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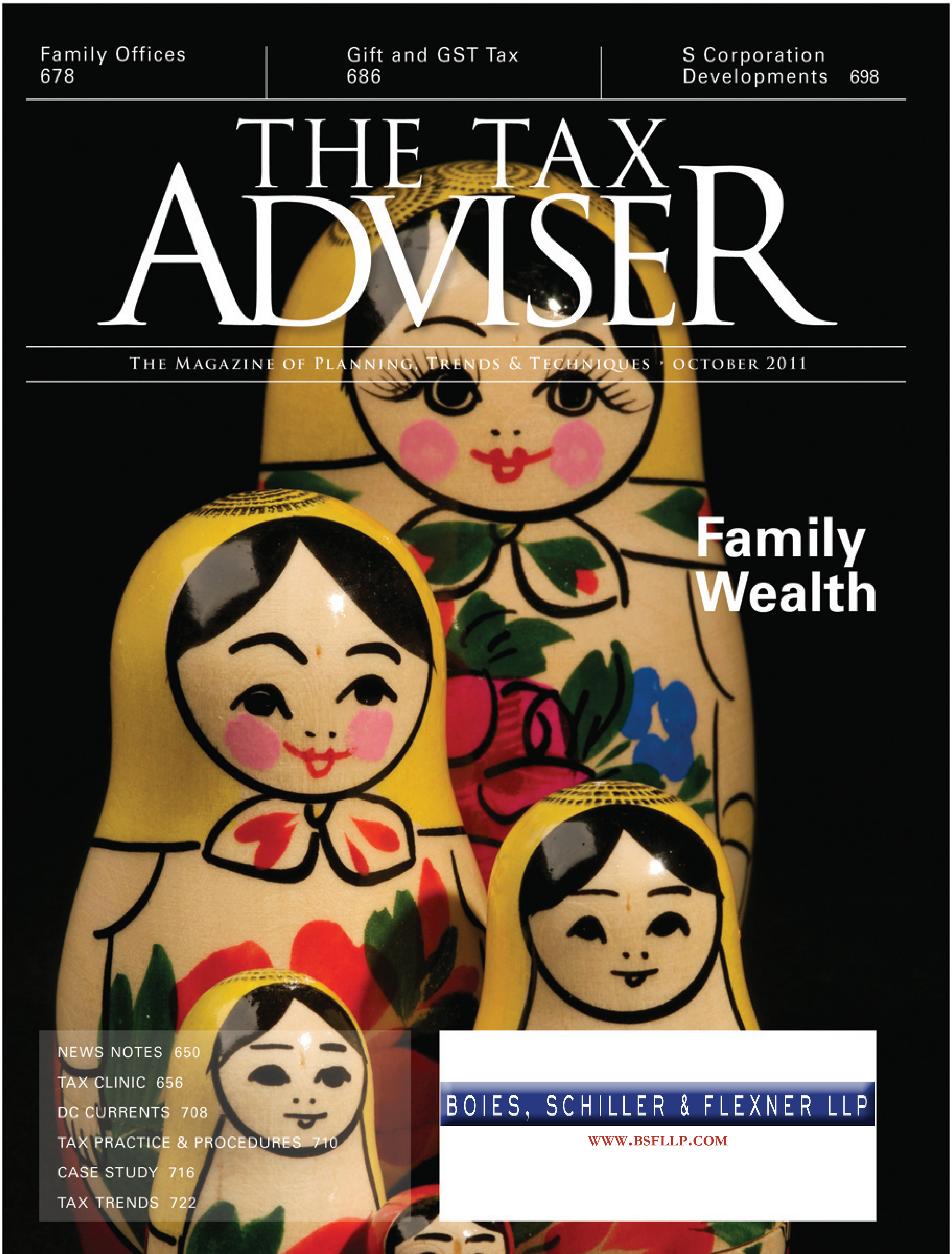

Family Wealth

Guide to Corporate Blockers

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Blockers are an integral part of international tax planning, particularly in inbound transactions where foreign persons participate in U.S. businesses. Blockers are U.S. or foreign entities that are classified as corporations for U.S. income tax purposes. If they are formed in the United States, they are usually established as state law corporations. On the other hand, offshore blockers may check the box under Regs. Sec. 301.7701-3 to elect their classification for federal tax purposes, or they may, under Treasury regulations, be classified as corporations under the default rules.

