IRS announces forthcoming regulations limiting deferral of gain on contributions to partnerships with related foreign partners and addressing valuation of controlled transactions involving partnerships

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In brief

The IRS on August 6 issued Notice 2015-54 (the Notice), announcing its intention to issue regulations significantly changing the treatment of partnerships with US and foreign partners that are related parties.

The new regulations will have two main features. First, significant new restrictions will apply if the US partner and related foreign partner together own more than 50 percent of the partnership, and the US partner contributes built-in gain property) to the partnership. Immediate gain recognition will be required on the contribution unless the partnership adopts the remedial allocation method with respect to the property contributed by the US transferor (causing the U.S. transferor to recognize the built-in gain under a remedial method over the property's cost-recovery period) and certain other requirements are met.

Second, new regulations under Section 482 will be issued to specify transfer pricing methods applicable to controlled transactions involving related-party partnerships. These specified methods, which may apply to partnership contributions, partnership distributions, and partnership allocations, will mirror the methods currently prescribed for cost-sharing arrangements and will include a 'periodic trigger' feature similar to the cost-sharing periodic trigger.

The Notice reflects Treasury's and the IRS's concern that taxpayers are using partnerships to shift income or gain from US persons to related foreign partners that are not subject to US tax. In particular, the Notice reflects the view that this income shifting is facilitated by the use of Section 704(c) allocation methods other than the remedial method and the use of valuation techniques that are inconsistent with the arm's-length standard. In addition, Treasury and the IRS believe that non-arm's-length valuations of property contributed to a partnership could be combined with special allocations of income with respect to such property to achieve inappropriate tax results.

The provisions of the Notice addressing contributions of built-in gain property are intended to apply to a contribution of either intangible or tangible property, and the Notice contains an anti-abuse rule to capture transactions undertaken with a principal purpose to avoid the new rules. Further, even in situations in which affected US transferors successfully navigate the requirements to avoid immediate gain recognition upon a contribution of built-in gain property to a partnership, the Notice describes certain actions that may later require the US transferor to recognize gain, including transfers of the contributed property as well as the failure of the partnership to comply with reporting or other requirements. These new rules will impose a substantial monitoring and compliance burden on affected partners and partnerships.

The Notice provides that the new built-in gain rules are generally effective for transfers occurring on or after August 6, 2015. The new Section 482 rules, which will be accompanied by new documentation regulations under Section 6662, will apply to transfers and controlled transactions occurring on or after the date the regulations are published in final form.

In detail

Background: current rules

Sections 721 and 367(d)

In general, property may be contributed to a partnership tax free. Section 721(a) provides that no gain or loss is recognized by a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. The IRS has the authority (under Section 721(c)) to issue regulations calling off this nonrecognition treatment if the gain, when recognized, will be includible in the gross income of a person other than a US person. No such regulations have been issued.

The IRS has similar authority, under Section 367(d)(3), to apply the rules of Section 367(d) to the transfer of intangibles by a US person to a partnership. Section 367(d) generally requires a US taxpayer that contributes intangible property to a foreign corporation to recognize income with respect to the contributed intangible annually over the useful life of the intangible. No regulations have been issued under Section 367(d) to extend this treatment to the partnership context. The Notice acknowledges that Sections 721(c) and 367(d)(3) are not self-executing, stating that "absent regulations under section 721(c) or section 367(d)(3), a U.S. person generally does not recognize gain on the contribution of appreciated property to a partnership with foreign partners."

Section 704(c)

Section 704(c) governs a partnership's allocation of tax items relating to property contributed to the partnership by a partner when the basis of the property differs from its fair market value (Section 704(c) Property). Section 704(c) principles also apply to allocations with respect to property for which differences between book basis and adjusted tax basis are created when a partnership revalues partnership property (Reverse Section 704(c) Allocations). Section 704(c) is intended to cause the contributing partner to recognize the tax benefit or burden associated with the built-in gain or loss inherent in property contributed to a partnership, and prevent the shifting of such gain or loss to other partners for US tax purposes.

Allocations of income, gain, loss, and deduction with respect to property contributed to a partnership under Section 721 must be made using a reasonable method that is consistent with the purpose of Section 704(c). The regulations under Section 704(c) describe three allocation methods that are generally reasonable: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method.

