

The Remarkable Resilience of Inbound Private Equity Structures

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Reprinted from *Tax Notes Federal*, June 8, 2026, p. 1701

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In this article, the authors examine recent international tax developments that could affect private equity buyers' decision-making on whether to adopt an inbound or U.S.-parented structure.

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Before enactment of the One Big Beautiful Bill Act (P.L. 119-21), private equity buyers generally preferred inbound multinational structures. The primary advantage of an inbound multinational structure was that it usually enabled the buyer to avoid the application of the global intangible low-taxed income and subpart F rules, which could require a U.S. shareholder to include most or all of

a controlled foreign corporation's income for the tax year in its own income.¹ However, the GILTI inclusions themselves were usually not the problem; the problem was the reduction in the foreign tax credit limitation resulting from the apportionment of interest expense to those inclusions. Because private equity acquisitions are typically financed with significant leverage, a U.S. corporation would often incur substantial interest expense. The tax cost resulting from the allocation of the interest expense to the GILTI category generally made a U.S. multinational structure less desirable for private equity acquisitions.

However, two recent developments in international tax could affect the calculus of whether to adopt an inbound or U.S.-parented structure. First, for tax years beginning after December 31, 2025, the OBBBA eliminates interest expense allocations to the GILTI category (referred to as net CFC tested income, or NCTI, after the OBBBA) for purposes of determining a U.S. corporation's FTC limitation.² Second, the OECD's side-by-side rules disapply the undertaxed payment and income inclusion rules of pillar 2 to certain U.S. groups.³ Because of these favorable developments for U.S.-parented structures, U.S. multinational structures might overtake (as a result of the side-by-side rules), or at least catch up (as a result of the OBBBA) to, inbound structures in private equity. However, as we will see, because of certain technicalities with the OBBBA and the very broad scope of the exclusion in the side-by-side rules, absent further

¹Section 951A.

²OBBBA section 70311(a) (amending section 904(b)(5)).

³See Treasury, "G7 Statement on Minimum Taxes" (June 28, 2025).

changes in law, inbound structures are likely to continue to be preferred in most cases.

I. U.S.-Parented Structures Before the OBBBA

After enactment of the Tax Cuts and Jobs Act, many in the tax community did not grasp that interest expense was required to be apportioned to the GILTI category for purposes of calculating the U.S. parent's FTC.⁴ Further, because of the immediate inclusion of almost all CFC income as GILTI (and related CFC taxes) and the reduction in the corporate rate (from 35 percent to 21 percent), the tax cost of apportionment was generally much higher post-TCJA than it was pre-TCJA. Thus, apportionment made U.S.-parented structures significantly less desirable in private equity investments.

Pre-TCJA law required the apportionment of interest expense to foreign-source income; however, a U.S. shareholder within the meaning of section 951(b)⁵ did not include most of a CFC's earnings in its income until distribution, and as a result, many U.S. shareholders included very little, or even no, foreign-source income each year. Because of this, the interest and other expenses allocable and apportionable to gross foreign-source income for a taxpayer would often exceed the taxpayer's gross foreign-source income itself and thus result in a negative amount of net foreign-source income, which would create an overall foreign-source loss (OFL) for U.S. tax purposes.⁶ This OFL would carry forward and would cause net foreign-source income to be recharacterized as U.S.-source income in future years, when sufficient foreign-source income was earned — generally, when either dividends were distributed or the earnings of a CFC were included in the U.S. shareholder's income under either subpart F or section 956. Still, a U.S. shareholder of a CFC could defer indefinitely the effect of the OFL (and thus the tax cost of the

apportionment of interest and other expenses to gross foreign-source income) by keeping the CFC's earnings offshore — that is, by not distributing the earnings or allowing them to be included in income under subpart F or section 956. Further, a U.S. parent corporation would not have to accrue a deferred tax liability if it could make an Accounting Principles Board Opinion No. 23 assertion that a CFC's earnings would remain permanently invested offshore.⁷ Thus, because of deferral, the tax cost from the apportionment of interest expense to a CFC's earnings pre-TCJA would often result in neither a current nor a deferred tax cost.

After the TCJA, a U.S. shareholder must now immediately include in its income almost all the earnings of its CFCs as either GILTI or subpart F income.⁸ If not for apportionment, pre-OBBBA, a U.S. shareholder's GILTI inclusion would be fully offset by a deemed-paid FTC if the blended foreign effective tax rate on the GILTI (now, NCTI) was at least 13.125 percent (21 percent less a 50 percent section 250 deduction divided by 80 percent of taxes allowed).⁹ Because the blended ETR incurred by CFCs on their earnings will usually exceed that rate (resulting from most CFCs operating in jurisdictions with statutory tax rates significantly exceeding 13.125 percent), a U.S. shareholder would expect to be able to offset its U.S. tax liability on GILTI with a full FTC and owe no residual U.S. tax.

However, the apportionment of interest expense of the domestic corporation to its GILTI inclusion often prevents the full use of the FTC and results in a current U.S. tax cost to the corporation. In determining a U.S. shareholder's FTC limitation, pre-OBBBA, the expenses of that U.S. shareholder, including interest, were required to be apportioned between U.S.-source income and each category of foreign-source income (that is, general, passive, branch, and GILTI) earned by the U.S. shareholder.¹⁰ While a

⁴ See Eric Yauch, "Interest Expense Limitation Applied to GILTI Raises Questions," *Tax Notes Int'l*, May 21, 2018, p. 999.

⁵ A U.S. shareholder is defined as a U.S. person that owns (within the meaning of section 958(a)), or is considered to own by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of that foreign corporation.

⁶ Section 904(f).

