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U.S. Private Equity Funds Making Cross-Border Investments—Primary Tax Considerations,  
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## INTERNATIONAL

## U.S. Private Equity Funds Making Cross-Border Investments— Primary Tax Considerations

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*Tax law, in the U.S. and abroad, may be slow to adapt to changing business practices, but the explosive growth of cross-border private equity investments has spurred interest in changes to various rules, which already are extremely complicated. The place of organization and the choice of entity may have crucial consequences both during the operation of the fund and for its exit strategy.*

Private equity funds making cross-border, leveraged buyout investments face certain primary U.S. tax considerations in addition to certain foreign tax issues. The key tax issues that arise during the formation of the fund itself will be explored below, along with the primary tax drivers for the fund sponsors, U.S. taxable investors, and certain foreign and tax-exempt investors. U.S. and foreign alternatives to establishing a fund to make cross-border investments also will be considered.

Other issues relate to the formation of an acquisition vehicle for future non-U.S. portfolio investments. There may be advantages to establishing a non-U.S. acquisition vehicle, and both U.S. and non-U.S. tax considerations will affect the structure of acquisitions of foreign targets.

Finally, there will be U.S. tax consequences of certain exit events, including earnings repatriation (to the U.S.) from a foreign portfolio company, the sale of a part of a portfolio company's foreign subsidiaries or operations, and a sale of the portfolio company group altogether.

### Primer on Private Equity Fund Structure

In its most basic form, a private equity fund is organized for U.S. federal tax purposes as a flow-through entity, such as a limited partnership or LLC (generally referred to as "the fund"). Investors put money into the fund in exchange for equity interests. Investors typically commit to providing a

specified amount of capital, which is "called" as needed by the fund to make its investments. Capital commitments and capital calls are subject to time limitations. The fund organizational documents will contain a "waterfall" provision that specifies the priority of cash distributions and tax allocations from the fund to the investors.

The fund sponsors and/or managers generally organize a separate entity to serve as the general partner and/or manager of the fund. <sup>1</sup> The manager's stake in the fund has two components:

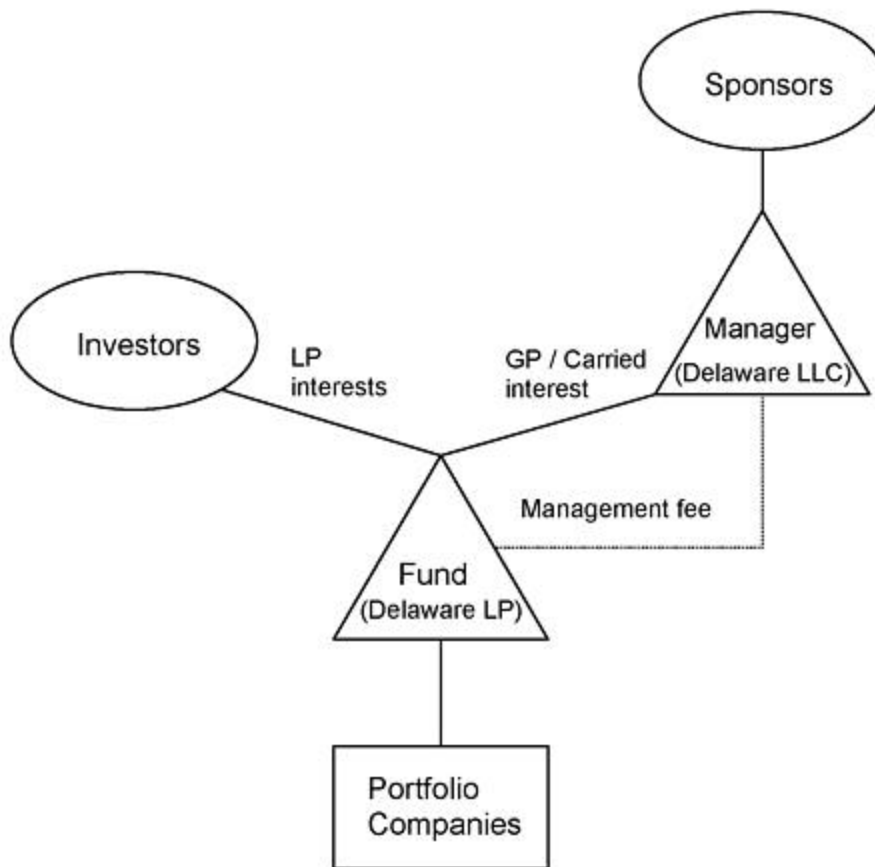
- (1) A management fee (around 1% to 2%).
- (2) The "carry" or "carried interest," which is a profits interest in the fund that entitles the manager to receive a specified percentage of future profits and gains (usually 20%). <sup>2</sup>

The manager often, but not always, contributes some capital for its carried interest. In addition, the manager may contribute to the fund additional capital in exchange for fund equity interests with terms similar or identical to those held by the investors.

Once the fund and manager have been established, the fund begins to implement its investment strategy. For a leveraged buyout (LBO) fund, the fund will acquire controlling (often 100%) stakes in mature businesses that the LBO fund will hold and operate with the intention of improving and selling them in the medium to long term.

This basic fund structure, or variations thereof, exists across all types of private (and even public) investment funds. Exhibit 1 illustrates a basic fund structure.

## **Exhibit 1. Basic U.S. Fund Structure**



## Types of Funds

The definition of "private equity fund" is not universally agreed upon. Private equity funds can include:

- Venture capital funds, which typically invest in start-up companies with innovative ideas or business models but limited access to traditional financing.
- Angel funds, which provide small amounts of financing to start-up companies and often involve informal networks such as wealthy friends or relatives.
- Mezzanine funds, which provide bridge financing to a company while it is preparing for a public offering or other significant event.
- LBO funds.

Our focus is primarily on the taxation of LBO funds. In general, LBO funds obtain third-party debt to acquire controlling interests in target companies that have an established business. Targets may be either stand-alone businesses or divisions of otherwise integrated businesses, but they typically have a history of sustained operations, regular cash flow, and a defined market. The cash flows generated by such businesses necessarily must be sufficient to service the increased amount of debt incurred as part of the buyout. LBO funds generally seek to acquire and operate such companies and then exit the investments through a medium to long-term (e.g., three to seven years<sup>3</sup>) sale or initial public offering.

The investors in an LBO fund may be U.S. or foreign, corporate or individual, taxable or tax-exempt. For purposes of this article, we focus on the taxation of U.S. sponsored LBO funds that have U.S. investors, both taxable individuals and corporations.<sup>4</sup> Nevertheless, because of the importance and regular participation of tax-exempt and foreign investors in these funds, we will periodically make

reference to certain key tax concerns of such investors.

## Growth of Cross-Border Buyout Funds

Buyout funds have continued to grow in size and activity in recent years. In 2006, LBO/mezzanine funds raised nearly \$103 billion, the highest fundraising year ever, compared with \$96 billion in 2005 and \$51 billion in 2004.<sup>5</sup> The universe of private equity funds raised a record \$215.4 billion in 2006.<sup>6</sup> Not only has the absolute amount of fundraising increased, the amount of fundraising per fund has increased significantly as well. In 2004, the mean investment amount of capital raised by LBO and mezzanine funds was \$369 million per fund. This increased to \$540 million in 2005 and \$746 million in 2006.<sup>7</sup> The largest buyout fund of 2006, TPG Partners V, LP, raised \$14 billion during the year.<sup>8</sup> This growth trend among LBO funds seems to be continuing into 2007, with Texas Utilities agreeing to a record buyout of \$45 billion (including debt assumption) by a consortium of buyers led by Kohlberg Kravis Roberts & Co. and Texas Pacific Group.<sup>9</sup>

Cross-border investment by LBO funds has increased as well, both in the number of acquisitions and in the size of the acquisitions. For example, private equity investment in emerging markets has ballooned in recent years. In 2006, 162 emerging market funds raised \$33.2 billion for investments in Asia, Eastern Europe, Latin America, the Middle East, and Africa, a 29% increase over 2005.<sup>10</sup>

## FORMATION OF THE LBO FUND

Building on the basic fund structure discussed above (and illustrated in Exhibit 1), the most common LBO fund structure involves a pass-through entity. In the U.S. context, this typically is either a Delaware limited partnership (LP) or a Delaware LLC. If the fund is likely to make substantial non-U.S. investments, however, the fund often will be organized as a foreign limited partnership or as a foreign entity that is eligible to be treated as a partnership for U.S. tax purposes under the check-the-box Regulations. Organizing the LBO fund as a non-U.S. entity may mitigate the unnecessary application of the U.S. controlled foreign corporation (CFC) anti-deferral regime.<sup>11</sup> As discussed further below, even with an identical U.S. investor base, two otherwise identical funds—one organized in the U.S. vs. the same fund organized outside the U.S.—may result in significantly different tax consequences to the general partner and to U.S. and foreign investors.

## Impact of Fund Jurisdiction on U.S. Anti-Deferral Rules

While the choice of whether the fund should be organized in the U.S. or in another country is critical to foreign and certain tax-exempt investors, it also can have a profound impact on the application of various anti-deferral rules that may apply to the general partner and other taxable U.S. investors.

When an LBO fund acquires a controlling interest (e.g., more than 50%) in a foreign portfolio company that is taxable as a corporation, the U.S. investors in such fund generally incur no tax until the repatriation of the earnings of the corporation or the disposition of the portfolio company. Various U.S. anti-deferral regimes, however, tax certain U.S. taxable investors immediately on certain earnings of the foreign portfolio company ("phantom income"), even if such earnings are not distributed. The primary U.S. anti-deferral vehicles are the CFC regime and the passive foreign investment company (PFIC) regime.<sup>12</sup> Whether these rules apply may depend on whether the fund is formed in the U.S.

**CFCs.** A CFC is any foreign corporation if more than 50% of (1) the total combined voting power of all classes of stock of such corporation entitled to vote or (2) the total value of the stock of such corporation is owned (or is considered as owned under certain attribution rules) by "U.S. shareholders" on any day during the tax year of such foreign corporation.<sup>13</sup> With respect to a foreign corporation, a "U.S. shareholder" is any U.S. person who owns (or is considered as owning under certain attribution rules) 10% or more of the total combined voting power of all classes of stock entitled to vote of such

foreign corporation. <sup>14</sup> Notably, a "U.S. person" includes a domestic partnership but not a foreign partnership. <sup>15</sup>

Under these rules, therefore, if the LBO fund is organized as a domestic partnership and such partnership purchases a 100% interest in a foreign target taxable as a corporation for U.S. tax purposes, the foreign target will be a CFC. U.S. taxable investors may have to include in income their attributable share of any "Subpart F income" of the CFC, regardless of the ownership percentage such U.S. investor has in the fund. <sup>16</sup> In other words, U.S. investors that otherwise would not be "U.S. shareholders" (i.e., they would not own 10% of the vote) if they invested in the foreign portfolio company directly nevertheless may be subjected to phantom income risk by investing through a U.S. fund. This would be the case even where, absent the domestic partnership, the portfolio company would not be a CFC—i.e., even if the U.S. fund were owned almost entirely by foreign persons. <sup>17</sup>

Special rules under Section 1248 may apply when a U.S. person such as a U.S. fund sells shares of a CFC. Under such rules, certain U.S. investors would have to treat a portion of any gain realized by the fund on the disposition of the stock of the CFC as a dividend. <sup>18</sup> For individual U.S. investors, the gain recharacterized as a deemed dividend may be "qualified dividend income" taxable at reduced long-term capital gains rates, provided certain requirements are met. <sup>19</sup> For certain U.S. corporate investors, the gain recharacterized as a dividend is generally beneficial because it may carry indirect foreign tax credits that can shelter tax on the gain. <sup>20</sup> Furthermore, as in the context of the application of the general CFC rules and Subpart F inclusions by investors, whether the fund is organized within or outside the U.S. will, under present law, affect the application of Section 1248. These rules will be discussed in greater detail below. As a practical matter, however, a fund should plan for efficient exits at the time of its formation, and most often, an efficient exit can be achieved through a foreign fund.

Subpart F income generally includes passive-type income that is perceived as being easily moveable to low-tax jurisdictions. There are multiple categories of income that constitute Subpart F income. The "foreign personal holding company income" category generally includes income such as dividends, interest, and royalties, but Subpart F income generally does not include income from active operations. <sup>21</sup> For example, if a portfolio company earns interest on loans to "regarded" subsidiaries and various look-through rules do not otherwise apply, <sup>22</sup> the interest income may generate Subpart F income that would be taxable to a fund's U.S. investors—all taxable U.S. investors in the case of a domestic fund and only certain taxable U.S. investors in the case of a foreign fund. Moreover, deemed income inclusions under Subpart F do not qualify for the reduced long-term capital gains rate accorded to qualified dividend income. <sup>23</sup> Various planning techniques, discussed in more detail below, generally can help mitigate the application of Subpart F and phantom income risk, even if the portfolio investment is a CFC. <sup>24</sup>

If the fund is organized in a jurisdiction other than the U.S., the foreign portfolio companies may not be CFCs at all. Unlike a domestic partnership, a foreign partnership is not a U.S. shareholder for purposes of the CFC rules. Whether the portfolio company will be a CFC therefore depends on the indirect and constructive ownership of U.S. investors in the portfolio company. <sup>25</sup> When foreign portfolio company stock is owned through a foreign partnership, the company is treated as being owned proportionately by the partners in the fund for purposes of determining whether the company is a CFC. <sup>26</sup> If U.S. investors own 50% or less of the fund and/or if no U.S. investor owns 10% or more of the fund, the portfolio company will not be a CFC. <sup>27</sup> Therefore, as a general matter, organizing an LBO fund as a foreign flow-through entity is generally advantageous from a U.S. tax perspective because it may preclude the unnecessary application of the CFC, Subpart F, and Section 1248 rules. <sup>28</sup>

**PFICs.** Like the CFC rules, the PFIC rules can apply when a fund invests in a foreign portfolio company. Unlike the CFC regime, however, there is no minimum ownership requirement for a foreign corporation owned directly or indirectly by a single minority U.S. person to be considered a PFIC. If a portfolio company is a PFIC, the potential tax consequences to taxable U.S. investors (regardless of ownership percentage) is that tax deferral (or the benefit thereof) of the PFIC's income is precluded through an

interest charge, phantom income, or through marking-to-market the stock of the PFIC. [29](#)

A foreign corporation is a PFIC if 75% or more of the gross income of such corporation for the year is passive income, or if 50% or more of its assets for the year produce passive income or are held for the production of passive income. [30](#) For this purpose, "passive income" means income that would be foreign personal holding company income. [31](#) For example, this would include interest, dividends, and certain rents and royalties. [32](#) If a PFIC is also a CFC, the foreign corporation will not be treated as a PFIC, i.e., where both the CFC and PFIC regimes apply, the CFC rules trump the PFIC rules. [33](#) Unlike the CFC regime, a corporation can be a PFIC even if only a single U.S. person owns only a small percentage (e.g. 1%) of the stock of the corporation.