Blockers often show up in the investment fund context, although they are helpful in other contexts as well. They can be formed below the fund (i.e., between the portfolio company and the fund) or above the fund (e.g., as feeder blockers). They can be single or multipurpose. A single-purpose blocker, as its name suggests, holds an interest in a single U.S. business. Conversely, a multipurpose blocker participates in several U.S. businesses.

The blocker does several things. It blocks potential U.S.-source effectively connected income at the blocker level and makes any required tax filings with respect to such income. In other words, the blocker itself, and not the owners of the blocker, is subject to U.S. tax. Similarly, the character of income is also blocked because the corporate entity is simply not flowthrough for purposes of U.S. tax law. Foreign persons invested in the United States through a blocker would not be required to file a U.S. tax return.

Moreover, blockers prevent attribution of a U.S. trade or business up the chain to the fund (if the blocker is below the fund) and to the foreign investors (if the blocker is below or above the fund). Foreign investors dread the attribution of a U.S. trade or business because it could cause income that otherwise would not be taxed in the United States to be subject to U.S. taxation. Such attribution would also cause the foreign investor to be subject to U.S. tax filing obligations. Thus, a blocker eliminates both the risk of filing a U.S. tax return and the risk that a foreign investor may be deemed to be engaged in a U.S. trade or business.

The blocker tax guide (p. 695) illustrates the U.S. income tax consequences of operating and disposing of a domestic or foreign blocker under several common scenarios.[1] This guide is intended to describe, in general terms, the U.S. tax consequences of various blocker structures. It does not recommend any particular structure. The structure of any investment by a fund in the United States must be made on a case-by-case basis and depends on the specific deal facts presented. Foreign taxpayers should consult U.S. tax counsel early on in any discussions of a proposed U.S. investment.

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EditorNotes

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1 To learn more about blockers, see Mitev, *The Private Equity and Venture Capital Tax Manual* (ABA Book Publishing 2011).

Corporate Blocker Tax Guide

	Single-Purpose U.S. Blocker	Single-Purpose Foreign Blocker	Multiuse U.S. Blocker	Multiuse Foreign Blocker
Operating income	• Subject to 35% federal corporate income tax.*	• Effectively connected U.S. trade or business income subject to 35% federal corporate income tax *plus* branch profits tax (BPT) of 30% on unreinvested after-tax profits resulting in an effective tax rate of 54.5%.	• Effectively connected U.S. trade or business income subject to 35% federal corporate income tax. • Losses from some investments can offset reported income from other investments.	• Effectively connected U.S. trade or business income subject to 35% federal corporate income tax *plus* BPT of 30% on unreinvested after-tax profits, resulting in an effective tax rate of 54.5%. • Losses from some investments can offset reported income from other investments.
Nonliquidating distributions	• Subject to 30% federal withholding tax to the extent of non-U.S. ownership of fund. U.S. income tax treaties may reduce or eliminate this withholding tax. • U.S. investors in fund will treat distribution as a qualified dividend taxed at a 15% tax rate to the extent distribution is made out of current or accumulated earnings and profits.	• No withholding tax on distributions to foreign investors. For U.S. investors in fund, dividends will not be eligible for qualified dividend treatment and will be subject to ordinary income tax rates.	• Subject to 30% federal withholding tax to the extent of non-U.S. ownership of fund. U.S. income tax treaties may reduce or eliminate this withholding tax. • U.S. investors in fund will treat distribution as a qualified dividend taxed at a 15% tax rate to the extent distribution is made out of current or accumulated earnings and profits.	• No withholding tax on distributions to foreign investors. • For U.S. investors in fund, dividends will not be eligible for qualified dividend treatment and will be subject to ordinary income tax rates.
Exit by sale of operating entity (by sale of partnership interests, membership interests, or assets)	• Gain will be subject to 35% federal corporate tax. • If blocker is liquidated following sale, no additional corporate-level tax will generally result, and there will be no withholding tax on liquidating distributions to foreign investors. However, if the blocker is a U.S. real property holding corporation, even a liquidating distribution may be subject to withholding. U.S. investors in fund will realize capital gain on liquidating distributions. • Buyer achieves step-up in basis.	• Gain on the sale of a U.S. operating entity will be subject to 35% federal corporate tax. • If blocker is liquidated immediately following sale and liquidation proceeds are not reinvested by the fund in other related U.S. operating businesses, there should be no BPT tax.† • U.S. investors in fund will realize capital gain on liquidating distributions, and there will be no withholding tax on liquidating distributions to foreign investors. • Buyer achieves step-up in basis.	• Gain will be subject to 35% federal corporate tax. • Because of other investments, blocker cannot be liquidated; distributions to the fund's foreign investors will be subject to a 30% withholding tax. U.S. income tax treaties may reduce or eliminate this withholding tax. • U.S. investor will treat distribution as a qualified dividend. • Buyer achieves step-up in basis.	• Gain will be subject to 35% *plus* BPT, resulting in overall 54.5% tax on gain. • Because of other investments, blocker cannot be liquidated. As a result, U.S. investors in fund will not be eligible for qualified dividend treatment, and distributions will be subject to ordinary income tax rates. • No withholding tax on distributions to foreign investors. • Buyer achieves step-up in basis.