Under the traditional method, 'appropriate' allocations of income, gain, loss, or deduction attributable to property with a book basis different from the contributing partner's adjusted tax basis at the time of contribution or revaluation must be made to avoid shifting the tax consequences of the built-in gain or loss. Thus, if the partnership sells Section 704(c) Property, the resulting gain or loss first must be allocated to the contributing partner, up to the amount of remaining built-in gain or loss. Similarly, the allocation of deductions attributable to amortization, depletion, depreciation, or other cost recovery of the Section 704(c) Property also must take into account the built-in gain or loss on the property at the time of contribution.

Tax allocations to the noncontributing partners of cost-recovery deductions with respect to Section 704(c) Property generally must, to the extent possible, equal the allocation of corresponding Section 704(b) book items to such partners. However, the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the tax year (the ceiling rule). If a partnership has insufficient tax items to match book items allocated to noncontributing partners, the allocation is said to be ceiling-rule limited. If a built-in gain item is ceiling-rule limited, application of the traditional method may result in the shifting of gain to the non-contributing partner.

A partnership using the traditional method may make reasonable curative allocations to reduce or eliminate disparities between Section 704(b) and tax items of noncontributing partners for the purpose of correcting distortions created by the ceiling rule. However, because curative allocations are limited to the real items of income, gain, loss or deduction of the partnership in the tax year, a built-in gain item may still be ceiling-rule limited even if the partnership elects to use the traditional method with curative allocations.

As an alternative to the traditional method or the traditional method with curative allocations, a partnership may eliminate distortions caused by the ceiling rule by using the remedial allocation method. Under the remedial allocation method, to the extent of the adjusted tax basis of the contributed property, allocations are made using the traditional method; however, with respect to the book basis of the contributed property in excess of its tax basis, the partnership makes 'remedial allocations' of notional items for tax purposes to the noncontributing partner of income, gain, loss, or deduction equal to the full amount of the Section 704(b) book-tax disparity for that year. An offsetting notional item of an identical amount is allocated to the contributing partner.

Although these remedial items affect the partners' tax liabilities, they have no effect on the partnership's tax computation or the partners' capital accounts. As a result of the allocation of the notional items under the remedial allocation method, the disparities between Section 704(b) and tax items are eliminated in the year they would otherwise arise if the traditional method were used.

Highlights of the Notice

Transfers of built-in gain property by certain US persons to partnerships with related foreign partners

Under the terms of the regulations described in the Notice, the transfer of property with built-in gain other than cash equivalents and certain securities (Section 721(c) Property) by a US person other than a domestic partnership (a US Transferor) to a 'Section 721(c) Partnership' will result in immediate recognition of such built-in gain, unless the requirements of the 'Gain Deferral Method' described below are met. Generally, a Section 721(c) Partnership is any domestic or foreign partnership in which a US Transferor and a related foreign person or persons together own more than 50 percent of the interests in partnership capital, profits, deductions, or losses.

Observation: Even this general rule contains potential pitfalls. First, it is not always clear whether the economic relationship between taxpayers constitutes a partnership for US federal income tax purposes or whether a particular taxpayer's interest in a partnership is debt or equity. With the requirement of immediate gain recognition turning on whether a relationship is a tax partnership and who the partners are, the stakes surrounding these determinations have been raised. Second, although the Notice appears to be targeted at partnerships between related taxpayers, the rules are broad enough to affect some third-party joint ventures. For example, if one party to a joint venture is comprised of a US corporation and one of its foreign subsidiaries, and that party had a greater-than-50-percent interest in partnership capital, profits, deductions, or losses, the joint venture would be a Section 721(c) Partnership.

To apply the Gain Deferral Method, the following requirements must be met.

First, the Section 721(c) Partnership must adopt the remedial allocation method with respect to all Section 721(c) Property contributed to the Section 721(c) Partnership pursuant to the same plan by a US Transferor and all other US Transferors that are related to the US Transferor under Section 267(b) or Section 707(b).