Four of the more likely situations potentially implicating the PFIC rules that could arise in the context of an LBO fund making cross-border investments are:

- The fund is domestic and owns more than 50% of a foreign portfolio company. The PFIC rules would not apply as to the fund or investors in the fund (that otherwise would meet the definition of a U.S. shareholder) because of the CFC overlap rule. [34](#) The overlap rule applies, however, only to U.S. shareholders, i.e., those that own 10% of the vote of the foreign corporation. Thus, a foreign portfolio company may remain a PFIC as to U.S. investors in the fund that indirectly own less than 10% of the foreign portfolio company.
- The fund is domestic and the fund owns less than 50% of a foreign portfolio company. The PFIC rules may apply if the portfolio company satisfies the PFIC definition.
- The fund is foreign and the fund owns shares in a PFIC. Taxable U.S. investors in the fund will be subject to tax on their distributive share of the fund's income resulting from ownership of the PFIC. [35](#)
- If a foreign corporate blocker entity is organized to invest in a foreign fund and it has U.S. owners, it may be a PFIC.

Moreover, assuming the CFC rules do not apply, an investment in a PFIC can result if the fund invests in a start-up company with little revenue in its first several years of operations other than passive income (such as interest on a working capital bank account). The PFIC rules provide for a start-up exception, [36](#) under which a foreign corporation will not be treated as a PFIC for the first tax year in which the corporation has gross income (the "start-up year"), if all of the following conditions are met:

- (1) No predecessor corporation was a PFIC.
- (2) It is established that the corporation will not be a PFIC for either of the first two tax years following the start-up year.
- (3) The corporation in fact is not a PFIC for either of the first two tax years following the start-up year.

Nevertheless, because LBO funds typically acquire controlling interests in companies with established operations (and revenues) and because the CFC rules trump the PFIC rules, it is unlikely that a portfolio company would be a PFIC, i.e., the funds' foreign investments generally will be either CFCs, or neither CFCs nor PFICs, and the start-up rules generally will not be implicated. Foreign holding companies [37](#) and internal financing companies also have the potential of being classified as PFICs if the CFC rules do not otherwise apply. [38](#) Furthermore, certain foreign blocker entities through which foreign and U.S. tax-exempt investors invest may technically be PFICs, but without negative tax consequences to the U.S. tax-exempt investors.

## Choice of Entity

The considerations vary depending on whether the fund is to be organized as a domestic fund or a foreign fund.

**Domestic funds.** For funds organized in the U.S., the Delaware LP remains the most common entity choice, although LLCs are gaining in popularity. The income, gain, loss, and deductions of each of these entities flows through to the investors, provided that the fund does not file an election to be treated as an association taxable as a corporation and otherwise is not treated as a publicly traded partnership (PTP) taxable as a corporation. [39](#)

As a partnership for U.S. tax purposes, the fund generally may make distributions to its investors free of U.S. federal tax to the extent of each partner's basis in its partnership interest. [40](#) Such a fund is subject to the general partnership rules of Subchapter K that apply to any other U.S. partnership.

In an LP, the limited partners' (i.e., the investors') liability is limited to their investment. The general partner has unlimited liability for partnership liabilities, but organizing the general partner entity as a limited liability entity (usually an LLC) helps shield the sponsors, who will own the general partner entity, from unlimited liability. [41](#) As stated above, LPs are generally formed under Delaware law, which has flexible governance provisions, including allowing partners to modify fiduciary duties by contract. [42](#)

LLCs are growing in popularity as the entity of choice for a U.S. fund. LLCs have some potential advantages over LPs. The managing member of an LLC does not have unlimited liability. As noted above, however, LPs can achieve a similar result where the general partner itself is an LLC. Also, theoretically limited partners in an LP can lose their limited liability if they actively participate in management, but as a practical matter the limited partners have very limited roles. [43](#)

More important, the LLC may have some distinct disadvantages in the cross-border context. Certain foreign countries do not recognize LLCs as residents for treaty purposes. The Canada Revenue Agency (CRA), for example, takes the position that LLCs are not residents for purposes of the U.S.-Canada treaty. [44](#) Therefore, the treaty positions of the countries in which the fund is likely to invest should be considered to determine whether the use of an LP or LLC would make a difference.

**Foreign funds.** As demonstrated above, organizing the fund outside the U.S. can have certain U.S. tax advantages. Foreign funds are likely to be organized in tax-favorable jurisdictions with low withholding taxes, low tax rates on dividend and capital gain income, developed laws regarding the governance and taxation of legal entities and their investors, and access to an expansive income tax treaty network. [45](#)

*Electing partnership status of foreign fund.* Under the check-the-box Regulations, certain foreign legal entities are considered "per se" corporations and therefore are not eligible to be treated as partnerships for U.S. tax purposes. [46](#) If not a per se corporation, a foreign entity with two or more members nonetheless will be classified as a corporation by default if no member has unlimited liability. [47](#) Thus, the foreign analog to an LLC would be classified by default as a corporation for U.S. federal tax purposes. [48](#) The fund (assuming it is not a per se corporation) nevertheless may elect to be classified as a partnership for U.S. tax purposes. [49](#) Inadvertently organizing the fund as a per se entity or failing to make a timely check-the-box election to treat the foreign fund as a partnership for U.S. tax purposes could have disastrous tax consequences because the fund itself might be an undesirable PFIC or CFC. [50](#)

*Certain U.S. tax issues related to foreign funds and investors.* Although not the primary focus of this article, there are certain key issues that may arise if the fund's investments also include U.S. portfolio companies. In addition to U.S. trade or business issues, qualification for treaty benefits for the foreign owners of the fund may not be available because of numerous limitations.

For example, most U.S. bilateral income tax treaties contain limitation-on-benefits provisions that would deny treaty protection if certain ownership and/or business activity requirements are not satisfied. [51](#) Moreover, U.S. domestic law may preclude income tax treaty benefits to a nonresident if payments from the U.S. are made through fiscally transparent entities or if conduit arrangements are

employed. [52](#)

Treaty benefits are generally not necessary, however, to exempt foreign investors from U.S. taxation on capital gains from the sale of U.S. portfolio company stock. [53](#)

## Avoiding Taxation as a Corporation

Even where a fund otherwise would be classified as a partnership under the check-the-box Regulations, it still must avoid being taxed as a corporation under the PTP rules. Under the PTP rules, a partnership is a PTP if an interest in the partnership is traded on an "established securities market" or is "readily tradable on a secondary market or the substantial equivalent thereof." [54](#)

Many private equity funds rely on the "private placement" safe harbor, which provides that the fund's interests will not be considered to be readily tradable on a secondary market or the substantial equivalent thereof if all the interests were issued in transactions not subject to registration under the Securities Act of 1933 and the partnership does not have more than 100 partners at any time during the partnership's tax year. [55](#) The safe harbor does not apply with respect to sales of partnership interests outside the U.S. unless exemption from registration under the Securities Act of 1933 would have been available if the interests had been offered and sold in the U.S. [56](#) An anti-avoidance rule prevents the use of tiered arrangements (such as tiered partnerships, grantor trusts, or S corporations) with a principal purpose to permit the partnership to satisfy the 100-partner limitation. [57](#)

Funds that do not qualify for the private placement exception nonetheless may avoid being taxed as a corporation under the PTP rules by otherwise establishing that interests in the fund are not readily tradable or by satisfying the "qualifying income exception." This exception generally will apply if, for each tax year of the partnership, 90% or more of the gross income of the partnership is "qualifying income," which includes most types of interest, dividends, and capital gains. [58](#) As long as the fund's investments are exclusively entities taxable as corporations for U.S. federal tax purposes, the fund is likely to meet the qualifying income exception because its income will consist solely of dividends, capital gains, and interest. [59](#)

## Tax-Exempt and Foreign Investor Considerations

Certain pervasive tax issues are encountered by foreign persons and U.S. tax-exempt entities investing in a U.S. sponsored private equity fund. Foreign persons generally do not pay tax on U.S. source income, unless the income is (1) fixed or determinable annual or periodic (FDAP) income or (2) ECI.

FDAP generally includes nonbusiness items of income from U.S. sources such as interest, dividends, and rents, and is taxed on a gross basis at the rate of 30% unless a treaty between the U.S. and the foreign person's country of residence provides for a lower rate. [60](#) ECI is taxed on a net basis at the applicable individual or corporate rate. [61](#)

Foreign corporations are also subject to the "branch profits tax" on deemed repatriations of ECI at a 30% rate. [62](#) ECI includes gain from the disposition of a "U.S. real property interest" (USRPI). [63](#) Stock in a U.S. corporation will constitute a USRPI if the FMV of the USRPIs held by the corporation equals or exceeds 50% of the sum of the FMV of the corporation's real property (both in the U.S. and abroad) and any other assets used or held for use in the corporation's trade or business. [64](#)

These issues should not arise or can be minimized where (1) the fund is foreign and the fund makes investments in non-U.S. portfolio companies, (2) the foreign investors invest directly through a U.S. fund (that itself invests in non-U.S. portfolio companies) and the U.S. fund is not engaged in a U.S. trade or business and has no ECI, [65](#) or (3) the foreign investors invest through a foreign corporate

blocker entity.

The income of U.S. tax-exempt investors is generally not subject to U.S. federal income tax unless the income is unrelated business taxable income (UBTI), which is subject to tax at regular corporate rates. <sup>66</sup> UBTI is gross income derived from any "unrelated trade or business ... regularly carried on" by the exempt organization, less deductions allowed that are directly connected with the carrying on of such trade or business. <sup>67</sup> Dividends and interest, among other items, are specifically excluded from the definition of UBTI. <sup>68</sup> If, however, the property producing dividends or interest is financed using leverage, it may constitute "unrelated debt financed income" (UDFI), which is a separate type of UBTI. <sup>69</sup> Thus, tax-exempt investors generally are not taxed on dividends they receive from investments, including where such investments are made through a private equity fund, unless the investments are acquired through the use of leverage at the fund level or at the level of a foreign corporate blocker entity (through which U.S. tax-exempt entities often invest). In the international tax context—where the CFC and PFIC rules often apply—two special rules generally exempt from UBTI both Subpart F income and certain income from a PFIC. <sup>70</sup> Therefore, as a general matter, U.S. tax-exempt investors should be not be negatively affected by UBTI whether a foreign portfolio company is a CFC or whether a foreign blocker entity through which it invests is either a CFC or a PFIC.

## General Partner and Management Company

As noted above, the general partner of a fund is typically organized as an LLC in order to achieve flow-through status and to impose an additional layer of legal liability protection. The management company may be a separate LLC from the general partner, or the general partner also may be the management company. Also as noted above, in the typical private equity fund the general partner usually receives a 20% carried interest in the fund, entitling the general partner to 20% of the fund's profits and gains. The management company (or the general partner, if not organized as a separate entity) generally receives a management fee that covers the cost of running the fund, including salaries and overhead. A common fee is 1% to 2%, although it may vary based on numerous factors.

Certain recurring U.S. tax issues for the general partner/manager in an LBO fund making cross-border investments are:

- Ensuring status as a partner. <sup>71</sup>
- Preserving taxation at long-term capital gains rate, rather than ordinary income rates, on the carried interest. <sup>72</sup>
- Minimizing risk that the activities of the general partner/manager would give rise to a U.S. trade or business for a fund. <sup>73</sup>
- Taxation on the receipt of the carried interest and compensating members of the general partner. <sup>74</sup>
- Issues related to complying with partnership accounting and allocation rules while trying to preserve the economic bargain.

Recently, the taxation of the carried interest has attracted the attention of the Congress and the press. Although based on no authority we are aware of, it has been suggested by some that the carried interest should be taxed at ordinary income rates. We see no sound policy reason for changing current law. <sup>75</sup>

In the international context, the jurisdiction of the general partner (entitled to the carry) can have a significant impact on the taxation of the fund sponsors (i.e., the owners of the general partner entity) and U.S. investors in the fund. Because the general partner controls the fund (even if foreign), the general partner, if organized as a domestic entity, could be viewed as a U.S. shareholder for purposes of the CFC, Subpart F, and Section 1248 rules, described in more detail below. Sometimes a manager/general partner may not be able to avoid being organized as a U.S. entity or may have historically (or inadvertently) been established as such. Therefore, the consequences of CFC ownership

and exit should be of particular interest to fund sponsors and general partners.

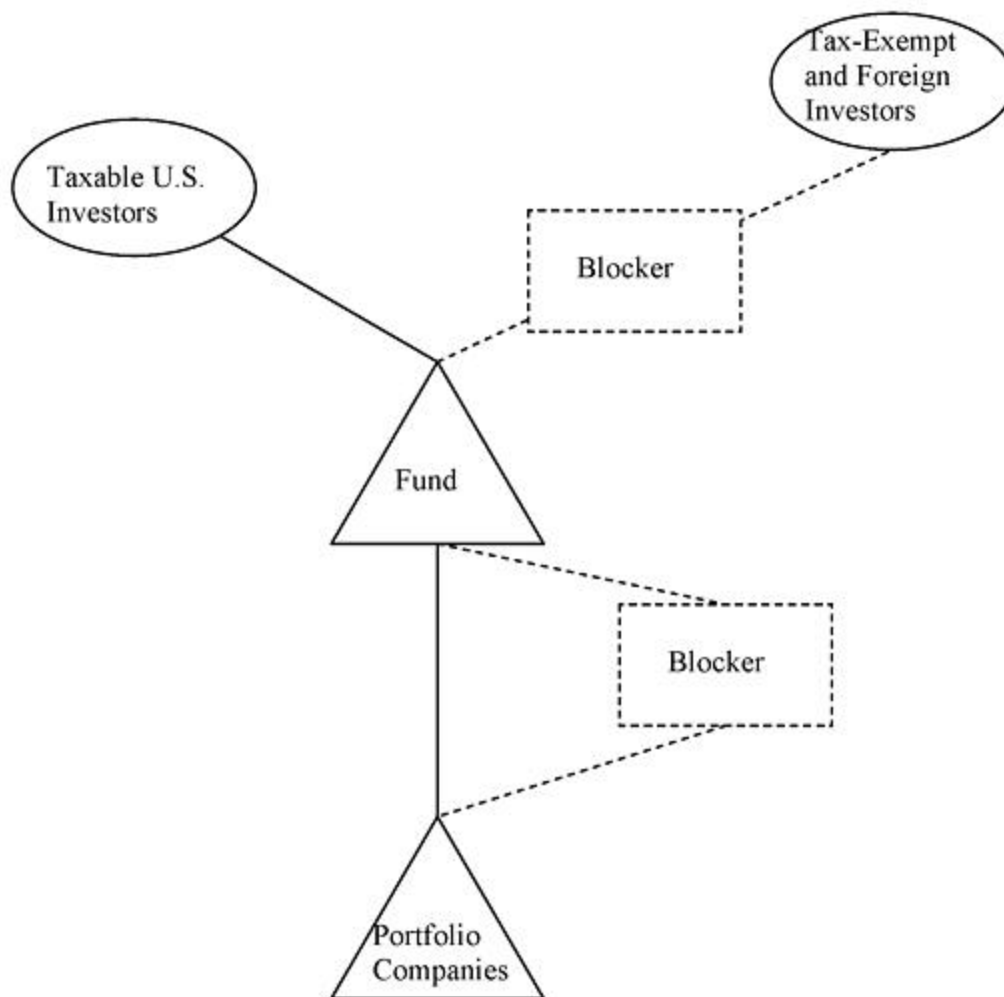
## **Alternative and Parallel Investment Vehicles**

In order to address the commercial and tax-related concerns of different classes of investors, many private equity funds organize one or more "alternative," "blocker," "parallel," or "feeder" investment vehicles in addition to the primary fund. <sup>76</sup> For example, to mitigate the risk of UBTI or ECI, funds can be structured so that foreign and tax-exempt investors can invest through foreign corporate "blocker" entities.

