An Improvement, But Issues Remain: The IRS Releases Temporary Regulations for Contributions to Partnerships with Related Foreign Partners

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Although the Temporary Regulations were drafted with much consideration, a number of features seem to miss the mark.

In 2015, the IRS issued Notice 2015-54, 2015-34 IRB 201 (the "Notice"), announcing its intention to promulgate regulations attacking transfers of property to partnerships with related foreign partners. In January 2017, at the zero hour, two days before the incoming Trump administration's regulatory freeze, Treasury followed through on the Notice, releasing temporary regulations under Section 721(c) (the "Temporary Regulations").

The Notice had taken aim at transactions in which a U.S. partner contributes appreciated property to a partnership that has a foreign partner that is related to the U.S. partner. The Notice did not go into detail explaining the motivation for regulatory action, but it is reasonable to presume that Treasury and the IRS were concerned that multinational businesses recognized the utility of partnerships in outbound tax planning. Unlike outbound transfers to corporations, outbound transfers to partnerships are generally not subject to immediate gain recognition. More specifically, prior to the Notice, the general non-recognition rule for contributions to partnerships applied without regard to the make-up of the partnerships' partners. The Notice proposed to modify this rule, imposing gain recognition when the U.S. transferor and the partnership were "related," and the partnership had foreign partners related to the U.S. contributing partner, unless the contributing partner and the partner-

ship applied what the Notice introduced as the "Gain Deferral Method." Generally, the Gain Deferral Method required: (1) adoption of the remedial method (discussed in detail below) with respect to contributed property; (2) recognition, by the U.S. contributing partner, of the pre-contribution built-in gain with respect to the property upon the occurrence of certain "Acceleration Events"; and (3) compliance with certain reporting requirements.

The Temporary Regulations follow the outline set forth in the Notice, with some extremely meaningful modifications that soften certain terms that had been proposed in the Notice. The Temporary Regulations also fill in the blanks, providing: (1) additional exceptions for transactions not treated as Acceleration Events; (2) extensive guidelines for reporting, both at the time of the contribution and on an annual basis; (3) a regime for the application of the Gain Deferral method to intangible property described under Section 197(f)(9) ("Anti Churning Property"); and (4) highly complex rules that apply to tiered partnerships. Reflecting on the Temporary Regulations' changes and additions to the Notice, it is clear that Treasury put a great deal of thought and consideration into crafting the Temporary Regulations. However, there remain a number of aspects of the Temporary Regulations that appear to miss the mark.

BACKGROUND

The background for the Temporary Regulations is set forth in a prior article analyzing the Notice,[1] but a summary is provided here. The general rule under Section 721 is that a partner does not recognize gain on contributions to a partnership.[2] This rule applies whether the partnership itself is domestic or foreign and whether any of the partners are domestic or foreign. In contrast, otherwise tax-free contributions from a U.S. contributor to a foreign corporation, generally, are subject to tax.[3] The general rule for such corporate contributions requires the contributor to recognize gain on the transfer.[4] A special rule, that applies to intangible property (instead of the general rule), requires the U.S. contributor to recognize annual income inclusions as a deemed royalty from the contributee's use of the contributed property.[5]

The distinction between contributions to partnerships and contributions to foreign corporations is straightforward. If property could be contributed to a foreign corporation tax-free, the contributed property's pre-contribution gain would be subject to recognition by an opaque foreign entity, outside of the taxing net of the United States. A partnership, on the other hand, is a transparent entity, so property transferred by a U.S. partner to a partnership is not transferred outside of the U.S. taxing net. Furthermore, Subchapter K has a mechanism specifically designed to ensure that a contributing partner recognizes pre-contribution built-in gain–Section 704(c). The underpinning of the Notice and the Temporary Regulations is the IRS's concerns that Section 704(c) and its governing regulations might be insufficient when it comes to transfers to partnerships with foreign related-party partners.[6]

EXPLANATION AND ANALYSIS

The Temporary Regulations apply when a person (a "U.S. Transferor") transfers certain property ("Section 721(c) Property") having pre-contribution built-in gain ("Built-In Gain") to a partnership that has a foreign partner that is related to the U.S. Transferor and that is owned 80% or more by the U.S. Transferor and parties related to the U.S. Transferor (a "Section 721(c) Partnership"). To avoid immediate gain recognition, the U.S. Transferor and the Section 721(c) Partnership must agree to apply what the Temporary Regulations refer to as the "Gain Deferral Method." This generally will require the Section 721(c) Partnership to apply the remedial method for Section 704(c) allocations with respect to the Section 721(c) Property (the "Remedial Method Requirement") and to allocate tax items related to the Section 721(c) Property in equal proportions (the "Consistent Allocation Method"). Additionally, the U.S. Transferor must recognize remaining Built-In Gain with respect to Section 721(c) Property upon the occurrence of certain events that would reduce, eliminate or defer recognition of Built-In Gain subject to the Gain Deferral Method ("Acceleration Events"), unless an exception applies (the "Exceptions to the Acceleration Events"). Finally, the U.S. Transferor and the Section 721(c) Partnership must comply with rigorous reporting requirements (the "Reporting Requirements") and the U.S. Transferor must agree to extend the statute of limitations with respect to the contribution, subsequent partnership allocations, and certain subsequent contributions (the "Statute Extensions").

