ALSTON & BIRD

WWW.ALSTON.COM

International Tax ADVISORY ■

AUGUST 17, 2015

IRS Announces Rules on Transfers to Foreign Partnerships

On August 6, 2015, the IRS issued Notice 2015-54 (the Notice), describing regulations under Section 721(c) meant to ensure that gain is recognized, immediately or periodically, when a U.S. person transfers appreciated property to certain partnerships with foreign partners. These rules, largely effective for transfers on or after August 6, 2015, would override the general nonrecognition rule of Section 721(a) for partnership contributions. The Notice also described rules under Sections 482 and 6662, designed to make sure controlled transactions involving partnerships use appropriate valuations, though these rules would not be effective until regulations are issued.

The immediate effective date for most of the Section 721(c) rules described in the Notice indicates that the government is serious about shutting down potentially abusive transactions. Unfortunately, the Notice's breadth may saddle taxpayers engaged in routine transactions with burdensome tax and/or reporting consequences.

Background

The Taxpayer Relief Act of 1997 repealed Sections 1491 through 1494 of the Code, which had imposed an excise tax on certain transfers of appreciated property by a U.S. person to a foreign partnership. According to the legislative history, new reporting requirements for foreign partnerships would eliminate the need for the excise tax. Nevertheless, as the Notice points out, Congress appreciated that taxpayers might use a partnership to shift gain to foreign persons. Thus, in Section 721(c), Congress granted regulatory authority to provide that Section 721(a) nonrecognition would not apply to gain realized on a transfer to a partnership if the gain would be included in the income of a non-U.S. person. Similarly, Section 367(d)(3), added by the 1997 Act, authorized the Treasury to apply the rules of Section 367(d)(2) (i.e., deemed sale treatment) to transfers of intangible property to partnerships. To date, regulations under Section 721(c) and 367(d)(3) have never been issued.

Section 367 (and its predecessor) was added to the Code to prevent U.S. persons from avoiding U.S. tax by transferring appreciated property (including intangibles) to foreign corporations in nonrecognition transactions. Regulations under Section 367 already contain some rules that address Section 351 or 361 transfers to foreign corporations where partnerships are involved. For example, if a U.S. person is a partner in a partnership that transfers property to a foreign corporation, Section 1.367(a)-1T(c)(3) treats the U.S. partner as transferring its proportionate share of the partnership's assets directly to the foreign corporation. Like Section 351(a) for transfers to corporations, Section 721(a) provides that no gain or loss is recognized on the contribution of property to a partnership in exchange for an interest in the partnership. Absent regulations under Section 721(c) or 367(d)(3), a U.S. person generally would not recognize gain on the contribution of appreciated property to a partnership with foreign partners.

Section 704(c) requires partnerships to allocate income, gain, loss and deduction with respect to contributed property so as to take into account any built-in gain or loss at the time of contribution. Existing regulations explain that Section 704(c) is meant to prevent the shifting of tax consequences for pre-contribution gain or loss among partners. Section 704(c) allocations must be made using any reasonable method consistent with this purpose. The regulations describe three methods as generally reasonable: the traditional method, the traditional method with curative allocations and the remedial method.

The remedial method is of special importance under the Notice because it is one of the requirements to avoid immediate gain recognition. The remedial method uses notional (i.e., made-up) tax allocations to cure "distortions" that can arise under the traditional method due to the "ceiling rule." The ceiling rule provides that the total income, gain, loss or deduction allocated to partners for a taxable year with respect to a property cannot exceed the total corresponding partnership items with respect to that property. The remedial method eliminates the ceiling rule limitation by making remedial allocations of notional items to noncontributing partners and making offsetting remedial allocations of notional items to the contributing partner. (See example below.) The existing regulations do not require use of the remedial method. However, pursuant to an anti-abuse rule, the IRS can make adjustments if a partnership's Section 704(c) method is unreasonable.

