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INSIGHT: IRS Regulations Surprisingly Permit Certain Partners to Avoid GILTI

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On June 21, 2019, the U.S. Treasury Department promulgated final regulations under the global intangible low-taxed income (''GILTI'') regime of IRC Section 951A. Among other things, these regulations look through a U.S. partnership that owns shares in a controlled foreign corporation (''CFC'') to treat the partners in the partnership, rather than the partnership itself, as the owners of such shares for purposes of applying the GILTI attribution provisions. Treasury on the same day also issued proposed regulations under IRC Sections 951 and 958 that would reach the same result for purposes of applying the other income attribution provisions of Subpart F. These regulations come as a welcome surprise to some: For the first time, a partner with a ''small'' interest in a U.S. partnership that owns a controlling interest in a foreign corporation could be exempt from the operation of these income attribution provisions (albeit with possible adverse consequences for such partners under the passive foreign investment company (''PFIC'') regime). This article describes the applicable law prior to and after the new regulations and discusses the planning opportunities and questions the regulations raise.

Background

Subpart F was enacted by the Revenue Act of 1962 as an adjunct to the previously enacted foreign personal holding company (''FPHC'') provisions of IRC Sections 551 *et seq*., which were later modified and ultimately incorporated into Subpart F. The FPHC provisions attributed income of foreign corporations controlled directly or indirectly by five or fewer U.S. individuals to their shareholders who were U.S. persons if a certain percentage (generally 60%) of the foreign corporation's income was comprised generally of certain types of passive income (denominated FPHC income).

Although Subpart F, like the FPHC provisions, attributes income only where there is control of a foreign corporation by U.S. persons, there are a number of significant differences (as well as potential overlap) in the two regimes. First, whereas the FPHC provisions required the existence of a controlling U.S. group consisting of U.S. individuals as a prerequisite for attribution of income to U.S. persons, rendering the provisions generally inapplicable to foreign corporations controlled by publicly traded U.S. corporations, Subpart F is not so limited but rather defines CFCs as foreign corporations that are ''controlled'' (*i.e.*, more than 50% of the voting power or value of the shares of which is owned. directly, indirectly or constructively) by all manner of ''United States persons'' within the meaning of IRC Sections 957(c) and 7701(a)(30) (including U.S. citizens or resident individuals, U.S. corporations, U.S. resident trusts and U.S. partnerships (collectively referred to herein as ''U.S. persons'')), each of whom owns (directly, indirectly or constructively) as much as 10% of the foreign corporation's voting power (or, for years beginning after 2017, value) of the shares. Each such U.S. person is considered a ''United States shareholder'' within the meaning of IRC Section 951(b) and is referred to herein as a ''U.S. shareholder.''

Second, whereas the FPHC provisions could as initially enacted attribute income only to U.S. persons who in fact were shareholders (*i.e.*, they could not attribute income to U.S. persons by virtue of their indirect ownership of shares through foreign entities including foreign trusts, foreign corporations or foreign partnerships), to prevent foreign entities from acting as blockers Subpart F (*see* IRC Section 958(a)(2)), expressly permits such income attribution through foreign entities (as did the FPHC provisions when later amended (*see* former IRC Section 551(f)) to conform to Subpart F in this respect).

More specifically, IRC Sections 951(a) and 951A(a) require every U.S. person who is both a U.S. shareholder of a CFC *and* the owner of shares in the CFC either directly or indirectly through a foreign entity such as a foreign partnership (a ''section 958(a) owner'') on the last day in the taxable year on which the corporation is a CFC to include in gross income for such year (i) such person's pro rata share of the CFC's ''Subpart F income,'' which generally includes passive income such as dividends, interest, royalties and rents and certain limited types of active business income (a ''section 951 inclusion'') and (ii) such person's aggregate (for all such CFCs) GILTI amount (which very generally speaking is the aggregate of such person's pro rata share of such CFCs' total net positive active business income (if any) minus a deemed return on such person's pro rata share of the CFCs' tangible assets), in each case without regard to whether the CFC makes a distribution to its shareholders.

