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KIRKLAND **ALERT**

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New Court Decision May Affect PE Fund Blocker Corporation Structures

Where a private equity fund invests in a flow-through portfolio company engaged in a U.S. business (i.e., a portfolio company organized as a partnership or LLC), certain tax-sensitive fund LPs — virtually all non-U.S. LPs and many U.S. tax-exempt LPs — typically elect to hold their share of such fund investment through a "blocker corporation." This structure blocks:

- flow-through to a non-U.S. LP of income "effectively connected with a U.S. trade or business" ("ECI") and
- flow-through to a U.S. tax-exempt LP of "unrelated business taxable income" ("UBTI"),
- either of which would otherwise be subject to U.S. tax if received directly by the LP.

Where a private equity fund invests in a flow-through portfolio company engaged in a U.S. business, certain tax-sensitive fund LPs typically elect to hold their share of such investment through a U.S. "blocker corporation."

General industry practice has long been to organize a blocker corporation as a U.S. entity (either as a U.S. corporation or a U.S. partnership/LLC electing to be taxed as a corporation). Where blocker is a U.S. entity subject to U.S. corporate taxation:

- all of blocker corporation's net income (both operating income and gain from asset sales) is taxed at a 35% federal tax rate (plus applicable state and local taxes),
- non-liquidating dividends paid by blocker corporation to certain non-U.S. LPs are subject to 30% U.S. withholding tax (but this withholding tax does not apply to U.S. tax-exempt investors, non-U.S. governmental entity investors, and non-U.S. investors qualifying for tax-treaty withholding exemption or reduction), and
- gain from sale of blocker corporation's stock and any liquidating distributions are generally not taxable to non-U.S. investors and U.S. tax-exempt investors.[1]

Where a U.S. blocker corporation has been utilized, it is generally tax-efficient to structure the fund's exit transaction as a sale of blocker corporation's stock (not of blocker corporation's ownership interest in flow-through portfolio company) in order to avoid triggering blocker-corporation-level tax. Although the buyer may seek to impose some purchase price reduction where it purchases blocker corporation stock (because buyer will not obtain tax basis step-up for the flow-through entity ownership interest obtained indirectly by purchasing blocker corporation stock), any such reduction in purchase price would typically be far less than the blocker corporation tax resulting from sale of blocker corporation's interest in the flow-through portfolio company.

A non-U.S. blocker corporation has generally not been used in connection with a private equity fund's ownership interest in the U.S. flow-through portfolio company for two reasons: *First*, substantially all of portfolio company's operating income would typically constitute ECI on which the non-U.S. blocker would be taxed at the normal 35% U.S. corporate tax rate.[2] In addition, the non-U.S. blocker would be subject to a 30% "branch profits" tax on the after-tax ECI withdrawn

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from the U.S. flow-through portfolio company's U.S. business (unless otherwise reinvested in a U.S. business). Although the branch profits tax was generally designed to replicate the effect of the 30% withholding tax on dividends paid by a U.S. corporation to its non-U.S. shareholders, the tax applies more broadly.[3] In particular, non-U.S. government investors and U.S. tax-exempt investors are not subject to 30% dividend withholding tax, but their share of the income of a non-U.S. blocker is nonetheless subject to 30% branch profits tax.

In July 2017, a Tax Court judge concluded that a foreign corporation was not liable for U.S. tax on capital gain derived from sale of an equity interest in a U.S. LLC engaged in a U.S. trade or business, except to the extent such gain was attributable to U.S. real property interests.

Second, with respect to the private equity fund's exit from the flow-through portfolio investment:

- the fund's exit through sale of non-U.S. blocker corporation's stock would be tax inefficient for most buyers (as compared to private equity fund's sale of U.S. blocker corporation stock), e.g., because of branch profits taxes on future operating income, and
- tax advisers have long been concerned (because of a 1991 IRS published position) that structuring ultimate sale of non-U.S. blocker corporation's assets (i.e., blocker's ownership interest in the flow-through entity) would be tax inefficient by subjecting to U.S. tax substantially all of non-U.S. blocker corporation's gain from sale of its ownership in the U.S. flow-through portfolio company.

Central to the concern that non-U.S. blocker corporation's gain from sale of its U.S. flow-through portfolio company investment would be subject to U.S. tax was a 1991 IRS revenue ruling (Rev. Rul. 91-32) concluding that, for a non-U.S. seller, gain from sale of an equity interest in a flow-through entity is treated as ECI (taxable in the U.S.) to the extent the flow-through entity's assets are used in a U.S. trade or business. Most tax advisors believed that, while the technical basis for Rev. Rul. 91-32 was debatable, its result was nonetheless sensible as a policy matter and it would thus not be prudent to risk exposure to additional taxes and potential penalties by taking a position inconsistent with the ruling in the hope that a court would disagree with the ruling.

Recent Tax Court Decision

A Tax Court judge recently concluded (in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Comm'r*) that a foreign corporation ("ForeignCorp") was not liable for U.S. tax on capital gain derived from sale of its equity interest in a U.S. LLC ("US LLC") engaged in a U.S. trade or business (U.S. mineral extraction and distribution), except to the extent such gain was attributable to U.S. real property interests.[4] Other than its interest in US LLC, ForeignCorp had no offices, employees, or other U.S. business operations. ForeignCorp's equity interest in US LLC was redeemed by US LLC at a gain.

