Certain Considerations Pertaining to Private Fund Blocker Structuring

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Private funds are organized by asset managers to invest in a variety of asset types. Principal among these are investments in the equity of private operating companies (or "private equity"). A typical private fund is organized as a limited partnership for legal purposes and is classified as a partnership for U.S. federal income tax purposes.[1] This structure achieves two important goals. First, a partnership can issue a profits interest ("carried interest") to the asset manager's affiliates for distribution to the principals and employees or, in certain cases, directly to the principals and employees. Second, because a partnership is a passthrough entity for U.S. federal income tax purposes and in many foreign jurisdictions, it allows investors to be taxed (or not taxed) on income attributable to investments based on their specific tax statuses.

Private fund investors span a wide range of tax profiles. Large private funds typically have both foreign and domestic investors, each of which may be taxable or eligible for a variety of tax exemptions (*e.g.*, Code Sec. 892 or 501 of the Internal Revenue Code of 1986, as amended (the Code)). Foreign investors in private funds often have high (or extreme) sensitivity to U.S. filing requirements arising as a result of an investment in a private fund. More importantly, foreign investors in private funds often do not want to recognize income effectively connected with the conduct of a U.S. trade or business (USTB) within the meaning of Code Sec. 864 (ECI) or otherwise be a partner in a partnership that is engaged in a USTB.

ECI is generally taxed to foreign persons at the same income tax rates applicable to individuals and corporations. In addition, irrespective of whether a foreign investor is allocated ECI, foreign investors that are partners in a partnership that is engaged in a USTB are generally required to make a U.S. tax filing as a result of investing in the private fund. ECI and the resulting tax filing requirement typically arise as a result of private fund investments in operating partnerships ("flow-through investments") that conduct a USTB.[2]

The reasons for foreign investors' aversion to filing tax returns and paying ECI taxes in the United States are twofold. First, foreign investors often lack familiarity with the process of reporting and paying ECI taxes and wish to avoid the burden and exposure of reporting and paying those taxes. Second, the effective tax rate applicable to foreign investors can be managed more effectively if the

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private fund "blocks" ECI for the benefit of such investors. Typically, in order to "internalize" the tax payment and filing requirements associated with ECI, private funds will cause foreign investors to participate in flow-through investments through corporations ("blockers"). Blockers may be domestic or foreign.[3]

A growing number of private funds make investments, each of which could generate both ECI and income other than ECI (non-ECI). Non-ECI may be U.S.-source income subject to U.S. gross-basis taxation under the "fixed or determinable annual or periodical" (FDAP) regime or foreign-source income not subject to taxation in the United States. The rise in such investments is attributable to several factors, including the growth of private funds that focus on investing in other private funds (also known as "secondaries funds"), the proliferation of legacy blockers held by portfolio companies that have been under private equity ownership, and investments in multinational enterprises.

The use of a domestic blocker for this type of investment may result in corporate taxation of the domestic blocker's share of all income attributable to such investment (whether ECI or U.S.-source). Therefore, understanding the difference between taxation of a foreign blocker's ECI and FDAP income *versus* all of a domestic blocker's income is of paramount importance when a fund selects where to form a blocker. If the ECI taxation system achieved perfect parity between domestic and foreign corporations' tax burdens with respect to U.S. business income, then a foreign blocker might be the preferred blocker; however, such parity is far from reality.

In addition to jurisdiction of formation, a blocker may be formed as an entity that is tax-transparent in the jurisdiction of the foreign private fund investor and tax-opaque in the United States. This type of blocker (often referred to as a "reverse hybrid") may be treated differently for various tax purposes, including the availability of foreign tax credits, eligibility of the investor's share of income for the benefits of the tax treaty between the United States and such jurisdiction, and deductibility of interest.

This article discusses the differences in tax consequences of forming a domestic blocker *versus* a foreign blocker and the reasons why private funds generally choose domestic blockers and proceeds in three parts. First, we discuss the difference between the taxation of a U.S. blocker and that of a U.S. branch of a foreign corporation in the ordinary course. Second, we discuss this difference in connection with the termination of each type of entity's U.S. business. Consideration of this fact pattern is of particular importance in the context of private funds, which typically acquire businesses for a later sale at gain. Finally, we discuss the taxation of reverse hybrid blockers. This discussion is limited to considerations relevant to foreign investors that are classified as corporations for U.S. federal income tax purposes, because many private fund investors (and often the largest private fund investors) are foreign corporations (including foreign governments, pension funds, and corporate enterprises such as insurers) or partnerships owned by such foreign corporations.