Significantly, under the relevant statutory language in IRC Section 951 and related provisions, much of which was incorporated into the GILTI regime by IRC Section 951A(e) and has been well understood for almost sixty years, a domestic partnership, defined in IRC Section 7701(a)(4) with one exception as any partnership created or organized under the law of the U.S. or any state (including the District of Columbia), is itself a U.S. person and therefore can be both a U.S. shareholder and a section 958(a) owner and thus an income attributee. IRC Section 7701(a)(4) grants to Treasury regulatory authority to treat what otherwise would be a domestic partnership as not being domestic, but the statute provides that such regulations generally cannot be applied to partnerships created or organized on or before the earliest of the date such regulations are promulgated as final regulations, proposed or substantially described in an IRS notice. *See* Pub. L. No. 105-34, section 1151(b); IRC Section 7805(b)(1). For example, where a partnership formed under Delaware law before any applicable regulations under IRC Section 7701(a)(4) are proposed or identified in a notice owns 100% of the shares of a foreign corporation, such partnership is a domestic partnership for purposes of the applicable provisions of Subpart F, and therefore is itself a U.S. person, irrespective of the identity, residence or ownership interests of its partners.

Thus, under the literal terms of the statute, a domestic partnership not considered to be a foreign partnership under applicable regulations, rather than its partners, is itself the section 958(a) owner and thus the income attributee of a CFC in which the domestic partnership is a direct owner. This is so even though its partners may be considered to own shares in the CFC under the constructive ownership rules of IRC Section 958(b) for purposes of determining whether they are U.S. shareholders and whether the corporation is a CFC. These rules, for example, treat stock owned by a partnership (whether domestic or foreign) as owned proportionately by its partners, and treat a partnership as owning stock owned by its partners. For ease of discussion, a person who is considered as owning shares by application of IRC Section 958(b) will be referred to as a ''section 958(b) constructive owner.'' By contrast, a foreign partnership can be neither a U.S. person nor a U.S. shareholder and therefore cannot be an income attributee. To prevent a foreign partnership from serving as a blocker and thereby avoiding a section 951 inclusion, IRC Section 958(a)(1)(B) effectively treats the partners in a foreign partnership as the section 958(a) owners of the shares owned by a foreign partnership and therefore as the potential income attributees.

Illustrative Examples

Example 1. P, a Delaware partnership that has not elected to be treated as an association taxable as a corporation, owns 100% of the single class of shares of FC1, a foreign corporation that is not considered to be engaged in a trade or business in the United States and has no U.S.-source income. The partners in P are USP, a 95% partner that is a Delaware corporation, and A, a 5% partner who is a U.S. citizen. There is no relationship among the partners in P other than that they are partners in P. The income of FC1 includes the types of passive income that would constitute Subpart F income in the hands of a CFC and sufficient active business income that there would be a GILTI inclusion in the hands of a U.S. shareholder of a CFC.

Example 2. Same facts as in Example 1 except that USP is a 40% partner in P and FC2, a foreign corporation, is a 55% partner in P. (A remains a 5% partner in P.)

Example 3. Same facts as in Example 1 except that USP is a 1% partner in P and the remaining partners are 11 unrelated U.S. citizens, each of whom has a 9% interest in P.

Results Prior to the New Regulations (and GILTI)

At the partnership level. In all three examples, under the rules outlined above, P, which was formed under the laws of Delaware, is a domestic partnership and thus a U.S. person. Being a U.S. person, P is the section 958(a) owner of 100% of the single class of shares in FC1. As a result, P is a U.S. shareholder of FC1 and FC1 is a CFC. This is true even though absent the existence of P, FC1 would not be a CFC in Examples 2 and 3. In Example 2, U.S. persons would own only 45% of the shares of FC1 and U.S. shareholders would own only 40% of the shares of FC1, and in Example 3, no U.S. shareholder would own any shares in FC1. Because P itself is both a U.S. shareholder in respect of FC1 and a section 958(a) owner of shares in FC1, absent the new regulations P itself would have a section 951 inclusion and would be required to report such inclusion on its partnership tax return (Form 1065) and the Schedules K-1 it issues to its partners (*see* IRC Section 6031), and its section 951 inclusion would be a ''partnership-related item'' for purposes of the partnership-audit rules (*see* IRC Section 6241(2)(B)).

