SULLIVAN & CROMWELL LLP

January 30, 2017

Taxation of Contributions to Partnerships With Related Foreign Partners

IRS Issues Temporary Regulations That Accelerate Gain Recognition on Certain Contributions of "Built-In Gain" Property to Partnerships With Related Foreign Partners

SUMMARY

The IRS and Treasury Department recently issued temporary regulations (the "*Temporary Regulations*") that can affect partnership contributions if: (i) a partnership receives a contribution of "built-in gain" property from a U.S. person and (ii) the partnership has one or more foreign partners that are related to the U.S. transferor. In general, the new regulations require U.S. persons that contribute assets to such a partnership to either recognize any "built-in gain" at the time of the transfer or apply a "gain deferral method" that—among other requirements—involves having the recipient partnership use the "remedial allocation method" to allocate items of "built-in" gain, income and deduction. A requirement to use the "remedial allocation method" means that although a U.S. transferor applying the "gain deferral method" will not need to immediately recognize "built-in gain", such a transferor will often be subject to tax on the entire amount of any "built-in gain" over time.

The Temporary Regulations implement a proposal that was first outlined in Notice 2015-54 (the "*Notice*") and are generally consistent with the Notice. However, several significant changes were made by the Temporary Regulations, including the following:

- Partnerships that are less than 80%-owned by a U.S. transferor and / or related parties are excluded from the scope of the Temporary Regulations. By contrast, the Notice applied to partnerships that were more than 50%-owned by a U.S. transferor (or related parties);
- Assets that give rise to "effectively connected income" that is fully taxed by the United States are subject to special rules under the "gain deferral method" that do not require the use of "remedial allocations";
- By contrast to the approach outlined in the Notice, the Temporary Regulations allow the "gain deferral method" to be elected on a property-by-property basis (rather than on a contribution-by-contribution basis);

- The Temporary Regulations provide a new "reasonable cause" exception under which inadvertent noncompliance with certain procedural requirements of the "gain deferral method" can be waived by the IRS; and
- Deemed contributions that occur because of a mere technical termination of a partnership are generally excluded from the scope of the Temporary Regulations.

The Temporary Regulations apply to transfers occurring on or after the date when the Notice was published (*i.e.*, August 6, 2015). However, taxpayers may generally elect whether or not to apply rules in the Temporary Regulations that either are new or represent a material change from the proposal in the Notice to a contribution made before January 18. In addition to the provisions discussed above, the Notice indicates that the IRS intends to issue new transfer pricing guidance for "controlled" transactions involving partnerships, but these rules are not included in the Temporary Regulations.

The Temporary Regulations do not appear to be affected by the "regulatory freeze" memorandum issued by the new administration on January 20.

BACKGROUND

A contribution of property to a partnership in exchange for a partnership interest is normally a tax-free transaction to both the contributing partner and the recipient partnership.[1] However, Section 721(c) of the Code authorizes the IRS to issue regulations overriding this general rule in cases where gain, when recognized for tax purposes, would be allocated to a non-U.S. person.[2]

On August 6, 2015, the IRS and Treasury Department issued Notice 2015-54 (the "Notice") announcing an intention to issue regulations under Section 721(c) of the Code in response to IRS concerns that then-current law governing partnership contributions and tax allocations may have permitted taxpayers to inappropriately defer "built-in" gains. As background, existing law generally requires partnerships to specially allocate pre-contribution items of gain, loss and deduction that are recognized with respect to contributed property back to the contributing partner.[3] Therefore, for example, if a U.S. person contributes low-basis, high-value assets to a partnership, any "built-in" gain recognized by the partnership with respect to those assets is generally allocated to the U.S. transferor. However, the so-called "Section 704(c)" regulations implementing this rule describe three "generally reasonable" methods that taxpayers may use to specially allocate "built-in" tax items, two of which (the "traditional method" and the "traditional method with curative allocations") are subject to a

1 *See* Section 721(a). There are exceptions to the general recognition rule for: (i) transactions determined to be sales of property to the partnership; (ii) transactions determined to be "disguised sales" of property to the partnership, of property by the partnership to a contributing partner, or of partnership interests; (iii) transfers to the partnership of interests that are not property, but instead a lease or license; (iv) certain transfers of property to partnerships classified as "investment companies"; and (iv) certain transfers of long-term contracts to partnerships.

