Special Allocations of The Foreign Tax Credit by Partnerships: Some Tentative Proposals

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The United States taxes its citizens and corporations currently on all income from foreign sources but allows a credit against the U.S. tax for foreign taxes paid on the income. In general, the foreign tax credit permits a dollar-for-dollar offset against the U.S. tax otherwise payable, but the Internal Revenue Code limits the credit to foreign taxes imposed at an effective rate not in excess of the U.S. tax rate on the income. In short, the foreign tax credit requires the taxpayer to pay the higher of the U.S. rate or the foreign rate on his foreign source income. Each taxpayer who pays creditable foreign income taxes may elect either to deduct those taxes or to credit them. He cannot deduct them if he elects the foreign tax credit. Furthermore, he cannot elect to credit some foreign income taxes and deduct others. The election, which is made anew each taxable year, must apply to all creditable taxes paid or accrued during that year to all foreign countries. The partnership form of enterprise may permit flexibility in the use of the foreign tax credit.

The Code generally treats a partnership as a “conduit” and requires

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1. § 7701(a)(2) (all section references are to the Int. Rev. Code of 1954) defines “partnership” as “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation . . . .” Treas. Regs. §§ 301.7701-2 (1960) (as amended) and 301.7701-3 (1960) (as amended) identify those factors which distinguish a partnership from an unincorporated “association” which is treated as a “corporation” for purposes of the Code.
the partners to report their own shares of the partnership's items of income, credit\textsuperscript{2} and deduction.\textsuperscript{3} The partnership entity must itself make most elections affecting the computation of taxable income. The Code, however, provides an exception in the case of a partner's distributive share of foreign income taxes paid or accrued by the partnership during the taxable year. Under section 703(b), the partners, rather than the partnership, may individually elect to credit or deduct such foreign income taxes.\textsuperscript{4} Section 901(b)(5) permits a partner of a partnership paying or accruing a foreign income tax to take the foreign tax credit in much the same manner that he is entitled to take other pass-through credits and deductions.

As part of the "conduit" view of partnerships in the Code, sections 704(a) and (b) provide that partners may agree upon special allocations of the partnership's items of income, deduction and credit, including foreign income taxes,\textsuperscript{5} in a manner different from the ratio for sharing losses and profits generally, so long as such special allocations do not have as their principal purpose the avoidance or evasion of federal income taxes.\textsuperscript{6} In the absence of either a special allocation agreement or the requisite non-tax purpose, the partners must allocate foreign taxes in the same proportions as they allocate the partnership's profit and loss,\textsuperscript{7} as provided in the partnership agreement and reflected in the partnership's books of account.

With proper planning, special partnership allocations may represent a device whereby an international joint venture can maximize the utility of its foreign tax payments by allocating foreign tax credits to the U.S. partner who can most benefit from them. It should be obvious that such a partnership arrangement would be an attractive vehicle for international joint ventures. Surprisingly, neither the regulations\textsuperscript{8} nor

\begin{itemize}
\item \textsuperscript{2} §§ 33 and 901 allow U.S. citizens and domestic corporations to elect to credit foreign "income, war profits, and excess profits taxes" [hereinafter "foreign income taxes"], if the taxpayer chooses.
\item \textsuperscript{3} Although § 164(a)(3) allows a deduction for foreign income taxes in the computation of taxable income, § 275(a)(4) explicitly provides that no such deduction is allowed if the taxpayer has elected to credit foreign income taxes under § 901.
\item \textsuperscript{4} "Foreign income taxes" generally include foreign levies imposed on a base which resembles the U.S. concept of "taxable income" in § 63, \textit{Biddle v. Comm'r}, 302 U.S. 573 (1938), as well as certain taxes imposed "in lieu" of general levies, § 903. \textit{See generally E. Owens, The Foreign Tax Credit} ch. 2 (1961).
\item \textsuperscript{5} § 704(a).
\item \textsuperscript{6} § 704(b)(2).
\item \textsuperscript{7} § 704(b).
\item \textsuperscript{8} Treas. Reg. § 1.704-1(b)(2) (1956) (as amended), Example (2) deals with the allocation of more than a prorata share of foreign income to a partner who is a resident of a foreign country.
\end{itemize}
any judicial or administrative decisions specifically address the problem of whether partners might provide for non-prorata allocations of a partnership’s foreign taxes while simultaneously passing the tax avoidance test of section 704(b)(2). This state of the art is not too surprising in view of the dearth of authority and commentary with respect to special partnership allocations generally.