⁷ See APB Opinion No. 23 (saying a U.S. parent company does not have to record a deferred tax liability on its foreign subsidiary's unremitted earnings if it can demonstrate that it has the intent and the ability to indefinitely reinvest those earnings outside the United States).

⁸ Section 951A.

⁹ Sections 951A and 960(d).

¹⁰ See reg. sections 1.861-9 and -12.

U.S. corporation might have income in each category, in a typical structure in which most of a corporation's foreign operations are conducted through its CFCs, most of its foreign-source income would be expected to be in the GILTI category. And to the extent that interest expense is apportioned to the GILTI category and creates or exacerbates an FTC limitation in that category, each dollar of apportioned expense imposes a U.S. tax cost to the U.S. corporation of 21 cents.

For example, if a U.S. corporation incurred \$6 million of deductible interest expense and 35 percent of its assets (generally measured by reference to U.S. tax basis) consist of stock in a CFC characterized as a nonexempt asset in the GILTI category,¹¹ then 35 percent of the interest expense generally will be allocated and apportioned to the GILTI category. Assuming the U.S. corporation is already limited in the GILTI category (because the blended ETR of the CFCs exceeds 13.125 percent), the interest expense apportionment would reduce its foreign tax limitation in the GILTI category by \$2.1 million (\$6 million of interest expense * 35 percent), resulting in a disallowance of \$441,000 of GILTI FTCs (\$2.1 million * 21 percent) under section 904, and thus an annual tax cost of the same amount.¹² Further, unlike with respect to other FTCs disallowed under section 904(d) (that is, general, passive, and foreign branch), no carryover is permitted for disallowed GILTI FTCs.¹³ Thus, interest expense apportionment arguably has the effect of causing double taxation of the CFC's earnings because those earnings were taxed offshore already and are taxed again by the United States.

The foregoing demonstrates that, despite the TCJA's professed attempt to favor U.S. multinationals over inbound financing structures, the after-tax cost of interest expense apportionment represented a significant deterrent to using U.S.-parented structures in private equity acquisitions. Indeed, if anything,

the TCJA encouraged the use of inbound structures in connection with foreign acquisitions as a way to minimize or even eliminate GILTI inclusions going forward.

II. U.S.-Parented Structures After the OBBBA

The OBBBA increased the ETR on NCTI to 14 percent (from 13.125 percent) for tax years beginning after December 31, 2025, by reducing the section 250 deduction to 40 percent and increasing the FTC allowance to 90 percent.¹⁴ However, this increase to the NCTI ETR is insignificant relative to the taxpayer-favorable changes to NCTI. In particular, the OBBBA eliminated interest expense apportionment to NCTI for purposes of calculating a U.S. corporation's FTC limitation for tax years beginning after December 31, 2025.¹⁵ New section 904(b)(5) provides:

DEDUCTIONS TREATED AS
ALLOCABLE TO FOREIGN SOURCE
NET CFC TESTED INCOME. — Solely for
purposes of the application of subsection
(a) with respect to amounts described in
subsection (d)(1)(A) [NCTI], the *taxpayer's*
taxable income from sources without the
United States shall be determined by
allocating and apportioning —

“(A) any deduction allowed under
section 250(a)(1)(B) (and any deduction
allowed under section 164(a)(3) for taxes
imposed on amounts described in
section 250(a)(1)(B)) to such income,

“(B) no amount of interest expense or
research and experimental expenditures to
such income, and

“(C) any other deduction to such income
only if such deduction is directly
allocable to such income.”

*Any amount or deduction which would (but
for subparagraphs (B) and (C)) have been
allocated or apportioned to such income shall
only be allocated or apportioned to income*

¹¹ In general, a portion of GILTI stock is characterized as an exempt asset to the extent that a section 250 deduction is available for the U.S. shareholder's GILTI inclusion. See section 864(e)(3); reg. section 1.861-8(d)(2)(ii)(C)(2)(ii).

¹² The calculation ignores any effect of section 904(b)(4), which could make the amount of interest expense apportioned to GILTI even greater.

¹³ See section 904(c) (last sentence).

¹⁴ OBBBA sections 70312(a) (amending section 960(d)(1)) and 70321 (amending section 250(a)(1)(B)).

¹⁵ OBBBA section 70311(a) (amending section 904(b)(5)).

*which is from sources within the United States.*¹⁶ [Emphasis added.]

The benefit of new section 904(b)(5) can be illustrated with the example discussed above. In that example, the U.S. corporation incurred \$6 million of deductible interest expense and 35 percent of its assets consisted of GILTI stock. After the TCJA, but before the OBBBA, these facts would have resulted in a \$2.1 million apportionment of interest expense to GILTI and a tax cost of about \$441,000. After the OBBBA, that \$6 million of interest expense would instead be apportioned solely to U.S.-source income, resulting in no disallowance of NCTI (formerly GILTI) FTCs (except, as discussed below, to the extent of the creation of or increase to an overall domestic loss).

The significance of this change in the context of the international tax rules cannot be overstated. Water's-edge apportionment has always overallocated a U.S. corporation's interest expense to the income of a CFC because it does not take into account interest expense directly incurred by those CFCs. In 2004 worldwide apportionment rules were enacted that would have properly accounted for CFC interest expense, but they were repealed before they ever became effective.¹⁷ Section 904(b)(5) goes much further than worldwide interest expense apportionment: It "corrects" the overallocation of U.S. interest expense to CFC income by not allocating that expense to NCTI at all. Thus, the OBBBA eliminates the primary disadvantage and tax cost to U.S.-parented structures for tax years beginning after December 31, 2025.