I. Taxation of U.S. Subsidiaries and U.S. Branches of Foreign Corporations

We begin with a summary of U.S. federal income taxation of foreign corporations.[4] A foreign parent may repatriate cash from a U.S. subsidiary by causing the U.S. subsidiary to make distributions to the foreign parent that are treated as dividends or by causing the U.S. subsidiary to pay interest or principal on outstanding debt that was previously loaned by the foreign parent to the U.S. subsidiary. Both methods for repatriating earnings are subject to U.S. taxation, as further discussed below. In addition, the United States imposes tax on dividends and interest deemed paid by a U.S. branch of a foreign corporation under the branch profits tax regime, as further discussed below. Despite an attempt to achieve parity between the foreign corporation with respect to its U.S. corporate subsidiaries and U.S. branches, the taxes imposed differ in significant ways. Part A discusses the basic tax framework, while Parts B and C discuss the taxation of dividends and interest deemed paid by a U.S. branch.

A. ECI and FDAP

A U.S. subsidiary of a foreign corporation is subject to net-basis U.S. tax on its worldwide income.[5] The foreign corporation is subject to gross-basis U.S. tax (collected by withholding) imposed on dividends paid by the U.S. subsidiary to the foreign corporation (see discussion of the FDAP regime below).[6] By contrast, a foreign corporation is generally not subject to tax on income that does not bear any relation to the United States.[7]

Under Code Sec. 882, a foreign corporation operating through a U.S. branch is subject to a net-basis U.S. tax. Under this provision, a foreign corporation with a USTB will be taxed on its net ECI at corporate income tax rates.[8] Whether a foreign person is engaged in a USTB is a facts-and-circumstances determination, which takes into account whether the person's activities are regular, continuous, and substantial.[9] Under Code Sec. 864(c), a foreign person engaged in a USTB will be taxed in the United States only on ECI.[10] ECI generally includes

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certain U.S.-source passive-type income (*i.e.*, interest, dividends, rents, and royalties) that is earned in the active conduct of business,[11] as well as non-passive-type U.S.-source income, regardless of whether the income has a factual connection to the foreign person's USTB (under the so-called "force of attraction" rule).[12]

The Code does not permit U.S.-source passive-type income earned by a nonresident alien or foreign corporation to escape taxation merely because it is not earned in the active conduct of business. Instead, such income is taxed under Code Sec. 871 or 881, which imposes a flat 30% tax on U.S.-source FDAP income that is not ECI.[13] The tax is collected through withholding at the source and can be reduced or eliminated pursuant to an income tax treaty.[14] As for tax base, while the Code specifically refers to interest, dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, and other FDAP gains, profits, and income, subject to certain exclusions,[15] the regulations promulgated by the U.S. Department of the Treasury under the Code have long taken the position that FDAP includes any income that is neither ECI nor capital gain.[16] Certain types of income are exempt from the FDAP regime, such as portfolio interest.[17]

B. Branch Profits Tax (BPT): The Dividend Equivalent Amount (DEA)

Upon consideration of the FDAP and ECI tax regimes applicable to foreign corporations and the worldwide taxation of domestic corporations, one might see an opportunity to repatriate cash at a lower tax rate. If a foreign corporation is taxed solely at corporate rates on ECI when conducting a U.S. business, then it would almost always prefer to conduct such business directly rather than through a U.S. subsidiary. Distributions from a domestic subsidiary could be subject to FDAP tax. However, this opportunity is foreclosed by the BPT.

The goal of the BPT regime is to achieve parity between the taxation of a foreign corporation conducting a USTB directly (*i.e.*, through a branch) and a foreign corporation conducting a USTB through a U.S. corporate subsidiary.[18] In particular, the rules are intended to provide equivalent results with respect to income that is repatriated to the foreign corporation from such branch, and interest paid by such branch.[19] Dividends paid by a U.S. corporate subsidiary would be subject to FDAP withholding tax, and interest paid by such a subsidiary would be treated as U.S.-source and similarly subject to FDAP withholding tax.

Accordingly, the BPT is a tax on repatriated ECI and a requirement to treat interest payments by the foreign corporation attributable to the branch as U.S.-source.[20] Beyond this, the BPT regime is intended to impose a tax on the excess of the amount of interest expense deducted against ECI over the amount of interest treated as U.S.-source.[21] This tax disincentivizes taking inconsistent positions with respect to the sourcing of interest payments and the apportionment of interest expense. The rules achieve the desired parity only approximately, and differences exist between the treatment of a branch and a U.S. corporate subsidiary.