The foreign blocker entity in effect "blocks" the income and the activities of the fund or its operating companies from giving rise to UBTI or ECI. Provided a tax-favorable jurisdiction is used, the income of the blocker entity should not be subject to corporate-level tax. A foreign blocker entity with U.S. owners (even tax-exempts) would likely be classified as a PFIC; however, for the reasons discussed above, no negative UBTI consequences should result to U.S. tax-exempt investors. <sup>77</sup>

Blocker entity structures may take various forms, including (1) "above the fund" blockers, where the tax-exempt and foreign investors contribute their capital to the blocker, which then contributes the capital to the fund, or (2) "below the fund" blockers, where the fund invests capital attributable to tax-exempt and foreign investors through a blocker and the blocker and the fund together then co-invest in the portfolio companies. Exhibit 2 illustrates these variations of a blocker structure.

### **Exhibit 2. Blocker Structure**

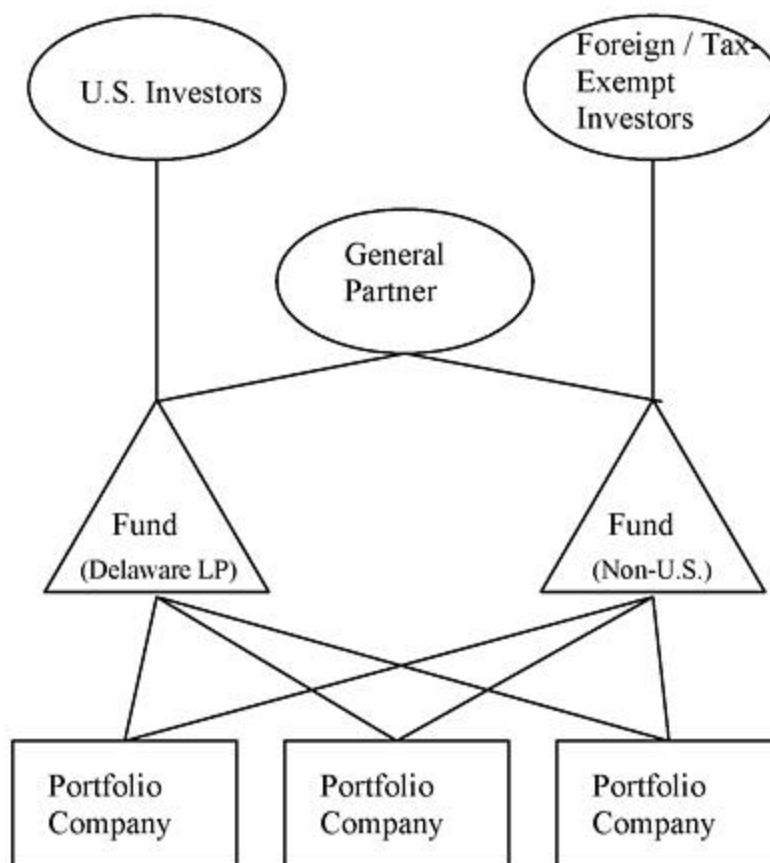


Parallel fund structures in the cross-border context are often employed to mitigate the application of CFC and PFIC rules and to achieve the foreign tax planning objective of non-U.S. investors. For example, a parallel fund structure could be used to allow U.S. investors to invest in what otherwise might be a CFC and simultaneously permit foreign investors to invest through a parallel fund organized in a jurisdiction that affords the foreign investors special tax treatment under their domestic law or income tax treaty. The same entity often serves as the general partner for both the U.S. and the foreign fund.

In other instances, funds will employ parallel investment agreements specifying the relationship between each fund, and which are intended to "lock in" both funds into a single, overall economic arrangement. Such agreements also may provide a contractual mechanism to achieve the non-U.S. tax planning objectives of foreign investors.

Because of the close contractual and economic links between parallel funds, consideration must be given to whether U.S. partnership law might potentially treat the overall arrangement as a single partnership or deem the existence of an additional partnership, and whether such a recast would negatively affect any of the parties. Exhibit 3 illustrates a basic parallel fund structure.

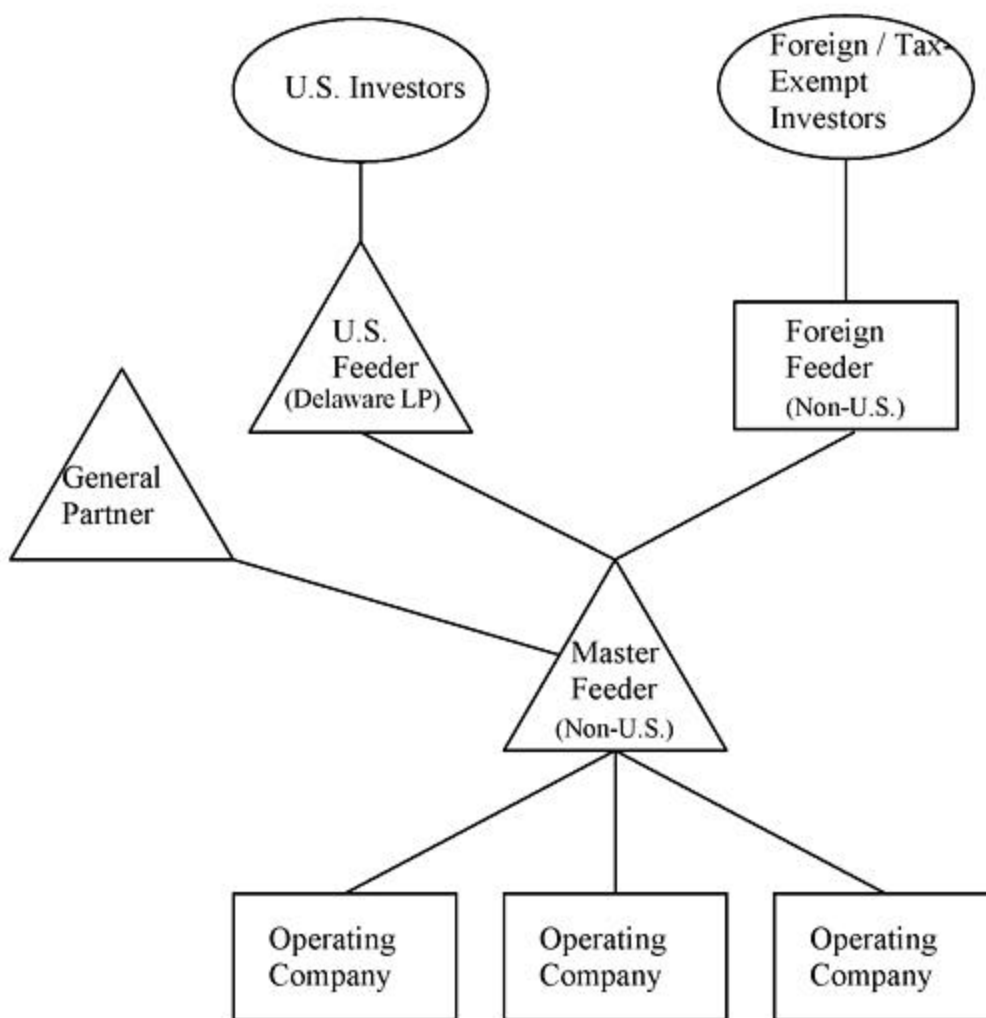
### **Exhibit 3.Parallel Fund Structure**



Another potential structure for cross-border private equity funds is what is often referred to as a "master feeder" structure. In a typical master feeder structure, U.S. taxable investors invest through a U.S. entity (the "U.S. feeder"), typically a Delaware LP. (Where foreign investments are being made, however, consideration should be given to having U.S. investors invest through a non-U.S. partnership feeder.) Tax-exempt and foreign investors invest through a non-U.S. (e.g., Cayman Islands) blocker entity (the "foreign feeder"), similar to the setup in a parallel fund structure. The U.S. feeder and foreign feeder then invest in a "master feeder" fund, which is a non-U.S. (e.g., Luxembourg or Cayman Islands) flow-through entity, which in turn invests in portfolio companies. <sup>78</sup>

Under the master feeder structure, the manager/general partner may receive its carried interest from the master feeder fund. This enables the centralization of management and control of the investment vehicles. Additional foreign law issues should be considered to preserve the general partner's control of the various feeder entities. Exhibit 4 illustrates a basic master feeder structure.

#### **Exhibit 4. Master Feeder Structure**



## STRUCTURING THE BUYOUT OF A FOREIGN TARGET GROUP

The remainder of this discussion generally assumes that, because of significant U.S. ownership in the fund (or the existence or unavoidable use of a domestic fund), CFC status of anticipated foreign portfolio companies could not be avoided. Nevertheless, establishing an acquisition vehicle and the steps taken in acquiring the foreign targets can have important U.S. tax consequences to the fund investors and the general partner, both while the target is held as a portfolio company and on an eventual exit.

### The Acquisition Vehicle

While a buyout fund can acquire the target group directly, it is unlikely that the existing foreign target portfolio company group (owned by foreign sellers) has been structured to address U.S. tax issues. Therefore, various U.S. and non-U.S. tax benefits can be achieved by establishing a separate acquisition company ("Buyco") to effectuate the acquisition.

**Use of foreign Buyco and reduced global effective tax rate.** In the context of U.S. sponsored cross-border LBO funds, it is generally advantageous to establish a foreign rather than a domestic Buyco. If the Buyco is organized in the U.S., and is taxable as a corporation, then the lowest effective tax rate the Buyco and the foreign portfolio group generally can achieve is 35%. <sup>79</sup> This is because any

earnings that are repatriated to the U.S. must necessarily be subjected to corporate-level tax at the U.S. Buyco level. Moreover, establishing a U.S. Buyco also makes eventual exit by the fund more difficult or costly because foreign buyers most likely will not want to buy the shares of the U.S. company but will instead want to purchase the assets (i.e., non-U.S. subsidiaries) of the Buyco. From a U.S. perspective, a sale of lower-tier foreign subsidiaries would give rise to two levels of tax—first at the U.S. corporate level (on the sale of the lower-tier subsidiaries or assets), and second at the level of the taxable U.S. investors (on a distribution of the sales proceeds). <sup>80</sup>

There may be unique circumstances in which a U.S. Buyco would be warranted. <sup>81</sup> If at the outset, however, a foreign fund has been organized to avoid CFC or PFIC status, organizing a non-U.S. Buyco is essential to preserve the benefits obtained by organizing a foreign fund.

Organizing the Buyco in a non-U.S. jurisdiction further enables effective global tax rate reduction, particularly if the Buyco is organized in a jurisdiction with a low tax rate, no withholding taxes on dividends to the U.S., exemptions from tax on gains from the sales of subsidiaries, and an expansive treaty network. Furthermore, assuming additional planning to mitigate the generation of Subpart F income in lower-tier entities, the earnings of the portfolio companies may be subject to tax at rates significantly less than 35%. If such planning is combined with local-country tax planning to insert permissible intercompany debt into lower-tier portfolio companies and achieve increased amortization and depreciation deductions, further reductions to local country taxes can be achieved—and ultimately reduce the global effective tax rate for the portfolio company group. For the fund sponsors and investors, a reduced global effective tax should result in greater after-tax earnings, higher returns to the general partner and investors, and a greater sales price on eventual sale or public offering.

**Common considerations in choosing Buyco jurisdiction.** Assuming that the buyout fund establishes a Buyco, many factors affect the choice of the Buyco's place of organization.

*Legal liability.* Buyco should be established in a jurisdiction the laws of which preserve limited liability for the Buyco's equity holders (i.e., for the fund itself).

*Treaty network.* All else being equal, the Buyco should be established in a jurisdiction that entitles the Buyco to the benefits of an expansive treaty network that includes the jurisdictions in which the target portfolio companies will operate. Luxembourg, the Netherlands, Cyprus, and Mauritius are some of the jurisdictions that often are used.

*Withholding taxes.* Jurisdiction can affect the withholding taxes that apply on the distribution of earnings, or the payment of interest, from the portfolio companies to the Buyco and from the Buyco to the fund. Withholding taxes may be especially important to tax-exempt investors, who otherwise would pay no tax on the earnings of the portfolio companies. Withholding taxes from the Buyco to the U.S. (through the fund) should be creditable by U.S. taxable investors. <sup>82</sup>

*Qualified dividends.* For U.S. individual investors, whether distributions from the Buyco, or sales of the Buyco shares, will give rise to "qualified dividends" is partly dependent on jurisdiction. <sup>83</sup> Dividends from foreign corporations are eligible for the reduced rate of tax only if certain requirements are met. <sup>84</sup>

- (1) The distribution must be made with respect to equity rather than debt, as determined by a facts and circumstances test under U.S. federal income tax principles. <sup>85</sup>
- (2) The deemed distribution must be a dividend, i.e., it must be paid out of current or accumulated E&P of the foreign corporation. <sup>86</sup>
- (3) Either (a) the stock with respect to which the deemed dividend is paid must be readily tradable on an established securities market in the U.S., or (b) the foreign corporation must be a "qualified foreign corporation," which means a foreign corporation that is incorporated in a possession of the U.S. or that is eligible for benefits of a comprehensive income tax treaty with the U.S. which the Treasury determines is satisfactory for purposes of Section 1(h)(11) and

which includes an exchange-of-information program. [87](#)

(4) The foreign corporation cannot be a PFIC. [88](#)

(5) The recipient of the dividend must satisfy certain holding period requirements. [89](#)

Also, dividends paid by the Buyco (which meet the requirements above) to U.S. individual investors through a foreign fund (i.e., a foreign partnership) should qualify for the reduced 15% rate, even if the foreign fund is organized in a non-treaty jurisdiction. [90](#) Nevertheless, organizing the Buyco as a corporation in a jurisdiction with which the U.S. has no income tax treaty (e.g., Cayman Islands or Bermuda) would make qualified dividends unavailable.

*Check-the-box planning.* It may be advantageous to treat the Buyco as a disregarded entity (owned by the fund) for U.S. tax purposes. The jurisdiction and entity-type of the Buyco will determine whether the Buyco is an "eligible entity" under the check-the-box Regulations. [91](#) In addition, to the extent the fund is relying on the "qualifying income exception" to the PTP rules, if the Buyco elects to be treated as a disregarded entity or partnership, the fund will need to ensure that (1) interests in the fund are not readily tradable, (2) the income received from the Buyco by the fund is qualifying income, or (3) a lower-tier entity (in this discussion, a CFC) "blocks" any nonqualifying income. Moreover, the third-party debt incurred to fund the acquisition might need to be obtained at the level of a lower-tier entity that is treated as a corporation for U.S. tax purposes.