If the analysis ended here, it would be relatively easy to make a quantitative assessment of the relative tax costs and benefits of an outbound structure compared with an inbound structure after the OBBBA. However, as was the case post-TCJA, there is another subtle interpretation of the interest expense apportionment rules that is likely to further complicate the analysis. The complication arises

from the flush language at the end of section 904(b)(5), which says that "any amount or deduction which would (but for subparagraphs (B) and (C)) have been allocated or apportioned to such income shall only be allocated or apportioned to income which is from sources within the United States." As a result of this language, the interest expense that otherwise would have been allocated to NCTI is instead allocated to U.S.-source income.

Initially, it seemed that allocating interest expense to U.S.-source income would not result in a U.S. tax cost. After all, U.S.-source income is considered the "residual grouping" in the context of expense apportionment because expense apportionment to that category should not generally affect the taxpayer's FTC limitation. However, as was the case with the TCJA regarding the apportionment of interest expense to the GILTI category, the tax community eventually realized that there was another, lurking consequence to that allocation. As commentators have pointed out, if the interest expense and other expenses of the U.S. corporation that are allocated and apportioned to gross U.S.-source income exceed that income, an overall domestic loss (ODL) will be created.¹⁸ And because section 904(b)(5) will in most cases significantly increase the expenses apportioned to U.S.-source income, an ODL will be much more likely to occur post-OBBBA than pre-OBBBA.

An ODL is the converse of an OFL. Recall that an OFL arises when expenses allocable to gross foreign-source income exceed that income. In that case, to the extent that the foreign-source loss offsets net U.S.-source income, an OFL is created, which will be recaptured in a later year by converting future foreign-source income to U.S.-source income. An ODL, on the other hand, arises when net expenses allocable to U.S.-source income exceed gross U.S.-source income. The ODL is then recaptured in a later year by converting future U.S.-source income to foreign-source income. Unlike an OFL, an ODL is generally viewed as a favorable attribute. And it usually is. The problem is the reduction to

¹⁶ *Id.* Interest expense is still apportioned to the other FTC categories. Also, research and experimental deductions were not required to be apportioned to GILTI in pre-OBBBA years, so section 904(b)(5) is not a change in that respect.

¹⁷ See section 864(f), American Jobs Creation Act of 2004 (repealed).

¹⁸ See David J. Sotos and J.P. Gregorcy, "Post-OBBBA Creation of Overall Domestic Losses and Pre-TCJA Recapture Methods," *Tax Notes Federal*, Aug. 25, 2025, p. 1239.

foreign-source income in the year of its creation — that is, an ODL will offset net foreign-source income on a category-by-category basis, and to the extent that the ODL offsets NCTI it will impose a tax cost on the taxpayer similar to the tax cost that was imposed pre-OBBA by interest allocation to GILTI. And although the recapture might create a benefit in the future, by creating additional NCTI in the year of recapture, the benefit is much less certain in light of the continued lack of a carryover of NCTI credits.

In the example above, 35 percent of the U.S. corporation's assets were in the GILTI category, and it incurred \$6 million of deductible interest expense so that \$2.1 million of interest expense would be apportioned to the GILTI category pre-OBBA. After the OBBA, that \$2.1 million of interest expense would be apportioned to gross U.S.-source income, which could result in an ODL if that interest expense, along with other expenses (including interest) that are allocated and apportioned to gross U.S.-source income under general U.S. tax principles, exceed that income. For example, assume further that the U.S. corporation had \$500,000 of net U.S.-source income before taking into account section 904(b)(5). The \$2.1 million of interest that would otherwise be apportioned to the NCTI category is instead apportioned to U.S.-source income, thus creating an ODL of \$1.6 million (\$500,000 - \$2.1 million).

The \$1.6 million ODL would then be allocated to the various FTC limitation categories (that is, general, passive, branch, and NCTI) based on the proportionate amount of income in each category, increasing an ODL account in the applicable category to the extent of that allocation.¹⁹ In the example above, assuming no other foreign-source income, the ODL will be solely allocated to the NCTI category, reducing the limitation for NCTI by the full amount of the \$1.6 million ODL, resulting in a current tax cost of \$340,000 (\$1.6 million * 21 percent). Even if the taxpayer has other sources of foreign income, the net amount of income in the NCTI category (before ODL allocation) is generally expected to increase relative to the net income in other categories of

foreign-source income by reason of the changes to the OBBA — particularly the nonallocation of interest expense to NCTI and the elimination of the qualified business asset investment exemption for NCTI.²⁰ Therefore, it is generally expected that the NCTI category will attract a disproportionate amount of an ODL created by reason of section 904(b)(5). This boomerang of the interest expense in the form of an ODL can replicate the effect of pre-OBBA interest expense apportionment.

The ODL in any category, including NCTI, can be recaptured in a later year in which there is net U.S.-source income, and this recapture would create additional limitation in that year.²¹ However, net U.S.-source income in any subsequent year is made less likely by the reallocation of section 951A-category interest expense to U.S.-source income required under section 904(b)(5). Further, even in a year that there is net U.S.-source income after the application of section 904(b)(5), recapture of an ODL would be capped at 50 percent of that taxable income.²² Moreover, and most importantly, as discussed above, NCTI category FTCs cannot be carried forward.²³ Thus, not only will it be difficult to generate sufficient net U.S.-source income to recapture an ODL, but the recapture of an ODL allocated to NCTI-category income in an earlier year would only benefit a taxpayer to the extent that the taxpayer has otherwise excess NCTI credit in the recapture year.

Pre-OBBA, it would have been possible to perform a high-level calculation of the tax cost of a U.S. multinational structure by estimating the percentage of interest expense that would be apportioned to the GILTI category. Post-OBBA, a tax planner would have to perform that same calculation, but then reallocate that interest expense to U.S.-source income, and then to the extent that an ODL is created, reallocate the loss to the separate limitation categories, including the NCTI category, proportionately. That calculation, obviously, will be complicated. And in most cases, if the downside of an inbound structure can be

¹⁹ Reg. section 1.904(g)-3(e).

