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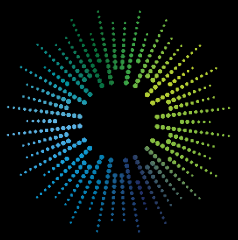

Final and proposed domestic passthrough entity rules

Tax Alert

On January 24, 2022, the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) released final regulations (T.D. 9960) (the "2022 Final Regulations") and newly proposed regulations (REG-118250-20) (the "2022 NPRM," collectively, the "2022 Regulations"). These regulations, published in the Federal Register on January 25, 2022, address a variety of issues relating to the treatment of domestic partnerships and other passthrough entities that own stock in foreign corporations, including the determination of subpart F income and section 956 inclusions, the identification of controlling domestic shareholders of a foreign corporation and of the owner of a CFC or qualified electing fund (QEF) for net investment income (NII) tax election purposes, and the application of the passive foreign investment company (PFIC) QEF and mark-to-market (MTM) regimes. The regulations also cover the treatment of S corporations with accumulated E&P attributable to subpart F income and GILTI and the determination and inclusion of related person insurance income (RPII) under section 953(c).

> ***Observations:*** The 2022 Regulations may affect current structures (see applicability dates below) and may alter the calculus of whether to structure investments in foreign corporations through domestic versus foreign partnerships.
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> The 2022 Regulations suggest that domestic partnerships are still generally required to file Form 5471 to report interests in certain foreign corporations where they otherwise meet the criteria for filing.

Background

A proposed regulation (REG-104390-18) that would have applied a hybrid approach to domestic partnerships for section 951A purposes, treating domestic partnerships as entities with respect to partners that are not US shareholders but as aggregates with respect to partners that are US shareholders, was published on October 10, 2018 (the "2018 Proposed Regulations"). The final GILTI regulations published on June 21, 2019 (T.D. 9866) shifted away from this hybrid approach, adopting an approach that generally treats a domestic partnership as an aggregate of its partners for purposes of computing GILTI inclusions and applying provisions that apply by reference to section 951A. See Treas. Reg. § 1.951A-1(e) (the "Final 951A Regulation"). Concurrent with the promulgation of the Final 951A Regulation, the government published Prop. Treas. Reg. § 1.958-1(d) (REG-101828-19), proposing to extend this aggregate approach to apply for purposes of

determining section 951 income inclusions and applying provisions that apply by reference to section 951 (the "Proposed 958 Regulation").

Under the Final 951A Regulation and the Proposed 958 Regulation (collectively, the "2020 Regulations"), domestic partnerships are generally treated in the same manner as foreign partnerships, with partners treated as owning, within the meaning of section 958(a), their proportionate shares of a domestic partnership's CFC stock. Thus, partners do not take into account their distributive share of a domestic partnership's GILTI and subpart F income inclusions under the 2020 Regulations, but rather US shareholder partners determine their own inclusions under sections 951 and 951A. The 2022 Final Regulations finalize the Proposed 958 Regulation with some modifications. However, they reserve on several important issues, including certain PFIC-related issues, previously taxed earnings and profits accounts and related tax stock basis adjustments, RPII rules under section 953(c), and section 1248 issues.

The 2022 NPRM contains newly proposed and re-proposed rules covering the treatment of domestic partnerships and S corporations under the PFIC and CFC RPII rules, as well as a handful of other proposed rules, with multiple requests for taxpayer comments and feedback.

> ***Observation:*** Although neither the 2020 Regulations nor the 2022 Final Regulations explicitly address the treatment of S corporations, it appears that they are treated as aggregates for purposes of section 951, 951A, and 956(a) based on their statutory treatment as partnerships for subpart F purposes.

Applicability dates

The 2022 Final Regulations apply to tax years of foreign corporations beginning on or after January 25, 2022 and the tax years of US shareholders in or with which such foreign corporation tax years end. Nevertheless, domestic partnerships are permitted to apply the domestic partnership aggregate rules of either the Proposed 958 Regulation or the 2022 Final Regulations to tax years of foreign corporations beginning after December 31, 2017 and tax years of US persons in or with which these foreign corporation tax years end assuming a consistency requirement is met. Under the consistency requirement, US shareholder partners, as well as domestic partnerships (under sections 267(b) or 707(b)) related to the domestic partnership in question and their US shareholder partners must also apply the Proposed 958 Regulation or the final version of the regulation (as applicable) with respect to all foreign corporations whose stock was owned through domestic partnerships.