## U.S. Tax Considerations—Acquisition of Foreign Targets

Once the fund and the Buyco have been established, it is necessary to structure the acquisition of the foreign target companies. The discussion that follows describes various techniques the fund may employ to reduce U.S. and foreign taxes, thus increasing the ultimate return to the sponsors, general partner, and investors on exit.

**Internal leverage.** Inserting the maximum feasible and permissible amount of debt into each of the portfolio operating companies and the Buyco is one of the most important issues for a fund. The primary objectives of internal leverage are:

- Obtaining a deduction at the operating-company level for external third-party debt regardless of the level at which such debt is originally borrowed.
- Maximizing the interest expense deductions at the Buyco level.

With respect to the latter point, this includes deductions both from external third-party debt and from disregarded intercompany debt from the fund to the Buyco (if the Buyco is a disregarded entity), or through a hybrid instrument that is considered debt for purposes of Buyco law and equity for U.S. tax purposes. Subject to various limitations, interest on indebtedness generally is deductible for U.S. and foreign tax purposes, while dividends on stock are not. [92](#)

Of paramount significance is "marrying" the interest deductions with the operating income generated by the portfolio operating companies because paying interest provides no tax benefit if the interest does not offset otherwise taxable income. For example, if the Buyco borrows funds from a third party, a common technique is for the fund to elect to treat select Buyco operating subsidiaries as disregarded entities for U.S. federal tax purposes and then cause the Buyco to on-lend borrowed money to such operating subsidiaries (or to disregarded holding companies formed to acquire each of those operating subsidiaries). [93](#) The loans from the Buyco to lower-tier disregarded entities would be disregarded for U.S. tax purposes (and would not give rise to Subpart F income) but would be respected for local country purposes and therefore would generate a local interest deduction. [94](#)

Another way to maximize local country interest expense deductions is to borrow a portion of the external third-party debt at the local country level. Because the interest payment would be to unrelated parties, this also may alleviate the application of local thin-capitalization limitations.

Where the Buyco makes intercompany loans to operating subsidiaries, Subpart F income is always a concern. The U.S. shareholders of a CFC generally must include in income their pro rata share of any Subpart F income earned by such CFC during the tax year in which earned. <sup>95</sup> As previously noted, Subpart F income includes interest income. <sup>96</sup> In addition to the use of disregarded debt, two separate rules may be employed to preclude interest on "regarded" debt from giving rise to Subpart F income.

First, under the "same-country-related-party" interest exception, foreign personal holding company income does not include (and therefore Subpart F income does not include) interest received from a related person that is a corporation created or organized under the laws of the same foreign country as the CFC and that has a substantial part of its assets used in its trade or business located in that same foreign country. <sup>97</sup> Thus, for example, if a fund organizes a Swiss Buyco to purchase the stock of a Swiss corporation (with a substantial part of its assets used in its Swiss trade or business), interest received by the Swiss Buyco from a loan to the Swiss operating company would not be Subpart F income. The Code provides an exception if the interest reduces the payor's Subpart F income or creates (or increases) a deficit that under Section 952(c) may reduce the Subpart F income of the payor or another CFC. <sup>98</sup>

The second rule is the related CFC look-through rule in Section 954(c)(6). Under this provision, dividends, interest, rents, and royalties received or accrued from a related CFC do not constitute foreign personal holding company income to the extent attributable or properly allocable to income of the related person that is not Subpart F income. <sup>99</sup> This look-through rule applies only to tax years of CFCs beginning after 2005 and before 2009. <sup>100</sup> Pursuant to this provision, if a fund organized a Luxembourg Buyco that purchased a French operating company, interest from the French company to the Buyco would not constitute Subpart F income to the extent attributable or properly allocable to income of the French company which is neither Subpart F income nor ECI. <sup>101</sup>

**General Subpart F planning.** In addition to Subpart F risks related to intercompany loans, the portfolio companies run the risk of creating phantom income for the U.S. taxable investors (and a U.S. general partner) of the fund under various other categories of Subpart F income. <sup>102</sup>

One common technique introduced in the internal leverage context above would be for each wholly owned subsidiary of the Buyco to elect to be treated as a disregarded entity for U.S. tax purposes. <sup>103</sup> From a U.S. tax perspective, transactions between a corporation and an entity disregarded as separate from such corporation (or among subsidiaries of a corporation, each of which is a disregarded entity) are generally ignored. <sup>104</sup> The U.S. tax law generally views such transactions as the movement of cash among or between branches of the same company. <sup>105</sup>

Thus, if the Buyco wholly owned a Swiss subsidiary and a French subsidiary, each of which was a disregarded entity for U.S. federal tax purposes, and if the Swiss subsidiary performed certain technical, managerial, engineering, or other services for the French subsidiary, the payment for such services would be disregarded for U.S. federal tax purposes and therefore would not give rise to any Subpart F income to the Buyco. This technique can limit Subpart F income that may be generated through various other transactions, including Subpart F income that may arise from intercompany dividends, leases, or royalties. <sup>106</sup>

Electing to treat Buyco's subsidiaries as disregarded entities provides the additional advantage of allowing the reinvestment of foreign earnings abroad without U.S. tax costs, i.e., the movement of cash from one disregarded foreign operating company to another without giving rise to phantom income under Subpart F. Such free movement of cash enables a more efficient deployment of capital to businesses with the most growth potential, or to businesses with short-term liquidity problems, or for any other purpose—all without a current U.S. federal tax cost. From a non-U.S. tax perspective, the check-the-box elections have no effect, however, and therefore the non-U.S. tax consequences of such transactions always must be considered. <sup>107</sup>

**Section 338(g) election.** Another technique to reduce phantom income risk to U.S. taxable investors (and a U.S. general partner) is to achieve, for U.S. tax and E&P purposes, a stepped-up basis in the operating subsidiaries' assets.

One way to achieve a basis step-up, albeit likely to be costly from a local country tax perspective, would be for the Buyco or a lower-tier local country holding company to purchase the assets of the foreign target, rather than the stock of the target, in a taxable acquisition. Foreign owners of the target, however, may be reluctant to cause the target to sell assets because of the potential foreign tax consequences—the target's gain on the sale of its assets may be taxable locally, the target's owners may be taxed on the distribution of the proceeds of the sale, and many countries impose VAT or other asset-transfer taxes. These additional tax costs might cause the sellers to demand a higher purchase price or, in a bid situation, may be viewed as an unfavorable proposed structure that introduces additional costs.

Section 338 provides a mechanism for the Buyco to obtain a stepped-up asset basis for U.S. tax purposes without adverse foreign tax consequences to a foreign seller. If a purchasing corporation, in connection with a "qualified stock purchase," makes an election under Section 338(g), the target corporation ("Old Target") is treated as having sold all of its assets to a new corporation ("New Target") for FMV.

A qualified stock purchase means any transaction or series of transactions in which stock possessing at least 80% of the total voting power and having a value equal to at least 80% of the total value of the stock of one corporation is purchased by another corporation during a 12-month acquisition period. [108](#) A Section 338(g) election is made unilaterally by the purchaser, even though, as described below, it can have adverse U.S. tax consequences to a U.S. seller of a foreign target. [109](#)

In the international context, the Old Target is a foreign corporation (presumably not subject to U.S. taxing jurisdiction), such that the deemed asset sale by Old Target to New Target generally will not give rise to U.S. tax. [110](#) Before making a Section 338(g) election, however, it is important to consider certain potential U.S. tax consequences that may arise. For example, the Section 338(g) election may result in U.S. tax costs if the assets held by the foreign target constitute USRPIs or if the foreign target is engaged in a U.S. trade or business. Moreover, if the seller is domestic and the foreign target is a CFC, the deemed asset sale may generate Subpart F income. From a foreign law perspective, the Section 338(g) election deemed asset sale fiction is ignored, and the foreign jurisdiction will not tax the foreign target as if it sold its assets. [111](#)

Therefore, New Target, which the Code will deem Buyco to have purchased, will have an FMV basis in its assets. Moreover, the foreign sellers should be subject to one level of tax on the gain from selling the shares of the target corporation. Such gain, ideally, also may be eligible for exemption from local-country residence-based tax (on the foreign sellers) under a residence country participation exemption.

The increased depreciation and amortization deductions should translate into reduced U.S. E&P at the target level. Lower E&P limits the amount of potential Subpart F income of the Buyco because Subpart F income generally is subject to an E&P limitation. [112](#) Moreover, reduced U.S. E&P also limits the amount of gain on the ultimate sale of the Buyco that would be recharacterized as a dividend under Section 1248. [113](#) The reduced E&P decreases the amount of E&P for purposes of the indirect foreign tax credit limitation. Thus, if the foreign target is located in a high-tax jurisdiction, the reduced U.S. earnings could have the added benefit of prospectively increasing indirect foreign tax credits if the company later makes a dividend distribution to the fund. [114](#) Furthermore, reduced E&P also may facilitate repatriation of earnings to the U.S. that would be treated as a tax-free return of capital. [115](#) Therefore, making a Section 338(g) election for foreign targets and lower-tier subsidiaries often is advisable. [116](#)

**Foreign tax credits.** If the Buyco makes dividend distributions to the LBO fund, certain taxable U.S. corporate investors in the fund may receive indirect foreign tax credits.

Section 902 provides for an indirect or "deemed -paid" foreign tax credit for any domestic corporation that owns 10% or more of the voting stock of a foreign corporation from which it receives dividends. The amount of the deemed-paid credit is the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount of such dividends bears to such foreign corporation's post-1986 undistributed earnings. <sup>117</sup> Because of the 10% limitation, the indirect foreign tax credit may not be available to corporate investors in widely held buyout funds, and in no event may an individual investor receive an indirect foreign tax credit.

Many LBO funds, however, do not cause their portfolio companies to make dividend distributions, but instead receive their economic return on a disposition of the portfolio companies. In that instance, indirect foreign tax credits under Section 902 nevertheless may be available to corporate investors in the fund that meet the 10% vote requirement to the extent Section 1248 applies to the sale. <sup>118</sup>

## Non-U.S. Tax Considerations—Acquisition of Foreign Targets

The primary non-U.S. tax drivers related to structuring the buyout of a foreign target are similar to those in the domestic context. Various additional tax- and structure-related issues may be presented, however, depending on the country. A discussion of local country rules is outside the scope of this article. Rather, the discussion that follows is intended to provide a list of certain non-U.S. tax and structural issues that will likely be common to a U.S. sponsored LBO fund (with U.S. ownership) regardless of the jurisdictions in which the targets operate. The specific laws, as well as the potential structural solutions to deal with the issues presented, will of course vary from country to country.

**Entity formation.** Formation of local entities is not always as straightforward as it is in the U.S., where a new legal entity may be formed almost immediately. In certain countries, the process can take several months. To alleviate this issue, local law firms, accounting firms, and trust companies often maintain inventories of "shelf" companies, i.e., dormant entities that have been previously formed and are immediately available (for purchase at a nominal price). Sometimes these shelf companies were former operating companies that are now inactive. It is therefore critical to conduct a legal due diligence review of such companies to avoid potential liability. <sup>119</sup>

**Regulatory approvals or registration of debt or capital.** Certain countries impose reporting, registration, or approval restrictions on foreign capital. If such procedures are not followed, there is a risk that a fund will not be able to extract its investment from the local country.

**Stamp and capital taxes.** Many countries impose stamp, duty, or capital taxes on the formation and capitalization of a legal entity (e.g., a non-U.S. fund vehicle and/or on the formation and capitalization of a non-U.S. Buyco). Such taxes are typically on the gross amount (or FMV) of the contributions. The tax rates vary from country to country, but range around 1% or 2%. Therefore, the costs can be quite high in actual dollar terms. <sup>120</sup>

**Reducing withholding taxes.** Eliminating withholding taxes on dividends, interest, royalties, and other intercompany payments among and between subsidiaries of the foreign target group and from a foreign Buyco (through the fund) to the U.S. is essential. Depending on the country, withholding tax rates can range from 5% to over 35% on the gross amount of the payment. These taxes are often reduced by income tax treaties. For this reason, the choice of the Buyco's country of organization is critical. For example, many Latin American and Caribbean countries impose very high withholding taxes that, because of limited treaty networks, cannot be reduced. <sup>121</sup>

**Reducing local tax.** In addition to federal taxes, provincial, state, municipal, cantonal, asset, VAT, and other local taxes must be considered.

**Asset basis step-up.** On acquisition of a non-U.S. target portfolio company group, it is desirable to obtain a stepped-up FMV basis in foreign subsidiary operating assets. Such step-up may allow for increased depreciation deductions that reduce local taxable income. We are not aware of the equivalent

of Section 338(g) type rules in other countries. Therefore, with limited exceptions, it likely would be necessary to acquire assets to achieve a basis step-up. This may result in entity-level tax (no participation exemption would apply), asset transfer taxes, and possibly VAT.

**External and internal debt.** As previously mentioned, a critical issue is to ensure the interest expense incurred to finance the acquisition offsets a portion of the taxable income of the target operating subsidiaries. This can be approached in a variety of ways. For example, part of the acquisition debt from the external lender could be borrowed at the local company level. If this is not commercially feasible, it is possible to cause the borrowing entity (e.g., the Buyco) to on-lend the borrowed funds to lower-tier acquisition entities organized in the particular jurisdiction in which the target is organized. If tax consolidation or group relief is not available, then additional planning may be necessary.

**Tax consolidation or group relief.** Not all countries allow for the consolidation of multiple controlled entities even if all local entities are 100% owned by a parent company organized in the same jurisdiction. This can present unique problems in the context of debt planning. One potential structural solution is to combine the leveraged entity with the operating company through merger, amalgamation, liquidation, or possibly some other transactional form permitted under local law.

**Thin capitalization rules.** Many countries have thin capitalization rules that prevent interest deductions if certain interest-expense-to-earnings or debt-to-equity ratios are exceeded. In Canada, for instance, to prevent the expatriation of earnings by way of deductible interest rather than nondeductible dividends, the Canadian Income Tax Act contains a thin-capitalization rule that disallows a deduction for interest paid by a Canadian subsidiary (e.g., the operating company) to a shareholder who is a "specified non-resident" (e.g., the Buyco).<sup>122</sup> Under this rule, the Canadian subsidiary may deduct only such interest as corresponds to a debt-equity ratio of 2:1. The Canadian thin-capitalization rule does not apply to deductions for interest paid by a Canadian company to a third party. Accordingly, the operating company can increase its deductible interest expense through having a combination of third-party borrowings and intercompany debt.

**Local-country CFC regimes.** Many countries other than the U.S. impose rules similar to the U.S. CFC regime. The effect of these rules is to tax owners of foreign entities on the income of the foreign entities on a current basis, even if the income is not distributed. Among others, the U.K., France, Australia, Germany, the Netherlands, and Mexico have CFC-type regimes. The application of multiple CFC-type regimes on the same legal structure can introduce considerable complexity.

For example, assume a U.S. fund organizes a Dutch Buyco, which acquires a U.K. target that owns French and German subsidiaries. It is conceivable that three different CFC regimes could apply—those of the U.S., the Netherlands, and the U.K. Planning to avoid unnecessary layers of CFCs is therefore essential to an efficient LBO fund structure.

