

Notice 2009-7: IRS Designates “Partnership Blocker” to Subpart F Inclusions as a New Transaction of Interest

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Noel Brock and Joseph Calianno discuss some of the issues raised by the Subpart F income partnership blocker transaction described in Notice 2009-7 and the IRS’s possible challenges to the position taken by Taxpayer, along with Taxpayer’s possible counterarguments to such challenges.



Introduction

On December 29, 2008, the Internal Revenue Service (IRS) issued Notice 2009-7 (the “Notice”),² which designated as a transaction of interest a “Subpart F income partnership blocker” structure. This structure has the purported benefit of insulating certain U.S. taxpayers from a Code Sec. 951(a) income inclusion.³

In the transaction outlined in the Notice, a U.S. taxpayer that owns controlled foreign corporations (CFCs)⁴ that, in turn, indirectly hold stock of a lower-tier CFC through a domestic partnership, takes the position that Subpart F income of the lower-tier CFC does not result in an income inclusion for the U.S. taxpayer under Code Sec. 951(a). The IRS noted that, in a typical transaction covered by the Notice, a U.S. taxpayer (“Taxpayer”) wholly owns two CFCs,

(“CFC1” and “CFC2”). CFC1 and CFC2 are partners in a domestic partnership (“USPartnership”). USPartnership owns 100 percent of the stock of another CFC (“CFC3”). Some or all of the income of CFC3 is Subpart F income (as defined in Code Sec. 952). As part of the transaction, Taxpayer takes the position that the Subpart F income of CFC3 currently is included in the income of USPartnership (which is not subject to U.S. tax) and is not included in the income of Taxpayer.⁵ The IRS also noted that variations of the transaction might include more than one person owning the stock of CFC1 and/or CFC2, USPartnership owning less than all of the stock of CFC3, a domestic trust being used instead of a domestic partnership in the structure, or the Code Sec. 951(a) inclusion amount resulting from an amount determined under Code Sec. 956.⁶

The result of the claimed tax treatment is that income that otherwise would be taxable currently to Taxpayer as a result of CFC3’s Subpart F income is not taxable to Taxpayer because of the interposition of a domestic partnership in the structure.

Interestingly, the IRS did not designate this transaction as a listed transaction nor did it specifically state that the transaction does not work. Instead, the IRS states that the transaction has the *potential*

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for tax avoidance or evasion. It goes on to state that it does not have enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. As a result, the transaction and substantially similar transactions are designated as transactions of interest for purposes of Reg. §1.6011-4(b)(6) and Code Secs. 6111 and 6112 effective December 29, 2008.⁷ The IRS further states that, when it has gathered enough information to make an informed decision as to whether these transactions are a tax avoidance type of transaction, it may take one or more administrative actions, including removing the transactions from the transactions of interest category of reportable transactions in published guidance, designating the transactions as a listed transaction, or providing a new category of reportable transactions.

Until additional guidance is published, the IRS, in appropriate situations, may attack Taxpayer’s position taken as part of these transactions under Subpart F, Subchapter K, other provisions of the Code or under judicial doctrines, such as sham transaction, substance-over-form, and economic substance.⁸ Unfortunately, the Notice does not shed much light on the specific analysis of such attacks. It merely mentions a nonexclusive list of potential ways it may attack the transaction.

This article discusses some of the issues raised by the transaction described in the Notice and the IRS’s possible challenges to the position taken by Taxpayer, along with Taxpayer’s possible counterarguments to such challenges.

Before delving into that discussion, it is worth comparing the structure described in the Notice with two alternative structures to understand the IRS’s concerns with the structure in question. Suppose USPartnership was removed from the structure such that CFC1 and CFC2 directly own CFC3 or, alternatively, USPartnership was replaced with a foreign partnership. In either of these alternative structures, Taxpayer generally would be required to include CFC3’s Subpart F income in income under Code Sec. 951(a).⁹ Thus, one can understand the IRS’s concern regarding this structure. Now we turn to the analysis of the transaction described in the Notice.