> ***Observation:*** The Proposed 958 Regulation's aggregate approach was often not adopted early with respect to domestic partnerships due to the potential for adverse collateral consequences with respect to other investments.

The rules in the 2022 NPRM are generally proposed to apply to tax years beginning on or after the date on which they are published as final regulations. Special effective date rules that apply with respect to the 2018 Proposed Regulations' hybrid approach, elective entity treatment for S corporations with accumulated E&P, and RPII provisions are noted below. The 2022 NPRM does not contain reliance language that would permit the proposed regulations to be applied to tax years prior to finalization.

2022 Final Regulations

Section 956

Section 956 itself does not specifically apply by reference to section 951 or section 951A, which raised a question as to whether the aggregate treatment of the 2020 Regulations applied for purposes of section 956. The 2022 Final Regulations clarify that aggregate treatment applies for purposes of section 956(a) and provisions that specifically apply by reference to section 956(a). On the other hand, domestic partnerships are not treated as aggregates for purposes of section 956(c) and (d).

Impact on other regulations

The 2022 Final Regulations clarify that aggregate treatment only applies for purposes of the specific provision within a Code section or regulation that references section 951, 951A, or 956(a), not the entire section or regulation. Certain existing regulations that treat domestic partnerships as aggregates for section 956 purposes have been removed from the regulations.

Also removed from the regulations as superfluous are the Final 951A Regulation in Treas. Reg. § 1.951A-1(e) and the subpart F partnership blocker rules in Treas. Reg. § 1.951-1(h).

Entity treatment

The 2022 Final Regulations refrain from treating a domestic partnership as an aggregate for purposes of: 1) determining US shareholder and CFC status under sections 951(b) and 957(a), respectively; 2) applying section 956(c) and (d); 3) applying section 1248; and 4) identifying controlling domestic shareholders. However, the 2022 NPRM would apply aggregate treatment for the purpose of identifying controlling domestic shareholders, as discussed below. The preamble to the 2022 Final Regulations confirms that aggregate treatment does not extend to domestic non-grantor trusts or domestic estates.

> ***Observations:*** The interim treatment of domestic partnerships as controlling domestic shareholders is inconsistent with the general framework of the 2022 Final Regulations and can create tension between a domestic partnership and its partners, as well as among partners. Given that the government concluded in the 2022 NPRM that aggregate treatment is appropriate, it is unclear why the government is finalizing a regulation propounding entity treatment that could apply until the 2022 NPRM is applicable.
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> Notably, although GILTI generally applies at the US shareholder-partner level under the 2022 Final Regulations, the GILTI high-tax election is currently made at the domestic-partnership level, not the US shareholder-partner level, as it is made by a CFC's controlling domestic shareholders.

Future guidance may address the application of section 1248 to transactions involving a domestic partnership's sale of CFC stock. In the meantime, foreign partnerships continue to be treated as aggregates and domestic partnerships as entities for section 1248 purposes.

Different taxable years

The preamble to the 2022 Final Regulations confirms the intent of the domestic partnership rules to deny deferral based on the difference in the tax years of the domestic partnership and its partners. This potentially can cause US shareholder partners to recognize two section 951 income inclusions within the same tax year, one from the last CFC tax year in which the partnership is treated as an entity and a second with respect to the first CFC year in which the partnership is treated as an aggregate, upon the transition to the 2022 Final Regulations. No change of accounting method or section 481 adjustments are required upon this transition.

Observation: Note that a US shareholder partner still may benefit from limited deferral to the extent its tax year does not align with the tax year of a CFC held by a domestic partnership.

2022 Proposed Regulations

PFIC rules

In general

Despite potential administrability considerations and concerns regarding partner access to PFIC information, the 2022 NPRM treats domestic partnerships and S corporations as aggregates for purposes of the QEF and MTM rules, maintaining consistency with the CFC rules and empowering partners and S corporation shareholders to decide whether to make a QEF or MTM election. (The preamble in the 2022 NPRM notes that the new Schedule K-2 and K-3 reporting is expected to facilitate a partner's ability to make a QEF election.) This aggregate treatment would be accomplished by revising the definition of the term "shareholder" for PFIC purposes to exclude domestic partnerships and S corporations. Thus, domestic partnerships and S corporations would be treated as aggregates for purposes of the QEF and MTM rules, including for purposes of making elections, recognizing income, and making purging elections. An electing partner or shareholder is required to notify the passthrough entity of its QEF or MTM election to facilitate the intermediate entity's information reporting and basis tracking with respect to the QEF stock. Conversely, the QEF and MTM rules would continue to apply to domestic nongrantor trusts and domestic estates rather than at the beneficiary level.

