Will the Overlap Rule of Code Sec. 1297(d) Still Protect “Small” Partners of Domestic Partnerships?

By Michael J. Miller

As cross-border tax practitioners are well aware, two separate and complex “anti-deferral” regimes apply to U.S. shareholders of controlled foreign corporations (“CFCs”) and U.S. investors in passive foreign investment companies (“PFICs”).

Brief Overview of Subpart F and PFIC Rules

The rules applicable to CFCs and their U.S. shareholders are set forth in Subpart F of the Internal Revenue Code (the “Subpart F rules”). Under the Subpart F rules, a foreign corporation is a CFC if U.S. shareholders collectively own (directly, indirectly, or pursuant to certain constructive ownership rules) stock representing more than 50% of the total vote or value of the outstanding stock of the foreign corporation.[1] For this purpose, a U.S. shareholder is any U.S. person that owns (directly, indirectly, or pursuant to certain constructive ownership rules) stock representing at least 10% of the total vote or value of the outstanding stock of the foreign corporation.[2]

U.S. shareholders of CFCs generally are subject to current taxation on their respective shares of (1) any Subpart F income earned by their CFCs, (2) any earnings of their CFCs that are invested in U.S. property, and (3) any global intangible low taxed income (“GILTI”) generated by their CFCs.[3]

By contrast, there is no ownership requirement for PFIC status. A foreign corporation is a PFIC if either (1) 75% of more of its gross income is considered “passive” income, or (2) the average percentage of its assets that produce (or are held for the production of) passive income during the year is at least 50%.[4]

Among other adverse consequences, U.S. investors who sell their PFIC stock at a gain (or who receive an “excess distribution” from the PFIC) generally are denied capital gain treatment and subject to a hefty interest charge as punishment for having deferred U.S. tax.[5] Certain elections may be made to avoid such adverse tax consequences.[6]

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Overlap Rule

Until 1997 there was no coordination whatsoever between the Subpart F rules and the PFIC rules. In 1997, Code Sec. 1297(d) was enacted to prevent, or at least minimize, overlap between the tax two regimes. The "overlap rule" set forth in Code Sec. 1297(d)(1) provides as follows:

> (d) Exception For United States Shareholders Of Controlled Foreign Corporations
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> (1) In General—For purposes of this part, a corporation shall not be treated with respect to a shareholder as a passive foreign investment company during the qualified portion of such shareholder's holding period with respect to stock in such corporation.

Pursuant to Code Sec. 1297(d)(2), the "qualified portion" of a shareholder's holding period is the portion (A) that is after December 31, 1997, and (B) during which the shareholder is a U.S. shareholder (as defined in Code Sec. 951(b)) of the foreign corporation and during which the foreign corporation is a CFC.

Accordingly, it is not clear what could—or should—stop the IRS from abandoning the position it took in the letter rulings and treating the overlap rule as inapplicable to small partners in domestic partnerships that are now exempt from taxation under Code Secs. 951 and 951A.

Since the qualified portion of a shareholder's holding period (to which the overlap rule applies) is limited to the period (after 1997) in which the shareholder is subject to the Subpart F rules—by reason of the shareholder being a U.S. shareholder and the foreign corporation being a CFC—it seems evident the purpose of Code Sec. 1297(d) was to except from the PFIC regime only those U.S. persons who are subject to the Subpart F rules.

Following enactment of the overlap rule in 1997, there has been a long standing question about how it applies in a scenario where a domestic partnership (USP) is a U.S. shareholder of a CFC but the "small" domestic partners of USP are not U.S. shareholders of the CFC. In such circumstances, Code Sec. 1297(d) clearly provides that the CFC is treated as a non-PFIC with respect to USP, but does that mean the CFC is also treated as a non-PFIC with respect to USP's small domestic partners?

For example, suppose that USP owns 100% of the stock of FC, a foreign corporation, and has two unrelated domestic partners: A and B, who own 95% and 5%, respectively, of the interests in USP. A is a U.S. shareholder of FC, so the overlap rule clearly causes CFC to be treated as a non-PFIC with respect to A. But how about B?

Code Sec. 1298(a)(3) provides that stock owned by a partnership is considered to be owned proportionately by its partners. Code Sec. 1298(a)(1) states that, except as provided in regulations, stock owned by a U.S. person shall not be attributed to any other person, but the regulations reverse this rule. Reg. §1.1291-1(b)(8)(iii)(A) provides that "If a foreign or domestic partnership directly or indirectly owns stock, the partners of the partnership are considered to own such stock proportionately in accordance with their ownership interests in the partnership."

