NOTICE 2015-54 ON REALLOCATION TO FOREIGN PARTNERS – THE BEGINNING OF THE END?

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Tags
Allocation
Contribution
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The I.R.S. announced in Notice 2015-54, 2015-34 IRB 210 (8/06/2015) that it intends to issue regulations that would change the nonrecognition rules on certain property contributions to partnerships and L.L.C.'s with foreign partners. The new regulations, generally effective for transfers occurring on or after August 6, 2015, would require that income or gain attributable to property be taken into account by the U.S. transferor either immediately or periodically. Regulations would also be issued under §§482 and 6662 of the Internal Revenue Code (the "Code") that apply to controlled transactions involving partnerships to ensure appropriate valuation of such transactions.

BACKGROUND

Since enactment of the Taxpayer Relief Act of 1997 (the "1997 Act"), transfers to foreign partnerships generally do not attract U.S. tax, although there are information reporting obligations.[1] Regulatory authority was granted to override the partnership nonrecognition provisions in Code §721. The latter relates to gain realized on the transfer of property to a partnership (domestic or foreign) if the gain, when recognized, would be includible in the gross income of a person other than a U.S. person. Additionally, the 1997 Act gave regulatory authority to apply the rules of §367(d)(2) to "outbound" transfers of intangible property to partnerships. Such regulations have never been issued.

CURRENT LAW

Code §367 prevents U.S. persons from avoiding U.S. tax by transferring appreciated property to foreign corporations using nonrecognition transactions. Section 367(d) treats a U.S. person that transfers intangible property to a foreign corporation as having sold such property in exchange for payments that are contingent upon the productivity, use, or disposition of such property, and receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property, or, in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. Because Code §367 only applies to the transfer of property to a foreign corporation, absent regulations, a U.S. person generally does not recognize gain on the contribution of appreciated property to a partnership with foreign partners.

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1 See, *e.g.*, Code §§6038, 6038B, and 6049A.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, §704(c)(1)(A) requires partnerships to allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership, so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. This prevents shifting of tax consequences among partners with respect to pre-contribution gain or loss. The Treasury regulations[2] describe three methods of allocation to effect this result, including the "remedial" allocation method under which a partnership may eliminate distortions caused by the so-called ceiling rule,[3] which prevents allocations of gain, loss, and deduction in excess of the total partnership tax gain, loss, or deduction. This is accomplished by making remedial allocations of income, gain, loss, or deduction to the non-contributing partners equal to the full amount of the limitation caused by the ceiling rule and offsetting those allocations with remedial allocations of income, gain, loss, or deduction to the contributing partner.

REASONS FOR CHANGE

Under the current rules, some taxpayers subject to U.S. Federal income tax have been able to contribute property to a partnership, with the partnership allocating the income or gain from the contributed property to related foreign partners that are not subject to U.S. tax. In effect, such re-allocation allows appreciation of certain types of property to escape U.S. taxation. In such scenarios, many taxpayers choose a §704(c) method of allocation other than the remedial method and/or use valuation techniques that are inconsistent with the arm's length standard. By way of example, a partnership agreement might provide a domestic partner with a fixed preferred interest in exchange for the contribution of an intangible that is assigned a value that is inappropriately low, while specifically allocating a greater share of the income from the intangible to a related foreign partner.

Remedial allocations can have the effect, in part, of ensuring that pre-contribution gain from contributed property is properly taken into account by the contributing partner. Allocating gain, income, loss, and deduction associated with the contributed property in a consistent manner, with respect to the contributing partner and any related foreign partner, can help to ensure that (i) the built-in gain associated with contributed property is properly taken into account by the contributing partner and (ii) income is not inappropriately separated from related deductions.

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[2] Treas. Reg. §1.704-3.

[3] See Treas. Reg. §1.704-3(b)(1). The other methods are the "traditional" method (which most favors the contributing partner) and the "curative allocation" method (which most favors the non-contributing partner). The remedial allocation method benefits the contributing partner by permitting greater depreciation deductions in earlier years and is a disadvantage to the non-contributing partner because of lesser depreciation over a longer period of time; it falls somewhere in between the other two methods.

Under these circumstances, the Treasury regulations will continue to allow tax-free contributions of appreciated property to partnerships[4] but only if the conditions described in §4.03 of Notice 2015-54 are satisfied (the "Gain Deferral Method"), as follows:

1. The remedial allocation method is adopted for Built-in Gain[5] with respect to all §721(c) Property[6] contributed to the §721(c) Partnership[7] pursuant to the same plan by a U.S. Transferor and all other U.S. Transferors that are Related Persons.

2. During any taxable year in which there is remaining Built-In Gain with respect to an item of §721(c) Property, the §721(c) Partnership allocates all items income, gain, loss, and deduction under Code §704(b) with respect to that property §721(c) Property in the same proportion. For example, if income with respect to an item of §721(c) Property is allocated 60% to the U.S Transferor and 40% to a Related Foreign Person in a taxable year, then gain, deduction, and loss with respect to that §721(c) Property must also be allocated 60% to the U.S. Transferor and 40% to the Related Foreign Person.

3. New reporting requirements (described in §4.06 of Notice 2015-54) are satisfied. The I.R.S. intends to modify Schedule O, Transfer of Property to a Foreign Partnership, of Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, or its instructions, for taxable years beginning in 2015 to require supplemental information for contributions of §721(c) Property to §721(c) Partnerships. New regulations describing additional reporting requirements for a U.S. Transferor for each taxable year in which the

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[4] The regulations also will apply to transactions involving tiered partnerships.

[5] Built-in Gain is the value of the property for book purposes over the contributing partner's adjusted tax basis in the property at the time of the contribution (and does not include gain created when a partnership revalues partnership property).