2 Section 721(c) was added by the Taxpayer Relief Act of 1997, and replaced an excise tax that was previously imposed on certain transfers of appreciated property by a U.S. person to a foreign partnership.

3 *See* Section 704(c).

"ceiling rule" or other provisions that limit the degree to which special allocations are required.[4] For example, if USP (a U.S. person) were to contribute land with a tax basis of $25 and a fair market value of $100 to a partnership in exchange for a 50% interest and the partnership were to subsequently sell the land for $75, the "ceiling rule" would only allow $50 of "built-in" gain to be specially allocated to USP, notwithstanding that USP would receive property worth $87.50 if the partnership were to subsequently liquidate (at a time when the partnership's other assets had not changed in value). While a third approach (the "remedial allocation method")[5] avoids this result by creating notional "remedial" allocations (*e.g.*, in the previous example, USP would have been allocated $50 in actual gain plus an additional $12.50 in "remedial" gain, while the other partners would have been allocated a $12.50 "remedial" loss), the regulations specifically provide that the IRS may not require partnerships to use the "remedial allocation method".[6]

The proposal in the Notice required U.S. contributors of "built-in gain" assets to a controlled partnership with related foreign investors to choose between: (i) immediately recognizing gain on the transfer and (ii) complying with a "gain deferral method" that, among other conditions, required covered partnerships to apply the "remedial allocation method". Because the "remedial allocation method" can create "notional" allocations in respect of depreciation and amortization deductions that are recognized for "book" purposes but not "tax" purposes (which are offset by "notional" income allocations to the contributing partner), a U.S. person that contributes high-value, low-basis depreciable or amortizable assets to a partnership using the "remedial allocation method" is generally required to—in essence—recognize any "built-in" gain over the property's cost-recovery period.[7] In addition to these rules, the Notice stated that the IRS and Treasury Department intend to issue new transfer pricing rules (under Sections 482 and 6662 of the Code) governing "controlled" transactions that involve partnerships.[8]

DISCUSSION

The Temporary Regulations generally track the structure of the IRS's Section 721(c) proposal in the Notice, but make a number of significant changes, many of which will reduce the impact of the new

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4 *See* Treas. Reg. § 1.704-3(b) (traditional method); Treas. Reg. § 1.704-3(c) (traditional method with curative allocations).

5 *See* Treas. Reg. § 1.704-3(d).

6 *See* Treas. Reg. § 1.704-3(d)(5)(ii).

7 By contrast, if the "remedial allocation method" is not used, a contribution of appreciated depreciable or amortizable property to a partnership could allow "built-in" gains to be allocated to a related foreign partner because "book" depreciation and amortization reduce "built-in gain", even if such "book" depreciation is not allocated to the contributing partner for "tax" purposes. Although such allocations to a foreign related partner are in a sense temporary because the relevant reduction in "built-in gain" does not increase a contributor's outside basis, such allocations have the potential to facilitate significant (and possibly indefinite) deferral of "built-in gain".

8 For additional background on the Notice, please see the Sullivan & Cromwell LLP publication entitled "New Restrictions on Property Transfers to Controlled Partnerships with Foreign Related Partners: Regulations to Require Current Gain Recognition on Certain Transfers of Property to Controlled Partnerships with Foreign Related Partners" (August 12, 2015).

rules. The Temporary Regulations do not include any new transfer pricing guidance, although the preamble to the Temporary Regulations indicates that the IRS and Treasury Department intend to issue transfer pricing regulations that are consistent with the transfer pricing guidance foreshadowed by the Notice in the future.

A. SCOPE OF THE TEMPORARY REGULATIONS

In general, the Temporary Regulations apply to transfers (including deemed transfers) of certain "built-in gain" assets (which the Temporary Regulations refer to as "Section 721(c) property") by a U.S. person (other than a domestic partnership) to a domestic or foreign partnership. A partnership will be within the scope of the new rules (and therefore will be what the Temporary Regulations refer to as a "Section 721(c) partnership") if: (i) at least 80% of the capital, profits, deductions or losses of the partnership are owned by a U.S. transferor or a related person and (ii) a "related foreign person"[9] to the U.S. transferor is a direct or indirect partner. The use of an 80% ownership threshold in this definition represents a departure from the approach outlined in the Notice, which would have applied Section 721(c) in cases where a partnership is more than 50%-owned by a U.S. transferor (or a related party).