In addition, Code Sec. 1298(b)(5)(A) provides as follows:

> (5) Application of part where stock held by other entity
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> (A) In general. Under regulations, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a)—
> (i) any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock, or
> (ii) any distribution of property in respect of such stock to the person holding such stock, shall be treated as a disposition by, or distribution to, the United States person with respect to the stock in the passive foreign investment company.

Thus, B in the above example should be taxable under the PFIC regime on various types of "indirect dispositions" and "indirect distributions," pursuant to Code Sec. 1298(b)(5)(A), unless the overlap rule applies.

The Internal Revenue Service ("IRS") has historically taken the view that small partners such as B in the above example are protected by the overlap rule. While no formal guidance has been issued, the IRS has issued 11 private letter rulings reaching this conclusion.[7] The first such letter ruling was released on October 23, 2009 and the other 10 were released on February 25, 2011. The last of them is LTR 201108022.

In LTR 201108022, the IRS considered a scenario where "Corporation B," a foreign corporation, was wholly owned by "Partnership X," a domestic limited liability company classified as a partnership. Partnership X's U.S. members included upper-tier domestic partnerships (the "Partnership Members") and U.S. individuals (the "Non-Partnership Members"). The Partnership Members and Non-Partnership Members owned less-than-10% interests in Partnership X and thus were not U.S. shareholders of Corporation B. In other words, they were "small" partners of Partnership X.

The entire analysis section of LTR 201108022 provides as follows:

> ANALYSIS
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> It is expected that Corporation B will qualify as a PFIC as defined under Code section 1297(a). Partnership X, a domestic partnership, is a U.S. person within the meaning of Code section 7701(a)(30). Partnership X is the sole owner of Corporation B for U.S. federal tax purposes and thus is a U.S. Shareholder with respect to Corporation B.
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> Accordingly, Partnership X will be subject to the subpart F rules with respect to Corporation B, and will not be subject to the PFIC regime with respect to Corporation B pursuant to the Overlap Rule. The Non-Partnership Members will take into account their distributive shares of Partnership X's income, including any section 951 inclusion with respect to Corporation B. The partners in the Partnership Members will take into account their distributive share of their respective Partnership Member's distributive share of Partnership X's income, including any section 951 inclusion with respect to Corporation B.

The portion of the letter ruling that sets forth the applicable law adds a tad more color:

> The legislative history to Code section 1297(d) provides that the Overlap Rule was enacted because of a concern about the unnecessary complexity caused by the application of the subpart F and PFIC regimes to the same shareholders. To address this concern, the legislative history to Code section 1297(d) states that "a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock."

Accordingly, the letter ruling appears to be driven entirely by the fact that the policy and legislative history of the overlap rule supports the extension of its protection to small partners of domestic partnerships who would be burdened by unnecessary complexity if also subject to the PFIC rules and who are not avoiding tax, because they are required to take into account their distributive share of the partnerships' Code Sec. 951 inclusions. The other 10 letter rulings are similar to LTR 201108022.

While the technical basis for the letter rulings has always been a bit murky, and letter rulings may be relied upon only by the taxpayers to whom they are issued, as a practical matter cross-border tax practitioners felt comfortable that the IRS would grant small partners of domestic partnerships safe haven from the PFIC regime under the overlap rule.

The TCJA and Post-TCJA Treatment of Domestic Partnerships

Following enactment of the so-called Tax Cut and Jobs Act (the "TCJA") in 2017, the Subpart F rules changed dramatically. Among other changes, the TCJA added new section 951A to the Code so that U.S. shareholders of CFCs would be taxed not only on Subpart F income (and investments of earnings in U.S. property), but also on a new and much broader class of income known as GILTI.

While the amount of Subpart F income generated by each CFC is determined at the CFC level, this is not true for GILTI. Rather, the rules for computing GILTI require various attributes of a taxpayer's CFCs to be taken into account and combined at the shareholder level in order to determine the shareholder's GILTI inclusion.