Section 721(c) Partnerships

The Temporary Regulations apply when a U.S. Transferor transfers Section 721(c) Property to a Section 721(c) Partnership.[7] A U.S. Transferor is a U.S. individual, corporation, trust, or estate.[8] Section 721(c) Property is virtually all property having Built-in Gain, excluding cash equivalents, corporate stock or equity in widely held or publicly traded partnerships or trusts, debt instruments, certain financial derivatives and tangible property with less than $20,000 of unrecognized appreciation ("Excluded Property").[9] Additionally, a partnership interest is Excluded Property if more than 90% of its assets (by value) are comprised of Excluded Property.[10] "Built-in Gain" is the excess of contributed property's book value over the partnership's tax basis in the property, at the time of contribution.[11]

A "Section 721(c) Partnership" is a partnership in which, after the contribution, a U.S. Transferor and one or more related persons own 80% or

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more of the partnership's capital, profits, deductions or losses and one of the related persons is foreign.[12] This definition is narrower than the definition that had been proposed in the Notice, under which a partnership would have been a Section 721(c) Partnership if more than 50% of the partnership was owned by parties related to the U.S. Transferor. Taxpayers should be wary, however, as the 80% threshold is a threshold for related ownership with respect to the partnership and has nothing to do with the determination as to whether partners in the partnership are related to one another. Relatedness is determined under Sections 267(b) and 707(b)(1).[13] Thus, for example, a two-person partnership owned by sisters is 100% owned by related persons.[14] Furthermore, generally speaking, corporations and/or partnerships connected by greater than 50% ownership are "related,"[15] so that a partnership's partners connected by more than 50% ownership will generally be combined to determine whether the partnership is held 80% or more by related persons.

The Temporary Regulations' 80% threshold for related ownership is certainly a vast improvement over the Notice's 50% threshold. Nevertheless, the Temporary Regulations' narrower threshold could still have unintended or counterintuitive consequence. Treasury explains that, in increasing the threshold for related party ownership, "the Treasury Department and the IRS expect that these regulations primarily will affect large domestic corporations."[16] However, with respect to related party ownership, the Temporary Regulations make no exception for family attribution. Thus, as mentioned above, if two sisters, one a citizen of Canada and the other a citizen of the United States formed a partnership, it would be a Section 721(c) Partnership subject to the Temporary Regulations.

Another seemingly odd result of the Temporary Regulations can be illustrated by comparing the following two scenarios. In one scenario, X owns 100% of two corporations, A and B. A is a domestic corporation, and B is a foreign corporation. A contributes property to a partnership, P, owned by B and an unrelated party so that after the contribution, A owns 37% of P, B owns 42% of P, and the third party owns 21% of P. In this scenario, it is clear that P is not a Section 721(c) Partnership. In a second scenario, X owns only 51% of each of A and B, and the remaining interests in those corporations are owned by parties unrelated to X. If A contributes property to P so that after the contribution, A owns 40% of P, B owns 40% of P, and the third party owns 20% of P, in this scenario, P is a Section 721(c) Partnership. In the first scenario, X's economic interest in P is 79%, but P is not a Section 721(c) Partnership. In the second scenario, X's economic interest in P is 40.8%, but P is a Section 721(c) Partnership.

The Gain Deferral Method

When the Temporary Regulations apply to a contribution to a partnership, Section 721(a) does not apply and the U.S. Transferor must recognize gain, unless the U.S. Transferor and the partnership comply with the requirements of the Gain Deferral Method.[17] Generally, under the Gain Deferral Method:[18]

- The partnership must abide by the Remedial Method Requirement.
- Allocation of items of income, gain, deduction and loss with respect to the Section 721(c) Property to the U.S. Transferor must be made using the same percentage, using what the Temporary Regulations refer to as the "Consistent Allocation Method."
- The U.S. Transferor must recognize remaining Built-In Gain with respect to the Section 721(c) Property upon the occurrence of certain "Acceleration Events."
- The partnership and the U.S. Transferor must comply with the Reporting Requirements.
- The U.S. Transferor must consent to the Statute Extensions.

There are two general exceptions where the Gain Deferral Method is not required: (1) a de minimis exception, when the sum of all of the built-in gain in all of the Section 721(c) Property contributed to the partnership during the partnership's tax year is less than $1 million and (2) an exception for deemed transfers pursuant to partnership technical terminations under Section 708(b)(1)(B). A technical termination of a partnership occurs when there is a sale or exchange of more than 50% of the interests in the partnership's profit and capital within a 12-month period.[19]

There is also a partial exception for Section 721(c) Property that generates income that is effectively connected to a trade or business conducted inside of the United State ("ECI"). Under this partial exception, the Remedial Method Requirement and the Consistent Allocation Method do not apply.[20] However, the U.S. Transferor must recognize Built-In Gain as a result of an Acceleration Event and comply with the Reporting Requirements and with the Statute Extensions. Moreover, the partial exception

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1 See Lipton, et al., "Notice 2015: IRS Attacks Transfers of Property to Partnerships with Related Foreign Partners," 125 JTAX 196 (November 2015) [hereinafter the "Notice Article"].

2 Section 721(a).

3 See Sections 351(a), 367(a), and 367(d).

4 See Sections 351(a) and 367(a).

5 Section 367(d). The deemed royalty is subject to periodic adjustment, it must be commensurate to the income from the transferred intangible and it continues for the useful life of the transferred intangible. See Section 367(d)(2).

6 See TD 9814, 1/18/17 (under the heading "Reasons for Exercising Regulatory Authority"); Notice 2015-54, 2015-34 IRB 201, ¶ 3.

7 Temp. Reg. 1.721(c)-2T(b).

8 Temp. Reg. 1.721(c)-1T(b)(18) (specifying "U.S. persons" as defined under Section 7701(a)(30), excluding domestic partnerships). A domestic partnership is not a U.S. Transferor because of the special set of complex rules applied to tiered partnerships, which are discussed below.