"Section 721(c) property" is generally defined as any "built-in gain" property that is contributed by a U.S. person to a partnership, other than certain "excluded property".[10] Because "excluded property" includes cash equivalents, stock in a corporation, debt obligations and other financial instruments that are considered "securities" under the mark-to-market rules, the Temporary Regulations apply primarily to contributions of depreciable or amortizable assets such as intangibles, depreciable real estate and equipment, as well as non-depreciable property such as land.

An interest in a partnership can be "Section 721(c) property", and under a look-through rule, a lower-tier partnership can become a "Section 721(c) partnership" if an upper-tier partnership has a U.S. partner and the lower-tier partnership would have been a "Section 721(c) partnership" had the U.S. partner contributed its share of any property transferred by the upper-tier partnership.[11] However, the Temporary Regulations provide (in a new rule that was added to the Temporary Regulations in response to public comments) that an interest in a partnership is treated as "excluded property" if 90% or more of that partnership's assets consist of "excluded property".[12] The Temporary Regulations also include a *de minimis* rule, under which tangible (but not intangible) property with $20,000 or less of built-in gain at the time of contribution is treated as "excluded property".[13] Property that gives rise to

9 Whether a foreign person is "related" to a U.S. transferor is determined under Sections 267(b) and 707(b) of the Code. *See* Treas. Reg. § 1.721(c)-1T(b)(12). Very generally, these provisions treat two parties as "related" if: (i) one party directly or constructively owns more than 50% of the other party, (ii) more than 50% of both parties is directly or constructively owned by the same persons or (iii) certain family or fiduciary relationships exist between both parties.

10 *See* Treas. Reg. § 1.721(c)-1T(b)(15).

11 *See* Treas. Reg. § 1.721(c)-2T(d).

12 *See* Treas. Reg. § 1.721(c)-1T(b)(6)(iv).

13 *See* Treas. Reg. § 1.721(c)-1T(b)(6)(iii).

"effectively connected income" (*i.e.*, income subject to U.S. tax; such property, "*ECI Property*") is not excluded from the definition of "Section 721 property". However, as discussed further below, the "gain deferral method" has been modified to allow ECI Property to be contributed to a partnership without requiring the use of the "remedial method".

Under a further *de minimis* rule, Section 721(c) does not apply to a partnership if the sum of all built-in gain with respect to "Section 721(c) property" received during a taxable year is less than $1 million.[14] Additionally, although as noted above, deemed contributions to a partnership are generally within the scope of Section 721(c), the Temporary Regulations include a new exception for deemed transfers that occur as a result of a "technical termination" of a partnership.[15]

B. GAIN DEFERRAL METHOD

Under a default rule, contributions within the scope of the Temporary Regulations are treated as taxable transactions. However, in lieu of immediately recognizing gain, the Temporary Regulations allow taxpayers to elect a "gain deferral method" under which "built-in gain" is recognized over time. By contrast to the approach taken by the Notice, the Temporary Regulations allow the "gain deferral method" to be elected on an asset-by-asset basis (rather than a contribution-by-contribution basis). Under the Temporary Regulations, the "gain deferral method" will apply only if the following requirements are met:[16]

- Either:
    - Both: (i) the "Section 721(c) partnership" adopts the "remedial allocation method"[17] (discussed above) with respect to the "Section 721(c) property"; and (ii) during any taxable year in which there is remaining built-in gain with respect to the "Section 721(c) property", the "Section 721(c) partnership" generally[18] allocates all "book" items of income, gain, loss, and deduction with respect to that "Section 721(c) property" to the U.S. transferor in the same percentage; or
    - The relevant "Section 721(c) property" is ECI Property and until the date on which there is no remaining built-in gain with respect to that property, income or gain allocated to any direct or indirect partners that are "related foreign persons" with respect to the U.S.

[14] *See* Treas. Reg. § 1.721(c)-2T(c).

[15] *See* Treas. Reg. § 1.721(c)-2T(d)(2). Notwithstanding the above, an anti-abuse rule may apply to transactions and arrangements engaged in with a principal purpose of avoiding the Temporary Regulations. *See* Treas. Reg. § 1.721(c)-1T(d).

[16] *See* Treas. Reg. § 1.721(c)-3T(b).

[17] Special rules (which were added by the Temporary Regulations) modify the "remedial allocation method" for intangibles subject to the "anti-churning" rules of Section 197(f)(2) that are contributed to a "Section 721(c) partnership".