Given the need to combine attributes from various CFCs in order to calculate GILTI at the shareholder level, the Treasury Department and IRS struggled with how this should be done in the case of a shareholder that is a domestic partnership. After some vacillation, Treasury issued final regulations that skip right past the domestic partnership for inclusion purposes, as if it were a foreign partnership, and calculate GILTI solely at the partner level.[8] Under those final regulations, one effect of calculating GILTI solely at the partner level is that small partners got a "free pass" from the GILTI rules.[9]

Treasury has issued proposed regulations that would take the same approach with respect to the more traditional inclusions of Subpart F income and other amounts under Code Sec. 951.[10] The proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of a Treasury decision adopting such rules as final regulations in the Federal Register (and to taxable years of U.S. persons in which or with which such taxable years of foreign corporations end).[11] However, the proposed regulations also provide that a domestic partnership may elect to provide the new rules to taxable years of a foreign corporation beginning after December 31, 2017 (and to taxable years of the domestic partnership in which or with which such taxable years of the foreign corporation end) provided that certain consistency requirements are met.[12]

Once the proposed regulations are finalized, or in any case where a domestic partnership elects to apply the proposed regulations, the small partners of the partnership will largely be exempt from all of the anti-deferral rules set forth in Subpart F. In particular, they will not be required to include any Subpart F income or GILTI with respect to foreign corporations with respect to which their domestic partnerships are U.S. shareholders.[13]

Revisiting the Overlap Rule

Given the new "aggregate" treatment of domestic partnerships for purposes of inclusions under the Subpart F and GILTI rules, it seems sensible to revisit application of the overlap rule to small partners.

As explained above, the letter rulings never provided much in the way of a technical explanation for their holdings and appear to have reached their conclusions primarily if not entirely on policy grounds. In particular, the small partners were taxed under Subpart F, so they were not avoiding any tax and would have been adversely affected by being subject to the PFIC rules as well as the Subpart F rules.

These policy considerations seem wholly inapplicable in our brave new world in which small partners are exempt from the GILTI rules and, at least when the proposed regulations go final, exempt from inclusions under Code Sec. 951. Certainly, it is difficult to imagine why the IRS would wish to take a rule designed solely to prevent shareholders from being subject to the double detriment of taxation under *both* Subpart F and the PFIC regimes and use it to confer upon some taxpayers the double benefit of being taxed under *neither* regime.

Of course, the IRS is obligated to apply the law as written, and there are circumstances where seemingly unintended benefits are unavoidable. This, however, is not such a case. As noted above, the attribution rules set forth in Code Sec. 1298 and the Treasury Regulations issued thereunder allow the IRS to treat small partners as indirect owners of the PFIC stock owned by their domestic partnerships, and Code Sec. 1298(b)(5)(A) applies the PFIC regime to such indirect PFIC shareholders.

Accordingly, it is not clear what could—or should—stop the IRS from abandoning the position it took in the letter rulings and treating the overlap rule as inapplicable to small partners in domestic partnerships that are now exempt from taxation under Code Secs. 951 and 951A.[14] Small partners should be prepared for the possibility if not the likelihood that the IRS will reverse course and subject them to the PFIC rules.

ENDNOTES

1 Code Sec. 957. Except as may otherwise be expressly indicated, all "section" and "§" references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

2 Code Sec. 951(b). The applicable rules regarding indirect and constructive ownership are set forth in Code Sec. 958.

3 Code Secs. 951(a)(1) and 951A.

4 Code Sec. 1297(a).

5 Code Sec. 1291(a).

6 *See*, *e.g.*, Code Secs. 1295 and 1296.

7 LTRs 200943004, 201106003, 201107004, 201107005, 201107006, 201107007, 201107008, 201107009, 201108020, 201108021 and 201108022.

8 Reg. §1.951A-1(e)(1).

9 *See* Reg. §1.951A-1(e)(3)(i), Ex. 1.

10 Proposed Reg. §1.958-1(d)(1) and (d)(3)(i), Ex. 1.

11 Proposed Reg. §1.958-1(d)(4).

12 Proposed Reg. §1.958-1(d)(4).

13 Domestic partnerships will still be treated as domestic, however, for other purposes of Subpart F. For example, for purposes of determining whether a foreign corporation is a CFC (as defined in Code Sec. 957) and for purposes of applying Code Sec. 1248, domestic partnerships will remain U.S. persons.

14 Even if one were to conclude that changes in the existing Treasury Regulations are needed, the Treasury Department is certainly at liberty to make the necessary changes.