**Qualification for participation exemptions.** Many countries, particularly European countries, exempt from taxation dividends received from, and gains from the sale of stock in, subsidiaries where certain ownership thresholds are met. Such rules can exist under local law or, in the case of certain European countries, under the European Commission Parents-Subsidiary Directive. For example, the Netherlands, Luxembourg, Cyprus, and Switzerland are generally viewed as having favorable local-law participation exemptions.

Planning to qualify for such exemptions can have a material impact on economic returns that may be generated to fund investors if earnings are repatriated to the U.S. or if there were a sale of lower-tier subsidiaries of the fund. One particular exemption applies to exempt from withholding taxes certain dividends paid by a subsidiary company to its parent company where the two companies are located within Member States of the European Commission Parents-Subsidiary Directive.<sup>123</sup> To qualify for the exemption, the parent company must own at least 15% of the shares of the subsidiary, and this threshold will decrease to 10% after 2008.

**Income tax treaties.** Bilateral income tax treaties play a significant role in the context of structuring the operations of any multinational group of portfolio companies. Income tax treaties, for example, can apply to reduce or eliminate withholding taxes and double taxation. Assuming the fund is organized in a tax-haven jurisdiction (e.g., Cayman Islands), it is necessary to ensure that the income tax treaties on which Buyco will rely in its dealings and transactions with its subsidiaries do not contain limitation-on-benefits or beneficial ownership provisions that would deny treaty benefits, such as reduced withholding taxes on payments from a subsidiary to the Buyco.

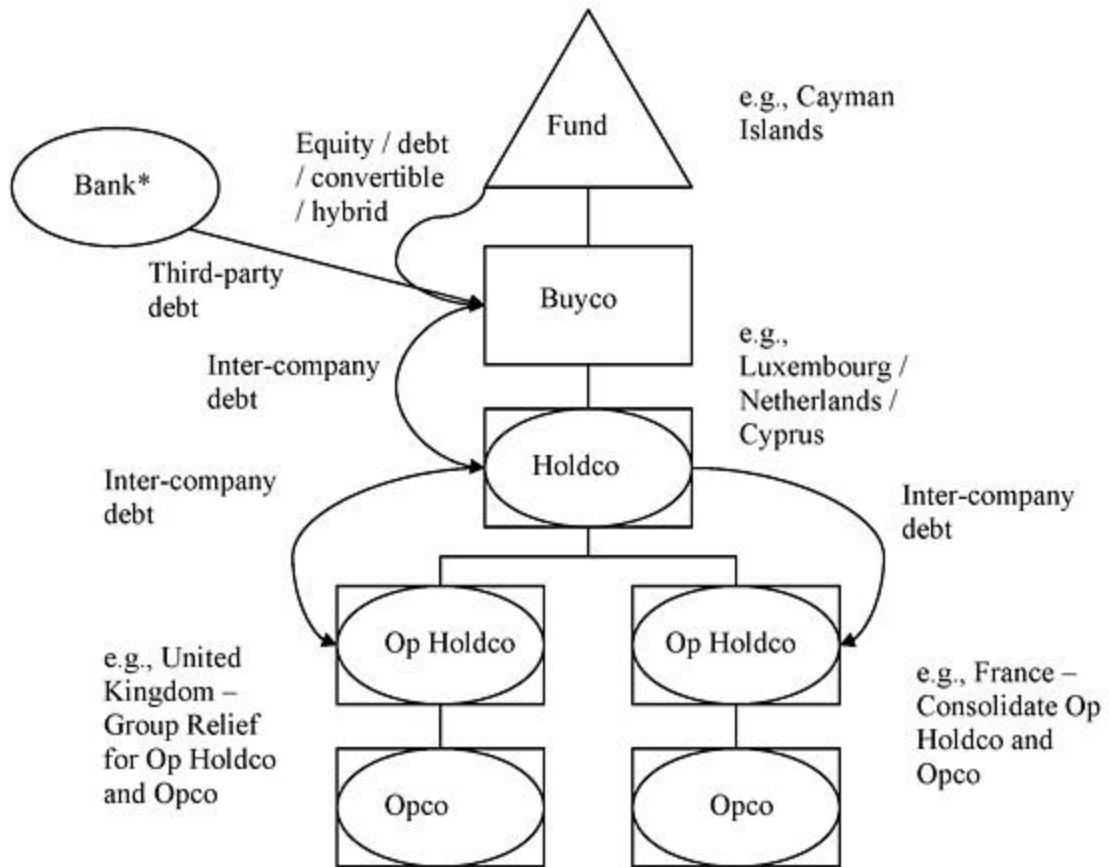
**The per se entity problem.** Often, multinational groups will consist of entities that are classified as per se entities for U.S. entity classification purposes, and therefore, they are not eligible to be treated as disregarded entities for U.S. tax purposes. When such entities engage in material intercompany transactions with other members of the multinational group, such transactions can create material Subpart F exposure. It is sometimes necessary to convert such entities into eligible entities in order to effectuate the check-the-box elections.

For U.S. tax purposes, such transactions often can be structured to qualify as tax-free reorganizations under Section 368(a)(1) or as tax-free liquidations under Section 332, and generally can be undertaken post-acquisition. For foreign law purposes, however, such transactions may have tax costs. Moreover, for various local law reasons, it can take a very long time to complete the conversions. In such situations, local country tax costs and Subpart F leakage will need to be quantified.

**Tax due diligence.** Identifying tax exposures and benefits in each of the jurisdictions in which the portfolio group operates can have material impact on bids, deal costs, and post-acquisition financial performance of a portfolio company group. A few examples of items that must be uncovered during the negotiation stage are the existence of valuable tax attributes and the existence of material tax exposures, such as audits, litigation, and penalty risks. Even early in the negotiation process, it is advisable for a fund to undertake at least a high-level tax due diligence review of the target group.

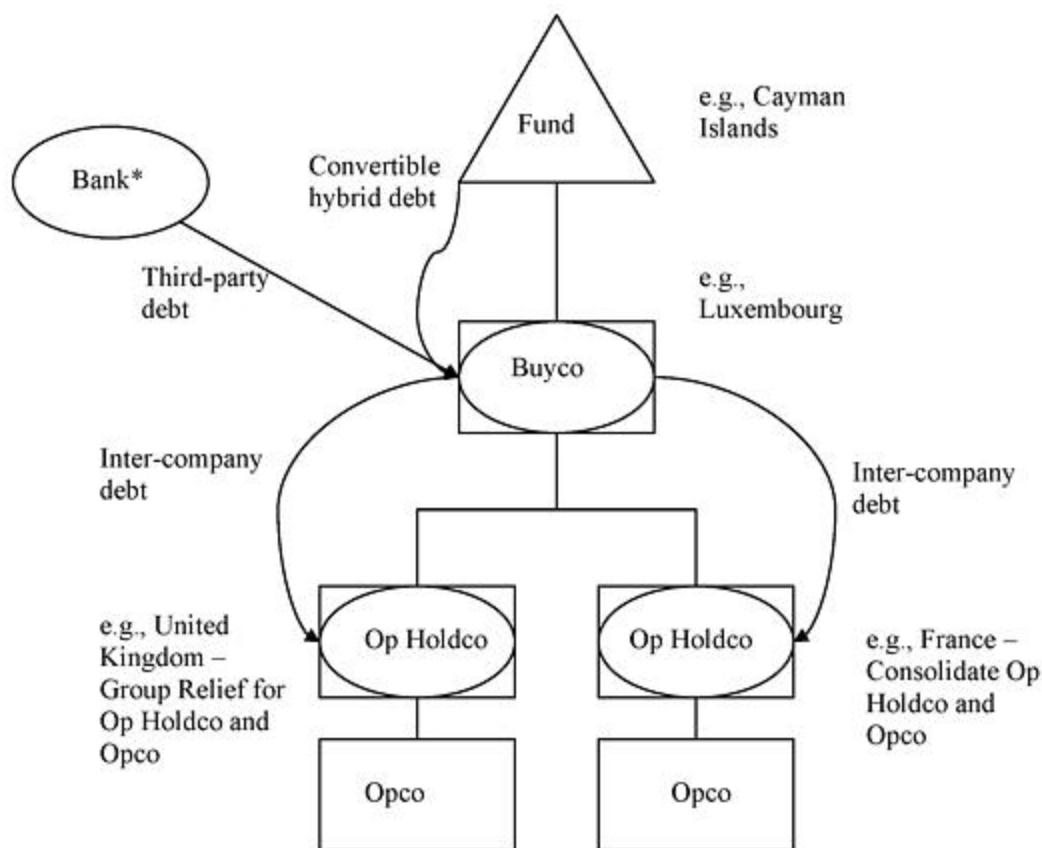
Exhibits 5 and 6 illustrate two conceptual structures a fund could employ for making cross-border buyout investments.

## **Exhibit 5. Cross-Border Buyout Fund Structure, Example 1**



\*Bank may lend at local level

**Exhibit 6. Cross-Border Buyout Fund Structure, Example 2**



\*Bank may need to lend at local level if Buyco is disregarded for U.S. tax purposes

## EXIT EVENTS

We begin the discussion of exit events <sup>124</sup> by reiterating that it is critical for LBO funds and their sponsors to plan for a tax efficient exit *during the fund formation and buyout process*. An exit event for an LBO fund can take various forms, including a distribution of earnings from profitable or cash-rich portfolio companies; a sale of part of a portfolio group's operations (e.g., sale of lower-tier subsidiaries owned by the Buyco), or a sale of the portfolio group altogether (e.g., a sale of the Buyco or an intermediary holding company owned by the Buyco).

## Repatriation Through Debt Service and Dividends

To finance its portfolio company acquisition, the fund will likely incur external third-party debt at the Buyco level, which, as discussed above, will be on-lent to lower-tier operating subsidiaries. Because it generally is advantageous to keep intercompany debt in place (in order for interest to reduce local country taxable income), repayment of principal on intercompany debt is not the preferred way to repatriate earnings to the Buyco. It is more beneficial to effectuate a repatriation of cash to the Buyco through dividend distributions that would be exempt from foreign taxes because they would qualify for participation exemptions and would not be subject to withholding taxes.

Nevertheless, once earnings are accumulated at the Buyco level, repatriation from the Buyco to the fund, and ultimately to the U.S., can be approached in various ways, including repayment of debt or even repayment of debt that is disregarded for U.S. federal tax purposes. An alternative repatriation

mechanism is to effectuate the repatriation from the Buyco through a hybrid instrument that is treated as equity for U.S. federal tax purposes and as debt for purposes of the Buyco jurisdiction, as shown in Exhibit 5. <sup>125</sup> Also, depending on the Buyco's jurisdiction, sometimes a tax-free liquidation of the Buyco may facilitate repatriation without withholding taxes at the Buyco level, although such approach may be more appropriate on final sale.

In general, the foreign tax objectives of efficient repatriation are to enable distributions that are tax free for local law purposes and free of withholding taxes. From a U.S. tax perspective, the objectives are to structure distributions so that they qualify as tax-free returns of capital or repayment of principal on a note; and, if the distributions are treated as dividends, that such dividends qualify for a reduced rate of tax in the U.S. (e.g., as a qualified dividend or long-term capital gain) and/or carry indirect foreign tax credits if there are U.S. corporate investors in the fund.

**Dividend distributions.** There are three primary considerations in the context of distributions from the Buyco to the fund that are treated as dividends for U.S. tax purposes.

First, the distributions may be subject to withholding taxes in the Buyco's place of residence or place of business. For both U.S. individual and corporate investors in the fund, the imposition of withholding taxes generally will give rise to direct foreign tax credits. <sup>126</sup> A particular investor may choose either to receive a credit for foreign taxes paid or it may deduct foreign taxes paid. The taxpayer may not, however, choose to deduct some foreign taxes and claim a credit for others. <sup>127</sup> Only in rare circumstances—such as when the particular taxpayer has significant excess foreign tax credits that it is unlikely to be able fully to use before they expire—is it advantageous for a taxpayer to deduct foreign taxes rather than claiming a credit.

For tax-exempt investors, the elimination of withholding taxes is especially important—if the withholding taxes can be avoided, the investor will not have to pay any tax on the distribution, provided that such distribution does not give rise to UBTI. If a withholding tax is collected, the tax-exempt investor will not be able to obtain a refund of such tax.

Second, if there are U.S. corporate investors in the fund that meet the 10% vote ownership requirement, a dividend distribution by the Buyco may carry with it indirect foreign tax credits. <sup>128</sup> As part of the AJCA Congress made clear that, for purposes of the deemed-paid foreign tax credit, stock owned, directly or indirectly, by a partnership is owned proportionately by its partners. <sup>129</sup> Therefore, U.S. corporate investors meeting the 10% vote ownership requirements of Section 902 should qualify for indirect foreign tax credits.

Third, certain dividends from the Buyco may result in "qualified dividends" currently taxed to U.S. individual investors at 15% long-term capital gains rates. <sup>130</sup>

## Partial Sale of Portfolio Operations

A fund should preserve the flexibility to sell part of the operations held by the Buyco without triggering adverse foreign and U.S. tax consequences. For purposes of this discussion, assume that the Buyco, a regarded entity, is the selling entity and that a participation exemption is applicable in the Buyco's jurisdiction so that there would be no foreign tax on the sale of a lower-tier subsidiary. Also assume that the target jurisdiction does not impose tax on the Buyco.

From a U.S. tax perspective, the primary considerations in the partial sale of operating businesses are the avoidance of Subpart F income (on the gain) at the Buyco level, whether any gains/earnings will be reinvested abroad, or whether the gains/earnings will be repatriated to the U.S. as discussed immediately above.

Foreign personal holding company income, a subset of Subpart F income, includes the excess of gains

over losses from certain property transactions. <sup>131</sup> A sale of property that gives rise to dividends (i.e., stock) results in foreign personal holding company income. <sup>132</sup> Thus, if the operating companies are treated as corporations for U.S. tax purposes, a sale by the Buyco of the stock of such companies will result in Subpart F income to the Buyco, which could be taxable to U.S. investors (both individual and corporate at a 35% rate).

If the Buyco and the lower-tier subsidiary are CFCs, Section 964(e) will recharacterize gain from the sale of the lower-tier CFC stock as a dividend to the extent of the E&P of the lower-tier CFC. The "same-country exception" does not apply to any amount treated as a dividend under Section 964(e), and thus the amount recharacterized as a dividend might give rise to Subpart F income to the Buyco. <sup>133</sup> That dividend, however, would be eligible for the look-through rule in Section 954(c)(6), <sup>134</sup> which would mitigate the Subpart F consequences of a sale by a foreign Buyco of a lower-tier CFC. <sup>135</sup> When Section 964(e) applies, various collateral consequences and issues can result related to bifurcation of the payment into Section 964(e) dividend income and regular Subpart F income, and the effects of the previously taxed income (PTI) rules of Section 959. <sup>136</sup>

This issue—the generation of Subpart F income as a result of the sale of lower-tier CFC operating companies—would be exacerbated if the buyout fund is organized as a domestic partnership because it would be considered a U.S. shareholder with respect to the Buyco. Consequently, the fund would have to include its pro rata share of the Buyco's Subpart F income for the tax year in its income, and this amount would flow through and be taxed in the hands of all U.S. taxable investors, even if they did not otherwise meet the definition of a "U.S. shareholder" under Section 951(b).

