PARTNERSHIP TAX TRAPS AND RECENT GUIDANCE

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TRANSFERS OF PROPERTY TO FOREIGN PARTNERSHIPS – GUIDANCE EXPECTED SOON

The I.R.S. has come under pressure from practitioners demanding it relax proposed guidance regarding a contribution of property to a partnership that has foreign partners related to the contributing partner. In Notice 2015-54, issued last year, the I.R.S. stated a contribution of property with built-in gain to a partnership with related foreign partners may be taxable *unless* the partnership uses the remedial method of allocating depreciation deductions to the noncontributing partners.[1] The I.R.S. has indicated that guidance will presumably come in the form of temporary and proposed regulations that could be released in the first half of 2016.

Background

Property can generally be contributed by a partner to a partnership without recognition of gain or loss.[2] In that case, the partnership gets a carryover tax basis for the property equal to the tax basis the contributing partner had for the property.[3] As compared to the partnership getting a tax basis in the property equal to its fair market value or book value on the date of contribution, that carryover basis means that the unrealized gain is, in effect, deferred and may be recognized when the partnership later sells the property.

In the case of the contribution of property to a partnership where the partnership gets a carryover tax basis in the property, Code §704(c) and the regulations issued thereunder require the partnership to make certain special allocations of taxable income and loss at the partnership level to account for the tax differences that result from the partnership receiving a contribution of property with built-in gain. Under Code §704(c), if non-depreciable property (such as land) is contributed to a partnership with a built in gain (*i.e.*, the fair market value is greater than its tax basis), then when the property is later sold by the partnership, the built-in gain in the property is specially allocated to the contributing partner.

If depreciable property is contributed to the partnership with a built-in gain, then the §704(c) regulations require the partnership to choose one of three methods, whose goal is to specially allocate depreciation deductions each year to the non-contributing partners so as to put them in the same position they would be in if the contribution was a taxable event and the partnership would have had a stepped up tax basis in the contributed property equal to its fair market value or book value. The three

1 See Beate Erwin and Nina Krauthamer, "Notice 2015-54 On Reallocation To Foreign Partners – The Beginning Of The End?," *Insights* 8 (2015).

2 Code §721(a).

3 Code §723.

methods are (i) the traditional method, which is generally most favorable to the contributing partner; (ii) the traditional method with curative allocations; and (iii) the remedial method, which is generally most favorable to the non-contributing partners.[4]

The traditional method specially allocates the actual depreciation deductions claimed by the partnership for the contributed property to all the non-contributing partners so as to give them the same depreciation deductions they would have obtained if the tax basis of the contributed property was equal to its fair market value.[5] However, this rule is limited by the actual depreciation available for the contributed property. As a result, there may be a shortfall in depreciation deductions that can be allocated to the non-contributing partners to make them whole.

The remedial allocation method starts with the traditional method. If that method does not make the non-contributing partners whole since there are not enough actual depreciation deductions to specially allocate to the non-contributing partners, the remedial method creates (i) "notional" depreciation deductions to allocate to the non-contributing partners to make up the shortfall and (ii) a matching amount of "notional" income to allocate to the contributing partner.[6] These two notional amounts offset one another so that the aggregate income or loss of the partnership is not actually changed. However, under the remedial method, the non-contributing partners are made whole while the contributing partner bears the burden of recognizing added taxable income.

"The Notice indicated that the rules, when adopted, would have a retroactive effective date so as to be applicable to transfers made on or after August 6, 2015."

Special Rule for Contributions to Foreign Partnerships

In 1997, Congress enacted Code §721(c), which gives the Treasury Department the power to write regulations providing that when a U.S. person transfers certain property to a partnership that has related foreign partners, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The purpose behind Code §721(c) is to make sure that income that may be taxed in the hands of a U.S. person is not shifted to a non-U.S. related person through the use of a foreign partnership so that U.S. tax may be eliminated.

Last year, the I.R.S. issued Notice 2015-54 (the "Notice"), which stated that the I.R.S. will issue regulations requiring gain to be recognized when appreciated property is contributed to a foreign partnership with related foreign partners unless the partnership elects to use the Gain Deferral Method, which requires (i) the use of the remedial allocation method under Code §704(c); (ii) compliance with the proportionate allocation rule, which makes sure that any other items of income, gain, loss, or deduction with respect to the contributed property are allocated in the same manner; and (iii) compliance with certain reporting requirements.[7] The Notice indicated that the rules, when adopted, would have a retroactive effective date so as to be applicable to transfers made on or after August 6, 2015.[8]

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4 Treas. Reg. §§1.704-3(b), (c), & (d).

5 *Id.*, 3(b).

6 *Id.*, 3(d).

7 Notice 2015-64, §4.03.

8 *Id.*, §6.

TRANSFERS OF PROPERTY TO FOREIGN PARTNERSHIPS – A.B.A. COMMENTS RELATING TO §482

Code §482 provides that the Secretary may make allocations between or among two or more organizations, trades, or businesses that are owned or controlled by the same interests in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. Treasury Regulation §1.482-7 provides methods to be used to evaluate whether a cost sharing arrangement produces results consistent with an arm's length result.

The Notice discussed above indicates that the I.R.S. will also issue guidance under Code §482 to deal with contributions of property to a partnership that has foreign partners who are related to the contributing partner.[9] The Notice indicated that regulations will be issued regarding the application to controlled transactions involving partnerships under the rules set forth in Treasury Regulation §1.482-7, which are currently applicable to cost sharing arrangements.