At the partner level. In all three examples, under IRC Section 702(a), each of P's partners takes into account its distributive share of P's section 951 inclusions. Because the income tax liability of a partner would be affected by whether the partner separately takes these items into account as opposed to lumping them together with the rest of the partnership's net income, P's section 951 inclusions must be separately stated by P and separately taken into account by P's partners. IRC Section 702(a)(7); Treas. Reg. § 1.702-1(a)(8)(ii). IRC Section 702(b) provides that the character of such items ''shall be determined as if such item were realized directly from the source from which realized by the partnership.''

While the latter provision is somewhat ambiguous—it is unclear whether it requires what might be called a ''bottom-up'' characterization of items at the partnership level before flowing them up to the partners with that characterization or a ''top-down'' characterization of items at the partner level as if the partnership did not exist—in the absence of a statutory provision to the contrary it is generally interpreted as calling for a bottom-up characterization at the partnership level. *See, e.g., United States v. Basye*, 410 U.S. 441 (1973) (''The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares.''); *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996); *Campbell v. Commissioner*, 813 F.2d 694 (5th Cir. 1987); *Estate of Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991); *Madison Gas & Electric Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980); *Barham v. United States*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd*, 429 F.2d 40 (5th Cir. 1970); Rev. Rul. 2008-39, 2008-2 C.B. 252; Rev. Rul. 68-79, 1968-1 C.B. 310. When these amounts so characterized at the partnership level flow up to the partners, each partner's tax consequences depend on considerations such as whether such partner (i) is a U.S. person,

(ii) is subject to tax at corporate or individual rates, (iii) is a tax-exempt entity, (iv) has available net operating loss carryforwards or foreign tax credits, etc.

Thus, prior to the new regulations the conventional wisdom as to the tax treatment of P's partners was as follows:

Examples 1 and 2:

1. USP includes in its gross income its distributive share (95% in Example 1 and 40% in Example 2) of P's section 951 inclusion. Under IRC Section 1297(d), because FC1 is a CFC and USP is a U.S. shareholder in respect of FC1 (by reason of being the section 958(b) constructive owner of more than 10% of the shares of P), FC1 is precluded from being a PFIC with respect to USP.

2. In Example 2, FC2 is neither a U.S. shareholder of FC1 nor subject to U.S. tax on the amounts flowing through to it from P, which are neither effectively connected with the conduct of a U.S. trade or business nor from U.S. sources. *See* IRC Sections 11(d), 881 and 882.

3. Unlike USP, A herself does not have enough of an interest in P to be considered a U.S. shareholder of FC1. Nonetheless, the conventional wisdom is that A is subject to tax on her distributive share of P's section 951 inclusion, presumably on the theory that such amount is characterized and included in income at the partnership level as a section 951 inclusion, which income retains its character as such in the hands of those of its partners who would be taxable on such income, *e.g.*, U.S. citizens such as A. Presumably on this basis, the Service has issued private rulings taking the view that where a U.S. partnership owns 100% of the shares of a CFC, IRC Section 1297(d) operates to preclude the CFC from being treated as a PFIC with respect even to a less-than-10% partner in the partnership even though such partner does not literally meet the statutory requirement of being a U.S. shareholder with respect to the CFC. *See, e.g.*, PLR 201107005 (Nov. 8, 2010); PLR 200943004 (Jun. 26, 2009).

Example 3:

Each of P's partners is in the same situation as A in Examples 1 and 2 -- subject to tax on such partner's distributive share of P's section 951 inclusion (and not considered a shareholder of a PFIC) even though none of the partners has enough of an interest in P to be considered a U.S. shareholder of FC1.

One could quibble about some of the results reached under the rules as they existed prior to the new regulations, but these rules had the advantage of being a closed system that worked reasonably well. To be sure, a small U.S. investor in a U.S. investment fund that acquired more than 50% of the shares of a foreign corporation could find himself in a situation where he was required to include in income his distributive share of the partnership's section 951 inclusions whereas that would not be case had the investor made the investment directly. But the system largely held together and worked, and had the benefit of being consistent with the statutory language and its clear intent.