Analysis of Transaction

The starting point of the analysis would be Code Sec. 951(a). That provision provides that:

If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in section 951(b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) his pro rata share (determined under section 951(a)(2)) of the corporation’s subpart F income for such year,...¹⁰

Interestingly, the IRS did not designate this transaction as a listed transaction nor did it specifically state that the transaction does not work.

Thus, under Code Sec. 951(a), only a U.S. shareholder (as defined in Code Sec. 951(b)) of a CFC that owns (as defined in Code Sec. 958(a)¹¹) stock of a CFC must include its share of Subpart F income in gross income when the conditions above are satisfied and no exception applies. For this purpose, a U.S. shareholder is defined to mean, with respect to any foreign corporation, a U.S. person (as defined in Code Sec. 957(c)) who owns (within the meaning of Code Sec. 958(a)), or is considered as owning by applying the constructive ownership rules of Code Sec. 958(b), at least 10 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.¹²

For purposes relevant to the transaction described above, a U.S. person generally is defined in Code Secs. 957(c) and 7701(a)(30) to include a domestic partnership and a domestic corporation.¹³ Code Sec. 958(a) generally defines “stock owned” to mean stock owned directly and stock owned indirectly through certain foreign entities.¹⁴ Code Sec. 958(b) provides constructive ownership rules that apply for several purposes, including determining whether a U.S. person is a U.S. shareholder. These constructive ownership rules generally incorporate Code Sec. 318(a)

attribution rules with certain modifications. Under these rules, stock owned, directly or indirectly, by or for a partnership is considered as owned proportionately by its partners, and if a partnership owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it is considered as owning all of the stock entitled to vote. Further, if 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person is considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all of the stock in such corporation. Also, if a corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote in a corporation, it is considered as owning all the stock entitled to vote. Additional constructive ownership rules apply under Code Sec. 958(b).¹⁵ Important to the analysis below, even though the rules of section 958(b) are used in determining who is a U.S. shareholder, only the rules of Code Sec. 958(a) are used in determining who has a Code Sec. 951(a) income inclusion.

Applying the rules above, USPartnership would be treated as a U.S. person that is a U.S. shareholder of CFC3 that owns (as defined in Code Sec. 958(a)) 100 percent of the stock of CFC3. Thus, under Code Sec. 951(a), USPartnership generally would be required to include in income CFC3's Subpart F income.¹⁶

The analysis next turns to Taxpayer. Although Taxpayer would be a U.S. person that would be considered a U.S. shareholder of CFC3 under the rules discussed above, it likely would assert that it does not own (as defined in Code Sec. 958(a)) stock of CFC3 that would require an income inclusion under Code Sec. 951(a). Taxpayer does not directly own any stock of CFC3. With respect to indirect ownership under Code Sec. 958(a) through foreign entities, Taxpayer likely would rely on Reg. §1.958-1(b). Reg. §1.958-1(b) interprets the indirect ownership rule of Code Sec. 958(a) and provides that attribution under this rule stops with the first U.S. person in the chain of ownership running from the foreign entity.¹⁷ In this case, the first U.S. person in the chain of ownership of CFC3 is USPartnership. Thus, applying this rule to this fact pattern, Taxpayer likely would assert that USPartnership serves as a "blocker" to it indirectly owning CFC3 through CFC1 and CFC2 and having a Code Sec. 951(a) income inclusion (*i.e.*, attribu-

tion stops at the first U.S. person, which would be USPartnership).¹⁸ It is worth noting that if one were to look past the first U.S. person in the chain (*e.g.*, a chain of U.S. persons each owning 100 percent of the other in the chain with the lowest-tier U.S. person owning the CFC) there could be a potential for multiple Subpart F inclusions with respect to the same item of Subpart F income—an inappropriate result. As discussed later in this article, the IRS may try to disregard USPartnership under the facts of the transaction described above such that the only U.S. shareholder that would have a Code Sec. 951(a) inclusion would be Taxpayer.

The next step of the analysis would be to determine the treatment of the Subpart F income that is included in the income of USPartnership under Code Sec. 951(a). This requires a brief overview of Code Secs. 702 and 703.