	Single-Purpose U.S. Blocker	Single-Purpose Foreign Blocker	Multiuse U.S. Blocker	Multiuse Foreign Blocker
Exit by converting operating entity to U.S. corporation and selling operating entity stock	• Gain will be subject to 35% federal corporate tax at blocker level. • If blocker is liquidated following sale, no additional corporate-level tax will generally result, and there will be no withholding tax on liquidating distributions to foreign investors. However, if the blocker is a U.S. real property holding corporation, even a liquidating distribution may be subject to withholding. U.S. investors in fund will realize capital gain on liquidating distributions. • No step-up in basis for buyer.	• No tax at blocker level. • U.S. investors in fund will realize capital gain on liquidating distributions from blocker; no withholding tax on distributions to foreign investors. • No step-up in basis for buyer.	• Gain will be subject to 35% federal corporate tax at blocker level. • Because of other investments, blocker cannot be liquidated; distributions to the fund's foreign investors will be subject to 30% withholding tax. U.S. income tax treaties may reduce or eliminate this withholding tax. • U.S. investor will treat distribution as a qualified dividend. • No step-up in basis for buyer.	• No tax at blocker level. • Because of other investments, blocker cannot be liquidated. As a result, U.S. investors in fund will not be eligible for qualified dividend treatment, and distributions will be subject to ordinary income tax rates. • No withholding tax on distributions to foreign investors. • No step-up in basis for buyer.
Exit by converting operating entity to U.S. corporation and selling assets or selling stock with a Sec. 338(h)(10) election when blocker owns at least 80% of operating entity	• A sale of assets or the sale of stock with a Sec. 338(h)(10) election will result in tax on the gain at the operating entity level at a 35% tax rate (in the case of sale of assets) or at the blocker level at a 35% tax rate (in the case of a Sec. 338(h)(10) election if the operating entity is a member of the blocker's consolidated group). The liquidation of the operating entity following the sale, or deemed liquidation in a Sec. 338(h)(10) election, will result in no further corporate-level tax on the operating entity. • No tax on blocker when operating entity makes liquidating distributions to blocker. • If blocker is liquidated following sale, no withholding tax on liquidating distributions to foreign investors. However, if the blocker is a U.S. real property holding corporation, even a liquidating distribution may be subject to withholding. U.S. investors in fund will realize capital gain on liquidation. • Buyer achieves step-up in basis.	• A sale of assets will result in tax on the gain at the operating entity level at a 35% tax rate. The liquidation of the operating entity following the sale will generally result in no further corporate-level tax on the operating entity. • A Sec. 338(h)(10) election is not available unless the operating entity is otherwise includible in the consolidated return group for U.S. tax purposes. • No tax on blocker when the operating entity makes liquidating distributions to blocker. • U.S. investors in fund will realize capital gain on liquidating distributions from blocker; no withholding tax on liquidating distributions to foreign investors. • Buyer achieves step-up in basis.	• A sale of assets or the sale of stock with a Sec. 338(h)(10) election will result in tax on the gain at the operating entity level at a 35% tax rate (in the case of sale of assets) or at the blocker level at a 35% tax rate (in the case of a Sec. 338(h)(10) election if the operating entity is a member of the blocker's consolidated group). The liquidation of the operating entity following the sale, or deemed liquidation in a Sec. 338(h)(10) election, will result in no further corporate-level tax on the operating entity. • No tax on blocker when operating entity makes liquidating distributions to blocker. • Because of other investments, blocker cannot be liquidated; distributions to the fund's foreign investors will be subject to 30% withholding tax. • U.S. investor will treat distribution as a qualified dividend. • Buyer achieves step-up in basis.	• A sale of assets will result in tax on the gain only at the operating entity level at a 35% tax rate. The liquidation of the operating entity following the sale will generally result in no further corporate-level tax on operating entity. • A Sec. 338(h)(10) election is not available unless the operating entity is otherwise includible in the consolidated return group for U.S. tax purposes. • No tax on blocker when operating entity makes liquidating distributions to blocker. • Because of other investments, blocker cannot be liquidated. U.S. investors in fund will not be eligible for qualified dividend treatment, and distributions will be subject to ordinary income tax rates. No withholding tax on distributions to foreign investors. • Buyer achieves step-up in basis.