Existing QEF and MTM elections made by passthrough entities would remain in effect, although partners and S corporation shareholders would begin to be subject to QEF inclusions and the requirement to file Form 8621. The preamble in the 2022 NPRM requests comments on whether an entity-level QEF or MTM election should be permitted in addition to the general election at the interest-holder level.

QEF rules

Consistent with the rules for subpart F income and GILTI in the 2022 Final Regulations, a partner and S corporation shareholder includes its pro rata share of a QEF's ordinary earnings and net capital gain as if it held the QEF stock directly, rather than including a distributive share of the passthrough entity's QEF-related income. In a departure from current law, a QEF election with respect to an indirectly held interest would apply to all stock in the QEF held by the partner or S corporation shareholder. Conforming changes would be made to the current QEF regulations, including for purposes of determining whether a PFIC is a pedigreed QEF with respect to an indirect shareholder

Observations: Under the 2022 NPRM, domestic partnerships and S corporations cannot make QEF elections on behalf of their investors, which can be expected to increase the amount of Form 8621 filings required in the context of private equity and small business investments. US-investor partners and S corporation shareholders will need to affirmatively make their own QEF elections and will now need to file Form 8621 annually, regardless of whether a QEF election is in effect.

A QEF election generally must be made by the due date for the US investor's tax return (with extensions). Where a domestic partnership's tax year ends after the partner's, the partner may not receive the information necessary to make a timely QEF election (absent special arrangements with the partnership or PFIC).

Under the proposed regulations, if stock subject to a QEF election is transferred by a shareholder to a passthrough entity, the QEF election remains in effect with respect to the transferor shareholder while the other interest holders in the passthrough entity are only subject to the QEF regime if they make QEF elections. The entity treatment contained in current regulations would continue to apply with respect to domestic nongrantor trusts, such that only the trust can make a QEF election and if it does not, only the transferor could be subject to the QEF regime with respect to the transferred PFIC stock.

MTM rules

As with the QEF regime, the 2022 NPRM provides that the MTM rules apply at the partner or S corporation-shareholder level. The 2022 NPRM would remove a rule in the current regulations providing that when an MTM PFIC is owned through certain passthrough entities MTM gain or loss is determined as of the end of the intermediate entity's tax year because, under the general aggregate treatment of passthroughs for MTM purposes, the tax year of the shareholder that owns the MTM PFIC through the passthrough entity is the appropriate tax year for such determination. They would also clarify that the transition rules applicable to a taxpayer that makes an MTM election with respect to a section 1291 fund, applying the excess distribution rules to current year distributions, gain on dispositions, and the MTM gain with respect to the transition year, apply at the partner or S corporation shareholder level.

CFC/PFIC overlap rule

The CFC/PFIC overlap rule under section 1297(d) was enacted to prevent duplicative taxation of a US shareholder's pro rata share of a foreign corporation's income under both the subpart F and PFIC regimes where the foreign corporation is both a CFC and a PFIC. Under the overlap rule, a foreign corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period. The qualified portion of a shareholder's holding period is defined as the portion during which the shareholder is a US shareholder and the corporation is a CFC.

In the case of CFC/PFIC stock held through domestic partnerships and S corporations, the government determined that the overlap rule should apply at the partner or shareholder level. In the 2022 NPRM preamble, the government explains that the existing definition of US shareholder under Treas. Reg. § 1.1291-1(b)(7) already provides that neither a domestic partnership nor an S corporation is treated as a PFIC shareholder for purposes of sections 1291, 1297 and 1298, except for information reporting purposes. Consistent with this provision, the 2022 NPRM proposes to limit the qualified portion of an indirect shareholder's holding period to periods in which the indirect shareholder is itself a US shareholder within the meaning of section 951(b).

