Tax Traps in Cross-Border Partnerships

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Practicing Law Institute recently held a three-day seminar addressing tax planning for domestic and foreign partnerships and joint ventures. In one panel, Paul Oosterhukis of Skadden Arps, Christopher Trump of Deloitte and Daniel McCall of the IRS discussed international tax aspects of joint ventures. The panel focused on unique aspects of cross-border partnerships that can sometimes be traps for the unwary.

When in Doubt, Make it Foreign

Partnership tax law is a mix of aggregate and entity principles. This highlights the importance of considering the implications of different types of entities. In the context of outbound transfers of property by U.S. persons, the aggregate rules can help alleviate concerns about Code Sec. 367. The partners of a partnership are generally deemed to own the property of a partnership in proportion to their ownership interest. That means the normal rules of Code Sec. 367 have limited application to transfers of property to a partnership.

In some cases, however, the entity rules applied to partnerships can create head-scratching results in the international context. For example, it has long been settled that a U.S. partnership (measured at the entity level) is a U.S. person. This means that if a U.S. partnership owns more than 50 percent of a foreign corporation, the foreign corporation will be a controlled foreign corporation subject to Subpart F. This is true even if the U.S. partnership is owned entirely by foreign persons.

Inversions Too

Curious results can also occur with inversions. Assume that a U.S. partnership (again wholly owned by foreign persons) holds foreign operations as disregarded entities. If the U.S. partnership is sold to another foreign person, that transaction could be characterized as an inversion!

It is generally possible to convert a U.S. partnership to a foreign partnership with minimal tax consequences. But if a potential inversion is on the horizon, it is important to have a business purpose for the conversion (not just avoiding the U.S. inversion rules). If the conversion from a domestic to foreign partnership is completed solely to make Code Sec. 7874 inapplicable, the rules can nonetheless apply to a subsequent sale of the newly foreign partnership.

PLI's course *Tax Planning for Domestic & Foreign Partnerships, LLC's, Joint Ventures and other Strategic Alliances* is available at *www.PLI.edu*.