This article will explore the problem by analyzing such allocations under the avoidance test of section 704(b)(2), the regulations thereunder, and relevant decisions and legislative history; by extending to the foreign tax credit context a recent seminal analysis of allocations of deductions and losses by real estate partnerships; and by advancing, on the basis of such analysis, several tentative proposals for making valid allocations in the international joint venture setting.

I

THE SUBSTANTIAL ECONOMIC EFFECT TEST

Section 704(b)(2) denies effect to an allocation provision in the partnership agreement which has as its principal purpose the avoidance or evasion of federal income taxes. The regulations thereunder generally provide that, in determining what constitutes avoidance or evasion, consideration should be given to all “the surrounding facts and circumstances.” While the question of whether the allocation has “substantial economic effect” is only one of several specifically enum-


erated "facts and circumstances" to be considered, it is generally agreed to be the single most important factor in determining the validity of a special allocation under section 704(b)(2). The legislative history of section 704 supports this consensus.

Both section 704(b)(2) and the phrase "substantial economic effect" first appeared in 1954. As approved by the Ways and Means Committee and as passed by the House of Representatives, section 704 of H.R. 8300 allowed special allocations only if not principally tax-motivated. While the Senate approved H.R. 8300 without changing the substantive language of sections 704(a) or (b), the report of the Senate Finance Committee added to the House report the following explanatory paragraph:

Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting the shares of partnership income, then such a provision will be recognized for tax purposes. (Emphasis added.)

The Senate Report then illustrated a permissible special allocation by means of a partnership agreement which allocated to a partner resident in Puerto Rico a percentage of the income derived from Puerto Rican sources which was greater than the partner's distributive share of income generally.

Against such a valid allocation, the Senate Report contrasted, in one instance, an allocation that merely reduced taxes "without actually affecting the [partners'] shares of partnership income," and in another, an allocation of an exemption that had no "real economic effect on either partner's share of the total partnership income." In both instances, the validity of the allocation depended upon its affecting the partners' income shares before considering tax consequences. Elaborating on this theme, the regulations state that an allocation has substantial economic effect if "the allocation may actually affect the dollar amount of the partners' share of the total partnership income or loss independently of tax consequences." Conversely, a special allocation will not have substantial economic effect if the partners each would

16. Id. at 379.
17. Id. at 379.
receive the same total of dollars that they would have received if no special allocation had been made.

Thus, whether a special allocation has an economic effect is determinable in most cases by inquiring whether the special allocation increases or decreases the total number of dollars a partner will receive (other than by way of tax deductions and the like). That is, would he receive, absent tax effects, the same amount of dollars if there were no special allocation? If he would, then the allocation does not have an economic effect. Even a favorable determination under this test, however, will not guarantee an allocation's validity. As the structure of the regulations under section 704(b) indicates, and as most commentators agree, the substantial economic effect test is probably only a threshold inquiry. While failure to comply is certainly fatal, an allocation might fail despite compliance, if principally tax motivated.

