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Exiting a Joint Venture Partnership That Owns a Foreign Subsidiary

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When a joint venture partnership owns a foreign subsidiary, different U.S. tax consequences can result to a U.S. corporate partner exiting the partnership, depending on whether: (1) the partnership is U.S. or foreign; (2) the subsidiary is sold by the partnership or the U.S. partner sells its interest in the partnership; and (3) the subsidiary is a controlled foreign corporation (CFC). Careful planning is important to minimize U.S. tax expense.

To illustrate, assume a U.S. corporation (USP) owns 50% of JVP, an entity classified as a partnership,¹ and the other 50% is owned by a foreign corporation (FP). JVP owns all of the stock in a foreign subsidiary (FS). JVP may be a U.S. or a foreign entity. For simplicity, we will assume JVP has no other assets, has no liabilities, and there are no special allocations.

Generally USP might expect to exit JVP recognizing capital gain in an amount equal to the amount received less its adjusted basis in JVP. As discussed below, however, because JVP owns stock in a foreign subsidiary (FS), under certain circumstances a portion of the gain can be reclassified as ordinary income. In addition, depending on how the exit is structured, the

¹ A foreign eligible entity with more than one owner may be classified as a corporation or a partnership for U.S. tax purposes. Regs. §301.7701-2, -3.

ordinary income portion of the gain can be treated as a deemed dividend from FS accompanied with foreign tax credits which can be used to reduce or eliminate USP's U.S. tax on the deemed dividend.

JVP Sells FS. If JVP sells the stock in FS (its foreign subsidiary), USP would include 50% of the gain in its income in the year of the sale. Gain recognized on the sale of the FS stock generally is capital gain, and it retains its character when included in income by USP.² USP's receipt of its share of the sale proceeds upon distribution from JVP generally should not result in additional U.S. taxation.³

Often stock in a foreign subsidiary can be sold without incurring foreign taxes. If, however, JVP pays foreign income tax on the gain, USP should be entitled to claim a foreign tax credit for income taxes paid on its share of the gain,⁴ subject to limitations.⁵ The source of the gain on the sale of the stock in FS is determined at the partner level, and generally should be U.S.-source under the residency rule (subject to certain exceptions).⁶ Any foreign-source capital gain should generally fall within the passive bas-

² §§1221, 702.

³ §731(a) (partner level) and (b) (partnership level).

⁴ §901(b)(5). See also §702(a)(6) and Regs. §1.702-1(a)(6); §703(b)(3) and Regs. §1.703-1(b)(2). The allocation of taxes among partners must have substantial economic effect. §704(b); Regs. §1.704-1(b)(4)(viii). USP should also be entitled to a credit for any withholding taxes paid on the distribution by JVP of the sales proceeds to USP (even though such distribution is not subject to U.S. taxation).

⁵ The amount of foreign income taxes that may be claimed as a credit by USP is limited by §904.

⁶ §865(a)(1), (g)(1)(A), (i)(5). Under certain circumstances gain on the sale of stock in a foreign corporation can be foreign-source

ket,⁷ and foreign taxes paid on any gain should be classified in the same basket as the gain.⁸

The U.S. tax results can change significantly if the foreign subsidiary is a CFC.⁹ FS would be a CFC if JVP is a U.S. partnership because FS would be wholly owned by a U.S. person.¹⁰

The sale by a U.S. JVP of stock in FS (a CFC) is subject to §1248.¹¹ Under that provision, the gain is recharacterized as dividend income to the extent of the undistributed earnings and profits (E&P) derived by FS while it was a CFC and owned by JVP. Such deemed dividend generally is foreign-source income¹² and general basket income under look-through rules.¹³ The deemed dividend would be accompanied with deemed-paid foreign taxes.¹⁴ USP's share of such taxes should flow through and be creditable against U.S. taxes on the §1248 amount.¹⁵ Thus, it is possible to significantly reduce U.S. taxes on the portion of gain recognized by USP on exit that is treated as a dividend under §1248 (without paying any additional foreign taxes).