Under the Tax Court's technical analysis, ForeignCorp's non-real estate capital gain would constitute ECI only if:

- ForeignCorp had a "U.S. office" (either directly or by attribution from US LLC or from a ForeignCorp agent),
- such "U.S. office" was a "material factor" in the production of ForeignCorp's gain, *and*

- the transaction giving rise to ForeignCorp's gain occurred in the ordinary course of the business carried on through such U.S. office.

The Tax Court then assumed for purposes of its analysis that US LLC's U.S. office would indeed be attributed to ForeignCorp.[5]

The Tax Court concluded that, although US LLC's general business activity through its U.S. office resulted in an increase in the value of ForeignCorp's investment in US LLC, US LLC's activities relating to its redemption of ForeignCorp's US LLC equity interest were not a "material factor" with respect to ForeignCorp's capital gain (so that (b) above was not satisfied). In addition, the Tax Court concluded that the redemption of member interests in US LLC was an infrequent occurrence for US LLC, and accordingly should not be treated as having occurred in the ordinary course of US LLC's business (so that (c) above was not satisfied).

This Tax Court decision may cause private equity investors seeking to avoid ECI and UBTI to consider using non-U.S. (rather than U.S.) blocker to hold investments in flow-through portfolio companies.

Application of the Tax Court Decision to Private Equity Investment in U.S. Flow-Through Entities

Based on this Tax Court decision private equity funds are likely to consider using a non-U.S. blocker corporation (rather than a U.S. blocker corporation) to hold an investment in a U.S. flow-through portfolio company, as the court decision may permit the non-U.S. blocker to exit its investment in the U.S. flow-through portfolio company by sale of the fund's equity interest in the underlying flow-through portfolio company without triggering full blocker-level corporate tax.

We recommend, however, that private equity funds (and foreign direct investors) tread carefully and consult with a U.S. tax advisor when considering such a change in blocker corporation structures:

- *First*, depending on the facts, even under the Tax Court's decision, use of a non-U.S. blocker corporation may result in incremental tax leakage (as compared to use of a U.S. blocker corporation), depending on the nature and composition of the returns from the flow-through investment. As discussed above, the branch profits tax on a non-U.S. blocker corporation may produce greater tax leakage on distributions of flow-through portfolio company operating earnings than would the U.S. dividend withholding tax imposed on dividend distributions from a U.S. corporate blocker. Also, on exit, non-U.S. blocker's sale of its equity interest in flow-through portfolio company will produce corporate-level tax on U.S. real estate related gains and (although not addressed in the Tax Court case) will likely produce corporate-level tax on ordinary income attributable to flow-through portfolio company's appreciated inventory and depreciation recapture.[6]

- *Second*, in the private equity context, there is risk that activities of the private equity sponsor's U.S. office(s), if any, relating to sale of its equity interest in the U.S. flow-through portfolio company could be attributed to the non-U.S. blocker corporation, causing all of the non-U.S. blocker's gain from the sale to be treated as ECI, even under the Tax Court analysis.

- *Third*, there is risk that the recent Tax Court decision could be reversed on appeal or by Congressional action. Accordingly, a private equity sponsor choosing to utilize a non-U.S. blocker corporation should evaluate the pos-

sible future need to migrate from the non-U.S. blocker corporation back to a U.S. blocker corporation should the Tax Court decision be reversed.[7]

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[1] Gain from sale of blocker corporation stock could be subject to U.S. federal income tax under the FIRPTA rules (the "Foreign Investment in Real Property Tax Act of 1980") if the blocker corporation's asset value was primarily composed of U.S. real estate at any time during the five-year period preceding the sale.

[2] Also, the flow-through portfolio company could be required to withhold tax on the non-U.S. blocker corporation's allocable share of portfolio company income.

[3] Branch profits taxes may be reduced or eliminated if (1) the non-U.S. blocker is resident in a jurisdiction that has an income tax treaty with the United States providing for such a reduction and (2) the non-U.S. blocker is eligible for such treaty benefits (including satisfaction of requirements imposed by any "Limitation on Benefits" article).

[4] Prior to trial, ForeignCorp and IRS agreed that the portion of taxpayer's gain attributable to U.S. real property interests was subject to U.S. tax under the FIRPTA rules.

[5] The parties disputed whether US LLC's U.S. office should be attributed to ForeignCorp. However, it was not necessary for the Court to resolve this dispute since it concluded the gain was not subject to U.S. tax even if ForeignCorp was treated as having a U.S. office by virtue of its ownership interest in US LLC.

[6] In certain circumstances, the 30% branch profit tax could also apply upon exit from an investment (for example, an exit transaction involving a rollover or a re-investment of exit proceeds into another U.S. portfolio company).

[7] Because of U.S. anti-inversion rules, it is generally not possible to migrate from a U.S. blocker corporation to a non-U.S. blocker corporation after the initial investment.

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