Although a partnership is not a tax-paying entity, Code Sec. 703(a) mandates that partnership taxable income be computed and, pursuant to other partnership provisions, passed through to its partners. Code Sec. 703(a)(1) requires, however, that certain items of partnership income, gain, loss, deduction or credit contained in Code Sec. 702(a) be "separately stated" and not included in the computation of partnership taxable income.¹⁹ Code Sec. 702(a) also grants the Secretary of the Treasury the authority to provide for other items of income, gain, loss, deduction or credit to be separately stated. Code Sec. 702(b) and the regulations promulgated under Code Sec. 702 provide that the character in the hands of the partner of any such separately stated item is determined as if such item were realized directly from the source which it is realized by the partnership or incurred in the same manner as incurred by the partnership.²⁰

The Treasury has acted pursuant to this grant of authority discussed above and enumerated additional items of partnership income, gain, loss, deduction or credit that must be separately stated.²¹ Additionally, a catch-all category in the Code Sec. 702 regulations requires that each partner "take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately."²²

The regulations contain three nonexclusive examples of items that must be separately stated under this catch-all category of separately stated items. One requires

that all partners separately take into account any items of income that would be gross Subpart F income if separately taken into account by a CFC partner where the partnership has a partner that is a CFC.²³

The proper characterization under Subchapter K of CFC1 and CFC2’s distributive share of USPartnership’s Code Sec. 951(a) income inclusion of CFC3’s Subpart F income raises several interesting issues.

Query whether the IRS may try to assert that the underlying Subpart F income of CFC3 that resulted in the Code Sec. 951(a) income inclusion retains its character as Subpart F income under the rules discussed above such that CFC1 and CFC2 are treated as having Subpart F income, and, as a result, Taxpayer has a Code Sec. 951(a) income inclusion.

To give context to the separately stated rules of Code Sec. 702 as they relate to Subpart F income, these rules generally apply when income actually earned by a partnership with a CFC partner would result in Subpart F income if earned directly by the CFC partner. For instance, the regulations provide an example in which a CFC has Subpart F income as a result of being a partner in a foreign partnership that receives payments of interest from an unrelated person that would be Subpart F foreign personal holding company income if received directly by the CFC.²⁴

If the IRS were to assert the argument mentioned above, Taxpayer likely would argue that CFC1 and CFC2’s distributive share of USPartnership’s Code Sec. 951(a) income inclusion is not a category of Subpart F income in the hands of a CFC1 and CFC2 (it is worth noting that a CFC would not have a Code Sec. 951(a) Subpart F income inclusion relating to another CFC’s Subpart F income). Taxpayer likely would assert that, applying the rules above, CFC1 and CFC2’s distributive share of such income is merely foreign source income that is not a category of Subpart F income. Further, Taxpayer may assert that, if the IRS wanted such income to retain its Subpart F income taint, the IRS could have written a rule specifically providing for such a result but it has not done so.

Another possible line of attack that the IRS may try to pursue under the facts of this transaction is an aggregate theory of partnership taxation so that Taxpayer is treated as the U.S. shareholder that has a Code Sec. 951(a) income inclusion relating to CFC3’s Subpart F income.

As a general matter, Subchapter K embodies a blending of two views as to the nature of partnerships. The first is that a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. This is sometimes referred to as the “aggregate” view of partnerships. The second view is that a partnership has a separate tax existence apart from its partners (*i.e.*, that the partnership is a separate entity). Under this “entity” view of partnerships, no partner has a direct interest in partnership assets or operations, but only an interest in the partnership entity.

Congress indicated in the committee reports that, when a given provision of the tax law is otherwise silent on the issue, one view of partnerships should not take precedence over the other. Instead, whether a partnership is treated as an entity separate from its partners or as an aggregate of its partners depends on which characterization is “more appropriate” for the particular Code section under consideration.²⁵

Generally speaking, in the context of Subpart F, Congress sought to limit the deferral of U.S. taxation on certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited deferral was retained after the enactment of Subpart F to protect the competitiveness of CFCs doing business overseas.²⁶