The New Regulations

Acknowledging the historical treatment of domestic partnerships as Subpart F income attributees and noting that the GILTI provisions "employ the basic subpart F architecture in several regards," and in the absence of any amendment to IRC Section 958(a), Treasury nevertheless asserts in the preamble to the June 2019 final regulations (*see* 84 Fed. Reg. 29316) that Congress was silent in 2017 regarding the treatment of domestic partnerships for GILTI purposes and that such silence justified a fresh look at the issue. On the basis of a determination that an aggregate approach furthers the purposes of the GILTI regime, the June 2019 final regulations provide that for GILTI purposes "a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a)" but rather its partners are treated as the section 958(a) owners in the same manner as the partners of a foreign partnership are treated under IRC Section 958(a), while providing that this aggregate approach does not apply for purposes of determining whether a U.S. person is a U.S. shareholder or whether a foreign corporation is a CFC. Treas. Reg. § 1.951A-1(e). These new rules apply only to taxable years of foreign corporations beginning after December 31, 2017. Treas. Reg. § 1.951A-7.

Moreover, stating that "Congress intended for the subpart F and GILTI regimes to work in tandem" (*see* 84 Fed. Reg. 29118), Treasury also proposed regulations in June 2019 that would apply the same rule for purposes of section 951 inclusions, generally effective for taxable years of foreign corporations beginning on or after the date the regulations are published as final regulations in the Federal Register, but with an ability of taxpayers to elect application of these provisions to taxable years of a foreign corporation beginning after December 31, 2017. Prop. Reg. § 1.958-1(d). Accordingly, the proposed regulations if finalized could not be used to eliminate any otherwise applicable repatriation tax required under IRC Section 951 by reason of IRC Section 965.

Results Under the New Regulations

Under the new regulations, and subject to the discussion below regarding IRC Section 951A(e)(2), P in our examples would continue to be treated as a U.S. shareholder of FC1, and FC1 would thus continue to be treated as a CFC. However, P itself would no longer be treated as a section 958(a) owner of shares in FC1, but rather, as is the case for a foreign partnership, P would be disregarded for purposes of IRC Section 958(a). As a result, P itself would not have a section 951 inclusion nor would it take into account any of FC1's GILTI items. Rather, the partners in P would be treated as the section 958(a) owners of shares in FC1.

In Example 1 above, the results for USP would be the same as under prior law: USP, being both a U.S. shareholder of FC1 by virtue of its 95% interest in P and a section 958(a) owner of FC1 shares by virtue of the new regulations, would have a section 951 inclusion and would be required to take into account its share of FC1's GILTI items in computing its GILTI inclusion. In Example 2, the results for FC2 would also be the same as under prior law: FC2, being a non-U.S. person, would not be a U.S. shareholder of FC1 and therefore would not have income inclusions under IRC Section 951 or 951A. As to USP in Example 2, the regulations by their terms would continue the prior-law treatment of USP, which, being both a U.S. shareholder of FC1 by virtue of its 40% interest in P and a section 958(a) owner of FC1 shares by virtue of the new regulations, would have a section 951 inclusion and would be required to take into account its share of FC1's GILTI items in computing its GILTI inclusion. It is not clear, however, whether this treatment of USP for GILTI purposes is consistent with IRC Section 951A(e)(2), which provides that for purposes of IRC Section 951A, a person shall be treated as a U.S. shareholder of a CFC only if such person is a section 958(a) owner of stock in such foreign corporation. Since under the regulations P itself is no longer treated as a section 958(a) owner of shares in FC1, and since under IRC Section 951A(e)(2) one must be a section 958(a) owner in order to be a U.S. shareholder for GILTI purposes, U.S. shareholders literally do not own the requisite interest in FC1 and FC1 therefore cannot be a CFC for GLTI purposes even though FC1 would be a CFC for purposes of attributing income under IRC Section 951; if FC1 is not a CFC for purposes of IRC Section 951A, USP can have no GILTI attribution from FC1.

Putting aside whether the result that may follow from the application of IRC Section 951A(e)(2) was intended, it appears that the new regulations dramatically change the treatment of A in Examples 1 and 2 -- whereas under prior law A would have been required to include in gross income her distributive share of P's section 951 inclusion and to take into account her distributive share of P's GILTI items, under the new regulations A rather than P is considered the section 958(a) owner of FC1 shares and, because A is not also a U.S. shareholder of FC1, A would not have a section 951 inclusion or a share of FC1's GILTI items for purposes of IRC Section 951A. Likewise, in Example 3 above, in which none of the partners in P has more than a 9% interest in P, since none of the partners would be a U.S. shareholder of FC1 none of them would have a section 951 inclusion nor would they have a share of FC1's GILTI items for purposes of IRC Section 951A.