²⁰ Section 904(b)(5)(B). Reg. section 1.861-17.

²¹ Reg. section 1.904(g)-2.

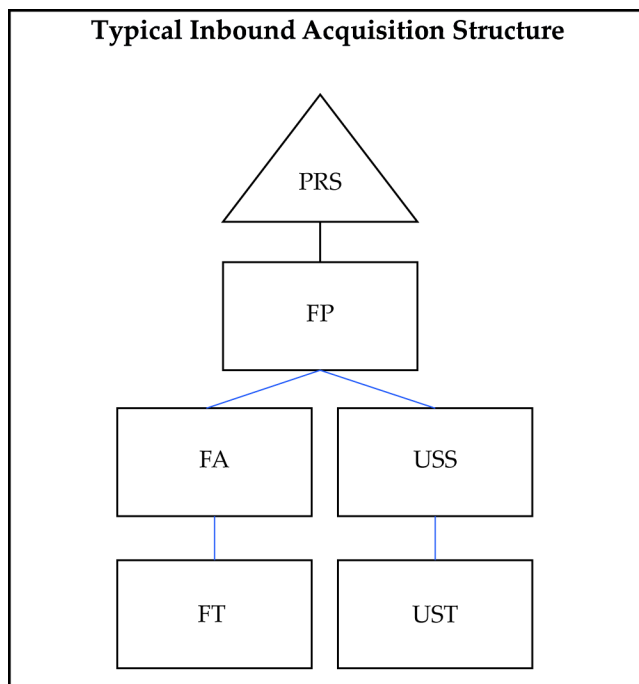
²² *Id.*

²³ Section 904(c) (last sentence).

appropriately managed, a tax planner will likely choose to forgo the U.S. multinational structure in favor of the inbound structure.

III. Inbound Acquisition Structures After OBBBA

A typical inbound structure for a private equity acquisition has a partnership parent (PRS) through which waterfall distributions to the investors are made. In this structure, PRS may own a foreign parent company (FP), which in turn owns the foreign and U.S. acquisition companies (FA and USS), which are brother and sister. FA and USS then acquire the foreign and U.S. target (FT and UST), respectively. This structure is depicted in the figure.



In an inbound acquisition structure, the private equity investor might acquire UST and FT separately as part of a carveout acquisition. Or FT might own UST, in which case it might be possible to unwind FT's ownership of UST as part of the sale to permit FA and USS to acquire FT and UST, respectively. In that case, USS and UST can consolidate, thus permitting USS to deduct its financing costs against UST's operating earnings. Also, if direct ownership is required for consolidation in FA and FT's jurisdiction of residence, this acquisition structure permits consolidation there, as well.

From a financing perspective, either FA or USS can borrow from a third-party lender and then "on-loan" the borrowed proceeds to the other jurisdiction. Or FA and USS can be co-obligors on the same borrowing. However, USS is usually the borrower (rather than FA) because (1) lenders generally prefer to lend to companies incorporated in the United States, insofar as the lenders are more familiar with U.S. corporate and bankruptcy laws; (2) in the case of nonbank lenders, the portfolio interest exception can provide relief from withholding;²⁴ and (3) interest payments on an intercompany loan from FA to USS would be base erosion payments subject to the base erosion and antiabuse tax.²⁵

A. Pillar 2

Even if the OBBBA did not go far enough for certain U.S. multinational structures (because of the ODL issue discussed above), at first blush, it appeared that the side-by-side rules would provide those structures with a clear advantage. Under the side-by-side rules agreement, inbound structures are subject to the onerous undertaxed profits and income inclusion rules, whereas U.S. multinational structures are largely exempt. Although side-by-side rules were issued providing exactly that, there are several reasons why pillar 2 might not be a material consideration.

First, the multinational enterprise group might not have consolidated revenues of at least €750 million in at least two of the preceding four fiscal years, in which case it will not be in scope of pillar 2.²⁶ Second, the side-by-side rules exempt from pillar 2 any multinational group with a U.S. ultimate parent entity (UPE), which would include an inbound structure if PRS is organized as a U.S. partnership.²⁷ In that case, PRS will generally be the UPE because it will own a controlling interest in FP and presumably will not be controlled by some other entity.

²⁴ Sections 871(h) and 881(c).

²⁵ Section 59A.

²⁶ OECD, "Tax Challenges Arising From Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)," at article 1.1 (2021).

²⁷ OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two), Side-by-Side Package" (2026).

Admittedly, there is a significant change-in-law risk, or even a “failure to change law” risk, regarding the future implementation of the side-by-side rules. The law is not well settled, to say the least.²⁸ Thus, careful monitoring of pillar 2 guidance will be required to ensure that the law does not change for an inbound group with a U.S. partnership UPE.

B. Dry Income Inclusions

Pre-OBBA, the most significant tax advantage of the inbound structure was the avoidance of GILTI inclusions and the elimination of the resulting cost associated with the related interest expense apportionment. In an inbound structure, USS is generally not the direct or indirect owner of any CFC, in which case none of its interest expense will be apportioned to GILTI, thus eliminating the inefficiencies in the U.S.-parented structure discussed above.