The BPT on "repatriated earnings" is imposed at a rate of 30% on the DEA.[22] This rate is reduced to the BPT rate provided by a U.S. tax treaty, or if no such rate is provided, the treaty tax rate imposed on dividends paid by a wholly owned U.S. corporation to a foreign corporate parent resident in the same country as the foreign corporation in question, provided that the foreign corporation is a "qualified resident."[23] Certain tax treaties include a nondiscrimination clause that acts to prevent a treaty partner from taxing a U.S. permanent establishment of its residents more heavily than the U.S. taxes its own residents carrying on the same activities.[24]

As indicated above, the BPT is imposed on the DEA. The tax base is a foreign corporation's "effectively connected earnings and profits" (ECE&P) for a taxable year, reduced (but not below zero) to reflect any increase in "U.S. net equity" (*i.e.*, the "reinvested earnings") and increased to reflect any decrease in "U.S. net equity" (*i.e.*, the "repatriated earnings").[25] These adjustments are made by computing the difference between U.S. net equity at the close of the preceding taxable year and U.S. net equity at the close of the current taxable year.[26]

An increase in the DEA cannot exceed accumulated ECE&P as of the end of the prior taxable year.[27] Furthermore, a deficit in accumulated ECE&P does not impact the calculation of the DEA with respect to ECE&P for the current taxable year. The reason is that such deficit is not taken into account in the current-year ECE&P, which is only decreased for the reinvestment of ECE&P in the United States. In combination, these rules are intended to approximate the "nimble dividend rule" as well as provide for nontaxable repatriation of capital.[28]

"U.S. net equity" is the aggregate amount of "U.S. assets" over "U.S. liabilities" as of the applicable date.[29] "U.S. assets" are generally property held by a foreign corporation if all income from its use and all gain from its disposition are ECI.[30] The regulations provide a number of specific inclusions and exclusions from this definition, which swallow much of this general rule.[31] "U.S. liabilities" are determined in the same way as "U.S.-connected liabilities" in accordance with the rules set forth in

Reg. §1.882-5 for purposes of the determination of the amount of interest expense apportioned to the USTBs of foreign taxpayers.[32] The calculation of U.S. assets and liabilities is complex and is discussed briefly below.

C. BPT: Treatment of Interest

The BPT takes a two-pronged approach to taxing branch interest. First, Code Sec. 884(f)(1)(A) treats any interest paid by the U.S. branch (branch interest) as paid by a U.S. corporation. This in turn may result in FDAP taxation of such interest. Taxation of such interest is eligible for treaty reduction and other exemptions (such as the portfolio interest exemption).[33] Second, Code Sec. 884(f)(1)(B) imposes a tax on the foreign corporation on the excess of the amount of its interest expense taken into account in the computation of ECI over the amount of its branch interest (excess interest). The portfolio interest exemption is not available with respect to excess interest in the same way as with respect to branch interest, as excess interest is taxed in the same manner as if it were interest paid to the foreign corporation by its wholly owned U.S. corporate subsidiary.[34]

The reader might wonder why there would be any daylight between the interest expense apportioned to the USTB of the foreign corporation and the interest deemed paid by such trade or business. Notably, branch interest does not arise by virtue of the accrual of original issue discount. It arises only upon payment, although an election is available to taxpayers to treat branch interest as paid when it accrues.[35] When payment is made after accrual, this election accelerates withholding because interest is deemed paid when accrued. When payment occurs before accrual, the deemed payment at the time of accrual is relevant only for purposes of the calculation of excess interest.

Furthermore, the manner in which branch interest is computed provides more flexibility to taxpayers. In particular, the computation emphasizes the manner in which liabilities are booked or specifically identified, subject to limitations. On the other hand, the calculation of interest expense for purposes of the computation of ECI is intended to be more objective. Reg. §1.882-5 was drafted based on the premise that interest expense is fungible and that a proportionate amount of the interest expense of the foreign corporation must relate to its U.S. activity.[36]

A detailed discussion of the interest apportionment rules, as well as the calculation of branch interest, is beyond the scope of this article. However, we note that the interest expense allocable to U.S. activities for purposes of calculating ECI will not necessarily always be less than the interest expense of a domestic corporate subsidiary conducting the same activity. In fact, Reg. §1.882-5 provides several elections and opportunities for maximizing such interest expense.[37] Furthermore, certain U.S. tax treaties, notwithstanding the language of the regulations, recognize interbranch transactions (that are otherwise disregarded for U.S. federal income tax purposes), which in turn may be used to manage ECI taxation.[38]

D. Contextualizing FDAP, ECI, and BPT for Private Funds

As noted, the principal difference between the taxation of foreign and domestic corporations is that foreign corporations pay tax on ECI when conducting business activity in the United States, while domestic corporations are taxed on their worldwide income. With respect to an investment in a flow-through operating company that conducts its business solely in the United States, it might appear that the use of a foreign blocker or a domestic blocker results in similar outcomes. This is far from the case.