The risk that a sale of lower-tier operations will result in a Subpart F inclusion can be minimized if, before the sale, the fund were to treat the target lower-tier portfolio companies as disregarded entities for U.S. tax purposes. While in form the Buyco would be selling shares for U.S. tax purposes, the Buyco would be treated as selling assets. <sup>137</sup>

Although generally this may eliminate most Subpart F income on the sale, the analysis is more complicated. A sale of assets may trigger Subpart F income to the extent the assets otherwise would give rise to dividends, interest, royalties, rents, or annuities or if the assets do not give rise to any income. <sup>138</sup> For example, if the lower-tier portfolio companies each owned a portfolio of stock, then a sale of such stock by the Buyco would result in Subpart F income to the Buyco.

Thus, to the extent the assets of the operating company disposed of are assets used or held for use in the company's trade or business, a sale of the shares of the operating company would not give rise to Subpart F income to the Buyco. <sup>139</sup> From a U.S. buyer's perspective, the purchase of a disregarded entity may be viewed favorably because the buyer would obtain a stepped-up basis in the assets of the target for U.S. tax purposes and would not inherit U.S. tax attributes (similar to the effects of a Section 338(g) election). Moreover, the U.S. buyer could organize a foreign corporate acquisition vehicle if it desired to hold its foreign operations in corporate solution (as opposed to owning directly the shares of a disregarded entity). From a foreign buyer's perspective, the purchase of shares of an entity that is disregarded for U.S. tax purposes should not have any adverse tax consequences.

If and when a partial sale of a portfolio group is completed, various commercial issues related to the economic arrangement between the fund and the investors must be considered. In particular, the fund terms may require that the sales proceeds be distributed to the investors and the general partner. In more limited cases, a fund may be permitted to reinvest the sales proceeds if certain conditions are met or if the sale occurs within a relatively short time after the initial investment.

## Sale of the Entire Portfolio Group

Perhaps the most significant event for a fund is the final exit from the portfolio investment because it is at this point that the investors receive a substantial part, if not all, of their return and the general

partner or manager receives its carried interest. A sale of the entire portfolio group can generally be effectuated if the fund sells its entire interest in the Buyco—it is this approach that is discussed below.

**General U. S. tax consequences to selling fund.** If the buyout fund is a domestic partnership, and if the Buyco being sold is a CFC (which always will be the case if the domestic fund owns more than 50% of the voting power or value of the Buyco's stock), then gain derived by the fund on the sale of the stock of the Buyco will be recharacterized as a dividend to the extent of the E&P attributable to the fund's percentage and period of ownership. <sup>140</sup> E&P that already has been taxed to the fund is not taken into account in calculating the E&P under Section 1248. <sup>141</sup> Further, the amount of earnings taxable to the fund cannot exceed the fund's gain on the sale of the Buyco stock.

In general, the recharacterization as a dividend is beneficial to U.S. corporate investors in the fund that own, indirectly through the fund, at least 10% of the stock of the Buyco because such investors may become entitled to indirect foreign tax credits under Section 902. These credits will shelter from U.S. federal taxation some of the gain on the sale of the Buyco shares. Moreover, the dividend triggers the application of a look-through rule pursuant to which the dividend is considered to be general category income for purposes of the foreign tax credit limitation in proportion to the ratio of the portion of E&P attributable to income in such category to the total amount of E&P of the Buyco. <sup>142</sup>

Under current law, recharacterization as a dividend may not necessarily be detrimental to U.S. individual investors in the fund to the extent the dividend constitutes a "qualified dividend." To the extent the rate of tax on such dividends *in the future* becomes greater than the rate of tax on long-term capital gains, however, such recharacterization may not be desirable for U.S. individual investors. Section 1248(b) provides a limitation on the tax applicable to individuals as a result of such Section 1248 recharacterization. This limitation applies if the tax rate that applies to the gain treated as a dividend is higher than the rate that would apply to a capital gain. If the stock of the CFC sold is a capital asset held for more than one year, the tax attributable to an amount included in gross income as a dividend cannot be greater than the sum of (1) the individual's pro rata share of the excess of the taxes that would have been paid by the CFC had it been a domestic corporation over the income, war profits, and excess profits taxes actually paid by the CFC, and (2) an amount equal to the tax that would result by including in gross income as long-term capital gain an amount equal to the excess of the amount included in gross income as a dividend under Section 1248(a) over the amount determined in (1). <sup>143</sup>

If the fund is a foreign partnership, then Section 1248(a) by its literal terms would not apply to recharacterize the gain from the sale of the Buyco stock as a dividend to the extent of the Buyco's E&P, because a U.S. person would not have sold the CFC stock. Under current law, it is unclear whether a literal application of the statute, treating the foreign partnership as an entity, rather than as an aggregate, is the proper approach. Under Proposed Regulations, however, a foreign partnership would be treated as an aggregate for purposes of applying Section 1248(a), and the partners would be treated as selling or exchanging their proportionate share of stock held by the foreign partnership. <sup>144</sup> The Preamble to the Proposed Regulations states that an aggregate approach is necessary to carry out the purpose of Section 1248(a), which is to ensure that the E&P of CFCs are taxed as dividends and not as capital gains. <sup>145</sup>

**Buyer makes Section 338(g) election.** A U.S. buyer may desire to make a Section 338(g) election for the same reasons that the Buyco may have made such an election at the time it initially acquired the foreign target, i.e., to obtain a stepped-up U.S. tax basis in the assets of the Buyco. A non-U.S. buyer will have no reason to make a Section 338(g) election because the election has no effect for non-U.S. tax purposes.

The consequence of such an election is that the target company (here, the Buyco) is treated as selling its assets to a new target, after which the owner of the new target sells the new target's shares to a buyer. Absent the generation of Subpart F income currently includable to U.S. shareholders of the Buyco, the deemed asset sale generally will not be taxable in the U.S. <sup>146</sup> A Section 338(g) election

increases the E&P recharacterized as a dividend under Section 1248, but the election cannot be used to increase the foreign tax credits that would have been available in the absence of the election. <sup>147</sup> If, however, the buyout fund is a domestic partnership, such that the Buyco is a CFC, or if the Buyco otherwise is a CFC because of the ownership of the fund, a Section 338(g) election can have significant collateral U.S. tax consequences (described below). Accordingly, the sale agreement between the fund and the buyer should specify whether the buyer will make a Section 338(g) election.

Under Section 951(a)(1)(A), the Subpart F income of a foreign corporation that is a CFC for 30 or more days during the tax year is includable in the gross income of every person who is a U.S. shareholder of such corporation who owns stock on the last day of the CFC's tax year. Absent a Section 338(g) election, this provision can have undesirable consequences. For example, if the buyer is a U.S. person, such that the Buyco remains a CFC following the sale, the buyer would include in its income all Subpart F income of the Buyco for the entire tax year of the sale. <sup>148</sup> Conversely, if the buyer is foreign, such that the Buyco ceases to be a CFC following the sale, U.S. shareholders who own stock in the CFC at the time of the sale—such as the fund, if the fund is domestic, or particular investors, if the fund is foreign—would include their pro rata share of all Subpart F income derived by the Buyco during the full tax year, including any Subpart F income derived following the sale.

Because a Section 338(g) election ends the tax year of the CFC, such election would eliminate the risk that the selling fund and its investors might be subject to Subpart F income risk for any post-acquisition period. Similarly, in the absence of a Section 338(g) election, post-sale distributions or investments in U.S. property by the Buyco could reduce the amount of the Section 1248 dividend, thus reducing the amount of the deemed-paid tax credit available to U.S. corporate investors in the fund. <sup>149</sup> The fund may therefore consider requiring that even a foreign buyer make a protective Section 338(g) election or, alternatively, cause pre-sale distributions to extract E&P.

The Section 338(g) election also might give rise to Subpart F income. The effect of the election is to cause a deemed sale of the Buyco's assets, such that gain from the sale of the assets may constitute foreign personal holding company income. <sup>150</sup> The fund's basis in its Buyco stock would be increased by the amount of the Subpart F inclusion, reducing the taxable gain on the sale of the Buyco stock, and if the Subpart F inclusion were material, the basis adjustment could even create a loss on the sale of the Buyco stock. <sup>151</sup> This may create a mismatch because the Subpart F income will be ordinary income to the investors, while any loss from the sale would be a capital loss.

Once the sale is complete, the fund would then distribute the proceeds to its investors. At this point, the manager of the fund would receive its carried interest. U.S. individual investors generally would be taxed on their distributive shares of the gain at long-term capital gains rates (currently 15%). Taxable U.S. corporate investors would be taxed on their distributive shares of the gain at regular corporate rates (currently 35%).

## CONCLUSION

As cross-border investments by U.S. sponsored LBO funds continue to grow in both volume and size, fund sponsors and managers would be well advised to consider U.S. and international taxes in structuring transactions and in projecting deal costs and future returns on investments. There are frequent changes to U.S. and international tax laws that may apply to funds and their investments. Moreover, the U.S. and many other countries are monitoring cross-border private equity activities and reconsidering the policies and tax laws that presently apply to private equity funds. <sup>152</sup>

Cross-border private equity investing is among the most complex areas of the tax law because quantifying tax costs and benefits requires an understanding of corporate, partnership, international, and local country tax laws, as well as a balancing of the interests of, and different technical rules that apply to, the diverse investor groups, the general partner/manager, and the sponsors. While there are many approaches to structure a fund efficiently, to protect each participant's interest, and to reduce the global effective tax rate of the portfolio company group, many of the U.S. and international tax

rules discussed in this article can be traps. Fund sponsors, general partners, managers, and investors should thus proceed with caution in structuring cross-border LBO funds and acquisitions.

## Practice Notes

- While the choice of whether the fund should be organized in the U.S. or in another country is critical to foreign and certain tax-exempt investors, it also can have a profound impact on the application of various anti-deferral rules that may apply to the general partner and other taxable U.S. investors.
- Electing to treat Buyco's subsidiaries as disregarded entities provides the additional advantage of allowing the reinvestment of foreign earnings abroad without U.S. tax costs, i.e., the movement of cash from one disregarded foreign operating company to another without giving rise to phantom income under Subpart F. Such free movement of cash enables a more efficient deployment of capital to businesses with the most growth potential, or to businesses with short-term liquidity problems, or for any other purpose—all without a current U.S. federal tax cost.
- Identifying tax exposures and benefits in each of the jurisdictions in which the portfolio group operates can have material impact on bids, deal costs, and post-acquisition financial performance of a portfolio company group. A few examples of items that must be uncovered during the negotiation stage are the existence of valuable tax attributes and the existence of material tax exposures, such as audits, litigation, and penalty risks. Even early in the negotiation process, it is advisable for a fund to undertake at least a high-level tax due diligence review of the target group.

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1

For various tax and commercial reasons, the manager and general partner are often organized as two separate entities.

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2

The amount of the management fee and carried interest may vary depending on the type of fund or industry. For example, larger fund managers may charge less than a 2% management fee. Moreover, managers of real estate funds and hedge funds may receive a larger carried interest.

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3

The period is a rule of thumb—the time between investment and exit will vary.

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4

The taxation of other entities subject to special U.S. tax regimes, such as real estate investment trusts (REITs), regulated investment companies (RICs), and insurance companies, is beyond the scope of this article.

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5

National Venture Capital Association, "Private Equity Fundraising Recedes in Fourth Quarter," available at [www.nvca.org/pdf/4Q2006Fundraisingfinal.pdf](http://www.nvca.org/pdf/4Q2006Fundraisingfinal.pdf) (1/16/07) (hereafter "NVCA Fundraising").

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6

Tracy, "Private-Equity Firms Raked in Record Amounts Last Year," *Wall St. J.*, 1/11/07, page C6.

7

NVCA Fundraising, *supra* note 5.

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8

*Id.*

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9

See Koons, "TXU Buyout Proposal's Mixed Effect," *Wall St. J.*, 2/27/07, page C8. The consortium of buyers of TXU also includes Goldman Sachs Group, Citigroup, Morgan Stanley, and Lehman Brothers.

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10

Emerging Markets Private Equity Association, "Emerging Markets Private Equity Funds Raise Over US\$33 Billion in 2006," available at [www.empea.net/docs/EMPEA\\_fundraising\\_2006PressReleaseFINAL.pdf](http://www.empea.net/docs/EMPEA_fundraising_2006PressReleaseFINAL.pdf), 2/28/07, page 1.

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11

As discussed below, the CFC rules trump the passive foreign investment company (PFIC) rules where both regimes otherwise would apply; see Section 1297(e). Because organizing a fund as a foreign entity may *decrease* the likelihood that the CFC rules would apply, it may increase the likelihood that the PFIC rules would apply.

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12

See Sections 951-964 and 1291-1298. The American Jobs Creation Act of 2004 (AJCA) repealed two other anti-deferral regimes—the foreign personal holding company rules in former Sections 551-558 and the foreign investment company rules in former Sections 1246-1247.

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13

Section 957(a).

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14

Section 951(b).

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Sections 957(c) and 7701(a)(30).

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16

Section 951(a)(1)(A).

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17

*Query* whether there is support for an alternative conclusion. The fact that a U.S. partnership is a U.S. shareholder for purposes of determining the CFC status of its corporate subsidiaries arguably should not necessarily be determinative of the tax consequences to a partner in a U.S. fund. Section 951(b)

provides that only U.S. persons that are "U.S. shareholders" must include Subpart F income in gross income. Although a U.S. partnership is a U.S. shareholder for purposes of Section 951(b), partnerships are not subject to tax; rather, items of income flow through to the partners. Moreover, under Reg. 1.702-1(a)(8)(ii), "[e]ach partner must also 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." Although a complete discussion of this issue is beyond the scope of this article, it is unlikely that there is much support for the view that Subpart F income of a U.S. partnership must be included in the gross income only of partners that independently would satisfy the definition of a U.S. shareholder.

Furthermore, a foreign partner of a U.S. partnership should not be subject to U.S. tax on its distributive share of partnership income, unless such income is effectively connected with the conduct of a U.S. trade or business of the foreign partner or otherwise is subject to tax on a gross basis. While Section 875(1) attributes the U.S. trade or business of a partnership to each of its partners, private equity funds structure their activities to support their position that they are not engaged in U.S. trades or businesses. Even if a foreign partner were viewed as engaged in a U.S. trade or business, Subpart F inclusions are foreign source income and are unlikely to be effectively connected income (ECI).

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[18](#)

Section 1248. Very generally, this rule would apply to U.S. taxable investors that own 10% or more of the vote of the CFC.

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[19](#)

See Notice 2003-79, 2003-2 CB 1206, and the discussion in the text, below.

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[20](#)

Section 902(a). While U.S. individual investors are not eligible to receive indirect foreign tax credits, Section 1248(b) limits the amount of tax attributable to an amount included in gross income under Section 1248(a). See the discussion in the text, below.

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[21](#)

Sections 952(a)(2), 954(a)(1), and 954(c); Reg. 1.954-2(e)(3).

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[22](#)

See Sections 954(c)(3) and (c)(6).

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[23](#)

Notice 2004-70, 2004-2 CB 724.