If JVP instead were a foreign entity, under the above facts FS would not be a CFC, and §1248 would not apply. However, if USP owned more than 50% of JVP, FS would be a CFC. Although JVP would not be a U.S. shareholder, USP would be a "United States shareholder" and the regulations provide that §1248 is applied by treating USP as selling its proportionate share of the stock of FS.¹⁶ Because the application of

§1248 generally is beneficial, consideration might be given to taking steps to cause FS to become a CFC.¹⁷

It should be noted that only E&P derived by a foreign subsidiary after becoming a CFC are taken into account for purposes of §1248. To access pre-CFC E&P with accompanying foreign tax credits, FS could distribute a dividend of such E&P prior to being sold, which can provide a result similar to the application of §1248.¹⁸ A pre-sale distribution might also be considered if CFC status is not obtained for FS.¹⁹

USP Sells Its Interest in JVP. If USP sells its interest in JVP (a partnership), under the general rules any gain recognized would be capital gain.²⁰ This is the case whether JVP is a U.S. or foreign entity.

However, gain on the sale of an interest in a partnership can be recharacterized as ordinary income to the extent the amount received is for the partner's interest in the partnership's unrealized receivables or inventory items. In relevant part, §751(c) provides that the term "unrealized receivables" includes the amount of gain treated as ordinary income under §1248 if stock in a CFC owned by the partnership were sold by the partnership.²¹ The §1248 amount is determined under the rules discussed above.

As discussed above, FS would be treated as a CFC if JVP were a U.S. partnership. On the other hand, if JVP were a foreign partnership, FS would not be a CFC under the above facts (unless there is otherwise sufficient ownership by USP to cause FS to be a CFC).

Where FS is a CFC, an issue arises concerning whether the amount of gain recognized by USP on the

income. §865(e), (f), and (h). Foreign income taxes paid on both foreign-source and U.S.-source gain are creditable.

⁷ Regs. §§1.904-4(b)(2)(i)(A), 1.904-5(c)(4)(iv), *Ex. 2*. *But see* Regs. §1.904-4(c)(1) (high-tax kick-out to general basket).

⁸ Regs. §1.904-6(a).

⁹ §957 (a foreign corporation is a CFC if U.S. persons that own at least 10% of the voting stock own in the aggregate more than 50% of the vote or value of the stock of the foreign corporation, taking into account stock owned indirectly and constructively).

¹⁰ §957(c); *see* Regs. §1.701-2(f), *Ex. 3*.

¹¹ Rev. Rul. 69-124, 1969-1 C.B. 203; *see* REG-135866-02, 71 Fed. Reg. 31985 (6/2/06), at 31989.

¹² §865(k)(1).

¹³ §904(d)(3); Regs. §1.904-5(c)(4)(iv), *Ex. 2*. *See* Regs. §1.904-5(h) and (i) (look-through rules applied to distributive share of partnership income).

¹⁴ §1248(a); Regs. §1.1248-1(a) and (d); Regs. §1.902-1(a)(11). *See* §902(c)(7) (10% voting test applied at partner level); Regs. §1.904-5(a)(4).

¹⁵ *See* n. 4, above. Any excess foreign taxes associated with the gain recharacterized as ordinary income under §1248 should also be available to offset U.S. tax on other foreign-source general basket income, and any excess foreign tax credits USP has in the general basket should be available to offset U.S. tax on the §1248 deemed dividend.

¹⁶ Regs. §1.1248-1(a)(4) and (5), *Ex. 4*. These regulations became effective in 2007. Prior to these regulations, apparently

§1248 did not apply to a sale by a foreign partnership of a foreign subsidiary even if it were a CFC, because §1248 applies only when a U.S. person sells stock in a CFC, and a foreign partnership is not a U.S. person. *See* Morrison, "Section 1248's Application to the Sale of CFC Shares by a Foreign Partnership," 32 *Tax Mgmt. Int'l J.* 85 (2/14/03).

¹⁷ This might be achieved by having USP acquire a small additional interest in JVP or a small interest in FP. Regs. §1.957-1(c), *Exs. 8* and *9*. Before taking steps to cause FS to become a CFC, the results of the application of Subpart F to FS should be assessed.

¹⁸ §902(a); *see* §902(c)(7) (10% voting test applied at partner level); Regs. §1.904-5(a)(4). The look-thru rules for basket purposes apply to a dividend received from a foreign corporation where the U.S. shareholder owns at least 10% of the voting stock, even if the foreign corporation is not a CFC. §904(d)(4). *See* Yoder, "Look-Through for 10/50 Joint Venture Corporations: Not a Panacea," 32 *Tax Mgmt. Int'l J.* 86 (2/14/03).