The application of BPT can have several adverse consequences. First, where investors in the blocker have certain withholding tax exemptions such as Code Sec. 892 on outbound payments, using a foreign blocker causes the repatriation of earnings (*i.e.*, the "deemed" repatriation by the U.S. branch to its foreign blocker parent) to no longer qualify for such exemptions. Therefore, repatriated earnings can be subject to 44.7%[39] combined ECI and BPT in the hands of the foreign blocker, whereas a domestic blocker would have resulted in ECI tax at a rate of only 21%. Furthermore, *Moline Properties, Inc.* and its progeny afford domestic blockers flexibility to arrange their affairs with other fund vehicles (as long as such arrangements are arm's-length).[40]

The BPT regime requires a foreign blocker to track the degree to which U.S. earnings have been repatriated, and it prevents taxpayers from relying on the form of affiliate loans and their books and records to apportion interest expense to U.S. business activity.[41] A domestic blocker may use affiliate loans to permit deployment of cash elsewhere with greater autonomy, and the repatriation of earnings is less dependent on the operation of the Code or federal income tax doctrine than on whether cash is distributed.[42] Finally, as discussed further below, in the context of dispositions of investments, the BPT rules impose far more stringent requirements for tax-efficient repatriation.

We now move beyond the contrast between a U.S. and a foreign blocker with flow-through investments that

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conduct business solely in the United States. Private fund investments may include investments in (1) multinational operating partnerships, (2) operating partnerships that conduct activity partly directly and partly through corporate subsidiaries (*e.g.*, legacy blockers acquired from prior owners), and (3) other private funds that have a mix of investments.

In the first instance, a fund may consider investing in such a mixed investment through both domestic and foreign blockers with respect to specific assets underlying the investment. This might appear to afford the fund the best of both worlds: The foreign blocker may be organized in a low- or no-tax jurisdiction, thereby preventing taxation of non-ECI (other than FDAP income), and the domestic blocker will not be subject to the complex and onerous BPT regime. This type of structure can be effectuated by conducting ECI and non-ECI activities through distinct partnerships or by using domestic and foreign blockers that track to ECI and non-ECI activities, respectively.[43]

This type of structure might not always be feasible. Constraints include a lack of the information and control necessary to disaggregate assets or income from the underlying assets as well as the significant administrative expense required to do so. For example, in the context of tracking structures, an operating partnership might move cash onshore and offshore without prior notice to its private equity investors. This type of cash movement may result in certain deemed transactions, such as distributions by one blocker followed by contributions to another, which may result in FDAP withholding.[44]

As such, this type of structure may be more suitable where the U.S. and foreign businesses of the portfolio company are conducted generally as distinct units, and transactions among them are subject to carefully conducted and documented transfer pricing. Moreover, transactions among branches of an operating partnership may be disregarded for tax purposes in the hands of the partnership. Uncertainty exists as to the impact of such disregarded transactions on foreign and domestic blockers tracking to distinct branches of the operating partnership.

Further, a foreign blocker does not always achieve a better after-tax result for purposes of an investment in the foreign business or the foreign assets of a multinational operating partnership. The reasons for this are no different in the private fund context than in the context of intercompany planning of a foreign-parented multinational organization. Foreign tax credits might significantly mitigate the detriment of worldwide taxation of U.S. blockers.[45] Furthermore, where an operating partnership includes corporate subsidiaries, dividends paid by such corporate subsidiaries may be eligible for dividends-received deductions in the hands of a U.S. blocker.[46]

The above discussion highlights the importance of a case-by-case determination of the appropriate blocker structure. There is no one-size-fits-all solution. While it is almost always the case that a foreign blocker is not suitable for an investment in an operating partnership with only U.S. operations, the prevalence of "mixed investments" and the complexities related to control, information rights, and interbranch transactions, among other factors, make tracking or disaggregating businesses challenging. The choice between foreign and domestic blockers requires careful consideration of the after-tax impact of the alternatives.