Observation: By its terms, this rule applies only to contributions by US Transferors after August 6, 2015. Nevertheless, taxpayers will need to monitor carefully transfers of partnership interests that could result in a technical termination of a partnership in existence before the date of the Notice, which could cause a deemed contribution to a new partnership of built-in gain assets contributed to the old partnership prior to the date of the Notice. Current law should continue to apply to any contributions by foreign persons. Moreover, to the extent a partnership revalues its capital accounts in connection with a contribution and must, as a result, make Reverse Section 704(c) Allocations, there is no indication that the Gain Deferral Method requires the use of remedial allocations for the Reverse Section 704(c) Allocations. Nevertheless, because of the changes to Section 482 discussed below, future appreciation and revaluations could result in additional income inclusion by the US Transferor.

Second, during any tax year in which there is any remaining built-in gain with respect to an item of Section 721(c) Property, the Section 721(c) Partnership must allocate all items of Section 704(b) income, gain, loss, and deduction with respect to that Section

721(c) Property in the same proportion (the same proportion rule).

Observation: In effect, the same proportion rule prohibits special allocations of particular Section 704(b) items (income, gain, loss, deduction, or credit) with respect to an item of Section 721(c) Property. For example, a partner could not receive an allocation of 20 percent of the income and 30 percent of the amortization with respect to an item of Section 721(c) Property. Nevertheless, the same proportion rule does not apply to property purchased or developed by a partnership nor to property contributed by partners other than US Transferors.

The reference to 'an item' of Section 721(c) Property indicates that the determination is made on a property-by-property basis. If all Section 704(b) items with respect to an item of property are shared in the same proportions, the regulations should not pose a problem even if different allocation ratios apply to different properties (as they do in a partnership with so-called tracking allocations). Similarly, preferred allocations of partnership net income also should not violate the rule.

The intention of the same proportion rule appears to be to prevent US. Transferors from mitigating the impact of remedial allocations by, for example, reducing a non-contributing partner's allocation of cost-recovery deductions with respect to built-in gain property relative to the income allocated to the foreign partner with respect to such property. But the full scope of the same proportion rule is not clear. Regulatory allocations and allocations of foreign tax credits required under the Section 704(b) regulations may require certain items to be shared in different proportions. Regulations will need to address whether such allocations violate the same proportion rule.

Third, certain reporting requirements must be met. The reporting requirements include information reporting under existing regulations and reporting requirements to be issued under the regulations described in the Notice.

Fourth, the U.S. Transferor is required to recognize gain upon the occurrence of any 'Acceleration Event.' In general, an Acceleration Event is any transaction that either (1) would reduce the amount of remaining built-in gain that a US Transferor would recognize under the Gain Deferral Method if the transaction had not occurred or (2) could defer the recognition of built-in gain.

Upon the occurrence of an Acceleration Event, gain is recognized in an amount equal to the remaining built-in gain that would have been allocated to the US Transferor if the Section 721(c) Partnership had sold the item of Section 721(c) Property immediately before the Acceleration Event for its fair market value. Thus, if an item of Section 721(c) Property is amortizable, the amount of gain that would be recognized by the US Transferor should be reduced over time as the US Transferor picks up remedial income with respect to such property. Gain also would be reduced if the fair market value of the Section 721(c) Property declined.

Transactions that could reduce a US Transferor's remaining built-in gain and be Acceleration Events include, for example, the sale or exchange of all or part of the US Transferor's interest in the Section 721(c) Partnership or the distribution of the contributed Section 721(c) Property to a partner other than the US Transferor.

For example, the distribution of contributed property to a partner other than the contributing partner after eight years might, in the absence of the regulations described in the Notice, lead to the elimination of built-in gain to the contributor. Under the Notice, such transactions would result in gain recognition to the contributor (as illustrated by Example 4 of the Notice).

Another example of an Acceleration Event, not highlighted in the Notice, is an increase to the basis of Section 721(c) Property by operation of Section 734. This basis increase would be treated as an Acceleration Event because the basis adjustment would reduce the remaining amount of built-in gain that the US Transferor would recognize. In addition, an Acceleration Event is deemed to occur with respect to all Section 721(c) Property of a Section 721(c) Partnership for the tax year of the partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method. Thus, failure to meet the reporting requirements or proportionate allocation requirements, for example, also would trigger recognition of any remaining built-in gain by the US Transferor.