9 Temp. Reg. 1.721(c)-1T(b)(6).

10 *Id.*

11 Temp. Reg. 1.721(c)-1T(b)(2).

12 Temp. Reg. 1.721(c)-1T(b)(14).

13 Temp. Reg. 1.721(c)-1T(b)(12).

14 See Section 267(b)(1).

15 See Sections 267(b)(3), 267(b)(10), and 707(b)(1).

16 TD 9814 (under the heading "Special Analyses").

17 Temp. Reg. 1.721(c)-2T(b).

18 Temp. Reg. 1.721(c)-3T(b).

19 Section 708(b)(1)(B).

20 Temp. Reg. 1.721(c)-3T(b)(1)(ii).

applies only if all income and gain from the contributed Section 721(c) Property is ECI from the time of contribution until there is no remaining Built-In Gain.[21] The Temporary Regulations themselves do not indicate what happens if the contributed property ceases to generate ECI, exclusively. However, the Preamble to the Temporary Regulations (the "Preamble") states that the property ceasing to generate ECI, exclusively, constitutes an Acceleration Event because the terms of the Gain Deferral Method are violated.[22]

The big headline with respect to the Gain Deferral Method, under the Temporary Regulations, is that, unlike the rule proposed in the Notice, the Gain Deferral Method is applied on a property-by-property basis. In other words, a U.S. Transferor may decide to apply the Gain Deferral Method for some, but not all contributed property. As commenters pointed out, the Notice's "unified approach" was highly burdensome and seemed not to have any logical basis.

Remedial Method Requirement

As mentioned above, Treasury's most significant focus in promulgating the Temporary Regulations was to require Section 721(c) Partnerships to use the remedial method with respect to Section 721(c) Property. Treasury's stated reason for promulgating the Temporary Regulations focuses on Treasury's determination that the regulations governing Section 704(c) do not work in the context of partnerships with a U.S. contributing partner and related foreign partners. To understand and evaluate the Treasury's position, some background in Section 704(c) is necessary.

Under Section 704(c), built-in gain or loss in property contributed to a partnership must be allocated to the contributing partner.[23] When a partner contributes built-in gain property to a partnership, three things happen. The partnership receives a tax basis in the property that is equal to the partner's prior basis,[24] the contributing partner receives a basis in its partnership interest equal to the partner's prior basis in the contributed property,[25] and the partner's book capital account in the partnership is increased by the fair market value of the property at the time of the contribution.[26] The difference between the contributing partner's book capital account and the partnership's tax basis in the contributed property is the mechanism that Section 704(c) uses to allocate income and/or gain to the contributing partner to account for pre-contribution built-in gain.[27] This is generally accomplished by specially allocating gain from the disposition of contributed property to the contributing partner and by specially allocating depreciation and amortization deductions from the property to the noncontributing partner.

The Temporary Regulations' 80% threshold for related ownership is certainly a vast improvement over the Notice's 50% threshold.

The three methods for making such allocations are provided in the regulations under Section 704(c): the traditional method, the traditional method with curative allocations, and the remedial method. With respect to depreciation (and amortization), the goal of the three methods, to the extent possible, is to allocate tax depreciation to the noncontributing partner equal to the noncontributing partner's book depreciation. Under the traditional method, only tax depreciation taken with respect to the remaining basis of the contributed property can be specially allocated to the noncontributing partners. In this respect, the tax depreciation allocable to the noncontributing partner is limited by the partnership's tax basis in the contributed property. This limitation is referred to as the "ceiling rule."[28] Under the traditional method with curative allocations, tax items of the partnership may be specially allocated between the partners to "cure" the effect of the ceiling rule. For example, tax depreciation from other partnership properties may be specially allocated to the noncontributing partner or items of income or gain may be specially allocated to the contributing partner. However, under this method, the availability of curative allocations is limited to the actual tax items derived by the partnership. Under the remedial method, however, the effect of the ceiling rule may be completely cured through the invention of notional tax items that the partnership allocates to the contributing partner and to the non-contributing partner. For example, if the noncontributing partner is allocated $100 of book depreciation, but only $50 of tax depreciation, the partnership may invent another $50 of tax depreciation to allocate to the non-contributing partner by inventing a $50 notional item of income that it allocates to the contributing partner.

None of the three methods are perfect in accomplishing the goal of Section 704(c), as illustrated from the following fact pattern.

X and Y form a partnership, XY. X contributes P1, five-year depreciable property with a basis of $0 and a value of $100. Y contributes P2, five-year depreciable property with a basis of $100 and a value of $100. XY splits all partnership items 50/50 between X and Y. For five years, XY has no income or loss other than depreciation. Then, in year six, XY sells P1 for $200. The $200 received from the sale of P1 results in $200 of gain. The gain is allocated $100 to X and $100 to Y be-

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21 *Id.* The Temporary Regulations also require that the foreign related partner waive treaty benefits with respect to the income and gain from the contributed property.

22 TD 9814, section VII, subsection b.

23 Section 704(c).

24 Section 723.

25 Section 722.

26 Reg. 1.704-1(b)(2)(iv)(d)(1).

27 Reg. 1.704-3(a)(3).

28 Reg. 1.704-3(b)(1).

cause the book and tax basis of P1 was zero.

Under the traditional method, there would have been no special tax allocations made over the five-year period because there was no tax depreciation from P1 available to be specially allocated to Y. Nevertheless, X is not required to recognize any additional gain in the disposition of P1 on account of X's pre-contribution built in gain. Conversely, had the remedial method been used with respect to P1, for each of the five years prior to XY's disposition of P1, Y would have been allocated $10 of notional tax depreciation by requiring X to recognize $10 of notional income each year. Here too, X is not required to recognize any additional gain in the disposition of P1, but X already recognized income in the amount of X's pre-contribution built-in gain. Under the traditional method with curative allocations, $50 of depreciation from P2 would have been specially allocated to Y. Therefore, in this scenario, the traditional method with curative allocations would neither have increased X's share of the built-in gain on the disposition of P1 nor required or led to any preemptive inclusion of income or gain. However, had P2 been sold instead of P1, the traditional method with curative allocations would have caused X to have gain on account of the pre-contribution gain with respect to P1 even though, in this alternative, P1 had not been sold.