A. The McKee Analysis: The Analogy of Special Allocations of Depreciation Deductions in a Real Estate Partnership

Professor William S. McKee's recent analysis of special partnership allocations of real estate depreciation deductions makes a valuable contribution to the understanding of section 704(b). Professor McKee demonstrates how the recent cases of Jean V. Kresser19 and Orrisch v. Commissioner20 implicitly define and clarify the "substantial economic effect" test. In Orrisch, the partnership agreement was amended to allocate to the taxpayer 100 percent of the depreciation for the taxable year because he was in a high tax bracket and his partner could not use the depreciation deduction that year. The partnership agreement was oral, and the Tax Court first had to determine the provisions of the agreement. The Court concluded that the agreement between Orrisch and his partner was to share all items of partnership gain or loss, cash flow, and liabilities on a 50-50 basis, except for the tax allocations of depreciation during the taxable year in question and, in the case of sale, except for a like allocation to Orrisch of an amount of gain equal to such depreciation. Since the cash distributable at any time, including

upon liquidation of the partnership, remained 50-50 notwithstanding the allocation of that year's depreciation to Orrisch, it appeared that the allocation would have had no economic effect at all in the event the partnership sold the depreciable property at a loss. In no way did it impair Orrisch's right to receive at any time exactly one-half of all dollars paid to the partners by the partnership.

The Tax Court noted that the allocation would have no effect if the partnership assets were sold at a profit because the disproportionate allocation to Orrisch of an amount of gain equal to the amount of depreciation previously allocated to him disproportionately would then leave Orrisch entitled to receive the same 50 percent of the cash from the partnership as though neither depreciation nor gain had been allocated specially. In the case of a sale of the partnership property at a loss, however, the allocation of depreciation to Orrisch was without economic effect and was clearly inconsistent with the economic substance of the agreement to share the cash 50-50. The agreement would have permitted Orrisch to take his proportionate (50 percent) share of the proceeds, rather than requiring him to accept a reduced share owing to his reduced capital account. In short, had Orrisch's agreement complied with the court's suggestion that he suffer a disproportionate share of any cash loss, reflecting the depreciation specially allocated to him, the court would have upheld the special allocation of depreciation.

The Orrisch rule, according to Professor McKee, is simply that "one partner cannot take a tax loss which in economic terms is being borne by another partner. A divergence between tax and economic consequences for any period of time means that the rule has been violated." Professor McKee's analysis of the "substantial economic effect" test, consistent with Orrisch, asks, in effect, whether the partner receiving the specially allocated item of deduction will actually bear the corresponding economic loss, in the form of a reduced share of the proceeds, if the partnership project is sold at any point in time. If so, the allocation has substantial economic effect, and the taxpayer has at least survived the threshold inquiry of the section 704(b)(2) tax avoidance test. This analysis may be applied to the special allocation of foreign tax payments by an international joint venture.

Two factors suggest that this analysis bears on special allocations of foreign tax payments. First, determination of the economic effects of a provision allocating foreign tax payments involves similar, but less complex, considerations than those of a provision allocating depreciation

and other deduction items, which was the primary focus of Professor McKee's article. In each situation, for example, an allocation need not have an immediate impact on amounts distributed to a partner as his share of current cash flow. Undistributed income may be credited and losses may be charged directly to the capital accounts of the respective partners. In each case, such credits and charges will simply affect the total number of dollars ultimately to be received by a particular partner from the partnership and thereby meet the regulation's definition of "substantial economic effect." In the case of the real estate partnership, however, which in its early years typically suffers net tax losses as a result of accelerated depreciation, prepaid interest and other factors, negative capital accounts present special section 704 problems, and Professor McKee's article necessarily discusses them at some length.22 In contrast, the parties to an international joint venture will generally not anticipate net losses and negative capital accounts in the early period of operation. While such possibilities should not be ignored, they are certainly far less important in the international joint venture than in the domestic real estate investment setting.