The most significant tax disadvantage of the inbound structure pre-OBBA also related to GILTI inclusions, but at the U.S. investor level. These “dry income” inclusions to the U.S. investor resulted principally from the TCJA’s amendment to section 958(b), which cross-references the constructive ownership rules under section 318 for purposes of determining U.S. shareholder and CFC status. Importantly, before the TCJA, section 958(b)(4) turned off section 318(a)(3) to prevent downward attribution from a foreign corporation to its U.S. subsidiary. The TCJA repealed section 958(b)(4) effective for the last tax year of a foreign corporation beginning before January 1, 2018.²⁹ As a result of that repeal, post-TCJA, the FA and FT stock held by FP could be attributed “downward” to USS under section 318(a)(3), causing USS, because it constructively owned at least 10 percent of each of FA and FT, to be a U.S. shareholder of each foreign corporation, and FA and FT, because they would be constructively owned more than 50 percent by USS (a U.S. shareholder), to be CFCs.³⁰ While USS itself would not have subpart F, GILTI, or section 956

inclusions (CFC inclusions) for these CFCs (because of the lack of section 958(a) ownership), a U.S. investor that owned at least a 10 percent indirect interest in FA or FT through PRS could have CFC inclusions for FA or FT, because that U.S. investor would be an indirect U.S. shareholder of FA and FT, each a CFC on account of USS’s constructive ownership.³¹ That investor is hereafter referred to as a “U.S. shareholder investor.”

Moreover, an individual U.S. shareholder investor could be subject to especially severe tax consequences as a result of CFC inclusions (absent a section 962 election). First, an individual U.S. shareholder investor’s GILTI inclusion would not be reduced by the section 250 deduction available to corporations.³² Thus, the individual would include the amount at full marginal rates, which could be as high as 37 percent.³³ Second, the individual would not be entitled to a deemed paid FTC for any foreign taxes paid or accrued for the CFC inclusions it receives in its income.³⁴

Finally, if any of the CFC’s income constituted earnings that were excluded from the U.S. shareholder investor’s income as subpart F income or GILTI, those earnings could still be included under section 956.³⁵ The section 956 inclusion would often arise because FA and FT usually would have guaranteed USS’s third-party debt (or would be a co-obligor for USS’s debt), which guarantee (or co-obligation) would, under section 956, cause FA or FT to be viewed as holding USS’s debt obligation, which would be U.S. property for U.S. tax purposes.³⁶ Although a U.S. corporation generally would be able to claim a reduction for a hypothetical section 245A dividends received deduction (section 245A DRD) and thus a reduction to the section 956 inclusion, an individual would not be eligible for

²⁸ See Lee A. Sheppard, “Pillar 2 Side-by-Side Safe Harbor: A Slightly Choppy Period,” *Tax Notes Federal*, Feb. 2, 2026, p. 709.

²⁹ TCJA section 14213(a)(1)-(2).

³⁰ Sections 318(a)(3)(C), 951(b), and 958(b).

³¹ Sections 951(a) and 951A(a).

³² Section 250(a)(1).

³³ Section 1(j).

³⁴ Section 960.

³⁵ Section 956(a)(2).

³⁶ Reg. section 1.956-2(c)(2).

a section 245A DRD and thus would include the full amount of their section 956 amount in its income.³⁷

The OBBBA reinstated section 958(b)(4) for tax years of foreign corporations beginning after December 31, 2025.³⁸ In its place, the OBBBA enacted section 951B, which provides for a more limited downward attribution.³⁹ Section 951B, simply stated, would apply CFC inclusions to a U.S. shareholder investor only if it owned at least 50 percent (rather than 10 percent) of a foreign corporation directly, indirectly, or constructively (with constructive ownership determined without regard to the OBBBA's reinstatement of section 958(b)(4)'s restriction on downward attribution).⁴⁰ That U.S. shareholder is designated as a "foreign controlled U.S. shareholder" for purposes of section 951B, and a foreign corporation that is a CFC solely by reason of downward attribution is designated as a "foreign controlled foreign corporation."⁴¹

For example, in the chart above, USS and UST are foreign-controlled U.S. shareholders of FA and FT, each a foreign-controlled foreign corporation (FCFC), because they own at least 50 percent of each corporation constructively. Although the downward attribution of FA and FT's stock to USS and UST would be prohibited as a result of the OBBBA's reinstatement of section 958(b)(4), it is permitted for purposes of the special rules of section 951B that treat USS and UST as foreign-controlled U.S. shareholders and FA and FT as FCFCs.⁴² Still, despite USS and UST's status as foreign-controlled U.S. shareholders, they have no CFC inclusions under section 951B because they do not own FA or FT directly or indirectly (within the meaning of section 958(a)),

which is the same result that occurred pre-OBBBA.

Moreover, new section 951B should not affect a U.S. shareholder investor as long as it is unrelated to FT or FA and thus not a foreign-controlled U.S. shareholder, which will usually be the case in a typical private equity structure. In general, in such a structure, an investor generally will not own directly, indirectly, or constructively 50 percent or more of FP, FA, or FT, which is required for that investor to be a foreign-controlled U.S. shareholder within the meaning of section 951B. Further, if the U.S. investor is not a foreign-controlled U.S. shareholder regarding FP, FA, or FT, it would not have a CFC inclusion for any of those entities under new section 951B, even though those foreign corporations are FCFCs as a result of USS's constructive ownership.⁴³

With downward attribution no longer a problem, a post-OBBBA U.S. shareholder investor should not have CFC inclusions unless FP, FA, and FT are CFCs, regardless of downward attribution. Even without downward attribution, however, FP, FA, and FT could become CFCs if (1) U.S. shareholder investors indirectly own more than 50 percent of the indirect interests in FP, FT, or FA; (2) PRS is organized in the United States; or (3) one or more U.S. persons own directly, indirectly, or constructively more than 50 percent of the general partnership interests.