> Example: In 2012, X and Y form an equal partnership, P. X contributes land, Blackacre, with an adjusted tax basis of $4,000 and fair market value (FMV) of $10,000 to P – i.e., there is a $6,000 built-in gain on Blackacre. Y contributes $10,000 cash to P. Assume that X does not recognize its gain immediately on making the contribution, although it would have recognized that gain if it had sold the property. Thus, P has the same $4,000 basis in Blackacre as X had before the contribution. At the end of 2012, P sells Blackacre for $9,000, realizing capital gain of $5,000 ($9,000 less tax basis of $4,000). P has no other items of income, gain, loss or deduction.
>
> Under the traditional method, P is only allowed to make a tax allocation of the actual $5,000 gain. Thus, P would allocate the entire gain to X because there was built-in gain on Blackacre (in excess of $5,000). There is no tax loss to allocate, despite that Blackacre has apparently depreciated $1,000 since X contributed it to P.
>
> The remedial method would permit P to make (1) a remedial allocation of $500 loss to Y and (2) an offsetting remedial allocation to X of $500 additional gain. The net effect of these remedial allocations to P is zero, but they have an actual tax effect for X and Y. Specifically, X is allocated $5,500 of gain even though P only had $5,000 of gain. The theory is that Y in effect paid $5,000 for a 50 percent interest in Blackacre and suffers an economic loss of $500 when that 50 percent interest in Blackacre is sold for $4,500. The remedial method invents a notional tax loss that allows Y to deduct its economic loss. The cost of allocating this $500 notional loss to Y is the allocation of $500 of notional gain to X. This $500 gain is intended to represent a portion of the taxable gain that X deferred by contributing Blackacre to P in a tax-free transaction instead of selling Blackacre for cash.

Sections 704(a) and (b) provide that a partner's distributive share of income, gain, loss, deduction or credit will be determined based on the partnership agreement, unless the agreement does not have allocation rules or the allocation under the agreement does not have substantial economic effect. The existing regulations provide that an allocation respected under Section 704(b) may nevertheless be reallocated under other Code provisions, such as Section 482.

Section 482 authorizes the IRS to make allocations among two or more organizations, trades or businesses (whether or not incorporated, affiliated or organized in the United States) that are owned or controlled directly or indirectly by the same persons to prevent tax evasion or to reflect clearly the income of any such organizations, trades or businesses. An arm's-length standard applies to determine the proper results of transactions involving controlled taxpayers (controlled transactions) under Section 482. Under the regulations already in effect prior to the Notice, controlled transactions may include contributions.

Section 1.482-1 provides that the arm's-length result of a controlled transaction must be determined under the method that provides the most reliable measure of an arm's-length result under the facts and circumstances. Section 1.482-7 provides specific methods used to evaluate whether cost-sharing arrangements produce results consistent with the arm's-length standard. Similar regulations apply to the transfer or license of intangible property (as defined in Section 936(h)(3)(B)), the consideration for which, per Section 482, must be commensurate with income attributable to the intangible. The IRS may make periodic adjustments to ensure consideration is consistent with the arm's-length standard. Section 6662 and regulations thereunder impose penalties where a taxpayer fails to meet certain requirements, including the requirements to select and apply a Section 482 method that the taxpayer could reasonably conclude meets the regulatory standard of reliability and to maintain sufficient contemporaneous documentation to support the taxpayer's reasonable conclusion.

The Notice states that the Treasury and IRS intend to exercise regulatory authority because they are aware that "certain taxpayers purport 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." Moreover, the Notice says that "[m]any of these taxpayers choose a section 704(c) method other than the remedial method and/or use valuation techniques inconsistent with the arm's length standard." Based on the IRS' experience with these taxpayer positions, the Treasury and IRS have concluded that regulatory action is warranted.

Rules under Section 721(c) for Transfers to Partnerships with Related Foreign Partners

Under the rules described in the Notice, Section 721(a) nonrecognition will not apply when a U.S. person contributes "Section 721(c) Property" to a "Section 721(c) Partnership," unless the "Gain Deferral Method" is applied. In other words, subject to a de minimis rule, a U.S. transferor will be required to recognize built-in gain on the property contributed to the partnership unless the transferor applies the Gain Deferral Method. The Notice states that these rules will generally apply to transactions involving tiered partnerships.