A second factor suggesting the relevance of Professor McKee's analysis of allocation of deductions to allocations of foreign taxes lies in the general distinction between a "deduction" and a "credit."23 Although the partnership regulations are silent, the investment credit regulations do recognize the possibility of validly allocating the investment credit among partners by special agreement,24 provided the agreement allocates all related items of income and deduction in the same manner.25 By analogy,26 one might apply this same principle to the foreign tax credit area, permitting the partnership to allocate foreign tax payments to a partner only if he receives an allocation of all the foreign income on which the tax was imposed.27 This analogy should fail, however, because it overlooks a fundamental difference between the investment credit and the foreign tax credit. The investment credit never represents an item of deduction. The credit claimed

22. Id. at 37-45.
23. In general, a "deduction" is subtracted from "gross income" in arriving at "taxable income," the base to which the tax rate schedule applies in determining the tax due. See §§ 61 and 63. A "credit," on the other hand, is subtracted directly from the amount of the tax due. See §§ 31-42.
26. This analogy would seem to have some force, since the investment credit regulations are the only illustration in the regulations of a special allocation of a credit item.
27. Example (2) of Treas. Reg. § 1.704(b)(2) (1956) (as amended) deals only with a non prorata allocation of foreign income, not the related foreign taxes.
does not even reduce the basis of the property for computing deprecia-

tion.\textsuperscript{28} In contrast, foreign taxes eligible to be credited are merely items
of deduction in the absence of an affirmative election to claim the
payments as a credit against the taxpayer’s U.S. taxes.\textsuperscript{29} This difference
between the investment credit and the foreign tax credit, based upon
the similarity of foreign tax payments and deductions generally,
strongly suggests that one should test the economic effect of a special
allocation of foreign tax payments under the criteria applicable to
special allocations of items of deduction, rather than under the special
investment credit rules. Accordingly, Professor McKee’s analysis, which
focuses on the validity of special allocations of deductions, seems
particularly relevant to an analysis of special allocations of foreign tax
payments.

B. Application of the McKee Analysis to a
Hypothetical International Joint Venture

Assume a U.S. corporation and a French corporation form a
partnership to carry on a joint venture for the production of hydrogen
gas in a Middle Eastern country. The parties agree to allocate all items
of income and deduction on a 50-50 basis, except that the agreement
allocates all foreign income taxes imposed on the partnership to the
U.S. partner. In the first year of operation, the joint venture realizes
gross revenues of $100 million, incurs current operating expenses of
$50 million, and pays foreign income taxes of $10 million on its net
income. Under the terms of the partnership agreement,\textsuperscript{30} the U.S.
partner will report the following distributive shares of the partnership’s
income and deductions:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>50,000</td>
</tr>
<tr>
<td>Current Operating Expenses</td>
<td>-25,000</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>25,000</td>
</tr>
<tr>
<td>U.S. Tax Rate</td>
<td>\times 48%</td>
</tr>
<tr>
<td>Tentative U.S. Tax</td>
<td>12,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>-10,000</td>
</tr>
<tr>
<td>Net U.S. Tax</td>
<td>2,000</td>
</tr>
</tbody>
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\textsuperscript{28} § 48(g), which required a reduction of basis for investment credit claimed, was
\textsuperscript{29} §§ 164(a)(3) and 901.
\textsuperscript{30} Pursuant to § 704(a), the partners have agreed to a 50-50 split of all items except
foreign income taxes.
The special allocations of expenses (50-50) and taxes (100-0) initially reduce the U.S. partner's capital account by $35 million—$25 million of expenses and $10 million of taxes. The U.S. partner's $50 million share of the sales income, however, would make for a net increase of $15 million in the U.S. partner's capital account for the year. The French partner's capital account would increase by $25 million, its share of the taxable income of the partnership. Upon a sale of the partnership venture, the U.S. partner would receive a reduced share of the proceeds to the extent of its special allocation of foreign tax payments. Suppose, for example, that each partner's initial capital contribution consisted of $100 million in cash. At the end of the first year, the U.S. partner's capital account would be $115 million, while the French partner's capital account would be $125 million. If the partnership sold its assets for $240 million and liquidated at that point, the U.S. partner would receive $10 million less than the French partner and thus bear the burden of the foreign tax allocated to it. Accordingly, the special allocation of the foreign tax payments would pass the Orrisch test and otherwise satisfy Professor McKee's requirement that the allocation have substantial economic effect.