II. Taxation of U.S. Subsidiaries and U.S. Branches in Connection with Cessation of Business

A. U.S. Corporate Subsidiary Liquidation

A distribution to a shareholder in the complete liquidation of a corporation is treated as a payment made in exchange for such shareholder's stock.[47] This is often an efficient way to repatriate earnings for private funds since payments for stock are not subject to FDAP taxation.[48] The gain will be sourced by reference to the tax residence of the seller (which, in the case of partnerships, is the partners). Furthermore, such payment is not typically ECI to a foreign person.[49]

A complete liquidation can be effectuated over several years.[50] It is generally advisable to begin liquidating distributions after the adoption of a plan of liquidation; however, this is not strictly necessary.[51] The Internal Revenue Service (IRS) and the courts have found liquidations notwithstanding a lack of a formal plan in some cases.[52] Continuing business activities will generally prohibit such a finding.[53]

The rules do not mandate any form of liquidation as long as the effect is termination. The IRS has allowed various types of mergers and other transaction forms to qualify, including mergers in which the liquidating corporation does not survive.[54]

B. Branch Termination

Like Code Sec. 331 with respect to liquidating distributions, the BPT rules exempt the termination of a U.S. branch from BPT.[55] For such an exemption to apply, a

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foreign corporation must terminate all of its USTB activities in the applicable taxable year.[56] This rule requires the foreign corporation to no longer have any U.S. assets at the close of the taxable year or to adopt an irrevocable resolution in a taxable year to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year, no longer have any U.S. assets.[57] The succeeding year will also be treated as a termination year.[58] In addition, such a foreign business's "non-previously taxed accumulated ECE&P" will be eliminated.[59]

Further, to benefit from the BPT exclusion upon termination of a U.S. branch, a foreign corporation may not have any ECI at any time within the three years after the close of the year of complete termination.[60] Neither the foreign corporation nor any related corporation may use any of the U.S. assets of the terminated trade or business (or property attributable thereto or to ECE&P earned in the year of complete termination) in the conduct of any USTB at any time within three years after the close of the year of complete termination.[61] For this purpose, a corporation is "related" to the foreign corporation if either corporation owns 10% or more of the total combined voting power of all classes of stock of the other entitled to vote, or 10% or more of the value of all shares of the stock of the other.[62] The attribution rules set forth in Code Sec. 318 as modified by Code Sec. 871(h)(3)(C) apply, which include many technical traps that should be closely analyzed.

The fact that the branch termination rules are inflexible compared to the rules pertaining to liquidation of domestic subsidiaries is self-evident. Compare the lack of any restrictions on the use of a liquidating corporation's assets by its shareholders with the strict (and expansive) ban on the use of a terminated branch's assets by its 10%-or-larger shareholders. Corporate liquidations can take three years (or longer in some cases), while branch terminations must conclude within one or two years. These differences are generally more significant in the context of tax planning by private funds than by foreign-parented multinationals: Private funds typically acquire businesses with an eye toward a sale within a few years. Therefore, the inability to efficiently and easily repatriate earnings from a sale of a business held through a blocker often weighs in favor of the use of domestic blockers.[63]

III. Hybridity in Blocker Structures

A. Foreign Reverse Hybrid Blockers

We begin a discussion of hybridity with an increasingly commonplace fact pattern in the context of private funds, which is an investment by a private fund in another private fund. There is a proliferation of secondaries funds. Many secondaries funds are formed to accommodate tax-sensitive investors and accordingly include at least two parallel investment vehicles, one that invests through blockers and another that invests on an unblocked basis.

Secondaries funds (alongside certain other private funds such as those that acquire stakes in private fund managers) tend to prefer the use of reverse hybrid blockers. This type of blocker permits reliance on tax treaty benefits with respect to FDAP returns of target private funds, which may hold U.S. corporate investments.[64] Additionally, taxes payable by such blockers may be creditable in foreign jurisdictions.

Reverse hybrid foreign blockers may also take the position that BPT is reduced by tax treaties in the same manner as FDAP tax, by reference to such blockers' owners. The IRS recently provided clarity regarding availability of treaty reduction of BPT payable by foreign reverse hybrid entities.[65]

B. U.S. Reverse Hybrid Blockers

A less common type of blocker is a U.S. entity that is fiscally transparent in one or more foreign jurisdictions (*e.g.*, a Delaware limited partnership) but treated as a corporation for U.S. federal income tax purposes (a domestic reverse hybrid).[66] A benefit of this type of blocker is the ability of foreign investors to claim tax credits in their home jurisdictions for U.S. taxes paid by such a blocker. Code Sec. 894 and the regulations thereunder limit certain benefits of such entities. First, even if intuitively clear, these regulations state that an income tax treaty may not reduce the amount of federal income tax on U.S.-source payments *received by* a domestic reverse hybrid.[67] Similarly, a foreign interest holder of such entity is not entitled to the benefits of a reduction in U.S. income tax under a tax treaty on items of income received from a U.S. source by such entity.[68]

The regulations state that an item of income *paid by* a domestic reverse hybrid has the character of such item under U.S. law and shall be considered to be derived by a fiscally opaque interest holder (*e.g.*, a foreign corporation under foreign law), subject to an exception for certain deductible payments (*e.g.*, interest) paid to related foreign interest holders to the extent the domestic reverse hybrid receives dividend payments from a related domestic entity.[69] These deductible payments can be recharacterized as dividends pursuant to the regulations for all purposes of the Code.