Because private equity is relatively widely held, scenario (1) would, in most structures, be an atypical fact pattern. For scenario (2), it is usually easy to organize PRS outside the United States (however, as discussed above, forming PRS in the United States could permit the group to qualify for the side-by-side exemption from pillar 2). Scenario (3), the effect of a U.S. person's ownership of a general partnership interest in PRS, is discussed below.

C. General Partners of PRS

For tax years of a CFC beginning before January 25, 2022, if a U.S. partnership was a U.S. shareholder with respect to a CFC, then the partnership would have to include its ratable share of CFC inclusions in its own income, and

³⁷ Reg. section 1.956-1(a)(2). Importantly, an individual's inability to benefit from an exception to section 956 that a corporate U.S. shareholder enjoys cannot be cured with a section 962 election — that is, despite the fact that an individual who makes a section 962 election is treated as a U.S. corporation for certain purposes (namely, for purposes of permitting the individual to benefit from an FTC and the lower corporate rates), that individual would not be treated as a U.S. corporation for purposes of the exception to section 956 inclusions permitted to U.S. corporations to the extent of section 245A-eligible E&P.

³⁸ OBBBA section 70353(a).

³⁹ OBBBA section 70353(b).

⁴⁰ Section 951B(b).

⁴¹ *Id.*

⁴² Section 951B(c).

⁴³ Section 951B(a).

partners that were U.S. persons would have to include their distributive share of that income without regard to whether they themselves were U.S. shareholders.⁴⁴ In contrast, if PRS were organized outside the United States, only U.S. partners that were U.S. shareholders on account of their own ownership would have to include those amounts in their own incomes, and such an inclusion would be required only if their collective ownership was sufficient to cause the foreign corporation owned by PRS to be a CFC (that is, those U.S. shareholders collectively owned more than 50 percent of the vote or value), which as discussed above is usually not the case.⁴⁵ Thus, inbound structures would often organize PRS outside the United States to shield their “small” U.S. partners from subpart F inclusions.

However, even if a foreign partnership is sufficiently widely held so that its “large” U.S. partners do not cause the foreign partnership’s underlying foreign corporations to become CFCs, a foreign partnership still could be problematic from a subpart F perspective. Because a foreign corporation could be a CFC solely based on voting power, a foreign partnership’s general partners could cause a foreign corporation to become a CFC, notwithstanding no or minimal other U.S. investors. In particular, a U.S. person that is a general partner in a foreign partnership could be attributed disproportionate voting rights in a foreign corporation owned by the partnership, causing the general partner to be a U.S. shareholder solely on account of its ability to control the partnership.⁴⁶ And if that U.S. person (individually or collectively with other U.S. persons) owned more than 50 percent of the general partnership interests, any foreign corporation wholly owned by the partnership could be treated as a CFC.

A U.S. shareholder is defined under section 951(b) as “a United States person (as defined in Section 957(c)) who owns (*within the meaning of Section 958(a)*), or is considered as owning by

applying the rules of ownership of Section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation” (emphasis added). Under this definition, a U.S. person can be a U.S. shareholder if it meets the ownership requirements under either section 958(a) or section 958(b). Section 958(a) provides rules for direct and indirect ownership through foreign entities, whereas section 958(b), by cross-referencing section 318 with certain modifications, provides rules for constructive ownership. There is some overlap between indirect ownership under section 958(a) and constructive ownership under section 958(b), insofar as a person can be treated as both indirectly and constructively owning shares owned by an entity in which that person is an owner (for example, a partner in a partnership or a shareholder in a corporation).⁴⁷ However, there are important differences between indirect and constructive ownership. Most notably, while section 318, and by extension section 958(b), is generally understood to attribute stock based on value (for example, a partner is treated as owning stock owned by a partnership based on the value of the partner’s interest in the partnership),⁴⁸ section 958(a) determines ownership using a facts and circumstances approach that depends on the purpose for which the provision is applied.⁴⁹

As relevant here, the section 958(a) regulations state that “to determine the amount of voting power owned for purposes of section 951(b) [that is, U.S. shareholder status] . . . a person’s proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person.”⁵⁰ Under that test, a U.S. person that is the sole general partner in a foreign PRS could be viewed as owning 100 percent of the voting power of each of FP, FA, and

⁴⁴ Reg. section 1.958-1(e) (modified) (treating a domestic partnership as an aggregate for purposes of section 951A).

⁴⁵ Section 951(b).

⁴⁶ See Stephen Mills, “Partnerships Change Everything: Using a Partnership in an Outbound Stock Acquisition,” *Tax Notes*, Mar. 15, 2004, p. 1393.

⁴⁷ Compare section 958(a)(2) and section 318(a)(2).

⁴⁸ See section 318(a)(2)(A) (“Stock owned, directly or indirectly, by or for a partnership or estate shall be considered owned proportionately by its partners or beneficiaries.”).

⁴⁹ Reg. section 1.958-1(c)(2).

⁵⁰ *Id.*

FT, and thus each such foreign corporation would be a CFC even without downward attribution, and the general partner would also be viewed as a U.S. shareholder in those corporations.

While a foreign corporation can be a CFC solely by reason of a U.S. shareholder's voting power in that corporation, the U.S. shareholder's actual subpart F or GILTI inclusion is still limited to its economic interest. Thus, because a general partner's interest in the current earnings of the partnership is usually minimal, it might be expected that the amount of the inclusion will be equally minimal. However, a general partner might also have a carried interest in the PRS, in which case, if that carried interest is taken into account in determining the partner's pro rata share, the inclusion could be significant. At the very least, because of this carried interest, a general partner's pro rata share of a CFC owned by a partnership could be very difficult to ascertain. Moreover, as discussed above, if a general partner causes a foreign corporation to become a CFC, it also will cause a U.S. shareholder investor that is a limited partner in PRS to have CFC inclusions, as well, thus negating the benefit of the repeal of downward attribution for foreign PRS inbound structures.