Indeed, examples in the regulations (*see* Treas. Reg. § 1.951A-1(e)(3), example 1 and Prop. Reg. § 1.958-1(d)(3), example 1) make it clear that this change in the treatment of less-than-10% partners was intentional, and since the so-called hybrid approach under the October 2018 proposed GILTI regulations would have continued the prior-law treatment of less-than-10% partners, it seems clear that Treasury made a recent policy decision to exempt such partners from the section 951 and GILTI inclusion regimes.

Since domestic partnerships that own shares in foreign corporations are no longer treated as section 958(a) owners of the shares, their less-than-10% partners who do not also own additional shares are no longer subject to section 951 and GILTI inclusions in respect of such foreign corporations. This change can have very significant ramifications for ''small'' U.S. investors in investment funds such as hedge funds and private equity funds. For example, were the prior rules to be applied in the GILTI context, whether the less-than-10% U.S. investors in a private equity fund acquiring control of foreign portfolio companies operating active businesses would themselves be required to include in their GILTI calculations their distributive shares of the fund's GILTI items would depend on whether the fund was a domestic or foreign partnership. By contrast, under the new rules the less-than-10% U.S. investors would not be subject to GILTI in respect of their investment whether the fund is domestic or foreign.

Likewise, in the hedge fund (passive investment) context, the proposed regulations if finalized would reverse the current rule that requires less-than-10% U.S. investors in a hedge fund operated as a foreign corporation owned by a domestic partnership to include in their gross income their distributive shares of the fund's section 951 inclusions. One question lurking in the hedge fund context, however, is whether and how IRC Section 1297(d) will operate were the proposed regulations to be finalized, a question that the preamble to the proposed regulations (*see* 84 Fed. Reg. 29120) raises. Presumably, but not necessarily, a less-than-10% U.S. investor in a domestic hedge fund who is not subject to section 951 inclusions will not be excluded from the PFIC regime under IRC Section 1297(d) on the ground that such an investor would not be a U.S. shareholder with respect to the foreign corporation (although this was also the case in the private rulings cited above applying IRC Section 1297(d)) and Congress did not intend for a U.S. person to be exempt from both the PFIC regime and Subpart F. If so, less-than-10% U.S. investors could be subject to the PFIC regime rather than Subpart F and should consider making timely QEF elections under IRC Section 1295 for the first year the proposed regulations become effective to avoid the so-called ''PFIC hit'' under IRC Section 1291 when they sell their investment or receive ''excess distributions.''

Validity and Other Consequences of the New Regulations

Given that none of the statutory rules described above defining terms such as CFC, U.S. shareholder, section 958(a) owner, U.S. person and domestic partnership have changed, one might ask on what basis Treasury changed these rules. Indeed, the effect of the new regulations is as if IRC Section 958(a)(1) and (2) were amended as follows:

(1) General rule.--For purposes of this subpart (other than section 960), stock owned means—

(A) **other than in the case of a domestic partnership,** stock owned directly, and

(B) stock owned with the application of paragraph (2).

(2) STOCK OWNERSHIP THROUGH ~~FOREIGN~~ **CERTAIN** ENTITIES.--For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign **or domestic** partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. * * *

Congress, however, has not enacted any such amendments and, as noted above and as the preamble to the final GILTI regulations (*see* 84 Fed. Reg. 29288) acknowledges, the Code since 1962 has made it absolutely clear that a domestic partnership may be a section 958(a) owner of shares in a foreign corporation (as did the FPHC provisions since 1937), with the result that the partnership itself is subject to a section 951 inclusion. Moreover, both Congress (*see* Conf. Rep. No. 87-2508, 1962-3 C.B. 1129, 1158) and the Service (*see* Treas. Reg. § 1.701-2(f), example 3) have made it clear that entity treatment of a U.S. partnership for purposes of Subpart F is a result that Congress intended.