In sum, under the traditional method, in certain instances, a contributing partner's recognition of pre-contribution built-in gain may be deferred even beyond the time that the partnership recognizes such built-in gain. Under the remedial method, a contributing partner is generally required to preemptively recognize income or gain as a result of pre-contribution built-in gain before the partnership recognizes such built-in gain. Finally, under the traditional method with curative allocations, a contributing partner's recognition of income or gain, with respect to pre-contribution built-in gain, may either be accelerated or deferred depending on the actual items of income and loss generated by the partnership.

Taking into account all of the above, Treasury's concern becomes apparent. Under all methods except for the remedial method, a U.S. Transferor could form a partnership with a related foreign person and it would be possible that no allocations of income or gain would be made to the contributing partner to account for Section 704(c) gain. Nevertheless, as argued in a prior article and as commentators pointed out, the method Treasury has selected to remedy its concern is arguably outside of its authority under Section 721(c).[29] Furthermore, it is difficult to understand why Treasury and the IRS used one of Subchapter K's most complex mechanics when a much more obvious and simple solution is available. Specifically, as some comments alluded to, Treasury could have scrapped the Notice and simply required a U.S. Transferor to recognize the frozen, unreduced amount of pre-contribution built-in gain existing at the time of contribution upon the disposition by the partnership of the property contributed by the U.S. Transferor to the extent such gain is not then recognized by the U.S. Transferor. Such a "wait and see" alternative would have followed Treasury's approach to gain recognition agreements ("GRAs") for outbound stock transfers under Section 367(a)[30] and domestic use agreements, with respect to dual consolidated losses.[31] Treasury contends it did not need to follow such an approach.[32] However, even if that were true, it does not mean that a "wait and see" approach would not have been a far simpler and more accurate instrument to achieve the goal of Section 721(c).

Consistent Allocation Method

The Consistent Allocation Method is implemented to insure that the Remedial Method Requirement serves its purpose. The Consistent Allocation Method requires that "[f]or each taxable year of a section 721(c) partnership in which there is remaining built-in gain in the section 721(c) property, the section 721(c) partnership must allocate each book item of income, gain, deduction, and loss with respect to the section 721(c) property to the U.S. transferor in the same percentage."[33] As Treasury points out, if a Section 721(c) Partnership were able to allocate deductions to the U.S. Transferor at a higher percentage and gross income at a lower percentage, the impact of the remedial allocations could be offset.[34]

The process the Temporary Regulations outline to apply the Consistent Allocation Method can be broken down into the following steps:

1. The partnership allocates gross book income to the Section 721(c) Property, using any reasonable method. Such income will then constitute a "class" of gross income for the purpose of the next step.[35]
2. The partnership allocates losses and deductions to the class of gross income using the concepts for allocation and apportionment described in Reg. 1.861-8 and Temp. Reg. 1.861-8T. These rules generally allocate deductions to the class of income to which the deductions are "definitely related" (i.e., where the deduction is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived). Deductions not definitely related to a class of gross income are allocated to all gross income. Special rules apply to deductions from interest and R&D expenditures and, for the purpose of Section 721(c), those rules or any other reasonable method may be used to allocate deductions from such expenditures.[36]

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29 See Notice Article at 216; see also Comment Letter, AICPA, RE: Notice 2015-54, Transfers of Property to Partnerships with Related Foreign Partners and Controlled Transactions Involving Partnerships (5/19/16).

30 See generally Reg. 1.367(a)-8.

31 See generally Reg. 1.1503(d)-6(d).

32 TD 9814, section I.

33 Temp. Reg. 1.721(c)-3T(c)(1).

34 See TD 9814, section VI, subsection e.

35 Temp. Reg. 1.721(c)-3T(c)(2).

36 Temp. Reg. 1.721(c)-3T(c)(3).

3. The partnership allocates a percentage of income, from Step 1, to the U.S. Transferor.
4. The partnership allocates the same percentage of deductions and losses, from Step 2, to the U.S. Transferor. The allocation of deductions and losses is made in this manner without regard to the partners' interest in the partnership.

There are two exceptions to the Consistent Allocation Method, one for regulatory allocations and the other for creditable foreign taxes. The exception for creditable foreign taxes is unqualified.[37] However, the exception for regulatory allocations applies only to allocations of income or gain to the U.S. Transferor or allocations of deduction or loss to a partner other than the U.S. Transferor.[38] Otherwise, to the extent a regulatory allocation causes an allocation of income, gain, deduction, or loss to be made in an inconsistent percentage, the U.S. Transferor is required to recognize that amount of the Built-In Gain in the Section 721(c) Property.[39] Regulatory allocations are: (1) allocations of partner nonrecourse deductions; (2) allocations pursuant to a minimum gain chargeback; (3) a partner minimum gain chargeback; (4) a qualified income offset; (5) an allocation with respect to the exercise of a noncompensitory stock option; and (6) allocations of partnership level ordinary income under Section 751.[40]

The first point to make with respect to the Consistent Allocation Method is that it applies on an annual basis. Stated differently, only allocations in a given year are required to be made in equal percentages. The Consistent Allocation Method does not require an allocation percentage from one year to be used in another year. Therefore, for example, preferred returns are not off the table just because they would naturally result in different allocation percentages from year to year. However, the second point is that care must be taken in drafting any agreement where all items are not allocated based on uniform annual percentages. The most serious pitfall in this regard is that nonrecourse deductions are not included in the definition of "regulatory allocations." Consider a circumstance in which a Section 721(c) Partnership provided for a preferred return to a U.S. Transferor and, afterwards, allocated profits according to the partners' sharing percentage, allocating income accordingly. In this circumstance, if the partnership allocates non-recourse deductions according to the partners' sharing percentages, the partnership would fail the Consistent Allocation Method. This is so even though the allocation of nonrecourse deductions would result in extra deductions to the foreign partner.