As discussed above, section 958(a) requires that all facts and circumstances be taken into account in determining a person's proportionate interest in the voting power of the foreign corporation.⁵¹ Thus, a general partner's fiduciary duty obligations to the limited partners, as well as provisions in the partnership agreement that permit the limited partners to take action against the general partner in certain circumstances, might be viewed as limiting the general partner's voting control of the PRS, which in turn might be viewed as limiting attribution of the voting power of the CFCs to that partner. However, many partnership agreements do not permit the removal of a general partner absent a very high level of malfeasance, such as gross negligence, willful malfeasance, or intentional fraud (thus possibly undermining the extent of the general partner's fiduciary obligation), so there is some

uncertainty as to whether such an argument would succeed.

For tax years beginning on or after January 25, 2022, a partnership organized in the United States is treated the same as a partnership organized outside the United States for CFC inclusions, so U.S. persons that are partners in a U.S. PRS will have CFC inclusions for FP, FA, and FT only if those persons are themselves U.S. shareholders.⁵² For small U.S. partners (that is, partners that are not U.S. shareholders), the section 958(a) regulations make PRS's place of formation irrelevant for purposes of CFC inclusions; in either case, those partners will not include amounts of FP, FA, and FT in their incomes. For limited partners that own 10 percent or more of the value of FP, FT, and FA, the section 958(a) regulations continue to advantage the formation of a foreign PRS, because a U.S. PRS would cause each of FP, FT, and FA to be a CFC of which that limited partner would be a U.S. shareholder. However, as it pertains to general partners, these new rules actually enhance the benefits of a U.S. PRS relative to a foreign PRS by eliminating the attribution of supervoting rights under section 958(a) for a foreign PRS discussed above.

The first sentence of the relevant regulation, in reg. section 1.958(a)-1(d)(1), achieves the equivalence for small U.S. partners by providing that "for purposes of section 951, 951A, or 956 . . . a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a)."⁵³ Further, the last sentence of paragraph (d)(1) provides that "for purposes of determining the persons that own stock of a foreign corporation within the meaning of section 958(a) . . . stock of a foreign corporation owned by a domestic partnership is treated in the same manner as stock of a foreign corporation owned by a foreign partnership." Thus, regardless of whether a foreign corporation owned by a U.S. partnership is a CFC, the U.S. partnership is not a section 958(a) "inclusion" U.S. shareholder, and therefore U.S. partners of the U.S. partnership no longer need to include their distributive shares of the U.S. partnership's CFC inclusions.

⁵¹ *Id.*

⁵² Reg. section 1.958-1(d)(4)(i).

⁵³ Reg. section 1.958-1(d)(1).

However, paragraph -1(d)(1) is governed by the controlling language at the beginning of the paragraph, which states that these rules apply “except as otherwise provided in paragraph (d)(2).” And paragraph (d)(2) provides that “paragraph (d)(1) of this section [which treats a domestic partnership as a foreign partnership for purposes of section 958(a)] does not apply for purposes of . . . determining whether any United States person is a United States shareholder (as defined in Section 951(b)).” If a U.S. partnership is treated as a domestic partnership under section 958(a) for purposes of determining whether any U.S. person, including a general partner of a partnership, is a U.S. shareholder, then section 958(a), and its facts and circumstances analysis, will not apply in determining whether a U.S. person that is a partner in a U.S. partnership is a U.S. shareholder because section 958(a) considers indirect ownership only through foreign entities.⁵⁴ In that case, it should not be possible to attribute supervoting rights through that U.S. partnership to cause a general partner to be a U.S. shareholder on account of its voting control. Rather, only section 958(b) attribution would apply, and those rules attribute stock ownership through a partnership proportionately, which, as discussed above, is generally understood to be based on value.

D. Sorting It All Out

So where do all these changes leave us? What is a U.S. tax planner of an inbound private equity structure to do? First, if there is no U.S. shareholder investor that is a limited partner, it seems there is no downside to organizing PRS in the United States. In that case, there should be an exemption from pillar 2 (subject to future changes in law), a U.S. person that is a general partner should not be viewed as a U.S. shareholder because of the aforementioned section 958(a) regulations, and causing FP, FA, and FT to become CFCs generally should not be disadvantageous.

Second, if there is a U.S. shareholder investor that is a limited partner, it seems advantageous to organize PRS outside the United States unless (1) there are U.S. persons as general partners that will

cause FP, FA, and FT to become CFCs on account of their general partnership interests, or (2) there are adverse effects from pillar 2.

Of course, at some point, if an inclusion to the general or the limited partners cannot be avoided, or there will be adverse effects from pillar 2, it might make sense to consider blocking FP, FA, and FT with a U.S. parent structure, if possible, to avoid CFC inclusions to a U.S. shareholder, despite the complexity of the modeling required with those structures post-OBBA, as discussed above.

E. Exiting an Inbound Structure After the OBBA

If PRS is formed outside the United States, a taxable sale by PRS of FP will generally result in capital gains to U.S. limited partners that are not 10 percent or greater owners directly, indirectly, or constructively. A U.S. limited partner that is a 10 percent or greater owner should also realize capital gain unless FP, FA, and FT are CFCs. If FP, FA, and FT are CFCs, the U.S. shareholder investors would be subject to section 1248 and could realize ordinary dividend income subject to possible qualified dividend income (QDI) treatment in the case of individual shareholders and a section 245A DRD in the case of corporate shareholders.

If PRS is itself sold, and FP, FA, and FT are CFCs, the “hot asset” rules of section 751(c) would apply and the U.S. shareholder investors would have ordinary income to the extent of the underlying earnings of those CFCs. Importantly, the ordinary income under the hot asset rules, unlike section 1248, is not a dividend, and thus is not eligible for any reduction or elimination from taxable income applicable to dividends, such as QDI.

