSTP Adjustment") would be included in the Partnership QBAI of the CFC partner with respect to which the Section 743(b) PSTP Adjustment is made (the "Section 743(b) CFC Partner"). Under this rule, the section 743(b) adjustment would be associated with the transferee partner because the framework of section 743(b) is intended to give the transferee partner any benefit or detriment attributable to the adjustment that is made by the partnership solely with respect to that partner and because attributing PSTP basis of the section 743(b) adjustment according to the general rule for Partnership QBAI (*i.e.*, based on a partner's share of gross income) would not, in all cases, result in the transferee partner receiving all of the Partnership QBAI attributable to the Section 743(b) PSTP Adjustment.

[125] As used in this section, the term partnership is intended to also refer to other foreign passthrough entities, as appropriate.

[126] *See, in general,* I.R.C. § 743(b) and (c).

In addition, because "[a] tested loss CFC has no partnership QBAI for a CFC inclusion year," the special rule could clarify that although the Section 743(b) CFC Partner would generally include the Section 743(b) PSTP Adjustment in its Partnership QBAI, the Section 743(b) CFC Partner would have no Partnership QBAI if it is a tested loss CFC for its CFC inclusion year.[127] Furthermore, to preserve the association of the Section 743(b) PSTP Adjustment with the Section 743(b) CFC Partner (to the exclusion of other partners), no other partner would be permitted to include the Section 743(b) CFC Partner's Section 743(b) PSTP Adjustment in the other partner's Partnership QBAI. Finally, the special rule would take into account the cost recovery, if any, of the Section 743(b) PSTP Adjustment such that the Partnership QBAI attributable to the Section 743(b) PSTP Adjustment would be adjusted for the average amount of the PSTP Basis with respect to the section 743(b) adjustment for each taxable year of the partnership.

[127] Prop. Reg. § 1.951A-3(g)(1).