Example 2 in the Notice illustrates that even if a Section 721(c) Partnership complies with all of the requirements of the Gain Deferral Method with respect to one property that is Section 721(c) Property, the failure to meet the requirements for all Section 721(c) assets, including those contributed in subsequent years, causes the US Transferor to recognize remaining built-in gain with respect to *all* Section 721(c) Property in the Partnership.

The regulations will provide exceptions to the Acceleration Event rule for transfers of interests in Section 721(c) Partnerships to domestic corporations in transactions to which Section 351(a) or Section 381(a) applies. Also, the Section 721(c) Partnership will be able to transfer the Section 721(c) property itself to a domestic corporation in a transaction to which Section 351(a) applies without causing an Acceleration Event.

Observations: The concept of Acceleration Events set forth in the notice is very broad. As defined, it effectively prevents a tax-free redemption of the US Transferor or any other transaction that could reduce or defer built-in gain on Section 721(c) property for the full duration of the amortization period with respect to the Section 721(c) Property (e.g., 15 years, in the case of intangibles). In addition, because the regulations appear to measure built-in gain (and reductions in built-in gain) only at the level of the Section 721(c) Partnership, a distribution of Section 721(c) Property to the US Transferor that contributed such property could be an Acceleration Event, even though the built-in gain is preserved in the hands of the US Transferor.

Fifth, as a requirement for applying the Gain Deferral Method, the foregoing requirements must adopted for all subsequent contributions of built-in gain property to the 721(c) Partnership by the US Transferor and all other related US Transferors until the earlier of: (1) the date that no built-in gain remains with respect to any Section 721(c) Property to which the Gain Deferral Method first applied or (2) the date that is 60 months after the date of the initial contribution of the property to which the Gain Deferral Method first applied. A US Transferor (and in certain cases a Section 721(c) Partnership) also will be required to extend the statute of limitations for assessment of tax with respect to all items related to the Section 721(c) Property through the close of the eighth full tax year of the contribution. The regulations will not require the extension of the statute for tax years that end before the date of the publication of the regulations.

Observations: Depending on the facts and circumstances, contributions by a US Transferor to a Section 721(c) Partnership may produce a different tax result than a direct sale of the built-in gain asset to a related foreign person or the contribution of such property to a foreign corporation. Relevant facts include relative ownership of the partnership by the US partner and the related foreign partner, the type of assets contributed by the foreign partner, nature of the property contributed by the US partner, and the Section 704(c) allocation method applied to contributions by the foreign partner.

Valuation of controlled transactions involving partnerships

The Notice announces that the IRS intends to issue regulations regarding the application to controlled transactions involving partnerships of certain rules in Reg. sec. 1.482-7 that currently apply to cost-sharing arrangements. In particular, the regulations will provide specified methods for these partnership transactions that are based on the methods specified for cost-sharing 'platform contribution transactions' (PCTs). Currently, the methods prescribed in the cost-sharing regulations are not designated as specified methods for any related-party transactions other than cost-sharing PCTs, but these methods are nonetheless available for use as unspecified methods in evaluating non-cost-sharing transactions.

In practice, methods specified in Reg. sec. 1.482-7 often are applied as unspecified methods for transactions outside cost-sharing PCTs because they reflect the IRS's thinking about the principles broadly applicable to certain types of transactions. One significant effect of specifying these methods in the partnership regulations will be that analyses in US taxpayers' contemporaneous transfer pricing documentation reports will have to consider these methods in evaluating their contribution and other transactions with related-party partnerships. Methods that are not specified in the regulations for the transaction at issue are not required to be considered in contemporaneous documentation, unless the taxpayer selects an unspecified method as the best method in that documentation.

Observations: The most commonly used method used for cost-sharing PCTs is the income method, which generally seeks to assign a risk-adjusted rate of return or discount rate to the projected income flows expected to be generated by the relevant property. Although broadly based on discounted cash flow principles, the income method as specified in the cost-sharing regulations incorporates significant guidance and rules of application that, in certain respects, may deviate from the way discounted cash flow models typically are applied by valuation specialists. We would expect the same type of guidance and detailed rules of application to be incorporated into the regulation specifying an income method for transactions involving related-party partnerships.