Finally, even the way that the Temporary Regulations deal with regulatory allocations can become problematic for simple partnerships that allocate all items according to a fixed percentage. For example, when partner nonrecourse deductions are allocated to the foreign related partner and, subsequently, there is a related partner minimum gain chargeback, the effect of the two allocations offset. However, the partner nonrecourse deductions, which are regulatory allocations of deduction to the foreign related partner, are subject to the exception for regulatory allocations. Later, the partner minimum gain chargeback with respect to those deductions is a regulatory allocation; however, it is an allocation of income to the foreign related partner, resulting in a partial Acceleration Event. In sum, the reason that Treasury insists on implementing the Consistent Allocation Method is understandable. However, it creates a number of potential pitfalls.

Acceleration Events

Generally, an Acceleration Event is any event that would reduce the amount of remaining built-in gain that the U.S. Transferor would recognize under the gain deferral method had the event not occurred or could defer the recognition of the remaining built-in gain.[41] The Temporary Regulations specify additional instances that are Acceleration Events: (1) a Section 721(c) Partnership's contribution of Section 721(c) Property to another partnership (unless it qualifies as a successor event);[42] (2) the contribution of an interest in a Section 721(c) Partnership to another partnership (unless it qualifies as a successor event);[43] and (3) any failure to comply with the Reporting Requirements, but only if the failure is willful.[44] Moreover, at any time, by making certain filings set forth in the Temporary Regulations and reporting gain as though an Acceleration Event had occurred, a U.S. Transferor may opt to trigger a deemed Acceleration Event.[45]

When an Acceleration Event occurs, the U.S. Transferor recognizes remaining Built-In Gain as though the partnership had sold the Section 721(c) Property for its fair market value immediately before the Acceleration Event.[46] Both the U.S. Transferor and the partnership increase their basis in the Section 721(c) Property by the amount of gain recognized.[47] For the purpose of depreciation and amortization, any basis increase is treated as new property placed into service on the date of the Acceleration Event.[48]

As discussed above, the Notice had taken a "unified approach," requiring the Gain Deferral Method to be applied to all Section 721(c) Property for it to be applied to any Section 721(c) Property. The Notice also provided that an Acceleration Event with respect to one Section 721(c) Property was an Acceleration Event for all Section 721(c) Property. The IRS recognized that such a unified approach was not necessary in the Temporary Regulations. Therefore, the consequence of an Acceleration Event is also determined on a property-by-

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[37] Reg. 1.721(c)-3T(c)(4)(ii).

[38] Regs. 1.721(c)-3T(c)(4)(i)(A)-(B).

[39] Reg. 1.721(c)-3T(c)(4)(i)(C).

[40] Reg. 1.721(c)-1T(b)(10).

[41] Temp. Reg. 1.721(c)-4T(b)(1).

[42] *Id.*, see also Temp. Reg. 1.721(c)-5T(c)(5)(i).

[43] *Id.*, see also Temp. Reg. 1.721(c)-5T(c)(5)(ii).

[44] Temp. Reg. 1.721(c)-4T(b)(2).

[45] Temp. Reg. 1.721(c)-4T(b)(4).

[46] Temp. Reg. 1.721(c)-4T(c).

[47] *Id.*

[48] Temp. Reg. 1.721(c)-4T(c)(2).

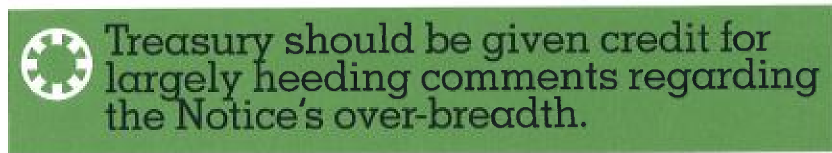
property basis, so that an Acceleration Event with respect to one Section 721(c) Property does not cause an Acceleration Event with respect to another.

Exceptions to Acceleration Events

The Temporary Regulations provide three categories of exceptions to Acceleration Events: termination events, successor events, and partial acceleration events. Termination events are not Acceleration Events and the obligation on the U.S. Transferor and the Section 721(c) Partnership to comply with the Gain Deferral Method terminates.[49] Successor events also are not Acceleration Events; however, the obligation on the U.S. Transferor and the Section 721(c) Partnership to comply with the Gain Deferral Method continues with respect to the successor of the U.S. Transferor or the Section 721(c) Partnership.[50] Finally, Partial Acceleration Events are Acceleration Events, but only with respect to a portion of a Section 721(c) Property's Built-In Gain. After a partial Acceleration Event, the Gain Deferral Method is continued with respect to remaining Built-In Gain.[51] For those familiar with GRAs, these concepts should be familiar. Termination events under the Temporary Regulations are like termination events for GRAs.[52] Successor events are similar to triggering events that can be cured by entry into a new GRA and partial acceleration events are similar to triggering events with respect to only a portion of the stock covered by a GRA.[53]

There are two additional exceptions that do not fall into any of the categories above. One exception applies to outbound transfers to a foreign corporation, governed under Section 367.[54] Generally, when a partnership with U.S. partners transfers property to a foreign corporation in a Section 367 transaction (e.g., a Section 351 contribution), for the purpose of applying Section 367's gain recognition rules, the U.S. partner is generally treated as transferring its proportionate share of the transferred property.[55] When a Section 721(c) Partnership transfers Section 721(c) Property in such a transaction, there is no Acceleration Event with respect to the portion of the property treated as transferred by the U.S. Transferor. However, the U.S. Transferor must recognize the Built-In Gain with respect to the portion of the property treated as transferred by the other partner(s).

The second exception applies to the U.S. Transferor's (or an intermediate partnership's) transfer of a portion of an interest in a Section 721(c) Partnership where gain or loss is recognized. In such a case, there is no Acceleration Event with respect to the transferred interest and the Gain Deferral Method continues to apply to the portion of the interest retained.