A detailed discussion of this exception is beyond the scope of our discussion, although we note that the

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definition of a "related person" for purposes of these regulations is incorporated from Code Sec. 267 and 707 relatedness rules (except that the language "at least 80%" applies instead of "more than 50%" where applicable) and takes into account the attribution rules of Code Secs. 267(c) and 318. Practitioners who have had the misfortune of grappling with the unexpected consequences of the application of these rules will immediately realize that this definition could result in highly counterintuitive results (including pursuant to the "partner-to-partner" attribution rule of Code Sec. 267(c)(3)). The relevance of this recharacterization will be primarily in the context of shareholder debt capitalization of domestic reverse hybrid blockers.[70]

IV. Conclusion

The current U.S. tax system generally favors domestic blockers over foreign blockers for U.S.-only flow-through investments, given the complexity of the BPT regime and the adverse tax consequences that may result from its application. In particular, the relative inflexibility of the branch termination rules, compared with the more flexible liquidation rules applicable to domestic corporations, further supports the use of domestic blockers in the private fund context, particularly where investments are expected to be sold in the near term. Mixed investments generating both ECI and non-ECI raise a more nuanced structuring question: The potential benefits of separating or tracking activities through domestic and foreign blockers must be weighed against the information, control, administrative, and interbranch-transaction challenges inherent in such arrangements. This requires a case-by-case analysis.

Reverse hybrid structures may offer potential treaty benefits and foreign tax-credit advantages, but they introduce additional uncertainty regarding the availability and application of treaty relief, among other issues. Ultimately, practitioners must weigh these competing considerations against the fund's particular investment strategy.

ENDNOTES

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1 This discussion is limited to U.S. federal income tax considerations.

2 Private funds do not typically take the position that the activity of investing in the equity of private companies alone gives rise to a USTB. *See* Code Sec. 864(b); Reg. §1.864-2(c)(2)(i).

3 Foreign investors in private funds that are foreign governments within the meaning of Code Sec. 892 are often sensitive to the conduct of business activity, whether or not in the United States (commercial activity) due to the potential loss of their tax exemption pursuant to Code Sec. 892. Commercial activity and the related considerations are outside of the scope of this paper.

4 This summary excludes any discussion of special taxes, such as Code Sec. 887 tax on transportation income or alternative minimum taxes.

5 Code Sec. 11.

6 Code Sec. 881(a). The withholding is generally imposed at a rate of 30%, which can be reduced or eliminated by a tax treaty or other exemptions (*e.g.*, pursuant to Code Sec. 892). *Id.*

7 Code Sec. 864(c)(4). Foreign-source income is generally not treated as ECI, subject to certain exceptions.

8 Code Sec. 882(a).

9 Code Sec. 864(b); Reg. §1.864-2(e).

10 Code Secs. 864(c) and 882(a)(2).

11 Code Sec. 864(c)(2).

12 Code Sec. 864(c)(3).

13 Code Secs. 871(a) and 881.

14 Code Sec. 1442; Reg. §1.1442-2 (pointing to Reg. §1.1441-6 which provides for a "claim of reduced withholding tax under section 1442 by certain foreign corporations pursuant to the provisions of an income tax treaty.").

15 Code Sec. 878(a)(1).

16 Reg. §1.1441-2(b) ("[FDAP] income includes all income included in gross income under section 61 (including original issue discount) except for the items specified in paragraph (b)(2) of this section .... The fact that a payment is not made annually or periodically does not, however, prevent it from being fixed or determinable annual or periodical income (*e.g.*, a lump sum payment) .... An item of income is determinable if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time").

17 Code Sec. 881(c).

18 Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 (Comm. Print 1987) 1036–1037.

19 *Id.*

20 Code Sec. 884. Treaties can reduce or eliminate the BPT.

21 Code Sec. 884(f).

22 Code Sec. 884(a).

23 While tax treaty benefits can be subject to limitations where the foreign person earns income through an entity that is fiscally opaque for local tax law purposes (*e.g.*, a disregarded Delaware limited liability company treated as a corporation for such foreign person's local tax law purposes), the IRS has taken the position that such limitations do not apply to the BPT in the absence of a contrary rule in the applicable tax treaty. LTR 202547011 (Nov. 21, 2025) and LTR 202607002 (Feb. 13, 2026).