To be sure, IRC Section 7701(a)(4) gives Treasury the authority to issue regulations treating otherwise-domestic partnerships as not domestic. While the legislative history (*see* Conf. Rep. No. 105-220, at 632, 1997-4 (Vol. 2) C.B. 1457) makes it clear that such regulations ''are expected to provide a different classification result only in unusual cases,'' it is conceivable that a regulation issued under this authority and providing that for purposes of IRC Section 958(a), an otherwise-domestic partnership is treated as a foreign partnership would be found to be valid. Indeed, the so-called ''partnership blocker'' regulations (*see* Prop. Reg. § § 1.951-1(h) and 1.965-1(e)), some of which would become superfluous were the proposed regulations to be finalized, were issued pursuant to this authority in an attempt to head off a perceived abuse of domestic partnerships interposed between two tiers of CFCs. However, not only did Treasury not claim to be issuing the new regulations under this authority, as noted any such regulations would require a grandfather rule, *i.e.*, could not be applied to partnerships created or organized on or before the June 21, 2019 date of the new regulations. Presumably, Treasury consciously chose not to invoke its IRC Section 7701(a)(4) authority in this case, at least in part to avoid having to grandfather existing partnerships (although this problem could have been avoided by permitting grandfathered partnerships to elect into the new rules, at least for taxable years beginning after 2017).

Under the more general regulatory authority granted under IRC Section 7805(a), it is difficult to see how regulations such as these that turn an explicit statutory rule that treats a domestic partnership as the section 958(a) owner of shares in a foreign corporation owned by the partnership on its head could be found to be valid if challenged. *See, e.g.*, *United States v. Home Concrete & Supply, LLC*, 566 U.S. 478 (2012). Treasury has suggested that their authority is derived from the general principle enunciated by Congress in 1954 when subchapter K was enacted (*see* Conf. Rep. No. 83-2543, at 59) that a partnership should be treated as an entity or an aggregate of its partners depending on the policies underlying the provisions in question, and that on the basis of these principles Treasury has determined that an aggregate approach is more consistent with the policies underlying the GILTI provisions than would be an entity approach. In this connection, Treasury alleges numerous technical problems that would arise under the GILTI regime were a domestic partnership to be treated as a section 958(a) owner, including whether the netting of income and losses that IRC Section 951A permits at the shareholder level would work as contemplated, whether the deduction that is allowed under IRC Section 250 to certain U.S. corporations against their GILTI inclusions would somehow be lost and whether the foreign tax credit allowable under IRC Section 960 would work as contemplated.

While a complete discussion of these alleged problems is beyond the scope of this discussion, suffice it to say for present purposes that at least some if not all of these problems may be solved by a straightforward application of IRC Section 702(b) to the partnership's section 951 inclusion and GILTI items. But even if this were not the case, as the preamble to the new regulations *(see* 84 Fed. Reg. 29315) as well as Treasury's own regulations under IRC Section 701 (*see* Treas. Reg. § 1.701-2(e)(2)) acknowledge, treatment of a partnership as an aggregate of its partners is inappropriate where, as here, the Code prescribes and clearly contemplates the entity approach by requiring that a domestic partnership be treated as the section 958(a) owner of shares it owns in a foreign corporation. *See Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner*, 149 T.C. 63 (2017), *aff'd on other grounds*, No. 17-1268 (D.C. Cir., Jun. 11, 2019).

Of course, if no one is harmed by these generally favorable regulations, no one may have standing to challenge them. Indeed, because as noted in our examples the new regulations will tend to be neutral in the case of non-U.S. partners as well as U.S. partners who own or are considered as owning more than 10% of the shares of the foreign corporation and therefore are themselves U.S. shareholders, and beneficial in the case of less-than-10% partners (who as noted would have been subject to Subpart F under prior law and are no longer so subject under the new rules), few will find fault with Treasury's largesse. But there is always somebody who can be worse off.