[18] The Temporary Regulations include several exceptions to the general "consistent allocation" rule, which were added in response to public comments. For example, the Temporary Regulations provide that regulatory allocations (which include allocations made to comply with the "qualified income offset" and "minimum gain chargeback" rules, but do not include allocations of nonrecourse deductions) of income to (or deduction away from) a U.S. transferor are deemed to satisfy the "consistent allocation" requirement. *See* Treas. Reg. § 1.721(c)-3T(c)(4).

transferor will be taxed as "effectively connected income" and without relief under a tax treaty;[19]

- Upon an "acceleration event" (discussed below) with respect to an item of "Section 721(c) property", the U.S. transferor recognizes the required amount of gain (which will generally be equal to any remaining built-in gain with respect to the relevant asset);
- Certain procedural and reporting requirements (discussed below) are satisfied;
- The U.S. transferor agrees to extend the statute of limitations for assessing tax as follows:
    - With respect to deferred contribution gain, through the eighth full taxable year following the year of the contribution;
    - With respect to items of partnership income, gain and deduction that arise from "Section 721(c) property" that are allocated to the U.S. transferor during the year of the gain deferral contribution and the following two years, through the sixth full taxable year after such items are recognized; and
    - With respect to gain that is recognized in a contribution for which "gain deferral method" is *not* applied that takes place during the five years following a "gain deferral" contribution, through the fifth full taxable year after the taxable contribution; and
- If applicable, the rules governing tiered partnerships (discussed below) are followed.

In general, the requirements discussed above are similar to the prerequisites to applying the "gain deferral method" that were outlined in the Notice. However, the provisions allowing the "gain deferral method" to be applied on an item-by-item basis and the special rules for ECI Property are new, and were included in response to public feedback. Additionally, although the Notice indicated that a requirement for taxpayers applying the "gain deferral method" to extend the statute of limitations through the end of the eighth full taxable year following the taxable year of the contribution (as is required of U.S. transferors of property to a foreign corporation that enter into a "gain recognition agreement" instead of recognizing any "built-in gain" on the contribution)[20] was under consideration, the interim rules in the Notice allowed taxpayers to apply the "gain deferral method" without consenting to such an extension.

C. ACCELERATION EVENTS

Consistent with the Notice, the Temporary Regulations generally require a U.S. transferor to recognize any remaining built-in gain if an "acceleration event" occurs and define an "acceleration event" to normally include any occurrence that either: (i) would reduce the amount of remaining built-in gain that a U.S. transferor would have recognized under the "gain deferral method" if the event had not occurred or (ii) could defer the recognition of remaining built-in gain.[21] The Temporary Regulations also retain the Notice's approach of generally treating any failure to comply with the

[19] Among other provisions, the reporting and procedural requirements provide that a U.S. transferor intending to rely on this rule in respect of an asset that is ECI Property must obtain a waiver of treaty benefits from both the "Section 721(c) partnership" and each direct or indirect partner that is a "related foreign person". *See* Treas. Reg. § 1.721(c)-6T(c).

[20] *See* Treas. Reg. § 1.367(a)-8(f).

[21] *See* Treas. Reg. § 1.721(c)-4T(b)(1).

procedural or reporting requirements as an "acceleration event", but provide a new exception to this rule in certain cases where noncompliance is the result of reasonable cause.[22]

The acceleration rule in the Temporary Regulations also contains exceptions for certain enumerated "successor events" (*i.e.*, transactions that allow a U.S. person to inherit any deferred gain),[23] "termination events" (*i.e.*, transactions after which—in the view of the IRS—no potential for gain-shifting or income shifting exists)[24] and "partial acceleration events".[25] "Successor events" include a tax-free contribution of an interest in a "Section 721(c) partnership" to a domestic corporation, an intercompany sale of a "Section 721(c) partnership interest and a "technical termination" of a "Section 721(c) partnership.[26] After a "successor event", the new owner is treated as the U.S. transferor under the Temporary Regulations. "Termination events" include a contribution of assets by a "Section 721(c) partnership" to a domestic corporation, a "Section 721(c) partnership" ceasing to have any direct or indirect partners that are "foreign related persons", and a taxable sale of "Section 721(c) property".[27]