24 *See* Reg. §1.884-1(g)(3) (listing tax treaty countries for which this is the case, in each case, for so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect without modification on or after such date to expressly provide for the imposition of the BPT). Caution is advised as new treaties have been entered into with several tax treaty countries on this list. In a few cases, the bar on BPT may result in the application of dividend withholding on distributions by the foreign corporation pursuant to Code Sec. 861(a)(2)(B), as certain treaties do not bar this type of withholding. *See* Code Sec. 884(e)(3)(A).

25 Code Sec. 884(b).

26 *Id.*

27 Code Sec. 884(b)(2)(B)(i). Accumulated ECE&P is ECE&P for preceding tax years beginning after December 31, 1986, reduced by DEAs for such tax years. Code Sec. 884(b)(2)(B)(ii).

28 Code Sec. 316(a). Nonetheless, the DEA is not always equal to the dividend inclusion had the U.S. branch been a U.S. corporate subsidiary. *See, e.g.*, Reg. §1.884-1(b)(4) Ex. 5. In particular,

a distribution by a domestic subsidiary that has a current E&P deficit will be treated as a dividend to the extent of accumulated E&P taking into account such deficit, whereas, in the case of an ECE&P deficit, the DEA is, in effect, the amount of repatriated prior-year ECE&P reduced by such deficit, so the benefit of the deficit is front-loaded.

[29] Code Sec. 884(c).

[30] Reg. §1.884-1(d).

[31] Reg. §1.884-1(d)(2).

[32] Reg. §1.884-1(e)(1) (referring to Reg. §1.882-5).

[33] Reg. §1.884-4(a)(1) (branch interest remains subject to tax under Code Secs. 871(a) or 881 "unless the interest, if paid by a domestic corporation, would be exempt under section 871(h) or 881(c) ... or another provision of the Code"); Reg. §1.884-4(b)(8).

[34] Reg. §1.884-4(a)(2)(ii). Treaty reduction may be available. Reg. §1.884-4(c)(3)(ii).

[35] Reg. §1.884-4(c)(1).

[36] *See generally* Reg. §1.882-5.

[37] Reg. §1.882-5(b)(3) (Step 1 fair market value election for valuing U.S. assets, as an alternative to the adjusted tax basis method); Reg. §1.882-5(c)(4) (Step 2 election to use a fixed ratio, rather than the actual ratio, in determining U.S.-connected liabilities, with a fixed ratio of 95% for banks and 50% for non-bank, non-insurance taxpayers); Reg. §1.882-5(d)(5)(ii)(B) (Step 3 annual election available to banks to compute the interest rate on excess U.S.-connected liabilities); Reg. §1.882-5(e) (election to determine interest expense using the separate currency pool method).

[38] *See, e.g.*, Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, U.S.-Can., Sep. 21, 2007, Article 13, S. Treaty Doc. No. 110-15, *home.treasury.gov/system/files/131/Treaty-Canada-Pr2-9-21-2007.pdf*; Joint Declaration on the Occasion of the Signing of the Protocol Amending the Convention for the Avoidance of Double Taxation, U.S.-Ger., art. 18a, June 1, 2006, S. Treaty Doc. No. 109-20, *www.congress.gov/109/cdoc/tdoc20/CDOC-109tdoc20.pdf*.

[39] The combined 44.7% rate reflects the application of the 21% corporate income tax on ECI, followed by the 30% BPT imposed on the remaining after-tax earnings (*i.e.*, 21% + (30% × 79%) = 44.7%).

[40] *Moline Props., Inc.*, SCt, 43-1 USTC ¶9464, 319 US 436, 63 SCt 1132.

[41] *See* Section I.C, *supra*.

[42] *Id.*

[43] A reader might wonder why non-ECI-generating activities have to be conducted through a blocker at all. Typically, it is challenging to restructure the affairs of an existing operating partnership so that different assets are held through separate partnerships. Accordingly, if a private fund desires to hold non-ECI assets outside of domestic blockers, the private fund must cause the indirect ownership of such assets to be held outside of domestic blockers through "tracking" structures. The fund will invest in the operating partnership through a partnership (an "aggregator"). The blocked fund vehicle will invest in the aggregator through a domestic blocker with respect to the ECI assets of the operating partnership, and the resulting ECI will be allocated to such domestic blocker. If the blocked fund vehicle did not invest in other assets of the operating partnership indirectly through a foreign blocker (*i.e.*, it invested directly in the aggregator with respect to such assets), Code Sec. 875 would require foreign investors to file a U.S. federal income tax return in the United States due to attribution of the operating partnership's USTB to such investors, even if such investors are not allocated any ECI. Accordingly, blocked fund vehicles often invest in the aggregator through a foreign blocker with respect to non-ECI assets, to avoid their foreign investors being required to file U.S. federal income tax returns.

