Partnership Taxation

IRS Finalizes Regulations Relating to Allocations of Partnership Items Involving Partners That Are Look-Through Entities

SUMMARY
On May 19, 2008, the Internal Revenue Service issued final regulations on determining when allocations of partnership income, gain, loss, expense or credit will have substantial economic effect under Section 704(b) of the Internal Revenue Code (the “Final Regulations”) if one or more partners is a “look-through” entity or a member of a consolidated tax group. The Final Regulations generally adopt the regulations proposed on November 17, 2005, with some alterations in response to commentators. Thus, the Final Regulations, like the proposed regulations, generally provide that, if a partner in a partnership is itself a partnership, a controlled foreign corporation or other “look-through entity” (as defined in the Final Regulations), or is a member of a consolidated tax group, the determination of whether an allocation of a partnership item has substantial economic effect must take into account the interaction of the allocation with tax attributes of any person that owns an interest in such partner (in the case of a partner that is a “look-through entity”) or any person in the same consolidated tax group as such partner (where the partner is a member of a consolidated tax group).

THE FINAL REGULATIONS
The Final Regulations, which apply to partnership taxable years beginning on or after May 19, 2008, provide that the interaction of a partnership allocation of income, gain, loss, expense or credit with the tax attributes of non-partners must be taken into account in two cases.

First, the interaction of a partnership allocation with the tax attributes of an owner of a partner that is a “look-through entity” must be taken into account in testing the substantiality of an allocation to that partner. A “look-through entity” is a partnership, S corporation, trust, estate, disregarded entity or (for some purposes) a controlled foreign corporation if United States shareholders of the controlled foreign
Partnership Taxation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. If an interest in a look-through entity is indirectly held through another look-through entity, the Final Regulations provide that the intermediate look-through entity will be looked through as well. However, in all cases, the tax attributes of de minimis partners—defined as any partner that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and that is allocated less than 10 percent of each partnership item of income, gain, loss, deduction and credit—need not be taken into account.

Second, the Final Regulations provide that, if a partner is a member of a consolidated group, the interaction of a partnership allocation with the tax attributes of the consolidated group as a whole and the tax attributes of a member of the group for a separate return year must be taken into account in determining economic effect. However, just as in the case of “look-through entities” stated above, tax attributes of de minimis partners need not be taken into account.

The Final Regulations, like the proposed regulations, also eliminate the per capita allocation presumption that had applied in determining a partner's interest in the partnership.

The Final Regulations also make clear that the "baseline" comparison used to test whether the economic effect of any partnership allocation is substantial is the consequences if the allocation in question was not in the partnership agreement but instead if the allocation were determined in accordance with the partners’ interests in the partnership.

The Final Regulations continue to make clear that a partnership allocation that is respected under Section 704(b) may be allocated under other provisions, such as Section 482. In addition, while the Final Regulations are as such only applicable to partnership taxable years beginning after May 19, 2008, the preamble describes the regulations as simply "clarifying" the existing rules, noting specifically that the final regulations "merely confirm the proper application of the substantiality test" that was adopted in 1986 in the case of look-through entities and that the "look-through rule in the final regulations is not a change to the substantiality test."

**DIFFERENCES FROM THE PROPOSED REGULATIONS AND RESPONSES TO COMMENTS**

The IRS made several notable changes from the proposed regulations in response to comments:

- The IRS added estates to the list of "look-through entities," reasoning that estates, like trusts, generally pass through tax attributes to their beneficiaries.
- In response to concerns about the difficulty of administering the look-through rules in the case of controlled foreign corporations, the IRS added a provision that treats a controlled foreign corporation as a "look-through entity" only if the corporation’s United States shareholders own, directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.
- The IRS clarified that a controlled foreign corporation is treated as a look-through entity only with respect to allocations of items that enter into the computation of a United States shareholder's...
subpart F inclusions (or enter into the computation of any person’s income attributable to a United States shareholder’s subpart F inclusion, or would so enter into such computations if such items were allocated to such controlled foreign corporation).

- The IRS included the concept of a de minimis partner, and provided that tax attributes of de minimis partners need not be taken into account for purposes of determining the substantiality of the economic effects of allocations.

- The IRS added a specific definition of indirect ownership for the purposes of the Final Regulations.

- The IRS added another example which applied the Final Regulations in a case where the partners included a member of a consolidated group and a controlled foreign corporation.

- The IRS made clear that the “baseline” comparison for purposes of testing the substantiality of the economic effects of any partnership allocation was the same for the general test in the Section 704(b) regulations and the tests in those regulations for “shifting” and “transitory” allocations.

AREAS OF FURTHER CONSIDERATION

In the preamble to the Final Regulations, the IRS announced that it was still considering whether a controlled foreign corporation that is a partner should be treated as a look-through entity for all purposes, and to what extent actual or anticipated distributions of property by the controlled foreign corporation should be taken into account in testing the substantiality of an allocation. The IRS also announced that it was considering additional guidance on proper treatment of special allocations of items of a partnership that is owned primarily by related parties.

* * *

ENDNOTES

1 See Treas. Regs. §1.704-1(b)(2)(iii)(d)(2). A controlled foreign corporation with the requisite overlapping ownership between its United States shareholders and the partnership is treated as a “look-through entity” only with respect to allocations of income, gain, loss or deduction that enter into the computation of a United States shareholder’s subpart F inclusion (or enter into the computation of any person’s income attributable to a United States shareholder’s subpart F inclusion, or would so enter into such computations if such items were allocated to such controlled foreign corporation) with respect to such controlled foreign corporation.

2 Indirect ownership is for these purposes defined by cross-reference to the constructive ownership provisions of Section 318 (except that “50 percent” replaces “10 percent” each time it appears). See Treas. Regs. §1.704-1(b)(2)(iii)(d)(6).

3 See Treas. Regs. §1.704-1(b)(2)(iii)(e). In Example 29 of the Final Regulations the three partners in a partnership are a corporation that is a member of a consolidated group, an S corporation with
one individual shareholder and a partnership between and individual and a corporation that is a member of a consolidated group. In determining the after-tax consequences of an allocation to each of these partners, the interaction of the allocation with the tax attributes of its owners or other members of its consolidated group must be taken into account.


6 The Final Regulations added a new Example 28 to Treas. Regs. §1.704-1(b)(5), which makes clear that the IRS “may” reallocate various items between related persons even apart from Section 704(b), although the example comes to no conclusion about whether the IRS would reallocate under the given fact pattern.

7 For information on the proposed regulations, please consult Sullivan & Cromwell LLP’s prior memorandum on the proposed regulations, dated November 30, 2005.
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