The IRS may try to argue that if the entity approach to partnerships is applied in this context and Taxpayer is not required to include CFC3’s Subpart F income in income, there would be a contravention of the policies of Subpart F. (Although USPartnership is required to include CFC3’s Subpart F income in its gross income, it is not a tax-paying entity.) Thus, the IRS could try to argue that the aggregate view of partnership taxation should apply in this situation to ensure the policy behind Subpart F is not contravened by allowing the intervention of a domestic partnership to prevent a Subpart F inclusion by Taxpayer and that, under the aggregate view of partnerships, USPartnership should be disregarded and CFC1 and CFC2 should be treated as directly owning the stock of CFC3. In such case, Taxpayer would be the U.S. shareholder that must include in income CFC3’s Subpart F income under Code Sec. 951(a).²⁷

The IRS also may try to challenge the transaction set forth in the Notice under the partnership anti-abuse regulations.

It is worth noting that the IRS has taken an aggregate approach in other contexts (e.g., the application of Code Sec. 1248(a) to sales of CFCs by foreign partnerships) to “clarify” the treatment of a particular transaction when it believed the transaction was contrary to the application of a particular provision.²⁸

If the IRS were to assert the aggregate view of partnerships, then Taxpayer could assert that Congress has taken an entity approach to partnership taxation by including a domestic partnership as a “U.S. person” that can be a U.S. shareholder of a CFC (and, thus, a domestic partnership can have an income inclusion under Code Sec. 951(a)).²⁹ Taxpayer also could argue that the treatment of the transaction is contemplated under the rules of Subpart F. As discussed below, Taxpayer likely would cite to an example in the partnership anti-abuse regulations (Reg. §1.701-2(f), Example 3) that takes an entity approach to domestic partnerships in the CFC context as support for its position.

The IRS also may try to challenge the transaction set forth in the Notice under the partnership anti-abuse regulations. There are two separate tests under these regulations. The IRS can attack transactions under either or both tests. One of the tests (the “abuse of entity” test) limits perceived abuses of the entity concept of partnerships. The other test (the “intent of Subchapter K” test) addresses perceived abuses of the rules of the intent of Subchapter K. A brief discussion of each is provided below.

In the mid 1990s, the IRS attempted to formalize the law relating to the treatment of partnerships as aggregate or entities by issuing Reg. §1.701-2(e) (the “abuse of entity” test). This regulation allows the Commissioner to treat a partnership as an aggregate of its partners to carry out the purposes of any statutory or regulatory provision, unless: (1) the provision prescribes the treatment of the partnership as an entity; and (2) that treatment and the ultimate tax results are clearly contemplated by that provision. The abuse of entity test under the partnership anti-abuse regulations is broader than the congressional entity versus the aggregate approach discussed previously in at least two respects. First, it allows the IRS to impose aggregate treatment even if the Code or Regulations mandate entity treatment if the IRS believes the ultimate tax consequences resulting from entity treatment were not clearly contemplated. Second, it gives the entity versus the aggregate choice to the IRS without requiring that this choice be made consistently in applying a particular provision of the

Code or Regulations to different transactions or to different taxpayers.

Although the exact parameters of the partnership anti-abuse regulations are not well-developed, the analysis under the abuse of entity test of the partnership anti-abuse regulations likely would be very similar to that set forth above under the historic entity versus aggregate view of partnerships analysis. If the IRS were to try to rely on this regulation to challenge the transaction, it likely would argue that respecting USPartnership as the U.S. shareholder that has the Code Sec. 951(a) income inclusion (entity theory) with Taxpayer avoiding such an inclusion would circumvent the policies of Subpart F. It may assert that such an approach was not contemplated by either the Subpart F regime or Subchapter K.

Taxpayer likely would argue that entity treatment is specifically contemplated by the Code and regulations as it relates to the treatment of a domestic partnership under the Subpart F rules of the Code and treating USPartnership as the U.S. shareholder that has the Code Sec. 951(a) income inclusion is not contrary to the Subpart F or Subchapter K (instead, the result was clearly contemplated). Taxpayer likely would point to Reg. §1.701-2(f), Example 3 as possible support for its argument. That example provides the following:

Example 3. Prescribed entity treatment of partnership; determination of CFC status clearly contemplated.