In addition to the specified transfer pricing methods for transactions involving related-party partnerships, the Notice announces that the regulations will include periodic adjustment rules based on the periodic adjustment rule in the cost-sharing regulations. Thus, the regulations will provide for periodic adjustments when there is a significant divergence of actual returns from projected returns for controlled transactions involving a partnership. The adjustment in this circumstance will mirror the periodic adjustment outlined in the cost-sharing regulations. Treasury and IRS apparently believe that the cost-sharing periodic adjustment rule, which is based on the net present value of the profits and investments of the related-party transferee and provides a specific adjustment mechanism in the event an adjustment is triggered, provides a more effective periodic adjustment model for related-party partnership transactions than the general periodic adjustment rules in Reg. sec. 1.482-4.

Observations: The cost-sharing regulations issued in 2009 hinted that the transfer pricing implications of related-party partnership structures were on the radar screen of Treasury and the IRS. Those regulations noted that Reg. sec. 1.482-7 provides the specific methods for evaluating cost sharing arrangements, while Reg. secs. 1.482-4 and 1.482-9 provide specific methods to evaluate other intangible development arrangements, 'including partnerships.' (Reg. sec. 1.482-1(b)(2)(iii).) The issuance of the Notice may have resulted from the IRS's experience in examining related-party partnership structures since then, leading it to recognize the need for specific regulatory guidance in this area, and to develop specific ideas about the regulatory approaches it believes will allow it to appropriately police these structures.

In addition to announcing the forthcoming Section 482 regulations, the Notice also contains an extensive explanation of the IRS's authority to apply Section 482 to related-party partnerships under current law. The Notice explains that Section 482 and related penalties may apply under current law to partnership contributions, distributions, and allocations, even if such allocations have substantial economic effect under Section 704(b).

The Notice outlines various actions the IRS is authorized to take under Section 482 under current law, including its authority to impute contractual terms different from the parties' actual agreement when necessary to match the conduct of the parties, to apply the methods and principles prescribed in the cost sharing regulations as part of an unspecified method, to evaluate interrelated contributions of tangible and intangible property and the provision of services in the aggregate, and to apply the commensurate-with-income principle and the general periodic adjustment rules in Reg. sec. 1.482-4 and to partnership contributions of intangible property.

Effective dates

The built-in gain regulations described in the Notice will apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections filed on or after (but effective on or before) August 6, 2015.

The Section 482 and Section 6662 regulations described in the Notice will apply to transactions occurring on or after the date regulations are published.

The takeaway

The gain recognition rule announced by the Notice is a significant departure from the nonrecognition regime that currently applies to transfers of property to partnerships. In addition to addressing the perceived abuses specifically described in the Notice, the regulations described therein set potential traps for the unwary. US taxpayers contemplating transfers to Section 721(c) Partnerships will need to consider carefully the implications of the Notice when planning, drafting, and monitoring transfers to such partnerships.

The new Section 482 regulations described in the Notice, and in particular the new periodic adjustment rule, will require taxpayers to carefully evaluate the transfer pricing results of any related-party partnership transactions that may be contemplated after these regulations are published. In the meantime, the Notice's recitation of the various elements of the IRS's Section 482 authority under current law serves as a reminder of the tools and approaches that the IRS may bring to bear in scrutinizing related-party partnership structures under current law.

Let's talk

For more information, please contact:

Mergers & Acquisitions

Karen Lohnes, *Washington, DC*
+1 202 414 1759
karen.lohnes@us.pwc.com

Elizabeth Amoni, *Washington, DC*
+1 202 346 5296
elizabeth.amoni@us.pwc.com

Michael Hauswirth, *Washington, DC*
+1 202 346 5164
michael.j.hauswirth@us.pwc.com

APMA & Transfer Pricing Controversy

Horacio Peña, *New York*
+1 646 471 1957
horacio.pena@us.pwc.com

Richard F. Barrett, *Washington DC*
+1 202 414 1480
richard.f.barrett@us.pwc.com

Ward Connolly, *San Jose*
+1 408 817 8234
ward.connolly@us.pwc.com

Gregory J. Ossi, *Washington DC*
+1 202 414 1409
greg.ossi@us.pwc.com

Gregory Barton, *Chicago*
+1 312 298 6084
greg.barton@us.pwc.com

Lili Kazemi, *Washington DC*
+1 202 346 5252
golaleh.kazemi@us.pwc.com