PROPERTY CONTRIBUTIONS TO PARTNERSHIPS WITH RELATED FOREIGN PARTNERS

Authors
Philip R. Hirschfeld
Nina Krauthamer

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INTRODUCTION

One of the tax advantages of a partnership is the ability of *any* partner to contribute "appreciated property"[1] to a partnership in a tax-free manner under Code §721(a).[2] In this case, there is a "built-in gain" for the property – equal to the excess of the property's fair market value ("F.M.V.") over its tax basis – which is not recognized under §721(a).[3] The I.R.S. has been concerned that transfers of appreciated property by a U.S. person to a partnership that has foreign partners related to the contributing partner ("related foreign partners") may be used as a way to avoid U.S. taxes.

Last year, the I.R.S. issued Notice 2015-54, which indicated that the I.R.S. intends to issue regulations that will override the §721 nonrecognition rule and treat the contribution as a taxable event unless the partnership adopts a set of requirements (the "Gain Deferral Method"), whose purpose is to insure that U.S. tax will not be avoided.

On May 23, 2016, the Section of Taxation of the American Bar Association submitted comments on the notice ("A.B.A. Report"). While generally agreeing with the approach taken in the notice, the A.B.A. Report recommends clarification on many of the mechanics of the Gain Deferral Method, including how it interacts with the Code §197 anti-churning rules and how it affects the allocation of creditable foreign taxes.

BACKGROUND

Nonrecognition Rules

Code §721(a) contains the general nonrecognition rule for transfers of property by a partner to a partnership. However, Code §721(c) gives the Treasury the power to issue regulations that override the general nonrecognition rule in the case of transfers of appreciated property to a partnership (whether foreign or domestic) if the gain, when recognized, would be includible in the gross income of a person other than a

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1 Appreciated property refers to property whose fair market value on date of transfer exceeds the property's tax basis. As a result, a taxable sale of this property will generate taxable gain.

2 By contrast, the Code §351 rules, which allow for transfers of appreciated property to a corporation, only apply if the transferors are in control of the corporation immediately after the transfer. Control requires the transferors to own 80% or more of the total combined voting power of the stock of the corporation and 80% or more of the total number of non-voting shares. Code §368(c).

3 The partnership gets a carryover basis for the contributed property. Code §723. As a result, taxation of the built-in gain is preserved and will occur when the partnership later sells the property.

U.S. person.[4] In addition, Code §367(d)(3)[5] gives the Treasury the power to use the rules of Code §367(d)(2), which applies to transfers of intangible property to foreign corporations. These rules may now be used for transfers of intangible property to certain foreign partnerships.

Special Allocation Rules

Code §704(c) deals with the transfer of appreciated property[6] to a partnership and how that affects the allocation of partnership income, gains, losses, and deductions among the partners. Special rules are necessary since the partnership gets a carry-over basis for the contributed property[7] and thus, the partnership inherits the built-in gain in the contributed property. This section requires that when the partnership later sells the contributed property, the built-in gain in the contributed property is specially allocated to the contributing partner.

For example, one partner ("A") contributes land with a F.M.V. of $100 and a tax basis of zero to the newly-formed partnership ("AB Partnership") and another partner ("B") contributes cash of $100. The Land has a built-in gain of $100. A and B are each 50% partners in AB Partnership. The partnership later sells the land for $300 and recognizes a $300 gain on the sale.[8] If §704(c) did not exist, A and B would each be allocated 50% of that gain, so that $150 of income would be allocated to each of them.

Section 704(c) changes this result. First, A is specially allocated $100 of the gain to match the built-in gain in the property. After this special allocation, there is $200 of gain left to allocate. This $200 gain is allocated 50% to A and 50% to B, so that A is allocated an additional $100 and B is allocated $100. In summary, A is allocated $200 of the gain and B is allocated $100 of the gain.

In this example, the contributed land is _not_ a depreciable asset. In addition, the special allocation is only made in _one_ year (*i.e.*, when the contributed property is sold). No special allocations are required for any other year.