A transition rule is provided for years beginning prior to the date on which the proposed changes in the 2022 NPRM are published as final regulations in the Federal Register, and for tax years of S corporation shareholders with respect to which an election to apply the S corporation transition approach (described below) is in effect. The transition rule allows for an indirect shareholder who is not a US shareholder under section 951(b) to include in the qualified portion of its holding period any period with respect to which it included its distributive or pro rata share of a domestic partnership's or S corporation's subpart F or GILTI inclusions in its gross income.

Purging elections

The 2022 NPRM clarifies that a domestic partnership and an S corporation may not make a PFIC purging election under either section 1291(d)(2) or section 1298(b)(1). These sections provide elections for taxpayers to recognize built-in gain on PFIC stock subject to the excess distribution regime upon becoming a QEF or CFC, and for a former PFIC shareholder to purge the PFIC taint under

the "once-a-PFIC, always-a-PFIC" rule. Under the proposed regulations, these purging elections are made at the partner or shareholder level, consistent with the fact that the purging gain results in inclusions directly taken into account at the partner or shareholder level under the excess distribution regime.

Information reporting

Domestic partnerships and S corporations would no longer be required to file Form 8621 with respect to PFICs that they held under the 2022 NPRM, although they would still need to report PFIC information on Schedule K-3. Rather, the burden of filing Form 8621 would fall squarely on partners and S corporation shareholders, as well as grantors of domestic grantor trusts. Language in the current regulations that imposes filing obligations on domestic partnerships and domestic grantor trusts would be removed. Given these changes, only beneficiaries of domestic estates and domestic nongrantor trusts would potentially be able to qualify for an exception from filing Form 8621 that applies to indirect shareholders that own a PFIC interest through a US person.

> ***Observation:*** The imposition of the Form 8621 filing requirement on partners of domestic partnerships and S corporation shareholders where a QEF or MTM election is in effect would be expected to require increased coordination between passthroughs and their investors and result in a proliferation of filings at the investor level, especially where the passthrough entity is widely held and/or it holds interests in many PFICs.

Subpart F and GILTI rules

Controlling domestic shareholders

Although the 2022 Final Regulations treat domestic partnerships as aggregates for the purpose of identifying a foreign corporation's controlling domestic shareholders, the government has concluded that passthrough entities should be treated as aggregates for this purpose in furtherance of the policy that the persons subject to the underlying section 951 and 951A inclusions should have the right to make elections affecting the determination of these inclusions. Accordingly, the 2022 NPRM provides for aggregate treatment with respect to domestic partnerships and S corporations for purposes of Treas. Reg. § 1.964-1(c)'s tax adjustment rules, as well as for purposes of provisions that specifically apply by reference to this regulation.

Aggregate treatment also applies for purposes of the requirement that the controlling domestic shareholders provide written notice of elections made and the adoption or change of an accounting method or taxable year on behalf of a foreign corporation. This ensures that indirect shareholders that are not themselves controlling domestic shareholders are notified of actions taken with respect to the foreign corporation that could affect their tax treatment. The 2022 NPRM would permit the controlling domestic shareholders to fulfill this requirement by providing the notice to the domestic partnership, which could then furnish the notice to other partners. The proposed regulations would also require the notice to be provided to any US person, such as a domestic partnership, that controls (within the meaning of section 6038(e)) the foreign corporation and is therefore a Category 4 filer of Form 5471.

S corporations with accumulated E&P

On September 1, 2020 the IRS issued Notice 2020-69 announcing that the government intended to issue regulations under section 958 to facilitate the smooth transition of S corporations with accumulated E&P from their historic entity treatment (and the hybrid treatment for section 951A purposes set forth in the 2018 Proposed Regulations) to the aggregate treatment required by the Final 951A Regulation (the "S corporation transition approach"). The S corporation transition approach permitted qualifying S corporations that elected entity status to be treated as an entity for purposes of applying section

951A until (but not including) the first year in which it no longer has E&P accumulated as of September 1, 2020, at which point it would start being treated as an aggregate. This approach enables amounts corresponding to S corporation shareholders' income inclusions with respect to the CFC to be distributed tax-free by the S corporation (even if no corresponding distributions have been made by the CFC) and prioritizes the distribution of S corporation accumulated E&P over C corporation accumulated E&P. The 2022 NPRM would adopt the S corporation transition approach for tax years of S corporations ending on or after September 1, 2020. Taxpayers are permitted to rely on this proposed regulation for tax years ending between June 22, 2019 and August 31, 2020 provided that the S corporation and its shareholders who are US shareholders consistently apply the proposed regulation to all CFCs owned by the S corporation.

