KPMG

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Temporary regulations: Transfers to partnerships with related foreign partners, controlled transactions

The U.S. Treasury Department and the IRS today released for publication in the Federal Register temporary regulations (T.D. 9814) (the “Temporary Regulations”) and, by cross-reference, proposed regulations (REG-127203-15), concerning transfers of appreciated property by U.S. persons to partnerships with foreign partners related to the transferor.

As explained by today’s release, the Temporary Regulations reflect rules previously described in Notice 2015-54 and override the rules providing for nonrecognition of gain on a contribution of property to a partnership in exchange for an interest in the partnership under section 721(a) pursuant to section 721(c) unless the partnership adopts the remedial allocation method under section 704(c) and certain other requirements are satisfied.

The Temporary Regulations also include rules under sections 197, 704, and 6038B that apply to certain transfers described in section 721.

Read the text of the **temporary regulations** [PDF 608 KB] and the **proposed regulations** [PDF 275 KB]

Background

As described in Notice 2015-54, the IRS and Treasury Department were aware that certain taxpayers purported to be able to contribute—consistently with sections 704(b), 704(c), and 482—property to a partnership that allocates the income or gain from the contributed property to related foreign partners that are not subject to U.S. tax. Notice 2015-54 explains that some taxpayers selected a section 704(c) method other than the remedial allocation method or used valuation techniques that were inconsistent with an arm’s-length standard, or both. The IRS and Treasury determined that regulations were needed to override the application of section 721(a) to gain realized on the transfer of property to a partnership (domestic or foreign) in certain circumstances in which the gain, when recognized, ultimately would be includible in the gross income of a foreign person. The IRS notice states that these regulations generally will apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections made on or after August 6, 2015. Read an initial description of Notice 2015-54 in ***TaxNewsFlash-United States***

Temporary regulations

The "Temporary Regulations" generally incorporate the rules outlined in Notice 2015-54, which override section 721(a) and require immediate gain recognition when a U.S. transferor contributes certain appreciated property ("Section 721(c) Property") to a domestic or foreign partnership that is owned by the U.S. transferor and certain related foreign persons (a "Section 721(c) Partnership") unless the Section 721(c) Partnership adopts the "Gain Deferral Method." The Temporary Regulations make some significant changes, additions, and clarifications to the rules in the notice, however, including those summarized below.

Definition of "Section 721(c) Partnership"

- **Relatedness threshold:** Notice 2015-54 defines a Section 721(c) Partnership as, among other things, a partnership in which a U.S. transferor and certain related foreign persons own "more than 50 percent" of the interests in partnership capital, profits, deduction, or loss. The Temporary Regulations increase the ownership threshold to "80 percent or more" of those interests.

- **Excluded property:** The Temporary Regulations expand the definition of "excluded property" to include an interest in a partnership that holds (directly or indirectly) property 90% or more of the value of which consists of the following: cash or cash equivalents; "securities" as defined in section 475(c)(2) (without regard to section 475(c)(4)); and tangible property with built-in gain not exceeding $20,000 or built-in loss.

- **Technical terminations under section 708(b)(1)(B)**: If a partnership that is not a Section 721(c) Partnership technically terminates, the "new" partnership will not become a Section 721(c) Partnership as a result of the technical termination. If a Section 721(c) Partnership technically terminates, the technical termination is a successor event (rather than an acceleration event) and, therefore, will not result in a recognition of built-in gain, so long as the "new" partnership continues to apply the Gain Deferral Method with respect to Section 721(c) Property that was subject to the Gain Deferral Method in the "terminating" partnership's hands. Successor events are described below.

- **Partnership recapitalizations:** Partnership recapitalizations, or other changes in form, identity, or place of organization, will not cause a partnership to become a Section 721(c) Partnership.

- **Look-through rule for identifying a Section 721(c) Partnership if an upper-tier partnership ("UTP") in which a U.S. transferor is a direct or indirect partner contributes property to a lower-tier partnership ("LTP"):** For purposes of determining if the LTP is a Section 721(c) Partnership, the U.S. transferor is treated as contributing to the LTP its pro rata share of the property contributed by the UTP to the LTP. If the LTP is a Section 721(c) Partnership, the UTP will recognize the entire built-in gain in the contributed property unless the LTP applies the Gain Deferral Method to the entire property and the UTP applies the Gain Deferral Method to its interest in the LTP.

"Gain Deferral Method"

- **In general:** The Gain Deferral Method's five requirements are reframed as: (1) the Section 721(c) Partnership must adopt the remedial allocation method and allocate section 704(b) items with respect to Section 721(c) Property in a manner that satisfies the "consistent allocation method;" (2) the U.S. transferor must recognize the "remaining built-in gain" with respect to Section 721(c) Property upon an acceleration event or a portion of the remaining built-in gain upon a partial acceleration event or certain transfers to foreign corporations described in section 367; (3) procedural and reporting requirements are satisfied; (4) the U.S. transferor extends the statute of limitations on assessment of tax; and (5) certain rules for tiered partnerships are satisfied. The Gain Deferral Method applies on a property-by-property basis. Accordingly, a Section 721(c) Partnership may choose not to apply the Gain Deferral Method to all of its Section 721(c) Property.

- **Consistent allocation method:** The method applies on a property-by-property basis and requires a Section 721(c) Partnership to allocate the same percentage of each item of section 704(b) income, gain, deduction, and loss with respect to a Section 721(c) Property to the U.S. transferor.