If a *depreciable* asset is contributed to a partnership, a more complex aspect of Code §704(c) is triggered. This affects tax allocations for _every_ year, starting in the first year in which the property is contributed to the partnership. The rationale behind these added rules is that the non-contributing partner is being harmed by the contribution of property with a built-in gain, since the partnership only gets a carry over basis for the property[9] and not a basis equal to its F.M.V. As a result, there will

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[4] Code §§1491-1494 imposed an excise tax on certain transfers by U.S. persons of appreciated property to a foreign partnership, but these sections were repealed by the Taxpayer Relief Act of 1997 (the "1997 Act"). The 1997 Act then adopted Code §721(c), discussed above.

[5] Added by the 1997 Act.

[6] Section §704(c) also deals with transfers of depreciated property to a partnership that have a "built-in loss" since the tax basis exceeds the property's F.M.V. However, since this is not the focus of Notice 2015-54, this article will not address that situation.

[7] Code §723.

[8] Gain equals the amount realized ("A.R.") on the sale minus the tax basis of the property. Code §1001(a). In this example, the A.R. is the sale price of $300; the tax basis of the land is zero. As a result, the gain is $300.

[9] Code §723.

be a shortfall in depreciation deductions allowed to the partnership[10] compared to those that would have been allowed if the basis was stepped-up to F.M.V.

In the foregoing example, if A had contributed *depreciable* property with a F.M.V. of $100 and a tax basis of zero then no depreciation would be available to the partnership to allocate between A and B. By contrast, if the basis of the contributed property would equal its F.M.V., then the partnership can depreciate the property and generate annual depreciation deductions available to B, the non-contributing partner. Absent some special allocation, there is a shortfall in depreciation deductions allocated to these partners.

"To specially allocate income, gains, losses, and deductions . . . Notice 2015-54 requires the remedial method be used to avoid income recognition."

To remedy this situation, the §704(c) regulations require the partnership to choose one of three methods to specially allocate income, gains, losses, and deductions among the partners each year: (i) the traditional method; (ii) the traditional method with curative allocations; and (iii) the remedial method.[11] As discussed below, Notice 2015-54 requires the remedial method be used to avoid income recognition. The following is a brief overview of these three methods and their impact on the partners.

The first two §704(c) methods specially allocate depreciation deductions to the *non-contributing* partners for the *contributed* property[12] or for *all* partnership property[13] up to an amount equal to the depreciation deductions they would have gotten if the partnership had a tax basis for the contributed property equal to its F.M.V.[14] However, in some cases, there may not be enough depreciation deductions to specially allocate.

The remedial method's goal is to make up the shortfall in depreciation deductions available to allocate to the non-contributing partner. The remedial method[15] creates a *deemed* amount of *added* depreciation deductions at the partnership level to specially allocate to the non-contributing partners to make them whole. The remedial method then creates a matching *deemed* amount of income to the contributing partner. This deemed income amount, which is called a correlative adjustment of income, is made outside the partnership.

The remedial method comes closest to the result that would happen if the partnership had acquired the property in a taxable transaction and had a tax basis for the contributed property equal to its F.M.V. The remedial method may not be the best choice for the contributing partner since, as noted above, it results in creation of correlative adjustments of income to the contributing partner outside the partnership. The other two §704(c) methods do not create any correlative adjustments of income outside the partnership; they only re-allocate depreciation deductions claimed by the partnership. A more detailed discussion of these §704(c) rules is not included here, but is available elsewhere.[16]

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10 Depreciation is based on the basis of the property. Code §§167, 168.

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

12 In the case of the traditional method.

13 In the case of the traditional method with curative allocations.

14 Any excess depreciation deductions can then be allocated in the normal way that allocations are made under the partnership agreement.

15 Treas. Reg. §1.704-3(d).

16 Philip Hirschfeld, "Partnership Property Contributions: The Good, The Bad and The Ugly," BNA Real Estate Journal (2016).