(i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under Treas. Reg. §§301.7701-2 and 301.7701-3. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under Treas. Reg. §301.7701-2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because

it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X’s credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and §1.904-4(g).

(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X’s foreign tax credit limitation.

If the IRS pursues this line of attack, the IRS likely would try to differentiate the example by asserting that, even though entity treatment is contemplated in the above example, the use of the domestic partnership in the transaction described in the Notice and the purported tax results of such transaction are quite different from the example above. The IRS also could argue that the abuse of entity test allows the IRS to impose aggregate treatment despite the fact that the Code and Regulations contemplate entity

treatment. Nevertheless, if this avenue is pursued, the IRS likely would have some hurdles given the general entity treatment of partnerships under section 957(c) as reflected in the clear language of the above example.

Under the “intent of Subchapter K” test of the partnership anti-abuse regulations, the Commissioner can recast part, or all, of a transaction where a partnership is used or availed with a principal purpose of reducing the partners’ federal tax liability in a manner that is inconsistent with the intent of Subchapter K.³⁰ Subchapter K is intended to permit taxpayers to conduct joint business through a flexible economic arrangement without incurring an entity-level tax.³¹ Implicit in this intent are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) except as otherwise provided in Reg. §1.701-2(a)(3), the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partners and the partnership must accurately reflect the partners’ economic agreement and clearly reflect the partner’s income (collectively, proper reflection of income).³²

The provisions of Subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of Subchapter K as set forth in Reg. §1.701-2(a).³³ Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of Subchapter K in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of Subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership’s assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported

partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction.³⁴ Various factors may be indicative, but do not necessarily establish, that a partnership was used in a manner inconsistent with the intent of subchapter K.³⁵

It is possible that the IRS may assert the intent of Subchapter K test of the anti-abuse regulations to try to disregard USPartnership to modify the claimed treatment of the transaction so that Taxpayer has the section 951(a) income inclusion.³⁶

As discussed above, the intent of Subchapter K test has as a prerequisite a partnership being used or availed with a principal purpose of reducing the *partners'* federal tax liability in a manner inconsistent with Subchapter K. It is worth noting that, unlike certain other partnership regulations that look not only to the impact on the partner but also to other persons such as the owners of the partners (e.g., the catch-all category of the Code Sec. 702 regulations relating

to separately stated items³⁷), this regulation focuses solely on the *partners'* federal tax liability without any specific reference to other persons whose federal tax liability may be reduced. In the transaction described in the Notice, it would seem that the person whose federal tax liability that is potentially reduced is Taxpayer, who is not a partner in USPartnership. Thus, if the IRS were to try to assert this test to challenge the transaction, it would have to read the regulation in a broad manner.

Taxpayer likely would make many of the arguments discussed above to refute such a challenge. In addition, Taxpayer may make an additional technical argument. That argument would be that the focus of the regulation is reducing the *partners'* federal tax liability, and Taxpayer is not a partner of USPartnership whose potential federal tax liability is reduced.³⁸

Finally, in addition to the possible arguments discussed above, the Notice makes clear that the IRS may challenge the transaction on other grounds, such as sham transaction, substance-over-form, economic substance as well as other provisions of the Code.³⁹ Many of the IRS's possible grounds for challenge discussed in this article may be embodied in these additional grounds for challenge.

Conclusion

Taxpayers should stay alert for future guidance from the IRS on the transactions described in the Notice because, as evidenced in this article, there is a need for clarity with respect to the regulations regarding the interaction of Subpart F and Subchapter K.

ENDNOTES

¹ The opinions expressed in this article are those of the authors and not necessarily those of their firm. The authors would like to thank Mark Harris, Tax Counsel for the Coca-Cola Company, for his insightful comments. Copyright 2009 Brock and Caliano.

² Notice 2009-7, IRB 2009-3, 312.

³ Unless otherwise noted, all references herein to the "Code" or "Code Sec." are to the Internal Revenue Code of 1986, as amended, and all references to "Regulation" or "Reg. §" are to the regulations promulgated thereunder by the IRS and U.S. Department of the Treasury.

⁴ For the definition of a CFC, see Code Secs. 957(a) and (b).