> ***Observation:*** The S corporation transition approach of the 2022 NPRM does not extend to all S corporations, but rather is limited to certain S corporations with accumulated E&P.

Limited hybrid approach for GILTI

On August 22, 2019, the IRS released Notice 2019-46, which indicated that the government would issue regulations permitting a domestic partnership or S corporation to apply the hybrid approach of the 2018 Proposed Regulations with respect to the application of section 951A for tax years of foreign corporations ending before June 22, 2019 and tax years of US shareholders in or with which such tax years end. The 2022 NPRM contains proposed rules implementing Notice 2019-46. In order to apply the hybrid approach, certain notice requirements must be met; if they are, the passthrough entity can avoid certain filing penalties to the extent that the entity's actions were consistent with the 2018 Proposed Regulations.

Related person insurance income

The 2022 NPRM provides that, while the aggregate approach is generally applicable for purposes of the captive insurance company rules in section 953(c), an entity level approach should be applied in determining whether a foreign corporation is a CFC for purposes of the reduced 25% threshold for CFC status under section 953(c)(1)(A) and (B) as well as the ECI election under section 953(c)(3)(E). Outside the scope of RPII, the proposed regulations set forth an entity level approach for purposes of the election to treat an insurance CFC as a US taxpayer under section 953(d)(1). The proposed exclusions from the aggregate approach for these unique insurance industry-specific rules are consistent with the general exclusions for determining US shareholder and CFC status under sections 951 and 957.

In contrast, the Treasury and IRS recognize that treating a domestic partnership as an entity for income inclusion purposes under section 953(c) is inconsistent with the pro rata share rules in section 953(c)(5). Accordingly, in an update to proposed regulations under section 953 issued in 1991, new Prop. Reg. § 1.953-3(b)(1)(iii) applies an aggregate approach for determining the amount of RPII attributed to section 953(c)(1)(A) US shareholders that own an RPII CFC through a partnership or a series of partnerships. In particular, the 2022 NPRM provides that the partnership agreement and the principles of section 704(b) govern how premiums are allocated to each relevant partner. The 2022 NPRM also updates the definition of RPII from the 1991 proposed regulations to reflect the new aggregate treatment of partnerships for income inclusion purposes.

The proposed regulations treat a passthrough entity as a "related insured" if a related insured person owns stock in an RPII CFC through the passthrough entity, and further provide that a person other than a publicly traded

corporation or partnership is treated as a related insured if that person is more than 50% owned (directly, indirectly, or constructively) by RPII US shareholders.

Finally, the government expressed concern with the use of arrangements with unrelated parties to insure risks of related parties in a manner that would circumvent the RPII rules under section 953(c) (so-called "cross-insurance" transactions). Such arrangements between unrelated parties in similar lines of business were previously subject to anti-abuse rules under the 1991 proposed regulations, which provided that income from such transactions of a CFC was RPII to the related person. The 2022 NPRM replaces and expands this anti-abuse rule, applying the "cross-insurance" concept expansively to include certain coordinated risk-sharing arrangements even if the unrelated parties are not in a similar line of business.

The general RPII rules are proposed to apply to tax years of foreign corporations beginning on or after the date that they are published as final regulations, and to tax years of US persons in or with which such tax years end. However, to prevent perceived abuse, the cross-insurance transaction rule applies to tax years of foreign corporations ending on or after January 24, 2022, and to tax years of US persons in or with which such foreign corporation tax years end.

Net Investment Income tax

Under current law, a domestic partnership may make an election on behalf of its partners pursuant to Treas. Reg. § 1.1411-10(g) to currently include sections 951(a) and 1293(a) inclusions as NII. Under the 2022 NPRM, however, only individuals, estates, and trusts may make NII elections with respect to a CFC or QEF, a rule change intended to conform to the new aggregate approach for making QEF elections. This new rule also applies to S corporations. The Treasury and IRS also request comments on the calculation of net gain attributable to indirect dispositions of PFIC stock for purposes of section 1411.

Get in touch

Amitai Barth
Ari Berk
Meredith Blanding
Morgan Hann
Jason Robertson