NOTICE 2015-54

In Notice 2015-54, the I.R.S. stated it will adopt regulations under Code §721 to address a transfer of appreciated property by a U.S. person to a "§721(c) Partnership."[17] A §721(c) Partnership is any partnership in which

- a U.S. person transfers appreciated property ("§721(c) Property");
- a related foreign person is a direct or indirect partner in that partnership; and
- the U.S. transferor and one or more related persons own more than 50% of the interests in the partnership's capital, profits, deductions, or losses.[18]

The I.R.S. said such transfers will not be eligible for Code §721's nonrecognition rule, unless the partnership adopts use of the Gain Deferral Method.[19] The most important part of the Gain Deferral Method is the requirement that the partnership adopt use of the §704(c) remedial method for making allocations of income, gains, losses, and deductions among the partners.[20]

The Gain Deferral Method also requires that

- the partnership make allocations of §704(b) income, gains, losses, and deductions with respect to the contributed built-in gain property in the same proportion;
- certain new reporting requirements are satisfied;
- the U.S. transferor recognizes the remaining built-in gain on the contributed property upon certain events that cause acceleration of the gain; and
- the Gain Deferral Method is adopted for all built-in gain property subsequently contributed to the partnership by the U.S. transferor (and all related U.S. transferors) until the earlier of
    - the date that no built-in gain remains with respect to any built-in gain property to which the Gain Deferral Method applies or
    - 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.[21]

In addition, the Notice describes certain additional guidance that will be developed, by analogy with Treas. Reg. §1.482-7T.[22]

A.B.A. REACTION

While acknowledging that the Treasury action in publishing Notice 2015-54 is

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17 Notice 2015-65, §4.

18 *Id.*, §4.01(5).

19 *Id.*, §4.02.

20 *Id.*, §4.03(1).

21 *Id.*, §4.03.

22 *Id.*, §5.01.

"generally appropriate,"[23] the A.B.A. Report commented on the need for further guidance to improve implementation of these rules.

The A.B.A. Report noted that the use of the remedial method raises a number of issues that are not addressed in the Notice, but which should be addressed in future guidance to provide clarity on the method's required application.[24]

First, concern was expressed on how the remedial method interacts with the anti-churning rules of Code §197. Code §197 was adopted in 1993 to eliminate controversy between the I.R.S. and taxpayers over whether the purchase price for goodwill, or other intangible assets, can be depreciated or amortized over time. Code §197(a) permits a taxpayer who purchases goodwill or certain other intangible property to amortize the cost of such property over a 15-year period. In order to stop taxpayers from engaging in transactions that convert pre-1993 intangibles that are not eligible for amortization deductions into §197 assets eligible for amortization, Code §197(f)(9) contains an anti-churning rule. The A.B.A. Report requested that if the anti-churning rule applies, then no adjustments should be made under the remedial method.[25]

"The A.B.A. Report noted that the use of the remedial method raises a number of issues that are not addressed in the Notice."

Second, concern was expressed as to whether the remedial method should apply to "reverse §704(c) gain" arising from revaluation events of the §721(c) Partnership. Reverse §704(c) gain arises in the following situation. When a partnership admits a new partner, the partnership may elect to revalue its assets, and increase (or "book up") or decrease (or "book down") the capital accounts of the old partners to reflect this new value.[26] A book up or book down creates a difference between the capital accounts of the partners and their shares of the inside basis of the partnership's assets. In that case, the regulations require that the partnership adopt special allocation methods that mirror those of Code §704(c), which are called reverse §704(c) allocations.[27] The A.B.A. Report said it is "unclear under the Notice" if the remedial method must be used for reverse §704(c) gain. The A.B.A. Report recommended that it not apply since application was not needed to accomplish the Treasury's goal and it would be an "administrative burden."[28]

Finally, the A.B.A. Report questioned whether allocations of remedial income and deductions under the remedial method should create separate categories under the §704(b) regulations governing a partnership's allocation of creditable foreign tax expenditures ("C.F.T.E.'s"). A partnership can allocate its paid or accrued foreign taxes (or C.F.T.E.'s) to the partners. The partners may then be able to use these foreign taxes to reduce the taxes owed. Code §704(b) requires that allocations of income, gains, losses, or deductions must have substantial economic effect ("S.E.E."). If S.E.E. is lacking, then the I.R.S. can reallocate such items among the partners based on the partners' interests in the partnership ("P.I.P.'s"). Allocations of tax credits (such as C.F.T.E.'s) cannot have S.E.E. since they do not affect the capital accounts of the partners. The §704(b) regulations contain a safe harbor for

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23 A.B.A. Report, Executive Summary.