⁵ The Notice does not discuss whether Taxpayer takes the position that CFC3 has previously taxed earnings and profits under Code Sec. 959 as a result of USPartnership's section 951(a) income inclusion that may be

distributed without further taxation under Code Sec. 959.

⁶ The discussion in this article focuses on Subpart F income generated by CFC3, but a similar type of analysis also would apply if CFC3 invested in U.S. property and USPartnership had a Code Sec. 951(a) income inclusion relating to a Code Sec. 956 amount rather than a Subpart F income inclusion.

⁷ The Notice also provides that persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in Reg. §1.6011-4. Further, material advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under Code Secs. 6111 and 6112. See Reg. §§1.6011-4(h) and §§301.6111-3(i) and 301.6112-1(g). The IRS notes that, independent of their classifica-

tion as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in the Notice may already be subject to the requirements of Code Secs. 6011, 6111 or 6112, or the regulations thereunder. Finally, the Notice provides information regarding potential penalties that may apply.

⁸ For illustrations in which the IRS has asserted substance-over-form, sham and the partnership anti-abuse regulations to attack certain partnership transactions that it viewed as abusive, see ILM 200246014 (Aug. 8, 2002) and CCA 200513022 (Nov. 15, 2004).

⁹ An analysis of all the potential exceptions and limitations to a Code Sec. 951(a) inclusion would need to be considered. Such an analysis is beyond the scope of this article.

¹⁰ As discussed earlier, this article focuses on Subpart F income of CFC3. However, a U.S. shareholder also can have an income inclu-