Reporting Requirements

Compliance with the Gain Deferral Method subjects the U.S. Transferor to extensive and complex reporting requirements.[56] First, for reporting purposes, the Temporary Regulations treat all Section 721(c) Partnerships as foreign partnerships, subjecting them to the reporting requirements of Section 6038B and, thereby, requiring a U.S. Transferor to file Form 8865 to report contributions to, and ownership of, all Section 721(c) Partnerships.[57] In other words, even when a Section 721(c) Partnership is organized in the United States, it is treated as a foreign partnership for Form 8865 reporting purposes. However, a Section 721(c) Partnership organized in the United States will still be required to file a U.S. return.[58]

The IRS has indicated its intent to update Form 8865 to include all of the information required under the Temporary Regulations for reporting the contribution in the year it occurs and for the annual reporting required for every year that the Gain Deferral Method applies.[59] Given the complexity and difficulty of the Reporting Requirements, perhaps the most important provision is the one excusing filing errors that are not willful.[60] The Temporary Regulations establish a procedure that a U.S. Transferor must follow to establish non-willfulness.[61] The threshold of non-willfulness and the procedure by which non-willfulness is established apply only for the purpose of curing reporting failures that otherwise would result in an Acceleration Event.[62] The willfulness

49 Temp. Reg. 1.721(c)-5T(b). Generally, termination events are: (1) transfers of Section 721(c) Property (other than a partnership interest) to a domestic corporation in a Section 351 transaction; (2) an incorporation of a Section 721(c) Partnership into a domestic corporation; (3) a distribution of Section 721(c) Property to the U.S. transferor or to a member of the U.S. Transferor's consolidated group, after the seven-year period described in Section 704(c)(1)(B); (4) a Section 721(c) Partnership ceases to have a related foreign partner; (5) a fully taxable sale of the Section 721(c) Property; (6) a fully taxable sale of the U.S. Transferor's entire interest in a Section 721(c) Partnership.

50 Temp. Reg. 1.721(c)-5T(c). Generally, successor events are: (1) a transfer of an interest in a Section 721(c) Partnership to a domestic corporation in a tax-free contribution or reorganization; (2) a transfer to a consolidated group member that is an intercompany transaction; (3) a technical termination of a Section 721(c) Partnership; (4) a Section 721(c) Partnership's contribution of Section 721(c) Property to a controlled partnership, when certain requirements are satisfied; (5) a contribution of an interest in a Section 721(c) Partnership to a controlled partnership, when certain requirements are satisfied.

51 Temp. Reg. 1.721(c)-5T(d). Generally, partial termination events are: (1) a partial acceleration event described above with respect to regulatory regulations; and (2) distributions of partnership property resulting in a basis increase to Section 721(c) Property under Section 734.

52 See Reg. 1.367(a)-8(o).

53 See Regs. 1.367(a)-8(k) and -8(c)(1)(i).

54 Temp. Reg. 1.721(c)-5T(e).

55 Temp. Regs. 1.367(a)-1T(c)(3)(i) and -1T(d)(1).

56 See generally Temp. Reg. 1.721(c)-6T.

57 Temp. Reg. 1.721(c)-6T(b)(4).

58 See *id.* Generally, domestic partnerships are required to file U.S. returns and foreign partnerships are not, unless they have ECI. See Sections 6031(a) and (e).

59 TD 9814, section X, subsection a.

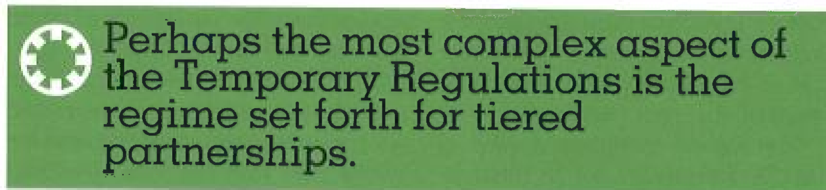
60 Temp. Reg. 1.721(c)-6T(f).

61 Temp. Reg. 1.721(c)-6T(f)(2).

62 Temp. Reg. 1.721(c)-6T(f)(1).

threshold and its accompanying procedure do not apply to avoid penalties under Section 6038B, under which a taxpayer must establish reasonable cause for filing errors.[63] This is especially important to keep in mind because, as mentioned above, Section 6038B penalties will apply to Form 8865 reporting failures with respect to Section 721(c) Partnerships formed in the United States.

The willfulness threshold is, of course, a welcome accommodation that aligns with the approach that Treasury has taken in other circumstances. The treatment of all Section 721(c) Partnerships as foreign partnerships, on the other hand, is of questionable validity. Section 7701(a)(4) grants Treasury the authority to treat a partnership organized in the United States as a foreign partnership. However, that does not necessarily mean that Treasury has the authority to treat a partnership as foreign for some purposes and domestic for other purposes. It is even less clear that Treasury has the authority to treat a partnership as both a foreign and a domestic partnership for return filing purposes.



Extension of the Statute of Limitations

The final requirement of the Gain Deferral Method is that the U.S. Transferor must consent to extend the period of limitations on the assessment of tax for: (1) eight full tax years for the gain realized but not recognized on a gain deferral contribution; (2) six full tax years for the U.S. Transferor's distributive share of all items with respect to the Section 721(c) Property for the year of contribution and two subsequent years; and (3) five full tax years for the gain recognized on the contribution of Section 721(c) Property for which the Gain Deferral Method is not applied, for all contributions made within five partnership tax years following a gain deferral contribution.[64]

The need for an extension of the statute of limitations in this scenario is unclear, because there do not appear to be any provisions in the Temporary Regulations where an action in one year retroactively reaches back to affect prior tax years. However, the more important aspect here is a technical one. Specifically, the Temporary Regulations require the U.S. Transferor to extend the statute of limitations with respect to its distributive share of all items with respect to the Section 721(c) Property. In general, under the new rules for partnership audits, passed under the Bipartisan Budget Act of 2015,[65] a partner's distributive share of a partnership's tax items is determined at the partnership level and an assessment with respect to this is subject only to the partnership's statute of limitations.[66] As a result, this provision should require the partnership (and not the partner) to extend the statute of limitations.