II
THE TAX AVOIDANCE TEST

The validity of special allocations of the foreign tax credit may also depend upon the ability of the taxpayer to ascertain the factors which determine the presence or absence of a tax avoidance purpose. As noted above, the substantial economic effect test may well be merely a threshold inquiry and the taxpayer must in addition prove that no tax avoidance motive is present. The legislative history of section 704(b)(2) supports this conclusion, but contributes little clarification. The report of the Committee on Ways and Means, for example, in explaining section 704(b) of the House Bill, states:

For example, if the provisions of a partnership agreement . . . allocate a greater portion of the foreign tax credit to one partner than to another partner, such provisions may be disregarded, and such items attributed to all the partners in accordance with the provisions of the partnership agreement for sharing income or losses.

This example offers no guidance beyond the suggestion that any disproportionate allocation of foreign taxes may be invalid. The report of the Senate Finance Committee restates this example but elaborates on it by specifying that the partnership agreement allocates to the other partners an amount of other partnership losses or deductions equivalent to the amount of foreign taxes allocated to the one partner. The Senate report states that such obvious efforts to "juggle" tax items through a special allocation should be disregarded for income tax purposes.\textsuperscript{33}

Whether a particular allocation is principally tax-motivated depends, according to the section 704 regulations, on "the surrounding facts and circumstances." While most observers regard the economic effect of the allocation to be the most significant factor, the regulations enumerate five additional "facts and circumstances" to be considered in determining whether the prohibited tax-avoidance purpose exists:

(a) the overall tax consequences of the allocation;
(b) the duration of the allocation;
(c) whether the allocation was made without recognition of normal business factors and only after the amount of the specifically allocated item could reasonably be estimated;
(d) whether related items of income, gain, loss, deduction or credit from the same source are subject to the same allocation; and
(e) whether the partnership or a partner individually has a business purpose for the allocation.\textsuperscript{34}

First, it is difficult to perceive how an allocation's "overall tax consequences" can represent a meaningful test, inasmuch as the overall effect of virtually every special allocation will be a reduction in taxes. A special allocation of foreign income taxes may often be inconsistent with the purpose of the foreign tax credit—avoiding "double taxation"—but this would not seem to affect the technical application of this test or the others.

Second, the factor concerning the duration of the allocation can readily be covered by careful drafting. In \textit{Kresser}, the Tax Court rejected a special allocation that was effective for only one year where it was clear that in subsequent years the parties would reverse the allocation and restore the partners to their initial arrangement. The allocation invalidated in \textit{Orrisch} was also short-term. Since the longer-

\textsuperscript{33} S. REP. No. 1622, 83d Cong., 2d Sess. 379 (1954).
\textsuperscript{34} Treas. Reg. § 1.704-1(b)(2) (1956) (as amended).
lived the allocation, the less likely a tax-avoidance purpose is present, the partnership agreement should simply provide for the allocation on a permanent basis.\textsuperscript{35}

The third factor primarily addresses situations in which the partners know what the tax effect of the special allocation will be at the time they adopt it, such as allocations made after the income has been earned or, as in the \textit{Orrisch} case, deductions for depreciation which do not vary from year to year with the fortunes of the business. This factor would seem much less likely to arise in an international joint venture, where the amount and nature of future income, and hence its liability for foreign taxes, is still reasonably uncertain at the time of allocation.

The fourth factor is dealt with in I.A. above.

The foregoing review suggests that the enumerated criterion meriting most serious attention, apart from economic effects, is the remaining "business purpose" factor. This item is reminiscent of the tests applied in such cases as \textit{Gregory v. Helvering},\textsuperscript{36} \textit{Knetsch v. United States}\textsuperscript{37} and \textit{Gilbert v. Commissioner}.	extsuperscript{38} The opinions in these cases indicate that transactions motivated by a tax avoidance purpose and having no economic substance will not be given tax recognition. An allocation to one partner of a tax benefit, the economic cost of which that partner cannot bear but which another partner will bear, would seem to constitute the paradigm transaction prohibited by the \textit{Gregory-Knetsch-Gilbert} standard. In short, the "business purpose" test may overlap the "economic effect" test to a great extent.