- **Application of consistent allocation method to certain regulatory allocations:** Certain regulatory allocations described in the Temporary Regulations (i.e., allocations pursuant to a minimum gain chargeback, partner nonrecourse deductions, partner minimum gain chargeback, qualified income offset, certain noncompensatory options, and partnership level ordinary income or loss described in Reg. section 1.751-1(b)(3)[1]) are deemed to satisfy the consistent allocation method so long as the allocation in question is an allocation of income or gain to the U.S. transferor or an allocation of deduction or loss to a partner other than the U.S. transferor. In addition, if the allocation does not meet this description, the allocation is subject to special treatment that generally requires that a portion of the remaining built-in gain be recognized in an amount equal to the amount of the allocation that, had the regulatory allocation not occurred, would have been allocated to the U.S. transferor in the case of income or gain, or would not have been allocated to the U.S. transferor in the case of a deduction or loss. In this

[1] **KPMG observation:** The Temporary Regulations cite Reg. section 1.751-1(a)(3); however, the cite appears to be referring to Reg. section 1.751-1(b)(3).

case, the amount of gain recognized is limited to the remaining built-in gain that would have been allocated to the U.S. transferor upon a hypothetical sale of that portion of the property at fair market value immediately before the regulatory allocation is made. Allocations of partnership nonrecourse deductions are not regulatory allocations for this purpose. As such, they are subject to the general consistent allocation method requirement. Allocations of creditable foreign tax expenditures are not subject to the consistent allocation method.

- **Extension of statute of limitations:** The U.S. transferor must extend the period of limitations for assessment of tax on all items related to property subject to the Gain Deferral Method through the end of the eighth full tax year following the contribution. A U.S. transferor also must extend the limitations period for gain recognized under section 721(c) with respect to any Section 721(c) Property contributed to the Section 721(c) Partnership through the end of the fifth tax year following the contribution if the property was contributed within five years of a "gain deferral contribution" (i.e., a contribution of Section 721(c) Property to which the Gain Deferral Method applied).

- **Application of Gain Deferral Method to property effectively connected with a U.S. trade or business ("ECI Property"):** ECI Property is not subject to the remedial allocation method or the consistent allocation method so long as all distributive shares of income or gain with respect to the property for all direct and indirect partners that are related foreign persons will be subject to tax as effectively connected income and neither the Section 721(c) Partnership nor a direct or indirect partner claims benefits under an income tax treaty that would exempt the income or gain from tax or reduce the rate of tax on the income or gain. All of the other requirements of the Gain Deferral Method apply to ECI Property.

- **Anti-churning property:** If Section 721(c) Property is described in section 197(f)(9), the Section 721(c) Partnership must amortize the portion of the property's book value that exceeds the partnership's tax basis in the property. The partnership must increase the tax basis of the property solely with respect to a non-contributing partner that is related to the U.S. transferor by an amount equal to the difference between the section 704(b) amortization allocated to the related non-contributor and the tax amortization allocated to the related non-contributor. The partnership then must allocate remedial income in the same amount to the U.S. transferor.

- **Acceleration events:** A failure to comply with one of the requirements of the Gain Deferral Method as applied to a Section 721(c) Property is an acceleration event only with respect to that property (and not with respect to all Section 721(c) Property, as was indicated in the Notice). Acceleration will not occur solely as a result of failure to comply with a procedural or reporting requirement so long as the failure is not wilful and relief is sought under prescribed procedures.

- **Acceleration event exceptions:** Certain events do not trigger acceleration: (1) "termination events" (the Gain Deferral Method ceases to apply); (2) "successor events" (the Gain Deferral Method continues to apply but with respect to a successor U.S. transferor or successor Section 721(c) Partnership); (3) “partial acceleration events” (a U.S. transferor recognizes gain that is less than the remaining built-in gain and the Gain Deferral Method continues to apply); (4) transfers of Section 721(c) Property described in section 367 (the Gain Deferral Method no longer applies and the U.S. transferor recognizes gain equal to the remaining built-in gain attributable to the portion of the Section 721(c) Property that is not subject to tax under section 367); and (5) fully taxable disposition of a portion of an interest in a Section 721(c) Partnership (the Gain Deferral Method continues to apply for the retained portion of the interest).

Tiered partnership rules

- **Indirect contribution of Section 721(c) Property:** If a UTP in which a U.S. transferor is a direct or indirect partner contributes Section 721(c) Property to an LTP, the LTP must apply the Gain Deferral Method to the property in order for the UTP to avoid gain recognition under section 721(c). In addition, the LTP must treat the UTP as the U.S. transferor for purposes of applying the consistent allocation method and, if the UTP is a controlled partnership, it must apply the Gain Deferral Method to its interest in the LTP.

- **Contribution of partnership interest:** If Section 721(c) Property is an interest in an LTP, and if the LTP is a controlled partnership, the LTP must revalue its property if the revaluation would result in a new positive reverse section 704(c) layer in at least one property that is not excluded property. The LTP must apply the Gain Deferral Method to each property for which there is a new positive reverse section 704(c) layer. The LTP must treat the UTP in which a U.S. transferor is a direct or indirect partner as the U.S. transferor for purposes of applying the consistent allocation method.

Effective dates

The Temporary Regulations generally apply to contributions occurring on or after August 6, 2015, and to contributions occurring before August 6, 2015, resulting from an entity classification election filed on or after August 6, 2015. New rules and substantive changes to rules outlined in Notice 2015-54 (as specified in the Temporary Regulations) generally apply to contributions occurring on or after January 18, 2017, or to contributions occurring before January 18, 2017, resulting from an entity classification election that is filed on after that date.

For more information, contact a tax professional with KPMG’s Washington National Tax:

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