[6] Section 721(c) Property is property with Built-in Gain, excluding (i) cash equivalents, (ii) any asset that is a security within the meaning of Code §475(c)(2), without regard to Code §475(c)(4), and (iii) any item of tangible property with Built-in Gain that does not exceed $20,000. In addition, under a *de minimis* rule, Code §721(a) will continue to provide non-recognition treatment for contributions of property with built-in gain if (i) the built-in gain in all §721(c) Properties contributed in the same year by a U.S. partner (or a group of related U.S. partners) does not exceed $1 million, and (i) the partnership is not otherwise applying the Gain Deferral Method with respect to a prior contribution by such U.S. partner (or a group of related U.S. partners).

[7] A partnership (domestic or foreign) is a §721(c) Partnership if a U.S. Transferor contributes appreciated property to the partnership, and, after the contribution and any transactions related to the contribution, (i) a Related Foreign Person is a direct or indirect partner in the partnership, and (ii) the U.S. Transferor and one or more Related Persons own more than fifty percent of the interests in partnership capital, profits, deductions or losses. A U.S. Transferor is a United States person within the meaning of Code §7701(a)(30) (U.S. person), other than a domestic partnership. A Related Person is a person that is related (within the meaning of §§267(b) or 707(b)(1) to a U.S. Transferor. A Related Foreign Person is a Related Person (other than a partnership) that is not a U.S. person.

Gain Deferral Method applies will be issued. Furthermore, such regulations will provide that, as an additional requirement for applying the Gain Deferral Method, a U.S. Transferor, and in certain cases a §721(c) Partnership must extend the limitations period for assessment of tax with respect to all items related to the §721(c) Property contributed to the §721(c) Partnership through the close of the eighth full taxable year following the taxable year of the contribution.

4. The U.S. Transferor recognizes Built-in Gain with respect to any item of §721(c) Property upon an Acceleration Event[8] (described in §4.05 of Notice 2015-54) as if the partnership had sold the item of §721(c) Property immediately before the Acceleration Event for its fair market value.

5. The Gain Deferral Method is adopted for all §721(c) Property subsequently contributed to the §721(c) Partnership by the U.S. Transferor and all other U.S. Transferors that are Related Persons until the earlier of (i) the date that no Built-in Gain remains with respect to any §721(c) Property to which the Gain Deferral Method first applied, or (ii) the date that is 60 months after the date of the initial contribution of §721(c) Property to which the Gain Deferral Method first applied.

ANTI-ABUSE RULE

If a U.S. Transferor engages in a transaction (or series of transactions) with a principal purpose of avoiding the application of the regulations, the transaction (or series of transactions) may be disregarded or the arrangement may be recharacterized (which may include disregarding an intermediate entity) in accordance with its substance.

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[8] An Acceleration Event is any transaction that would either (i) reduce the amount of remaining Built-in Gain that a U.S. Transferor would recognize under the Gain Deferral Method if the transaction had not occurred or (ii) defer the recognition of the Built-in Gain. Furthermore, an Acceleration Event is deemed to occur with respect to all §721(c) Property of a §721(c) Partnership for the taxable year of the §721(c) Partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method. However, an Acceleration Event will not occur if (i) a U.S. Transferor transfers an interest in a §721(c) Partnership to a domestic corporation in a tax-free transaction to which either Code §§351(a) or 381(a) applies, or (ii) a §721(c) Partnership transfers an interest in a lower-tier partnership that owns §721(c) Property to a domestic corporation in a transaction to which Code §351(a) applies, provided that in both cases the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor. An Acceleration Event will not occur if a §721(c) Partnership transfers §721(c) Property to a domestic corporation in a transaction to which §351(a) applies. If a §721(c) Partnership transfers §721(c) Property (or an interest in a partnership that owns §721(c) Property) to a foreign corporation in a transaction described in §351(a), an Acceleration Event will not occur to the extent the §721(c) Property is treated as being transferred by a U.S. person (other than a domestic partnership) pursuant to Treas. Reg. §§1.367(a)-1T(c)(3)(i) or (ii). The stock in a transferee corporation received by a §721(c) Partnership in a transaction described in this §4.05(4) will not be subject to the Gain Deferral Method.

RULES REGARDING CONTROLLED TRANSACTIONS INVOLVING PARTNERSHIPS

Regulations will be issued regarding the application of certain rules to controlled transactions involving partnerships. These include rules currently applicable to cost sharing arrangements and, in particular, the application of specified methods for such controlled transactions as appropriately adjusted in light of the differences in the facts and circumstances between such partnerships and cost sharing arrangements.[9]

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The Treasury Department and the I.R.S. also are considering issuing regulations under Treas. Reg. §1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. These regulations may require, for example, documentation of projected returns for property contributed to a partnership (as well as attributable to related controlled transactions) and of projected partnership allocations, including projected remedial allocations for a specified number of years.

BOTTOM LINE

Notice 2015-54 is very clear on the I.R.S.'s intention to shut down certain schemes to avoid U.S. taxation through what some may have considered a loop-hole under applicable partnership rules, *i.e.*, by means of re-allocation measures in the context of a partnership with foreign partners. In this respect, a partnership arrangement should not allow for more beneficial tax structuring than a corporate scenario. While certain exceptions to such anti-avoidance rules will exist under Notice 2015-54, it will most likely put an end to some arrangements that may have worked in the past. Thus far, respective Treasury regulations have not been issued. However, taxpayers are advised to consult with tax counsel before entering into contribution of property agreements and to closely monitor developments in this respect.

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[9] Treas. Reg. §1.482-7(g).