¹⁹ *See, e.g., Litton Industries Inc. v. Commissioner*, 89 T.C. 1086 (1987); *Uniroyal, Inc. v. Commissioner*, T.C. Memo 1993-214; Rev. Rul. 75-493, 1975-2 C.B. 109. Under certain circumstances a pre-sale dividend can be integrated with the stock sale, and recharacterized as sales proceeds. *See, e.g., Waterman Steamship Co. v. United States*, 430 F.2d 1185 (5th Cir. 1970).

²⁰ §741.

²¹ Regs. §1.751-1(a), (c)(4)(iv). *See also* §724(a) (sale by a partnership of unrealized receivable contributed by a partner).

sale of its interest in JVP that is treated as ordinary income under §751 is analyzed as if it were a §1248 deemed dividend, or as if it were some unique ordinary income inclusion. The issue is not expressly addressed in the Code, regulations, or any published ruling. It appears that the position of the IRS is that §1248 would not apply, apparently because the income is ordinary under §751 and not under §1248.²²

Under this view, USP would not obtain any deemed-paid taxes, and the gain treated as ordinary income generally would be U.S.-source, fully subject to U.S. taxation. In addition, the §751 portion of the gain could not be reduced by capital losses.

From a policy perspective, the proper treatment would be to adopt an aggregate approach and apply §1248 to the extent of the amount of the gain that is recharacterized as ordinary income under §751 by reference to §1248. This would achieve the same result as if the partnership had sold the CFC stock. Under the approach of the IRS, the U.S. tax result generally is worse than if the partnership had sold the CFC stock. Thus, it would seem appropriate for the IRS to issue guidance applying an aggregate approach for this purpose, similar to its regulations that adopted an aggregate approach for purposes of applying §1248 to the sale of CFC stock by a foreign partnership.²³

²² See T.D. 9345, 72 Fed. Reg. 41442 (7/30/07), at 41443; T.D. 9644, 78 Fed. Reg. 72394 (12/2/13), at 72419; §1248(g)(2)(B); Regs. §1.1248-1(e)(2) (§1248 does not apply to amounts treated as ordinary income under another provision of the Code).

²³ The IRS has treated a partnership as an aggregate in other

Exit Planning. With a U.S. JVP, the best exit approach from a U.S. tax perspective generally is for JVP to sell FS (a CFC) to obtain the foreign tax credit benefits provided by §1248. If this is not feasible and USP must sell its interest in JVP, then FS could distribute its §1248 E&P prior to the sale and thereby USP should obtain a similar benefit.²⁴

With a foreign JVP where FS is a CFC, a sale by JVP of FS should provide the §1248 foreign tax credit benefits. If FS is not a CFC or USP must sell its interest in the foreign JVP, then having FS pay out its E&P prior to exit should provide USP with similar foreign tax credit benefits.

contexts to achieve what it perceived to be the proper tax result. See, e.g., Regs. §1.952-1(g)(1) and Rev. Rul. 91-32, 1991-1 C.B. 107.

²⁴ If a U.S. partner cannot use foreign tax credits (e.g., it has overall foreign losses or net operating losses) and has substantial capital losses, consideration might be given to using a foreign entity for a 50/50 JVP that owns a foreign subsidiary. This should avoid ordinary income upon exit that results under §751 or §1248 from FS's being a CFC when owned by a U.S. JVP.

²⁵ Another common foreign joint venture structure is for USP to have one of its wholly owned foreign subsidiaries (i.e., a CFC) own its interest in JVP (classified as a partnership). If FS is disregarded, most or all of the gain on exit should not be currently subject to U.S. tax as Subpart F income. For Subpart F purposes, the CFC partner would be considered as deriving gain on the sale of the assets of FS, whether it sells its interest in JVP or JVP sells the interests in FS. §954(c)(4). Such gain would not be Subpart F income to the extent the assets are used in a trade or business (including intangibles). Regs. §1.954-2(e)(3). See also Yoder, "Foreign Corporate Joint Ventures: Foreign Tax Credit Planning," 42 *Tax Mgmt. Int'l J.* 482 (8/9/13).