Tiered Partnerships

Perhaps the most complex aspect of the Temporary Regulations is the regime set forth for tiered partnerships. The tiered partnership rules come into play when: (1) a U.S. Transferor contributes a partnership interest to a Section 721(c) Partnership and/or when (2) a partnership, with a U.S. Transferor as a direct or indirect partner, contributes Section 721(c) Property to a second partnership.

Contribution of a Partnership Interest to a Partnership. If an interest in a partnership (a "lower-tier partnership") that is Section 721(c) Property is contributed to a Section 721(c) Partnership (an "upper-tier partnership"), the standard rules discussed above apply without substantial alteration, unless the lower-tier partnership is a "controlled partnership."[67] Whether a partnership is a controlled partnership with respect to a U.S. Transferor is determined under the facts and circumstances, but a partnership is deemed to be a controlled partnership if the U.S. Transferor and related persons own, directly or indirectly, more than 50% of the interests in the partnership's capital or profits.[68]

When the lower-tier partnership is a controlled partnership then it too is treated as a Section 721(c) Partnership for the purpose of applying the Gain Deferral Method, and the following requirements are imposed:[69]

1. The lower-tier partnership must revalue all of its property if the revaluation would result in built-in gain (book value in excess of adjusted tax basis) with respect to any partnership property that is not Excluded Property.
2. Each property that the revaluation caused to have built-in gain is treated as Section 721(c) Property to which the Gain Deferral Method must be applied.
3. With respect to the application of the Consistent Allocation Method, the lower-tier partnership must treat the upper-tier partnership as

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63 *Id.*

64 Temp. Reg. 1.721(c)-6T(b)(5).

65 PL 114-74, 11/2/16, 129 Stat. 584 (the "Act"). Generally, the new partnership audit rules apply to returns filed for partnership tax years beginning after 12/31/17. Act § 1101(g).

66 See Section 6221(a) ("Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined .... at the partnership level pursuant to this subchapter."); Section 6235(a) ("Except as otherwise provided in this section, no adjustment under this subpart for any partnership taxable year may be made after [the expiration of the partnership's statute of limitations]"). Under the regime prior to the Act, courts had understood that the statute of limitations for assessments with respect to a partner's distributive share of partnership items was the later between the partner's and the partnership's statute of limitations. See *Rhone-Poulenc Surfactants and Specialties, L.P.*, 114 TC 533 (2000).

67 Temp. Reg. 1.721(c)-3T(d)(1).

68 Temp. Reg. 1.721(c)-1T(b)(4).

69 Temp. Reg. 1.721(c)-3T(d)(1); see also Temp. Reg. 1.721(c)-1(b)(14)(ii).

if the upper-tier partnership were the U.S. Transferor.

If there are any other controlled partnerships below the lower-tier partnerships, all of the above requirements that apply to the lower-tier partnership apply to them as well.[70]

Partnership Contribution of Section 721(c) Property. When a U.S. Transferor is a direct or indirect partner in a partnership and the partnership (an "upper-tier partnership") contributes Section 721(c) Property to another partnership (a "lower-tier partnership"), the first step is to determine whether or not the lower-tier partnership becomes a Section 721(c) Partnership.[71] For the purpose of this determination, the U.S. Transferor is treated as contributing its proportionate share of the property contributed by the upper-tier partnership to the lower-tier partnership.[72] Then, if the lower-tier partnership has an indirect foreign partner related to the U.S. Transferor and related parties to the U.S. Transferor own 80% or more of the interests in the lower-tier partnership, the lower-tier partnership is a Section 721(c) partnership. In such a circumstance:[73]

1. The upper-tier partnership is treated as a Section 721(c) Partnership for the purpose of applying the Gain Deferral Method.[74]
2. With respect to the application of the Consistent Allocation Method, the lower-tier partnership must treat the upper-tier partnership as if the upper-tier partnership were the U.S. Transferor.
3. If the upper-tier partnership is a controlled partnership, its interest in the lower-tier partnership is treated as Section 721(c) Property to which the Gain Deferral Method must be applied.

If there are controlled partnerships above the upper-tier partnerships (e.g., a "top tier partnership"), all of the same concepts apply with respect to the top tier partnership as though it were an upper-tier partnership and as though the upper-tier partnership were the lower-tier partnership.[75]

Anti-Churning

The Temporary Regulations introduce a completely new aspect to the Gain Deferral Method not alluded to in the Notice that applies to Anti-Churning Property. Generally, Anti-Churning Property is property that: (1) was not subject to amortization prior to the enactment of Section 197; (2) would be subject to amortization under Section 197; and (3) was held by the taxpayer (or a related party) prior to the enactment of Section 197.[76] Such property, generally, is not subject to amortization even after the enactment of Section 197. The general rule for Anti-Churning Property with respect to Section 704(c) allocations is that remedial allocations may be made with respect to the property to a partner that is not a related party of the contributing partner, but remedial allocations cannot be made with respect to the property to a partner that is a related party of the contributing partner.[77]

Here, Treasury faced a conundrum. At least 80% of the interests in all Section 721(c) Partnerships will be held by related partners. The Gain Deferral Method requires the remedial method to be used, but remedial allocations with respect to Anti-Churning Property cannot be made to related partners. Treasury appeared to have two options. Option one would be to exempt Section 721(c) Property that is Anti-Churning Property from the Remedial Method Requirement (an "Exemption Approach"). Option two would be to make an exception to the anti-churning rules, allowing remedial allocations to be made pursuant to the Gain Deferral Method (an "Exception Approach").[78] Treasury rejected both options and went with a third option that Treasury invented from whole cloth. That is, the Temporary Regulations require that the partnership make remedial allocations of income to the U.S. Transferor, but the related partners do not get remedial allocations of deduction.[79] Instead, a special basis adjustment (similar to a special basis adjustment under Section 743) is made, increasing the partnership's basis in the Anti-Churning Property, but only with respect to the related, non-contributing partners.[80]

Interestingly, the Temporary Regulations contain only two provisions that target taxpayers attempting to avoid the application of the regulations.