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[24](#)

See the discussion in the text, below.

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[25](#)

See Sections 958(a) and (b).

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26

Section 958(a)(2); Reg. 1.958-1(b); see also Section 958(b).

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27

This statement assumes, of course, that none of the attribution rules otherwise would cause the portfolio company to be a CFC. For example, certain individuals are considered to own the stock owned by other family members. See Sections 958(b) and 318(a).

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28

This can be achieved by organizing the fund as an entity that is a partnership under local law (and respected as such under U.S. law) or by electing on Form 8832 to treat the entity as a partnership for U.S. tax purposes under the entity classification rules. See Regs. 301.7701-1 through -3. Nevertheless, there are situations in which organizing a fund as a domestic entity would be appropriate. For example, a new fund sponsor may prefer promoting and selling interests in a U.S. entity to a select U.S. investor base.

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29

In general, the holders of stock in PFICs may be taxed under three regimes. First, in the absence of any election to the contrary, a U.S. person owning shares in a PFIC is not taxed until the shareholder receives a distribution from the PFIC or disposes of PFIC stock. The shareholder pays tax on the distribution/disposition at ordinary income rates, however, and must pay an interest charge that is generally intended to recover the value of the deferral. See Section 1291. Second, if the stock of a PFIC is "marketable," then a U.S. person may mark-to-market the stock at the end of each year, resulting in the annual inclusion of unrealized appreciation as ordinary income. See Section 1296(a). Finally, if the PFIC is a "qualified electing fund" (QEF), the PFIC becomes a pass-through entity for U.S. persons that own the stock. Accordingly, the U.S. owners of the PFIC must pay tax on a current basis on undistributed income even if the PFIC does not distribute any income. See Sections 1295 and 1293 (a). The QEF election does not apply at the fund level but rather at the investor level. Each U.S. investor can choose whether to make a QEF election. Therefore, the same entity can be a QEF for some and not for others.

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30

Section 1297(a).

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31

Section 1297(b).

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32

Nevertheless, interest, dividends, rents, or royalties received or accrued from a "related person" (within the meaning of Section 954(d)(3)) are not passive income to the extent such amount is properly allocable to income of such related person that is not passive income. See Section 1297(b)(2) (C).

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33

Section 1297(e). This "overlap rule" applies only to U.S. shareholders (as defined in Section 951(b)) with respect to the foreign corporation and only to the portion of the shareholder's holding period after

1997.

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[34](#)

The overlap rule applies only for tax years after 1997, however; see Section 1297(e)(2)(A).

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[35](#)

See Section 1298(a)(3).

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[36](#)

Section 1298(b)(2).

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[37](#)

Section 1297(c) provides that if a foreign corporation owns at least 25% of the value of the stock of another corporation, for purposes of determining whether such foreign corporation is a PFIC, the foreign corporation is treated as (1) owning its proportionate share of the assets of the other corporation and (2) receiving its proportionate share of the income of such other corporation.

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[38](#)

If the fund is acquiring a foreign group from U.S. sellers, it is possible that a foreign entity in the group could be an "old PFIC" under the "once a PFIC, always a PFIC rule," i.e., one that existed before Section 1297(e) and for which a purging election was never made. Such rule will not affect the new U.S. owners, provided that the foreign corporation is not a PFIC (e.g., because of the Section 1297(e) overlap rule) at any time during their holding period.

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[39](#)

Reg. 301.7701-3(b); Section 7704.

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[40](#)

Section 731.

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[41](#)

Although organizing the general partner as an S corporation may achieve the liability shield, the stringent limitations on S corporations (e.g., no foreign ownership, single class of stock) makes them unfavorable for general-partner purposes.

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[42](#)

See Del. Code. Ann. tit. 6, section 17-1101.

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[43](#)

It is becoming more prevalent for funds' organizational documents to provide for the existence of an advisory committee comprising certain limited partners. If the fund is organized as an LP, consideration should be given to whether this would affect the limited liability of such limited partners.

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44

According to the CRA's Interpretation Bulletin IT-343R, an LLC is treated as a "corporation" for Canadian tax purposes. Moreover, unlike partnerships, the CRA does not look through the LLC and determine treaty benefits based on the residence status of the individual partners. It generally is expected that the U.S. and Canada will address this issue in a treaty protocol.

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45

The Netherlands, Cyprus, Cayman Islands, Luxembourg, and Mauritius are examples of jurisdictions that are sometimes used to establish foreign funds and/or holding companies owned by U.S. sponsored funds.

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46

Reg. 301.7701-2.

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47

Reg. 301.7701-3(b)(2). The default rules are different for domestic eligible entities. Any domestic eligible entity with two or more members is classified by default as a partnership for U.S. federal tax purposes; see Reg. 301.7701-3(b)(1).

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48

Reg. 301.7701-3(b)(2)(i)(B).

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49

Reg. 301.7701-3(c).

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The IRS, through Section 9100 relief and private letter rulings, routinely grants extensions of time to file entity classification elections that were mistakenly not timely made due to inadvertent error. See, e.g., Ltr. Ruls. 200713007, 200712021, and 200712011.

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51

Certain U.S. income tax treaties, however, do not contain limitation-on-benefits provisions, e.g., Iceland and Hungary. The U.S. is either currently renegotiating (or plans to renegotiate) these income tax treaties. See 2006 TNT 220-40 (9/28/06) (announcing completion of negotiations between Iceland and the U.S.); 2001 TNT 14-117 (1/19/01) (announcing negotiation between Hungary and the U.S.).

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52

See, e.g., Sections 894(c) and 7701(l).

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53

If the sale of the U.S. portfolio company implicates the FIRPTA rules, the foreign investors generally would be subject to U.S. taxation regardless of whether the foreign investors otherwise qualify for treaty benefits. In addition, if the sale gives rise to ECI, the foreign investors generally would be subject to U.S. taxation, although an applicable treaty might exempt the foreign investors from U.S.

taxation on income that otherwise might be ECI, provided the income is not attributable to a permanent establishment in the U.S.

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[54](#)

Section 7704(b).

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[55](#)

Reg. 1.7704-1(h).

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[56](#)

*Id.*

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[57](#)

Reg. 1.7704-1(h)(3).

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[58](#)

Sections 7704(c) and (d).

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[59](#)

Recently, private equity-like funds or fund managers have raised money in the public markets. These fund structures present unique issues in the context of the PTP rules and require careful planning. Moreover, a domestic fund with U.S. portfolio companies that is considering reorganizing as a foreign fund should take into account the potential application of the anti-inversion rules of Section 7874. Under Temporary Regulations, certain publicly traded foreign partnerships may be taxed as domestic corporations even if they otherwise would satisfy one of the exceptions of Section 7704. See TD 9265, 6/5/06. Among the most important differences of Section 7874 is that, for acquisitions after 6/2/06, the foreign partnership will be tested as a PTP without regard to the exception for "qualifying income." Therefore, if these rules apply, confining the income of the fund to dividends, interest, and capital gains would not preclude PTP status and treatment as a taxable domestic corporation. Nevertheless, provided the partnership does not acquire U.S. targets, these special rules should be immaterial. Cash (non-equity) acquisitions also should be unaffected.

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[60](#)

Sections 871(a) and 881(a). This gross basis tax is generally collected via withholding at the source; see Sections 1441 and 1442.

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[61](#)

Sections 871(b) and 882. This tax is also collected via withholding; see Section 1446. For foreign investors eligible to claim treaty benefits, the income must be "attributable to" a U.S. permanent establishment.

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[62](#)

Section 884. As with the tax on FDAP income, the branch profits tax may be reduced or eliminated by treaty. If not reduced by treaty, the branch profits tax plus corporate tax can result in an effective tax rate of 54.5% (.35 + [(1-.35) × .30]).

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[63](#)

Section 897(a).

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[64](#)

Section 897(c)(2).

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[65](#)

The U.S. trade or business of a partnership is attributed to each of its foreign partners; see Section 875(1).

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[66](#)

Section 511(a)(1).

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[67](#)

Section 512(a)(1).

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[68](#)

Section 512(b).

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[69](#)

Sections 512(b)(4) and 514(a).

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[70](#)

See Section 512(b)(17); Reg. 1.1291-1(e)(1).

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[71](#)

Although Rev. Proc. 93-27, 1993-2 CB 343, and the check-the-box Regulations provide authority for the view that a general partner that provides only services is a partner for federal tax purposes, general partners often contribute capital to ensure partner status. See also Section 704(e)(1) and Culbertson, 37 AFTR 1391, 337 US 733, 93 L Ed 1659 (1949).

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[72](#)

Under current law, gains from the sale of capital assets held more than one year (e.g., stock in portfolio companies) and qualified dividends that meet certain requirements (discussed in the text, below) qualify for the 15% long-term capital gains rate.

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[73](#)

For example, Section 864(b)(2)(A)(ii) provides that trading in stocks or securities for the taxpayer's own account is an activity that does not give rise to the conduct of a U.S. trade or business. If (1) the sponsor/general partner/manager activities are limited to shareholder-type or stewardship activities, (2) the fund is holding portfolio company stock as an investment for medium- to long-term growth, and

(3) the primary business activity occurs at the operating-company level outside of the U.S. (in the case of foreign portfolio companies), it is less likely that U.S. activities of the fund sponsors/general partner would rise to the level of a U.S. trade or business or that such activities would be attributed to the fund (foreign or domestic) under agency principles. Nevertheless, the anticipated U.S. activities of the fund sponsors, general partner, and manager should be carefully analyzed and structured to minimize active trade or business risks. Moreover, in the international context, consideration should be given to whether there is a risk that the activities of the manager or sponsors (if composed of persons resident in other countries) might create a taxable presence for the fund in another country, through for example, permanent establishment rules (e.g., under an income tax treaty) or management and control rules (e.g., the "taxable presence" test in the U.K. and certain other countries).

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[74](#)

Whether the issuance of a profits interests for services is a taxable event is an issue that continues to evolve. Presently, two IRS pronouncements, Rev. Proc. 93-27, *supra* note 71, and Rev. Proc. 2001-43, 2001-2 CB 191, exclude from tax the receipt of a profits interest issued for services, if certain safe harbor requirements are satisfied. Nevertheless, Notice 2005-43, 2005-1 CB 1221, and Proposed Regulations (REG-105346-03, 5/24/05) contain new rules that, on the issuance of final Regulations, will apply to determine whether the grant of a profits interest is a taxable event. In the Preamble to REG-105346-03, Treasury and the IRS indicated that Rev. Procs. 93-27 and 2001-43 will be obsoleted on the issuance of final Regulations. See generally Banoff, Carman, and Maxfield, "Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K," 103 JTAX 69 (August 2005).

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[75](#)

Sen. Grassley (R-Ia.), ranking minority member of the Committee on Finance, is currently studying the characterization of private equity and hedge fund managers' compensation, considering whether the managers should be paying tax at ordinary income rates. Apparently the Committee's Chair, Sen. Baucus (D-Mont.), is not planning to introduce legislation on the topic, however. See "Grassley Looking at Hedge Fund Managers' Compensation," 2007 TNT 48-1 (3/12/07). Some writers have flatly criticized the 15% capital gains taxation of the carried interest. See, e.g., "Hedge Fund Managers' 15 Percent Tax on 20 Percent of the Profits," 2006 TNT 59-5 (3/28/06).

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[76](#)

The purpose of this discussion is neither to identify every possible variation of a fund structure nor to suggest that a fund must fit into one of these alternatives. On the contrary, there are countless possible variations of a fund structure that may be possible. Indeed, in the cross-border context, the participation of an investor group from a different country or the existence of new targets or portfolio companies in different jurisdictions often necessitates the development of narrowly tailored, fact-specific fund structures.

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[77](#)

Fund organizational documents should preclude U.S. taxable investors from investing in foreign blockers that would be PFICs.

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[78](#)

Depending on the residence of the foreign investors, alternative feeder structures that "feed" into the main fund may be needed to accommodate the tax planning objectives of the particular investor group.

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[79](#)

Section 11(b).

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80

Under Section 1248, gain from the sale of CFC stock by a U.S. person is recharacterized as a dividend to the extent of the E&P of the CFC. Section 964(e) provides a similar recharacterization rule for sales of CFC stock by another CFC. Thus, if the Buyco would be a CFC if incorporated outside of the U.S., then a disposition by the Buyco of stock in a CFC subsidiary would be recharacterized as a dividend to the extent of the E&P of the CFC subsidiary. Moreover, the "same-country exception" does not apply to any amount treated as a dividend under Section 964(e), and thus the dividend might give rise to Subpart F income to the Buyco (see Section 964(e)(2)). The dividend, however, would be eligible for the look-through rule in Section 954(c)(6), discussed further in the text, below. See Notice 2007-9, 2007-5 IRB 401.

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81

For example, a U.S. Buyco may be appropriate where the target companies are organized in a high-tax jurisdiction that accords favorable income tax treaty benefits to a U.S. Buyco.

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82

Section 901.

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83

H.R. 1672 (3/23/07), introduced by Rep. Neal (D-Mass.), a member of the House Ways and Means Committee, would deny qualified dividend treatment to certain foreign dividends. The bill would deem a dividend a "nonqualified dividend from a foreign corporation" if (1) any amount is allowable as a deduction to any person at any time under the tax law of any foreign country with respect to such dividend, (2) the entity making the dividend distribution is not treated as a corporation under local law, is tax-exempt under local law, or is a PFIC, or (3) the dividend is paid on a hybrid instrument (i.e., an instrument not treated as equity under local law).

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84

Section 1(h)(11)(B)(i)(II); Notice 2003-79, *supra* note 19.

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85

The determination of whether a particular instrument is debt or equity requires a multi-factor analysis and is a highly factual determination. See, e.g., *Litton Business Systems, Inc.*, 61 TC 367 (1973); Notice 94-47, 1994-1 CB 357.

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86

Section 316. Because Section 951 does not treat Subpart F inclusions as dividends, such inclusions cannot be qualified dividends. Notice 2004-70, *supra* note 23. Distributions by a CFC out of previously taxed income (PTI) also are not qualified dividends because they are not subject to U.S. tax. *Id.* Distributions by a CFC out of non-PTI will be qualified dividends provided the other requirements are met. *Id.*

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87

Sections 1(h)(11)(C)(i) and (ii). For a current list of U.S. tax treaties that meet the comprehensive

tax treaty requirement of Section 1(h)(11), see Notice 2006-101, 2006-47 IRB 930.

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88

Section 1(h)(11)(C)(iii). Where a foreign corporation could be both a PFIC and a CFC (but for the application of the PFIC/CFC overlap rule in Section 1297(e)), an amount received by a U.S. shareholder of such corporation nevertheless may constitute qualified dividend income. Notice 2004-70, *supra* note 23.

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89

Section 1(h)(11)(B)(iii). U.S. investors who are not U.S. shareholders (within the meaning of Section 951(b)) with respect to the foreign corporation will not receive qualified dividend treatment because, as to those shareholders, the PFIC/CFC overlap rule in Section 1297(e) would not apply.

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90

See Ann. 2004-11, 2004-1 CB 581 (discussing the pass-through of qualified dividends from a partnership to its partners and the separate statement of qualified dividends on Schedules K-1).