An example in the regulations dealing with the allocation of foreign source income suggests an acceptable business purpose in a related area.\textsuperscript{39} The example, which is grounded in the legislative history of section 704(b),\textsuperscript{40} specifically notes that the partner to whom the allocation is made is a resident of the foreign country involved. In the foreign tax credit context, the implication of this example is that the foreign taxes and related foreign income from operations in a

\textsuperscript{35} Whatever the duration of the allocation, a fixed period of time would be illusory because the parties could agree to modify it at any time. Indeed, in many cases one partner could unilaterally terminate the allocation by terminating the entire partnership.

\textsuperscript{36} 293 U.S. 465 (1935).

\textsuperscript{37} 364 U.S. 361 (1960).


\textsuperscript{39} Treas. Reg. § 1.704-1(b)(2) (1956) (as amended), Example 2.

\textsuperscript{40} S. REP. No. 1622, 83d Cong., 2d Sess. 379 (1954). See note 16 supra and accompanying text.
given foreign country could be allocated to a foreign partner resident there. Since large corporations as partners would not ordinarily be "residents" other than by their agents, a slightly revised test might be required for multinational joint ventures. Realistically, most agents of an international joint venture partnership would be employees solely of the partnership, not of either venturer. A business purpose similar to that illustrated in the regulations might be found, however, if the partnership agreement assigned geographic areas of responsibility to the respective partners. For example, if the hypothetical U.S.-French partnership described above engaged in business in a high-tax foreign country and a low-tax foreign country, the income taxes imposed by the high-tax country might be allocated to the U.S. partner if it were assigned primary responsibility for the operations conducted there. It is unclear whether the assignment of managerial responsibilities would be sufficient, or whether financial responsibility for losses incurred in the operations conducted in the high-tax country would also be necessary. It would seem logical to approve the latter allocation, since essentially the same situation would obtain had the two partners individually gone into the respective countries. Finally, assignment of the tax reporting and compliance functions for the high-tax country to the U.S. partner might also provide an adequate business purpose.

III

PARTNERSHIPS AS VEHICLES FOR DIRECT INVESTMENTS ABROAD

A. Ideal and Alternative Structures

One potentially ideal structure would be a 50-50 joint venture partnership between a U.S. corporation and an unrelated foreign corporation, with all foreign taxes allocated to the U.S. partner, offsetting all U.S. taxes and reducing the U.S. partner's capital account as required by the substantial economic effect test. Such a partnership would offer a number of advantages in addition to the favorable foreign tax credit result. For example, the entity would not produce

41. § 875(1) provides that a foreign corporation is considered to be engaged in a trade or business within the United States if a partnership of which the corporation is a member is so engaged.

42. The case law upholds special allocations to partners who apparently did not bear the risk of loss, Andrew O. Miller, Jr., 52 T.C. 752 (1969). CTR. Rev. Rul. 67-158, 1967-1 CUM. BULL. 188.
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subpart F income,\textsuperscript{43} even if the U.S. partner were found to be in "control."\textsuperscript{44} Subpart F, which taxes U.S. shareholders currently on certain "tax haven" income from controlled foreign corporations, simply does not apply to partnerships.\textsuperscript{45}

Also to be noted in the subpart F context, although its application is less clear, is the character rule of section 702(b). Under this provision, the character of any item of income, gain, loss, deduction or credit included in a partner's distributive share is to be determined at the partnership level, as if directly realized or incurred by the partnership itself rather than by the partner. If the U.S. investor participates in a foreign partnership through a foreign subsidiary corporation, the Treasury might try to find subpart F income in the hands of the foreign corporate partner if the income realized at the partnership level was similar to subpart F income.\textsuperscript{46}