If PRS is formed in the United States, a taxable sale by U.S. PRS of FP will generally result in capital gains to all U.S. investors subject to section 1248. Although reg. section 1.958-1(d) treats PRS as a foreign partnership for purposes of determining inclusions, a PRS formed in the United States is still treated as a U.S. person for purposes of section 1248.⁵⁵ Thus, a U.S. PRS would be a U.S. shareholder for purposes of section 1248,

⁵⁴ See section 958(a)(2).

⁵⁵ Reg. section 1.958-1(d)(2)(iv).

and its gain on the sale of FP would be recharacterized as a dividend to the extent of the earnings of FP and its non-U.S. subsidiaries accumulated while those entities were CFCs and owned by PRS.⁵⁶

PRS's U.S. partners would then include in their income their distributive share of the deemed dividend. Partners that are corporate U.S. shareholders may qualify for a section 245A DRD on their share of the income.⁵⁷ Further, an individual partner could be taxed at capital gains rates for its distributive share of the dividend if that dividend constitutes QDI.⁵⁸

If U.S. PRS is itself sold, all the selling U.S. investors would potentially be subject to the hot asset rules, which would recharacterize the investors' gain attributable to PRS's section 1248 amount for FP's stock as ordinary income (again, without the possibility of QDI).⁵⁹

For the section 1248 dividend to be QDI, FP must be a qualified foreign corporation, which generally requires that it be a resident of a jurisdiction with a comprehensive income tax treaty with the United States (for example, the United Kingdom) and be eligible to obtain benefits under that treaty.⁶⁰ Thus, FP will need to qualify under the limitation on benefits article of that treaty. FP will not, however, be publicly traded, which is one of the primary ways in which a resident can satisfy the LOB article of a treaty.⁶¹ Moreover, it might be difficult for it to satisfy derivative benefits or ownership/base erosion — two other tests by which a resident can satisfy the LOB — because both of these tests require looking through to the ultimate owners, and the identity and residence of those owners are often very

difficult to determine in a private equity structure.⁶² As such, FP will usually have to satisfy the active trade or business test, which would be satisfied by either FP or an affiliate conducting an active trade or business in FP's country of residence.⁶³

Importantly, the active trade or business test generally applies to “an item of income, profit or gain” derived by a resident of a contracting state (the resident state) through a trade or business in the other contracting state (the source state) “only if the trade or business activity in the [resident state] is substantial in relation to the trade or business activity in the [source state].”⁶⁴ That test makes sense when, for example, a U.S. corporation pays a dividend to a U.K. resident and the question is whether the U.K. resident's trade or business activity is substantial in relation to trade or business activity in the source state, the United States. However, it is uncertain whether and how to apply the active trade or business test to determine whether a dividend from a U.K. corporation qualifies for QDI treatment, because the test was designed to determine whether the recipient, not the payer, has an active trade or business.⁶⁵ But most tax planners conclude that a payer may be a qualified foreign corporation if the corporation, directly or through its affiliated foreign group, has sufficient substance in the treaty jurisdiction.

IV. Final Analysis

Because the OBBBA does not apportion interest expense to NCTI, and the side-by-side rules provide a pillar 2 exemption for U.S. structures, it seemed as if U.S. multinational structures might become the preferred structuring alternative in private equity. However, there are several reasons why inbound structures might remain prevalent going forward. First, the overallocation of interest expense to U.S.-source income under the OBBBA is likely to create ODLs for many U.S.-parented structures,

⁵⁶ Section 1248(a)(1).

⁵⁷ See section 245A(g) (providing for a delegation of regulatory authority “including regulations for the treatment of United States shareholders owning stock of a specified 10 percent owned foreign corporation through a partnership”).

⁵⁸ Section 1(h)(11)(B). See also section 4.01 of Notice 2004-70, 2004-2 C.B. 724 (acknowledging that gain recharacterized as a dividend under section 1248 is eligible for QDI treatment).

⁵⁹ See section 751(a) and (c).

⁶⁰ Section 1(h)(11)(C); Notice 2011-64, 2011-2 C.B. 231 (providing a list of income tax treaties considered “comprehensive”). There is no requirement, however, that FP actually claim treaty benefits. See Notice 2011-64, section 3, citing H.R. Rep. No. 108-126, at 42 (2003) (Conf. Rep.) (stating that a company will be treated as eligible for treaty benefits if it “would qualify” for benefits under the treaty).

⁶¹ Article 23(2)(c)(i) of the U.K.-U.S. income tax treaty.

⁶² *Id.* at article 23(2)(f)(i) and (3).

⁶³ *Id.* at article 23(4).

⁶⁴ *Id.* at article 23(4)(b).

⁶⁵ See New York State Bar Association, “Report on Limitation on Benefits Provisions and Section 1(h)(11)” (June 26, 2006).

resulting in unexpected limitations in various foreign-source categories, especially the NCTI category. Thus, in many cases, taxpayers might gain less from non-allocation of interest to NCTI than anticipated, and changes in the facts going forward could create nasty surprises. Second, under current law, the side-by-side rules exclude not only corporate UPEs but also partnership UPEs. Thus, inbound structures with domestic top-hat partnerships can seemingly benefit from a pillar 2 exemption, as well, at least for now. Finally, dry income inclusions for U.S. shareholder investors due to downward attribution have been largely remedied by the reinstatement of section 958(b)(4) in the OBBBA. Thus, it seems we might be back where we were before the OBBBA and the side-by-side rules, with inbound structures still often the preferred route in private equity.⁶⁶ ■

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