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91

Reg. 301.7701-3(b)(3).

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92

Section 163. For example, in the domestic context, the primary limitations on the deductibility of interest are: (1) the instrument giving rise to interest must be debt, and not equity, under U.S. federal income tax principles (see, e.g., Litton Business Systems and Notice 94-47, *supra* note 85); (2) Section 279 disallows interest deductions on indebtedness incurred to acquire stock or assets of another corporation if certain requirements are met; (3) the applicable high-yield discount obligation (AHYDO) rules in Section 163(i) limit interest deductions on debt with a maturity over five years issued by a C corporation where such debt has a yield to maturity that equals or exceeds the applicable federal rate plus five percentage points and that has substantial OID or paid-in-kind features; (4) the "interest stripping" provisions of Section 163(j) limit deductions on interest paid to related persons to the extent such interest strips out earnings from the U.S. tax base; and (5) Section 163(l) disallows a deduction for interest on debt payable in or by reference to issuer equity.

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93

This generally requires planning on a country-by-country basis, and variations of this technique will be required. For example, certain countries do not have consolidation rules and therefore require a merger of the leveraged disregarded holding company with the acquired operating company.

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94

Proposed Regulations (REG-113909-98, 7/9/99) would curb the use of foreign hybrid branches. See "Withdrawal of Guidance Under Subpart F Relating to Partnerships and Branches and Issuance of New Guidance Under Subpart F Relating to Certain Hybrid Transactions," 64 Fed. Reg. 37,727 (7/13/99). These rules, not yet finalized, will be effective five years after they are made final. Earlier attempts to limit the use of foreign hybrid branches were withdrawn; see Notice 98-35, 1998-2 CB 34.

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95

Section 951(a)(1)(A).

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[96](#)

Sections 952(a)(2), 954(a)(1), and 954(c). Subpart F income is limited to the CFC's E&P for the tax year; see Section 952(c)(1).

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[97](#)

Section 954(c)(3)(A)(i).

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[98](#)

Section 954(c)(3)(B).

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[99](#)

Section 954(c)(6)(A).

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[100](#)

Section 954(c)(6)(B).

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[101](#)

See generally Calianno and Collins, "Notice 2007-9: A Sound Approach for Applying the CFC Look-Through Rule," 2007 Worldwide Tax Daily 39-8 (2/27/07); Calianno and Collins, "The CFC Look-Through Rule: U.S. Congress Changes the Landscape of Subpart F," Tax Notes Int'l (7/11/06).

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[102](#)

Subpart F income includes insurance income, foreign base company income, and certain other types of income; see Section 952(a). Foreign base company income, the subset of Subpart F income most frequently encountered in practice, includes foreign personal holding company income (including certain passive-type income), foreign base company sales income, foreign base company services income, and foreign base company oil-related income; see Section 954(a).

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[103](#)

See Reg. 301.7701-3(c). This assumes that the entities are eligible entities or are converted into eligible entities. A per se entity can be converted into an eligible entity through transactions that qualify either as tax-free F reorganizations or Section 332 liquidations. For example, if a subsidiary was a per se corporation, the Buyco might transfer the stock of the subsidiary to a newly formed entity taxable as a corporation (but which is not a per se corporation) and then liquidate the subsidiary into the newly formed entity. See, e.g., Ltr. Rul. 200710003.

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[104](#)

Certain Subpart F rules "regard" transactions between CFCs and branches thereof. For example, if a CFC carries on purchasing or selling activities or certain manufacturing or production activities through a branch or similar establishment located outside the country of the CFC's organization, and the use of such branch has substantially the same tax effect as if the branch were a wholly owned subsidiary corporation of the CFC, then the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining foreign base company sales income. See Regs. 1.954-3(b)(1)

(i)(a) and (ii)(a).

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[105](#)

But see note 94, *supra*.

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[106](#)

This type of super-holding company planning has various collateral consequences on various other international tax provisions. For example, for foreign tax credit purposes, E&P and foreign tax pools would be blended.

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[107](#)

For example, certain European countries are members of the European Commission Parents-Subsidiary Directive, discussed in further detail below, which prevents double taxation of parent companies on the profits of their subsidiaries.

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[108](#)

Sections 338(d)(3) and 1504(a)(2). The election must be made no later than the 15th day of the ninth month beginning after the month in which the "acquisition date" occurs; see Section 338(g)(1). If the foreign target's owners plan to reinvest in the target indirectly via an investment in the LBO fund, then one must consider whether the rollover of interests may prevent the acquisition from constituting a qualified stock purchase.

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[109](#)

Section 338(a); Reg. 1.338-2(d). The purchaser generally is not required to provide notice to the seller. If, however, the target is a CFC or PFIC at any time during the portion of its tax year that ends on its acquisition date, the purchaser must deliver written notice to each U.S. person that holds stock in the target on the acquisition date and to each U.S. person that sells stock in the target to a purchasing group member during the target's 12-month acquisition period, unless the Section 338(g) election does not affect income, gain, loss deduction, or credit of the U.S. person. See Reg. 1.338-2(e)(4).

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[110](#)

By contrast, for a domestic target a Section 338(g) election generally is not desirable because it results in a double tax: the seller bears tax on its gain in the target's stock, and the target bears tax on the gain from the deemed sale of its assets. Nevertheless, a Section 338(g) election may be advantageous in the domestic context if the target has expiring NOLs that can be used to shelter the gain (and refresh the NOLs in the form of increased depreciation deductions). By contrast, a Section 338(h)(10) election is a beneficial option in the context of a domestic target because it permits a step-up in asset basis without triggering double tax. Such election is available only where the target is a member of a consolidated group, and thus cannot apply where the target is a foreign corporation.

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[111](#)

If the owners of the target corporation are domestic, the consequences of the Section 338(g) election would be different. See the discussion of exit considerations in the text, below.

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[112](#)

Section 952(c)(1)(A). If the Subpart F income of a CFC for any tax year is reduced by reason of the E&P limitation, then any excess of the E&P of such CFC for any subsequent tax year over the Subpart F income of such CFC for that tax year will be recharacterized as Subpart F income under rules similar to the overall foreign loss recapture rules in Section 904(f)(5); see Section 952(c)(2).

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[113](#)

Section 1248(a). Under current law, U.S. individual investors may be indifferent to the recharacterization of gains as dividends. Reducing the amount of dividend recharacterization may be detrimental to taxable U.S. corporations, however, to the extent they would have been entitled to claim an indirect foreign tax credit on the deemed dividends.

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[114](#)

See Sections 902 and 904(a). The foreign tax credits would be available only to U.S. corporate investors in the buyout fund, not to individual investors. Such corporate investors must own at least 10% of the voting stock of the foreign corporation (indirectly through the fund); see Section 902(a).

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[115](#)

Under Section 301(c), distributions constitute (1) dividends to the extent of current or accumulated E&P; (2) to the extent not dividends, return of basis; and (3) to the extent not a dividend and the distribution is in excess of basis, capital gain.

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[116](#)

Under Reg. 1.338-4(h), it is possible to make cascading Section 338(g) elections for lower-tier subsidiaries, provided they are made consistently down the ownership chain, i.e., "cherry picking" is not allowed.

If a foreign target is a CFC and if some of the target's stock is not acquired as part of a qualified stock purchase, such stock is considered "carryover stock" under Reg. 1.338-9(b)(3). To the extent the stock of the target is carryover stock, the E&P of the target carry over for purposes of (1) characterizing distributions as dividends, (2) characterizing gain on sales of target stock as dividends under Section 1248, (3) characterizing an investment by the target in U.S. property as income under Sections 951(a)(1)(B) and 956, and (4) determining deemed-paid foreign tax credits under Sections 902 and 960; see Reg. 1.338-9(b)(3)(ii). These rules would not affect a fund in the buyout context if the fund acquires a foreign target from a foreign seller.

Also, if the target is in a high-tax jurisdiction, and if investors in the fund include corporations that satisfy the 10% vote requirement necessary to claim indirect foreign tax credits, then such corporate investors may have an interest in forgoing the Section 338(g) election in order to avail themselves of preacquisition foreign tax credits to reduce post-acquisition tax. Complex special rules outside the scope of this article apply for purposes of determining the extent which a U.S. buyer can avail itself of preacquisition earnings and taxes of a foreign target. Therefore, the Section 338(g) election may cause tension between different 10% corporate investors and other investors that generally would benefit if the election were made.

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[117](#)

Section 902(a).

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[118](#)

Although Section 902 credits are available only to U.S. corporations, it should not matter whether the

LBO fund is a domestic or foreign partnership for purposes of obtaining look-through treatment on dividends; see Section 904(d)(4). Additionally, in the AJCA Congress clarified what many tax practitioners and taxpayers simply assumed: stock owned, directly or indirectly, by or for a partnership, will be considered as being owned proportionately by its partners for purposes of determining the indirect foreign tax credit; see Section 902(c)(7). Part of the apparent ambiguity in this area was due to the language of Rev. Rul. 71-141, 1971-1 CB 211, which discusses whether two partners in a partnership formed under the Delaware Uniform Partnership Act were entitled to Section 902 credits for taxes paid by a corporation owned in part by the partnership. While the Ruling held that the partners were entitled to Section 902 credits because each partner indirectly owned at least 10% of the corporation, technically the Ruling applied only to *general* partnerships. See TD 8708, 1/6/97. In Section 902(c)(7), Congress adopted the definition of "partnership" in Section 7701(a)(2).

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[119](#)

Even if the "shelf" company had previously been a PFIC, the fund and its investors acquiring the "shelf" company should not inherit the PFIC history. Rather, the testing for PFIC status would begin with the new owners. See Section 1297(b)(1).

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[120](#)

For example, Luxembourg imposes a capital duty ("droit d'apport") on the formation of a Luxembourg company and on subsequent contributions. The tax imposed is generally 1% of the FMV of the contribution.

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[121](#)

For example, Brazil, Colombia, and Venezuela generally impose withholding taxes on the locally sourced income of nonresidents.

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[122](#)

ITA, subsections 18(4)-(8). A specified non-resident includes a shareholder that owns at least 25% of the vote or value of the stock of the Canadian subsidiary.

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[123](#)

See Council Directive 2003/123/EC (12/22/03), amending Council Directive 90/435/EEC (7/23/90).

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[124](#)

Depending on the terms of the fund's organizational documents, it is these events that will result in cash distributions and tax allocations to the fund's investors and to the fund manager. Focusing on cash distributions under a standard waterfall provision (without getting into variations in distribution priority), the exit events typically would entitle the fund investors to a return of their capital, perhaps a payment of a hurdle rate or a preferred return, and ultimately a distribution of 80% of the profit realized on the event. Such event likewise would entitle the manager to a distribution of 20% of the profit realized pursuant to its carried interest.

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[125](#)

Additional steps would be required to effectuate the repatriation through the use of the hybrid debt.

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[126](#)

Section 901(a).

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[127](#)

Section 275(a)(4)(A).

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[128](#)

Section 902; see the discussion in the text, above.

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[129](#)

Section 902(c)(7); see note 118, *supra*.

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[130](#)

Section 1(h)(11); see the discussion in the text, above.

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[131](#)

Section 954(c)(1)(B).

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[132](#)

Section 954(c)(1)(B)(i).

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[133](#)

Section 964(e)(2).

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[134](#)

Notice 2007-9, *supra* note 80.

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[135](#)

The look-through rule in Section 954(c)(6), however, applies only for tax years beginning after 2005 and before 2009.

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[136](#)

For example, it is not entirely clear whether the seller or the buyer would obtain the PTI benefits.

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[137](#)

See, e.g., Ltr. Rul. 200710003.

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[138](#)

Section 954(c)(1)(B). Gains from the sale of inventory do not constitute foreign personal holding company income; see Section 954(c)(1)(B) (flush language). Property that does not give rise to income does not include tangible property used or held for use in the company's trade or business that is of a character that would be subject to depreciation allowances, real property that does not give rise to

rental or similar income (to the extent used or held for use in the company's trade or business), and intangible property, goodwill, or going-concern value (to the extent used or held for use in the company's trade or business). See Reg. 1.954-2(e)(3).

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[139](#)

In *Dover Corp.*, 122 TC 324 (2004), the Tax Court held that a "check-and-sell" transaction, in which a selling CFC caused a wholly owned CFC subsidiary to file a check-the-box election to be treated as a disregarded entity for U.S. federal tax purposes and then immediately thereafter in form sold the stock of the CFC subsidiary to a third party, did not result in foreign personal holding company income to the selling CFC. The court reasoned that the selling CFC succeeded to the business history of the lower-tier CFC, such that the selling CFC was considered to have used or held for use the assets of the lower-tier CFC in its trade or business immediately prior to the sale. Also, in 2003, the IRS withdrew the "extraordinary transaction" rule of Proposed Regulations that would apply to treat otherwise disregarded entities as corporations on the occurrence of certain events. See Notice 2003-46, 2003-2 CB 53.

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[140](#)

Section 1248(a). Rev. Rul. 69-124, 1969-1 CB 203, confirms that a domestic partnership is treated as an entity for purposes of applying Section 1248(a). The Ruling holds that the tax attributable to the amounts included in the gross income of the domestic partners of the domestic partnership is limited by Section 1248(b).

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[141](#)

Section 1248(d)(1); Reg. 1.1248-2(e)(3).

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[142](#)

Reg. 1.904-5(c)(4). Under Section 904(d)(2), for tax years beginning after 2006, there are only two "baskets" of foreign-source income for purposes of applying the foreign tax credit limitation: passive category income and general category income. See generally Calianno and Gottschalk, "The FTC's Changing Landscape—An Overview of the Impact of the AJCA," 103 JTAX 276 (November 2005).

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[143](#)

Section 1248(b).

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[144](#)

Prop. Reg. 1.1248-1(a)(4). These rules will become effective on the date they are published as final Regulations; see Prop. Reg. 1.1248-1(g).

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[145](#)

REG-135866-02, 6/1/06. While the Preamble does not explicitly state the view of Treasury and the IRS as to current law in this respect, the policy arguments made for issuing the Proposed Regulation may suggest that they would argue for aggregate treatment of the partnership.

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[146](#)

The acquisition also eliminates preacquisition E&P and foreign tax pools.

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[147](#)

See Section 338(h)(16). For a complete discussion of the effects of a Section 338(g) election in the context of cross-border acquisitions, see Yoder, "Buyers Electing Section 338 for CFC Targets: Sellers Beware," 28 Tax. Mgmt. Int'l J. 443 (10/12/01).

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[148](#)

In addition to making clear whether the buyer will make a Section 338(g) election, the sale agreement should contain appropriate indemnification provisions to address this circumstance.

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[149](#)

See Dolan, Jackman, Dabrowski, and Tretiak, *U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures* (Warren, Gorham & Lamont, 2002), ¶2.03[1][d].

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[150](#)

See Reg. 1.338-9(b)(1); see also the discussion in the text, above, under "Partial Sale of Portfolio Operations."

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[151](#)

Section 961(a).

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[152](#)

For example, the U.K., Germany, and Denmark are some of the countries considering altering interest expense deduction provisions in response to the significant use of leverage by private equity funds. See "Private Equity Fund Growth and Policy Implications," 2007 TNT 53-5 (3/15/07).

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