ENDNOTES

- sion relating to a CFC’s investment in U.S. property. See generally Code Secs. 951(a)(1)(B) and 956.
- ¹¹ Code Sec. 958(a) includes only direct and indirect ownership through certain foreign entities.
- ¹² Code Sec. 951(b).
- ¹³ For certain limitations on that definition not relevant here, see Code Sec. 957(c).
- ¹⁴ For this purpose, stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership or foreign trust or foreign estate (within the meaning of Code Sec. 7701(a)(31)) is considered as being owned proportionately by its shareholders, partners or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person. Code Sec. 958(a)(2). See Code Sec. 958(a)(3) for a special rule relating to mutual insurance companies.
- ¹⁵ For further details and rules on the application of the constructive ownership rules and the purposes for which they apply, see generally Code Sec. 958(b) and Reg. §1.958-2.
- ¹⁶ As discussed later in the article, an example under the Reg. §1.701-2 partnership anti-abuse regulations treats a domestic partnership as a U.S. shareholder of a foreign corporation for purposes of determining whether such foreign corporation is a CFC.
- ¹⁷ The Code Sec. 958 regulations contain an illustration of this rule. The example in the regulations illustrates the attribution rule where one domestic corporation wholly owns another domestic corporation that, in turn, owns CFCs. The example concludes that the attribution would stop at the first domestic corporation. Reg. §1.958-1(b), Example.
- ¹⁸ In the present situation, even though USPartnership would have an income inclusion, it is not subject to tax. The IRS likely would point to this distinction with respect to some arguments it may assert to challenge the transaction.
- ¹⁹ Code Secs. 703(a)(1) and 702.
- ²⁰ Code Secs. 702(a)(7) and (b) and Reg. §1.702-1(b).
- ²¹ Reg. §1.702-1(a)(8)(i).
- ²² Reg. §1.702-1(a)(8)(ii).
- ²³ *Id.*
- ²⁴ See Reg. §1.952-1(g)(2), Example. Specifically, the regulation states that “[a] controlled foreign corporation’s distributive share of any item of income of a partnership is income that falls within a category of Subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly.” Reg. §1.952-1(g)(1).
- ²⁵ H.R. REP. NO. 83-2543, at 59 (1954).
- ²⁶ S. REP. NO. 1881, 87th Cong., 2d Sess. 78-80 (1962).
- ²⁷ Query: if the IRS were to assert such a position, would it also apply an aggregate approach in all instances to domestic partnerships [e.g., would the IRS treat a foreign corporation as a CFC (and apply the Subpart F regime), if such foreign corporation is owned by a domestic partnership that is owned by U.S. persons that would not be U.S. shareholders of such foreign corporation if they owned the foreign corporation directly rather than through the domestic partnership]?
- ²⁸ See Preambles to REG-135866 and TD 9345. See also Treas. Reg. §§1.1248-1(a)(4) and -1(a)(5), Example 4 (stating that if a foreign partnership sells or exchanges stock of a corporation, the partners of such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation). Code Sec. 1248(a) applies to certain sales or exchanges by “U.S. persons.” Note that the IRS applied the aggregate view of partnership taxation under Code Sec. 1248 to treat the partners of a foreign partnership as selling stock sold by the foreign partnership despite the fact that those same regulations had adopted the definition of U.S. person contained in Code Sec. 7701(a)(30), which includes a domestic partnership—but does not include a foreign partnership. Reg. §1.1248-1(a)(1). As previously discussed, the legislative history to Subchapter K suggests that, once a view of partnerships has been adopted with respect to a particular provision, the issue generally is settled; however it is possible that the IRS may have relied on the general language of Code Sec. 7701(a), which permits a deviation from how a term is defined in Code Sec. 7701(a) for purposes of Title 26 if such interpretation is manifestly incompatible with the intent thereof. See, e.g., FSA 200117-19 (Jan. 24, 2001) (discussing the “manifestly incompatible” standard of Code Sec. 7701(a) with respect to whether a dual chartered corporation should be treated as domestic or foreign under Code Secs. 7701(a)(4) and (a)(5)). The IRS may have deemed treating a foreign partnership as an entity under Code Sec. 1248 to be manifestly incompatible with the intent of Code Sec. 1248.
- ²⁹ Code Secs. 951(b), 957(c) and 7701(a)(30). But see note 28 for a possible IRS counter-argument.
- ³⁰ Reg. §1.701-2(b).
- ³¹ H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954) and Reg. §1.701-2(a).
- ³² Reg. §1.701-2(a).
- ³³ Reg. §1.701-2(b).
- ³⁴ Reg. §1.701-2(c).
- ³⁵ *Id.* For further details on this anti-abuse rule, see Reg. §1.701-2(a) through (d).
- ³⁶ Query whether the IRS would analyze the transaction differently depending on how the structure arose or the assets that are held by the partnership (e.g., the interests in USPartnership were purchased from unrelated persons, Taxpayer’s CFCs formed USPartnership, USPartnership has other partners or other substantial assets).
- ³⁷ See also Reg. §1.702-1(a)(8)(ii) (requiring that each partner “take into account separately the partner’s distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.”) (emphasis added); Reg. §1.704-1(b)(2)(d) (for purposes of applying the after-tax, shifting and transitory tests to a partner that is a look-through entity, the tax consequences that result from an interaction of an allocation with the tax attributes of any person that is an owner of an interest in such partner must be taken into account); and Prop. Reg. 1.704-3(a)(10) (proposing to modify the Code Sec. 704(c) anti-abuse rule to take into account not only the tax liability of the direct partners in a partnership, but also the tax liabilities of “indirect partners”). This regulation was proposed on May 19, 2008. This is a trend in partnership tax law. The IRS apparently realizes that taxpayers use partnerships in a manner that do not change the tax ramifications to a tax-indifferent direct partner, but drastically change the tax ramifications to certain indirect owners somewhere up the chain.
- ³⁸ See note 37 and surrounding text.
- ³⁹ For some cases dealing with some of these judicial concepts, see *Gregory v. Helvering*, S.Ct., 35-1 USTC ¶9043, 293 US 465, 55 S.Ct 266; *ACM Partnership, CA-3*, 98-2 USTC ¶50,790, 157 F3d 231; *Boca Investments*, DC D.C., 2001-2 USTC ¶50,690, 167 FSupp2d 298; and *Moline Properties, Inc.*, S.Ct., 43-1 USTC ¶9464, 319 US 436. See also *supra* note 8 and the authorities cited therein. The IRS also may try to challenge the transaction on business purpose grounds, and even possibly Code Sec. 269 grounds, in certain instances.

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