Section 721(c) Property is any built-in gain property, except cash equivalents, securities within the meaning of Section 475(c)(2) and tangible property with built-in gain less than $20,000. (Section 721(c) Property includes an interest in a partnership that owns Section 721(c) Property.) A partnership, domestic or foreign, is a Section 721(c) Partnership if a U.S. person contributes Section 721(c) Property to the partnership and after the contribution and related transactions, (1) a related foreign person is a direct or indirect partner in the partnership, and (2) the U.S. transferor and one or more related foreign persons own more than 50 percent of the interests in partnership capital, profits, deductions or losses. A related foreign person is a non-U.S. person related to the U.S. transferor within the meaning of Section 267(b) or 707(b)(1).

The Gain Deferral Method allows a U.S. transferor to recognize the built-in gain on Section 721(c) Property over time rather than immediately but requires that:

1. The partnership adopts the remedial allocation method for all built-in gain with respect to Section 721(c) Property contributed pursuant to the same plan by a U.S. transferor and all related U.S. transferors;

2. During any taxable year in which there is remaining built-in gain with respect to an item of Section 721(c) Property, the partnership allocates all items of Section 704(b) income, gain, loss and deduction with respect to that Section 721(c) Property in the same proportion;

3. The U.S. transferor recognizes gain on "Acceleration Events";

4. The Gain Deferral Method is adopted for all Section 721(c) Property subsequently contributed to the partnership by the U.S. transferor and all other related U.S. transferors until the earlier of (i) the date no built-in gain remains with respect to any Section 721(c) Property to which the Gain Deferral Method first applied or (ii) the date that is 60 months after the date of the initial contribution of Section 721(c) Property to which the Gain Deferral Method applied; and

5. The U.S. transferor and the partnership meet certain reporting and other requirements (e.g., the U.S. transferor must extend the statute of limitations with respect to all items related to the Section 721(c) Property contributed).

An Acceleration Event is any transaction that would reduce or defer the amount of built-in gain that a U.S. transferor would have to recognize. If an Acceleration Event occurs, the U.S. transferor must recognize gain equal to the remaining built-in gain that would have been allocated to the U.S. transferor if the Section 721(c) Partnership had sold the Section 721(c) Property at its fair market value. The Notice provides that an Acceleration Event does not include the following:

- Transfer by a U.S. transferor of an interest in a Section 721(c) Partnership to a domestic corporation in a Section 351(a) or 381(a) transaction, provided the parties continue applying the Gain Deferral Method by treating the transferee corporation as the U.S. transferor for purposes of the Notice;

- Transfer by a Section 721(c) Partnership of a lower-tier partnership with Section 721(c) Property to a domestic corporation in a Section 351(a) transaction, provided the parties continue applying the Gain Deferral Method by treating the transferee corporation as the U.S. transferor for purposes of the Notice;

- Transfer by a Section 721(c) Partnership of Section 721(c) Property to a domestic corporation in a Section 351(a) transaction; or

- Transfer by a Section 721(c) Partnership of Section 721(c) Property to a foreign corporation in a Section 351(a) transaction, to the extent that the Section 721(c) Property is treated as transferred by a U.S. person (other than a partnership) under Section 1.367(a)-1T(c)(3)(i) or (ii). The stock received by the Section 721(c) Partnership in this or the preceding type of transfer will not be subject to the Gain Deferral Method.

The Treasury and IRS have requested comments on whether an Acceleration Event should also exclude the distribution of Section 721(c) Property to an unrelated foreign partner beyond the seven-year limit in Section 704(c)(1)(B).

If a Section 721(c) Partnership is a foreign partnership, a U.S. transferor (or domestic partnership in which a U.S. transferor is a direct or indirect partner) must satisfy any existing reporting obligations under Sections 6038, 6038B, and 6046 and the regulations thereunder with respect to the contribution of Section 721(c) Property to the partnership. For tax years beginning in 2015, the IRS plans to make relevant modifications to Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships) to require supplemental information for Section 721(c) transfers.