In fairness to Treasury, it is understandable that neither the Exemption Approach nor the Exception Approach was appealing. Treasury explains that it did not adopt the Exemption Approach because it would have incentivized a U.S. Transferor to attribute more value to Anti-Churning Property contributed together with other depreciable or amortizable property.[81]

The Exception Approach could also be problematic when, for example, a Section 721(c) Partnership had U.S. partners related to the U.S. Transferor that would receive remedial allocations of deduction with respect to the contributed Anti-Churning Property. The third approach adopted by the Temporary Regulations is just as subject to criticism as the other two approaches,

70 *Id.*

71 Temp. Reg. 1.721(c)-3T(d)(2).

72 Temp. Reg. 1.721(c)-2T(d)(1).

73 Temp. Reg. 1.721(c)-3T(d)(2).

74 Temp. Reg. 1.721(c)-1(b)(14)(ii).

75 *Id.*

76 Section 197(f)(9).

77 Reg. 1.197-2 -2(h)(12)(vii)(B).

78 See TD 9814, section VI subsection d.

79 Temp. Reg. 1.704-3T(d)(5)(iii)

80 *Id.*

81 TD 9814, section VI subsection d.

as it violates the essential nature of a remedial allocation, which allows for only the creation of two perfectly offsetting notional tax items. The bottom line is that there are three imperfect potential approaches to deal with Anti-Churning Property and Treasury made its selection based on the approach that favors the taxpayer the least.

Anti-Abuse

Interestingly, the Temporary Regulations contain only two provisions that target taxpayers attempting to avoid the application of the regulations. One provision is a very specific provision that applies to one of the termination events. More specifically, a termination event occurs when a Section 721(c) Partnership no longer has any foreign related partners.[82] However, no termination event will occur if there is a plan for a foreign related partner to subsequently become a direct or indirect partner of the partnership.[83] The other anti-abuse provision is more general, but still very limited, providing that:[84]

> If a U.S. transferor engages in a transaction (or series of transactions) or an arrangement with a principal purpose of avoiding the application of the section 721(c) regulations, the transaction (or series of transactions) or the arrangement may be recharacterized (including by aggregating or disregarding steps or disregarding an intermediate entity) in accordance with its substance.

It is not clear what this provision adds. The IRS always can recharacterize a transaction in accordance with its substance.[85] Moreover, engaging in transactions to avoid the application of the Temporary Regulations is not sufficient to trigger the anti-abuse rule. For the IRS to recharacterize such transactions, it must show that the form of the transactions do not accord with their substance. Thus, if an unrelated person owns 21% of a partnership, these rules simply do not apply.

CONCLUSION

Treasury believed that taxpayers were using partnerships with related foreign partners to outbound appreciated property without being fully taxed. Treasury published the Notice, which laid out a complicated regime deeply interwoven into the fabric of partnership taxation. As comments to the Notice pointed out, Treasury could have taken a far simpler approach. The amount of a U.S. Transferor's built-in gain could be frozen upon contribution and the U.S. Transferor could be required to recognize such amount, if the U.S. Transferor does not recognize the amount on a later disposition of the contributed property by the partnership. Commenters also pointed out that provisions in the Notice were overbroad.

After receiving comments, Treasury chose to push forward, adopting the framework set forth in the Notice. While questions remain over Treasury's authority to implement such a framework, Treasury should be given credit for largely heeding comments regarding the Notice's over-breadth. The Temporary Regulations take a more reasonable approach to their scope, applying only when there is a partnership with 80% or more related ownership instead of using the more than 50% threshold set forth in the Notice. The Temporary Regulations also are more reasonable in allowing the Gain Deferral Method and Acceleration Events to be applied on a property-by-property basis, instead of using the unified approach proposed in the Notice. There is room to criticize the details of the Temporary Regulations, but such is to be expected for a subject matter so complex. The complexity is self-inflicted, but having been inflicted, the Temporary Regulations are not the monstrosity they could have been. ●

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82 Temp. Reg. 1.721(c)-4T(b)(5).

83 *Id.*

84 Temp. Reg. 1.721(c)-1T(d).

85 See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 14 AFTR 1191 (1935); *True*, 190 F.3d 1165, 84 AFTR2d 99-5950, 1174 (CA-10, 1999) (substance over form is a "fundamental tax principle," and applies to "look beyond the taxpayers' characterization" of the challenged business transactions); *Kornfeld*, 137 F.3d 1231, 81 AFTR2d 98-907, 1234 (CA-10, 1998) ("the taxation scheme set out in the Internal Revenue Code is complicated and the tax consequences of many transactions depend on form, how the transaction is structured," but at the same time, the "incidence of taxation depends on the substance of a transaction."); *Scott*, 37 F.3d 1564, 74 AFTR2d 94-6454, 1572 (CA-10, 1994) ("the income tax consequences under the Internal Revenue Code depend upon the substance of the situation, not the form."); *Newman*, 894 F.2d 560, 65 AFYT2d 90-635, 562 (CA-2, 1990) ("[i]n reviewing a transaction for tax consequences, the substance of the agreement takes precedence over its form.").