Under section 1248, a United States shareholder of a controlled foreign corporation may have to include in income as a dividend its share of the earnings and profits of the corporation upon a taxable sale or liquidation. Section 1248 would not apply to a U.S. partner's disposition of its interest in an international joint venture.\textsuperscript{47} The U.S. partner could realize all capital gain when it disposed of its interest in the partnership.\textsuperscript{48} Another issue as to the application of the character rules would relate to the impact of sections 861 and 904 which deal, respectively, with domestic source income criteria and the per-country and overall limitations on the foreign tax credit. It is unclear how the partnership would be treated for purposes of applying the regulations governing the allocation of deductions to foreign source income.\textsuperscript{49} This situation might, in turn, affect the computation of the section 904 limitation on the foreign tax credit of the U.S. partner.\textsuperscript{50}

\textsuperscript{43} § 952(a) and § 954. \textit{Quaere} whether a partnership would necessarily bring into play the branch rule of § 954(d)(2) and cause the partnership to be treated as a separate subsidiary corporation where a foreign corporation was the partner.

\textsuperscript{44} § 957(a) defines a "controlled" foreign corporation as a foreign corporation in which the United States shareholders own more than 50 percent of the stock.

\textsuperscript{45} § 951(a).

\textsuperscript{46} One might argue that only those items of income and deduction specifically listed in § 702(a), which does not list subpart F income, retain their character in the hands of the partners.

\textsuperscript{47} § 1248(a) applies only to sales or exchanges of stock in a foreign corporation.

\textsuperscript{48} § 1221. Cf. § 751.


\textsuperscript{50} §§ 863(a) and 904.
A variation on the joint venture form would be for a U.S. partner to employ a 50-50 limited partnership for international operations with a financial institution as the limited partner. Such an arrangement might be attractive to an insurance company subject to a low rate of income tax or to a credit institution which was in an excess foreign tax credit position as a result of its other operations. In other words, the special allocation of foreign tax payments could be attractive to a partnership composed solely of domestic persons. The presence of a foreign partner is by no means essential.

Another possibility for using partnerships in the international context would be a partnership composed of a U.S. parent corporation and its wholly-owned foreign subsidiary. It is unclear whether such a partnership could permit the U.S. parent corporation to avoid the consequences of subpart F and otherwise avoid having all the income of the partnership taxed at the full U.S. rate as earned.

B. FOREIGN TAX SYSTEMS

A foreign tax system which would make special allocations of the foreign tax credit most attractive to the foreign partner of a U.S. person would be one in which the special allocation has no tax effects. In such a case, for example, the foreign partner might be able to claim a credit for its pro rata share of the foreign taxes paid by the partnership, notwithstanding the special allocation. Or the foreign tax system of the foreign partner's country might exempt its share of the partnership income from current taxation. A similar result would obtain if the foreign tax system exempted foreign source income. A final possibility would be for a U.S. person to form a partnership with a foreign government or foreign government corporation, which might

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51. From the non-tax point of view such an arrangement might be justified as the equivalent of a loan plus earnings participation in the venture, with the total return to the limited partner fairly characterizable as "interest." Such an arrangement would help the general partner claim a credit for all foreign income taxes imposed on the venture.

52. In general, the essence of the desirable set-up is to find a partner, of whatever description, which is either not subject to U.S. tax or subject only to a low rate.

53. Cf. Rev. Rul. 75-19, 1975 INT. REV. BULL. No. 2, at 18 (holding valid a partnership formed by four domestic subsidiaries of a domestic corporation, for the purpose of purchasing a crude oil storage barge and chartering it to an unrelated corporation).

54. See note 46 supra.

55. While the Code literally would permit the subsidiary to report its share of the income of the partnership, some imagination might be required to find a business purpose for such a parent-subsidiary partnership.
well be exempt from tax. In any event, the possible impact of foreign withholding taxes imposed on the partners, as well as any foreign income taxes imposed on the partnership as such, would have to be kept in mind.

CONCLUSION

Special allocations of foreign income taxes to U.S. partners may well be possible. The potential for tax savings would seem to be great, though largely unexplored. If the suggestions advanced here can be refined and applied in practice, the partnership should become an increasingly popular vehicle for international joint ventures.