In comments submitted to the I.R.S., practitioners have urged the I.R.S. to clearly state whether the I.R.S. position primarily addresses (i) traditional transfer pricing issues, including valuation and allocations of partnership income or (ii) application of Code §482 to override non-recognition provisions of the Code. Concern has been expressed that it is unclear whether the cost sharing regulations would be particularly useful in the partnership area without substantial modifications.

U.S. PARTNERSHIP FOREIGN TAX ALLOCATION REGULATIONS UPDATED

A partnership's allocation of taxable income, gain, loss, and deductions among its partners must have substantial economic effect under Code §704(b). Extensive regulations have been written to implement the substantial economic effect requirements.[10] If substantial economic effect is lacking, then the I.R.S. has the power under Code §704(b) to reallocate the item among the partners based on the partners interest in the partnership.[11]

In 2006, the I.R.S. issued regulations under Code §704(b) addressing the allocation by partnerships of "creditable foreign tax expenditures,"[12] which are are foreign taxes paid or accrued by a partnership under Code §901(a).[13] The regulations provide that allocations of creditable foreign tax expenditures do not have substantial economic effect, and accordingly, a creditable foreign tax expenditure must be allocated in accordance with the partner's interest in the partnership.[14] The regulations provide a safe harbor under which creditable foreign tax expenditure allocations are

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9 *Id.*, §5.

10 Treas. Reg. §1.704-1.

11 *Id.*, 1(b)(3).

12 *Id.*, 1(b)(4)(viii).

13 *Id.*, 1(b)(4)(viii)(b).

14 *Id.*, 1(b)(4)(viii)(a).

deemed to be in accordance with a partner's interest in the partnership. This safe harbor requires the partnership to first determine the different categories of creditable foreign tax expenditures that a partnership has; second, it must determine the partnership's net income to which each creditable foreign tax expenditure category applies; and third, it must allocate the partnership's creditable foreign tax expenditures for each category in the same way as the related net income is allocated.[15]

"The revisions add further guidance and will improve the operation of the existing safe harbor that is used to determine if allocations of creditable foreign tax expenditures are in accordance with a partner's interest in the partnership."

In February, the I.R.S. updated parts of the creditable foreign tax expenditure regulations when it issued new Temporary Regulations.[16] The revisions add further guidance and will improve the operation of the existing safe harbor that is used to determine if allocations of creditable foreign tax expenditures are in accordance with a partner's interest in the partnership.[17] These new rules are generally effective for taxable years that begin on or after January 1, 2016.[18]

One clarification was made to address what happens if a partner ("Selling Partner") sells its interest in the partnership to another person ("Buying Partner") and the partnership has, in effect, an election under Code §754. If such election is made and the partnership holds appreciated property, then such election will serve to increase the "inside basis" of partnership assets allocable to the Buying Partner to match the purchase price for the partnership interest paid to the Selling Partner.[19] This election only affects the Buying Partner and serves to generate (i) added depreciation deductions from the partnership or (ii) decreased gain (or a loss) on the sale of partnership assets.[20] The I.R.S. clarified that this election should not be considered in allocating creditable foreign tax expenditures since it is unique to the Buying Partner.[21]

Another set of changes tries to stop taxpayers from attempting to use payments to disregarded entities that are subject to foreign withholding taxes in order to circumvent the rules. In these cases, taxpayers have taken the position that withholding taxes assessed on the first payment in a series of back-to-back payments to disregarded entities are not apportioned among the creditable foreign tax expenditure categories that include the income out of which the payments are made.[22] The revised rules include examples that clarify that the withholding taxes must be apportioned among the creditable foreign tax expenditure categories that include the related income.[23]

WITHHOLDING BY PARTNERSHIPS WITH FOREIGN PARTNERS

On January 19, 2016, the I.R.S. updated its online guidance "Helpful Hints for

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15 *Id.*, 1(b)(4)(viii)(d).

16 *E.g.*, Treas. Reg. §§1.704-1T(b)(4)(viii)(c), (d).

17 T.D. 9748 (February 4, 2016).

18 *Id.*, §V.

19 Code §743 provides for these adjustments.

20 T.D. 9748, §I.

21 Treas. Reg. §1.704-1T(b)(4)(viii)(c)(3)(i).

22 T.D. 9748, §III.

23 Treas. Reg. §1.704-1T(b)(5), Exs. 36 & 37.

Partnerships with Foreign Partners." The update noted how a partnership with foreign partners that sells U.S. real estate may appear to be caught by two separate withholding regimes: Code §1445 requires a partnership to withhold U.S. tax on a foreign partner's allocable share of gain from the sale of real estate under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A") and Code §1446 requires a partnership to withhold U.S. tax on a foreign partner's allocable share of income that is effectively connected with a U.S. trade or business. In this case, the I.R.S. said the partnership should comply only with Code §1446.

CONCLUSION: USE WITH CAUTION

Partnerships (including limited liability companies) offer great flexibility in reducing or eliminating tax both domestically and in the international context. Partnerships can eliminate concerns about controlled foreign corporation or passive foreign investment company status as well as allow for the creditability of foreign taxes. However, as the discussion above shows, partnerships are also very complicated to use, and that complexity is increasing as the I.R.S. tries to clamp down on uses that it sees as inappropriate. As a result, while beneficial use of partnerships still continues, greater care is needed so as to not succumb to any tax traps.