Consider a less-than-10% partner in a domestic partnership who absent the new rules would have been subject to Subpart F and GILTI and excluded from the PFIC regime but who under the new rules finds himself subject to the PFIC regime. When such a partner sells his partnership interest or when the partnership sells its shares, unless he made a timely QEF election effective when the foreign corporation first became a PFIC, the partner could find himself subject to a substantial tax liability and interest charge under IRC Section 1291(a) to which he would not otherwise be subject. As another example, assume in Example 1 above that FC1 generates a ''tested loss'' for GILTI purposes and that A also owns 10% of more of the shares of another CFC that generates ''tested income'' for GILTI purposes. Absent the new regulations, P's tested loss would flow through to its partners, including A, and A should be able to offset her distributive share of such tested loss against her tested income from the other CFC. Under the new rules, however, because P would not be treated as the section 958(a) owner of shares in FC1, A, who is not a U.S. shareholder with respect to FC1, would not be considered as having a pro rata share of FC1's tested loss and thus would not be able to offset such loss against her tested income.

Were anyone in either of these situations to challenge the new regulations as being inconsistent with the statute (which would require locating counsel who would not have or perceive a conflict of interest vis-à-vis other clients who benefit from the new rules), it is at least questionable whether the regulations would be the basis for denying relief. And if the new regulations were invalidated, what then? Possibilities include withdrawal of the regulations, which would raise a host of questions including treatment of those who followed the regulations in the interim and whether a partnership and its less-than-10% partners that did not take into account section 951 inclusions and GILTI items in reliance on the regulations could find themselves facing a six-year limitations period under IRC Section 6501(e) by reason of a substantial omission of gross income. Perhaps a better solution would be to permit less-than-10% partners to elect whether to be subject to the new rules.

In addition, now that a domestic partnership will no longer have a share of GILTI items or, if the proposed regulations are finalized, a section 951 inclusion, such amounts will not be reportable by the partnership on its Form 1065 or its Schedules K-1 (although a controlling domestic partnership will continue to be required to file a Form 5471 with respect to its ownership in a foreign corporation), which raises the question how a 10%-or-greater partner in the partnership, now treated as the section 958(a) owner of shares in the foreign corporation, is expected to obtain the information such partner would need to comply with its tax and reporting obligations. To be sure, this problem always existed in the case of U.S. shareholders of CFCs who owned their shares directly, but by adopting these new rules Treasury is expanding this problem to partners in domestic partnerships. Similarly, by eliminating domestic partnerships' section 951 inclusions and inclusions in their GILTI calculations of their pro rata shares of the CFCs' GILTI items, Treasury is apparently removing these items from the scope of a partnership-level audit, which scope is limited to ''partnership-related items.'' *See* IRC Section 6241(2)(B); Treas. Reg. § 301.6241-1(a)(6)(iii). Whether Treasury determines that these are problems that can and should be fixed by additional regulations remains to be seen.

Conclusion

While we do not quarrel with Treasury's desire that the purpose of the GILTI provisions not be frustrated by the interposition of a domestic partnership between its partners and foreign corporations, for the reasons stated above Treasury's concerns in this regard appear to be overblown if not misplaced and in any event could have been dealt with more easily by issuing a more tailored regulation ''clarifying'' to the extent necessary the application of IRC Section 702(b) to GILTI amounts. Ironically, as noted, the solution adopted could cause the netting issue raised by Treasury to arise in situations in which it would not otherwise arise. Nor do we quarrel with relieving ''small'' investors that otherwise were subject to section 951 inclusions and would have been required to include their shares of the partnership's GILTI items from their obligation to do so, although for the reasons stated above the scope of the relief may literally be more extensive than is indicated in the illustrative examples in the regulations. Furthermore, unless Treasury pulls another rabbit out of its hat, small investors, who because of IRC Section 1297(d) were not otherwise required to deal with PFIC issues, may as a result of the new rules have to consider making QEF elections.

The use of domestic partnerships as the entity of choice for private equity funds acquiring foreign targets may well increase as a result of the new GILTI regulations, and the proposed IRC Section 958 regulations if adopted may be a catalyst for rethinking the use of foreign corporations by hedge funds formed as domestic partnerships as their vehicle of choice. Finally, it is unclear to us whether the decision to eliminate reporting of section 951 inclusions by domestic partnerships and the concomitant elimination of the application of the partnership audit rules for such inclusions will prove to be a wise decision. At the very least, investors in partnerships that could be U.S. shareholders may wish to insist on protections requiring the disclosure to them of information by the partnerships at least equal to the information that would be required to be disclosed were the partnership considered the section 958(a) owner of the shares.

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