24 *Id.*, II(A)(1).

25 *Id.*, II(A)(1)(a).

26 Treas. Reg. §1.704-1(b)(2)(iv)(f). Other events noted in regulations can also trigger a revaluation.

27 Treas. Reg. §1.704-1(b)(4)(i).

28 A.B.A. Report, II(A)(1)(b).

determining if allocations of C.F.T.E.'s are in accordance with P.I.P.[29] This safe harbor requires creating separate C.F.T.E. categories to reflect income from different activities of the partnership.

The A.B.A. Report indicated it was unclear how the remedial method will apply to C.F.T.E.'s. The A.B.A. Report recommended that future guidance specify that the §704(b) regulations "do not cause annual remedial allocations . . . to create separate C.F.T.E. categories when §704(b) income of the partnership is allocated to the partners in the same ratio."[30]

The A.B.A. Report recommended changes to the "Proportionate Allocation Requirement."[31] Partnerships often make a preferred or priority distribution of cash flow to partners (called a preferred return), which is equal to a certain percentage of capital invested by the partners. Once the preferred return is made, cash flow is distributed according to a set formula. For example, in a limited partnership, the partnership may first make a distribution to the limited partners in an amount equal to 5% of the partners' invested capital, and any excess cash flow is distributed 80% to the limited partners and 20% to the general partner. The A.B.A. asked that the Treasury confirm that a preferred return funded by net income does not violate the Proportionate Allocation Requirement.[32]

The A.B.A. recommended that future guidance clarify that yearly changes in the partners' allocation percentages with respect to §721(c) property are permissible and do not violate the Proportionate Allocation Requirement.[33] The A.B.A. also requested that the regulations confirm that guaranteed payments do not violate the Proportionate Allocation Requirement.[34]

With respect to the added reporting requirements, the A.B.A. recommended that "to the extent [that] duplicative information must be reported on Form 8865 and also on other new reporting form(s), an exception [should] be granted if the information is already reported by a taxpayer on Form 8865."[35]

Among other comments, the A.B.A. also commented on the rules applicable to subsequent contributions[36] and the rules that will accelerate the recognition of income by the contributing partner.[37] The A.B.A. was concerned about the impact of a technical termination of a partnership under Code §708(b)(1)(B)[38] and partnership conversions and recapitalizations,[39] which could trigger acceleration of gain in cases that the A.B.A. thought may not have been intended.

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29 Treas. Reg. §1.704-1(b)(4)(viii)(a)(1).

30 A.B.A. Report, II(A)(1)(c).

31 *Id.*, II(A)(2).

32 *Id.*, II(A)(2)(c).

33 *Id.*, II(A)(2)(a).

34 *Id.*, II(A)(2)(d).

35 *Id.*, II(A)(4).

36 *Id.*, II(A)(3).

37 *Id.*, II(B).

38 *Id.*, II(B)(2)(a). A technical termination occurs if here is a sale of 50% or more of the interest in partnership profits and capital within aa 12-month period.

39 *Id.*, II(B)(2)(b).

CONCLUSION

The A.B.A. Report offers some helpful guidance to the Treasury in adopting regulations based on Notice 2015-54. Those 42 pages of comments also illustrated that there is a great deal of complexity in these rules. As 2016 is an election year and the Treasury already has much work on its hands – addressing proposed regulations under Code §385 regarding characterization of related-party debt,[40] inversions,[41] and numerous other issues – the Treasury will be hard-pressed to review comments by the A.B.A. and others before adopting final regulations this year. The author hopes that the Treasury will have the time to address the issues raised in Notice 2015-54 in a meaningful way for both taxpayers and the I.R.S., even if it may result in delaying adoption of final regulations until next year.

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40 Philip Hirschfeld, "Related-Party Debt: Proposed Code Section 385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

41 Philip Hirschfeld, "Inversions Under Siege: New Treasury Regulations Issued," *Insights* 4 (2016).