	Single-Purpose U.S. Blocker	Single-Purpose Foreign Blocker	Multiuse U.S. Blocker	Multiuse Foreign Blocker
Exit by converting operating entity to U.S. corporation and selling assets when blocker owns less than 80% of operating entity	• A sale of assets will result in tax on the gain at the operating entity level at a 35% tax rate. A liquidation of the operating entity following the sale will generally result in no further corporate-level tax on the operating entity. • The blocker would be subject to a 35% tax rate on the gain from the liquidation of the operating entity. Alternatively, if the sale proceeds may be distributed as a dividend from the operating entity to the blocker, the dividends-received deduction may reduce the effective tax rate to 7% if the blocker is a 20% or more shareholder or to 10.5% if it is a less than 20% shareholder. • If blocker is liquidated following sale, no withholding tax on liquidating distributions to foreign investors. However, if the blocker is a U.S. real property holding corporation, even a liquidating distribution may be subject to withholding. U.S. investors in fund will realize capital gain on liquidating distributions. • Buyer achieves step-up in basis.	Same as above.	• A sale of assets will result in tax on the gain at the operating entity level at a 35% tax rate. A liquidation of the operating entity following the sale will generally result in no further corporate-level tax on the operating entity. • The blocker would be subject to a 35% tax rate on the gain from the liquidation of the operating entity. Alternatively, if the sale proceeds may be distributed as a dividend from the operating entity to the blocker, the dividends-received deduction may reduce the effective tax rate to 7% if the blocker is a 20% or more shareholder or to 10.5% if it is a less than 20% shareholder. • Because of other investments, blocker cannot be liquidated; distributions to the fund's foreign investors will be subject to 30% withholding tax. • U.S. investor will treat distribution as a qualified dividend. • Buyer achieves step-up in basis.	Same as above.
Exit by sale of blocker	• No tax at blocker level. • U.S. investors in fund will realize capital gain. • No step-up in basis for buyer.	• No tax at blocker level. • U.S. investors in fund will realize capital gain. • No step-up in basis for buyer.	• Not possible because of other investments in blocker.	• Not possible because of other investments in blocker.

* U.S. corporate income tax rates generally vary between 15% and 35%. For the sake of simplicity, the maximum rate of 35% is used throughout this chart.

† There is some tax risk that BPT could be assessed. A particular deal's facts and circumstances will have to be analyzed.