The Treasury and IRS also intend to issue regulations with additional reporting requirements for a U.S. transferor for each year the Gain Deferral Method applies. These requirements, comparable to those for U.S. transferors subject to gain recognition agreements under Section 367(a) regulations, would not apply to years that end before the date such regulations are published. The Treasury and IRS have specifically asked for comments on whether the regulations should provide rules similar to those recently finalized under Sections 367(a) and 6038D regarding failures to file gain recognition agreements or to meet other reporting obligations, including standards for relief.

The Notice provides a fairly broad anti-abuse rule: If a U.S. transferor engages in a transaction or series of transactions with the principal purpose to avoid the rules described in the Notice, then the transaction(s) may be disregarded or recharacterized according to its substance. Examples illustrate the Notice's basic definitional rules under Section 721(c).

Rules for Controlled Transactions Involving Partnerships

The Notice states that Section 482 principles and related penalties (already) apply to controlled transactions involving partnerships, including those described in the Notice. Where U.S. and foreign persons under common control enter a partnership, the amounts of contributions to and distributions from the partnership, partnership allocations and partners' relative interests in the partnership are subject to adjustments to reflect arm's-length results. Consequently, gains recognized if Section 721(a) does not apply or if remedial allocations are required by the Gain Deferral Method are subject to Section 482 adjustments. The IRS also notes that it can impute terms in a partnership agreement or related agreement among controlled taxpayers if the agreement does not comport with the substance of a transaction. Further, penalties may apply under Section 6662 if there is no basis (including contemporaneous documentation) to show that the taxpayer reasonably concluded that its valuation methods met the relevant reliability measure in Section 1.6662-6.

Despite the Notice's extensive description of current law application of Section 482 to transactions described in the Notice itself, the Treasury and IRS intend to issue regulations that would apply the rules of Section 1.482-7, currently applicable to cost-sharing arrangements, to controlled transactions involving partnerships. The future regulations would describe specified methods for such transactions based on the methods in Section 1.482-7(g) but taking into account the differences between partnerships and cost-sharing arrangements. The regulations will also provide rules based on those in Section 1.482-7(i)(6): In the event of a trigger due to a significant deviation of actual returns from projected returns for a controlled transaction involving a partnership, the IRS can make periodic adjustments to the results, as well as effect any corresponding adjustments to allocations under Section 704(b) or (c).

In addition to regulations under Section 482, the Treasury and IRS are considering adding rules under Section 1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. For example, such rules may require documentation of projected returns for property contributed to a partnership and of projected partnership allocations, including remedial allocations contemplated by the Notice's rules under Section 721(c). Comments are requested with respect to Section 482-related portions of the Notice, namely on specified valuation methods, periodic adjustments and the extent to which documentation requirements should include specific requirements for controlled transactions involving partnerships.

Notice 2015-54 Effective Dates

Provisions of the Notice describing regulations under Section 721(c) (except for certain reporting rules) are effective for transfers on or after August 6, 2015, and to transfers occurring prior to that date but resulting from retroactive entity classification elections filed on or after August 6, 2015. The Section 721(c) reporting requirements not effective as of the date of the Notice and the rules relating to controlled transactions involving partnerships will apply to transfers and transactions that occur on or after the date such regulations are published.

FBAR Deadline Will Move to April 15, 2017 for 2016 Year

Beginning with foreign bank account reports on FinCEN Form 114 (the FBAR) for the 2016 calendar year, FBARs will be due on April 15 of the following year. A six-month extension to October 15 will be available upon request. FBARs of U.S. citizens and residents living abroad will be due on June 15 – with an additional four-month extension available to October 15. No additional two-month extension to December 15 will be allowed, however, as is permitted for the tax returns of U.S. persons living abroad.

These changes were part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, enacted on July 31, 2015, and intended to help taxpayers by aligning the timing for FBAR reporting with that of individual income tax filing.

Note that the recent changes do not affect the FBAR deadline for calendar year 2015, which remains June 30, 2016 (no extension allowed).

For more information, contact **Edward Tanenbaum** at (212) 210-9425, **Andy Immerman** at (404) 881-7532 or **Heather Ripley** at (212) 210-9549.

If you would like to receive future *International Tax Advisories* electronically, please forward your contact information to **InternationalTax.Advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

Click **here** for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, CA 94303-2282 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333