D. TIERED PARTNERSHIPS

The Temporary Regulations also include new rules that apply to tiered partnerships. Under these provisions, if a U.S. person contributes an interest in a controlled partnership to a "Section 721(c) partnership" and intends to use the "gain deferral method", the following requirements will apply:[28]

- *First*, the lower-tier partnership must revalue all of its assets for "book" purposes (*i.e.*, perform a "book-up") if a revaluation would result in a separate positive difference between book value and adjusted basis in at least one asset that is not "excluded property";
- *Second*, the lower-tier partnership must apply the "gain deferral method" to each asset (other than "excluded property") with a fair market value at the time of the "book-up" in excess of that asset's tax basis; and
- *Third*, the partnership must treat an upper-tier partnership in which a U.S. person is a direct or indirect partner as if that upper-tier partnership was a U.S. transferor when applying the requirement that "book" items of income, gain, loss and deduction be allocated consistently.

In cases where a U.S. person is deemed to have transferred property to a "Section 721(c) partnership" under the look-through rule discussed above because an upper-tier partnership has

[22] *See* Treas. Reg. § 1.721(c)-4T(b)(2); Treas. Reg. § 1.721(c)-6T(f).

[23] *See* Treas. Reg. § 1.721(c)-5T(c).

[24] *See* Treas. Reg. § 1.721(c)-5T(b).

[25] *See* Treas. Reg. § 1.721(c)-5T(d).

[26] *See* Treas. Reg. § 1.721(c)-5T(c).

[27] *See* Treas. Reg. § 1.721(c)-5T(b). Additionally, the "gain deferral method" will cease to apply if a "Section 721(c) partnership" contributes property to a foreign corporation. However, the U.S. transferor's portion of any such property will remain subject to Section 367 of the Code. Additionally, the U.S. transferor will be required to recognize any remaining built-in gain that would have been allocated to the U.S. transferor if the "Section 721(c) partnership" had sold that portion of the "Section 721(c) property" immediately before the transfer for fair market value. *See* Treas. Reg. § 1.721(c)-5T(e).

[28] *See* Treas. Reg. § 1.721(c)-3T(d)(1).

contributed assets to a lower-tier partnership, the following are also prerequisites to applying the "gain deferral method":[29]

- *First*, the lower-tier partnership must treat the upper-tier partnership as a U.S. transferor applying the requirement that "book" items of income, gain, loss and deduction be allocated consistently;
- *Second*, the upper-tier partnership must use the "gain deferral method" in respect of the upper-tier partnership's interest in the lower-tier partnership if the upper-tier partnership is a controlled partnership with respect to the U.S. transferor; and
- *Third*, if the U.S. transferor is an indirect partner in the upper-tier partnership, the principles of the two preceding requirements must be applied to any other partnerships in the chain of ownership.

E. REPORTING AND PROCEDURAL REQUIREMENTS

The Temporary Regulations include a new and detailed list of reporting and other procedural requirements that must be satisfied by U.S. transferors electing the "gain deferral method". These compliance obligations are broadly analogous to what is required of a U.S. transferor that contributes property to a foreign corporation and enters into a "gain recognition agreement"[30] with the IRS in lieu of recognizing immediate gain on the contribution (including, for example, a requirement to initially elect the "gain deferral method" on a U.S. transferor's timely filed tax return, and an annual reporting requirement).

F. EFFECTIVE DATE

In general, the Temporary Regulations are effective for contributions occurring on or after August 6, 2015 (*i.e.*, the date of the Notice). However, taxpayers may generally elect whether or not to apply new rules in the Temporary Regulations (including, for example, the requirement that U.S. transferors consent to an extension of the statute of limitations) and substantive changes to the rules described in the Notice to contributions that took place before January 18, 2017. The Temporary Regulations are scheduled to expire on January 17, 2020, but were also published as proposed regulations.

On January 20, 2017, the White House issued a memorandum directing federal agencies to suspend certain new regulations until such regulations are reviewed and approved by a senior member of the new administration. Because the Temporary Regulations took effect on or prior to January 18 and were published in the Federal Register on January 19,[31] the Temporary Regulations do not appear to be affected by this "regulatory freeze" order.

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[29] *See* Treas. Reg. § 1.721(c)-3T(d)(2).

[30] *See* Treas. Reg. § 1.721(c)-6T. The requirements for a "gain recognition agreement" are described in Treasury Regulations Section 1.367(a)-8.

[31] *See* 82 Fed. Reg. 6368.

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