[44] *See* Section I.A, *supra*.

[45] *See generally* Code Secs. 27 and 901.

[46] Code Sec. 243. Consider the application of Code Sec. 246A where such domestic corporation is capitalized with shareholder debt or debt is incurred in connection with acquisition of such operating partnership.

[47] Code Sec. 331(a).

[48] *See* Section I.A, *supra*.

[49] Corporate stock is generally a capital asset. The sale of a capital asset is sourced to the tax residence of the seller. Code Sec. 865(a). In the case of a partnership, this rule is generally applied at the partner level rather than the partnership level. Code Sec. 865(i)(5). Foreign-source income, gain, or loss is generally not ECI, subject to certain exceptions, like income derived from and attributable to a fixed place of business in the United States. Code Secs. 864(c)(4)(A) and (B).

[50] The IRS will not issue rulings regarding the tax effects of a liquidation that occurs by way of distributions made over a period of more than three years from the adoption of the plan of liquidation. Rev. Proc. 2026-3, 2026-1 IRB. 152, Section 4.01(26).

[51] Code Sec. 331 does not require the adoption of a plan of liquidation, although adoption of one is recommended. *See* Code Sec. 346(a).

[52] *See, e.g., P.A. Rendina*, 72 TCM 474, Dec. 51,522(M), TC Memo. 1996-392; *Service Co.*, CA-8, 48-1 USTC ¶9198, 165 F2d 75; Rev. Rul. 65-235, 1965-2 CB 88.

[53] *See Herbert A. Nieman & Co.*, 33 TC 451, Dec. 23,878 (1959) (Acq.), 1965-2 CB 6.

[54] *See, e.g.*, LTR 200606009 (Oct. 17, 2005).

[55] Temporary Reg. §1.884-2T(a)(1). The recapture tax in response to making the election to reduce liabilities under Reg. §1.884-1(e)(3) is an exception. Reg. §1.884-1(e)(3)(v).

[56] Temporary Reg. §1.884-2T(a)(2).

[57] *Id.*

[58] Temporary Reg. §1.884-2T(a)(2)(A).

[59] Temporary Reg. §1.884-2T(a)(1).

[60] Temporary Reg. §1.884-2T(a)(2)(i)(C).

[61] Temporary Reg. §1.884-2T(a)(2)(i)(B).

[62] Temporary Reg. §1.884-2T(a)(2)(iv).

[63] We note that this analysis better fits private funds with term limits. Private funds do not always acquire assets with an intent to sell. Where funds recycle cash, other doctrine can constrain the ability to effectuate distribution of proceeds pursuant to Code Sec. 331 by a domestic blocker, including the "liquidation-reincorporation" doctrine. Furthermore, the noted differences are not exhaustive, and the branch termination rules present other complexities, including with respect to the treatment of deferred consideration.

[64] For purposes of the application of tax treaty benefits, one must look through fiscally transparent entities, including those treated as fiscally transparent under foreign law, for purposes of application of the tax treaty with foreign jurisdiction of the underlying interest holders. Reg. §1.894-1(d)(1). Code Sec. 894(c) ambiguously refers to "withholding tax imposed by [Title 26]." The regulations interpret the rule to apply only to FDAP taxes. *See* Reg. §1.894-1(d)(1).

[65] AM 2025-002 (Sep. 8, 2025).

[66] *See* Reg. §1.894-1(d)(2)(i).

[67] Reg. §1.894-1(d)(2)(i).

[68] *Id.*

[69] Reg. §1.894-1(d)(2)(ii).

[70] The debt capitalization of a U.S. blocker raises a number of issues that must be carefully considered, the principal among them being the deductibility of interest (*e.g.*, in light of Code Secs. 163(e)(3) and 267(a)(3), which limit deductions of interest and original issue discount in respect of obligations owed to related foreign persons, as well as Code Sec. 163(j)), withholding on interest (*e.g.*, where foreign investors have concentrated ownership), and transfer pricing and debt treatment. On balance, however, where the debt is supportable, *Moline Properties* and its progeny afford taxpayers flexibility in arranging their affairs among blockers and their fund partnerships. In the case of hybrid entities, consideration should be given to Code Sec. 267A (*e.g.*, where a deduction/no-inclusion outcome may result because of the fiscal transparency of a blocker in a foreign jurisdiction).

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