



International Tax ADVISORY ■

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Section 721(c) Partnership Regulations Arrive Just in Time

On January 18, 2017, the IRS issued temporary and proposed regulations (T.D. 9814) under Section 721(c) to address transfers of appreciated property by U.S. persons to partnerships with related foreign partners. With some alterations, these regulations deliver on guidance announced in Notice 2015-54, released in August 2015 ([see our prior coverage of Notice 2015-54 here](#)). The regulations incorporate a number of taxpayer-friendly updates in response to comments on the Notice. The prospect of further direction in this area, however, including guidance under Sections 482 and 6662 as described in the Notice, is uncertain given recent pronouncements by the Trump Administration to curb and scale back the regulatory landscape—to say nothing of the implications of any comprehensive tax reform.

Background

With the Taxpayer Relief Act of 1997's repeal of certain excise taxes on certain transfers of appreciated property by U.S. persons to foreign partnerships, Congress added Section 721(c) to the Code to authorize regulations that would deny nonrecognition under Section 721(a) for a U.S. person's pre-contribution gain that could shift to foreign persons. The recently issued regulations are the first exercise of this regulatory authority.

Many provisions in the regulations were described in good detail in Notice 2015-54. Subject to a de minimis exception, the Notice generally provided that Section 721(a) nonrecognition would not apply when a U.S. person contributed certain appreciated property ("Section 721(c) property") to a partnership with foreign partners related to the transferor (a "Section 721(c) partnership"), unless the "gain deferral method" were applied. Under the Notice, a Section 721(c) partnership is any partnership to which a U.S. person contributes Section 721(c) property and after the contribution and any related transactions, (1) a related foreign person is a direct or indirect partner; 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.

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The Notice's gain deferral method would allow a U.S. transferor to recognize precontribution gain over time but imposed a number of substantive, procedural and reporting requirements:

- The partnership adopts the remedial allocation method for all built-in gain on Section 721(c) property contributed pursuant to the same plan by a U.S. transferor and all related U.S. transferors.
- During any taxable year in which there is remaining built-in gain for an item of Section 721(c) property, the partnership allocates all items of Section 704(b) income, gain, loss and deduction with that Section 721(c) property in the same proportion (the "consistent allocation requirement").
- The U.S. transferor recognizes gain on "acceleration events," transactions that reduce or further defer gain to be recognized by a U.S. transferor on Section 721(c) property.
- 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 (1) the date no built-in gain remains with 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 Section 721(c) property to which the gain deferral method applied (the "unified application requirement").
- 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 for all items related to the Section 721(c) property contribution).

If the gain deferral method were not applied, the U.S. person would recognize full built-in gain on the transferred property immediately at the time of the contribution. The key requirement of the gain deferral method is to use the remedial allocation method under Section 704(c). 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 a property's total income, gain, loss or deduction allocated to partners for a taxable year cannot exceed the total corresponding partnership items for that property. The remedial method overcomes the ceiling rule limitation by allocating notional items to noncontributing partners and making offsetting notional allocations to the contributing partner.

The Notice had also announced an intent to issue regulations under Sections 482 and 6662 because of concern over inappropriate valuation in controlled transactions involving partnerships. The new regulations do not contain such rules, which the Treasury and IRS promise to take up in future guidance. But the preamble does repeatedly invoke the general application of existing Section 482 rules and principles.

Temporary and Proposed Regulations

The content and immediate effective date of the Notice's Section 721(c)-related guidance signaled that the Treasury and IRS had fairly diligently considered the rules described in the Notice. So it is no surprise that the recently issued regulations largely adopt the Notice's provisions. In response to comments, however, the new regulations bring some important changes and clarifications.

A significant change in the regulations is replacing the “more than 50 percent” threshold in the definition of Section 721(c) partnership with a “more than 80 percent” threshold. Practitioners had complained that the lower threshold was overly broad and swept in more routine transactions, so this modification is a welcome one.

Another responsive change is that the regulations permit application of the gain deferral method on a property-by-property basis—eschewing the Notice’s unified application requirement. That requirement in the Notice reflected a fear that taxpayers might disaggregate contributions to undervalue transferred property. Despite the government’s lingering concern, the regulations embrace the more targeted per-property approach and require only that a U.S. transferor extend the limitations period as to any gain on Section 721(c) property to which the gain deferral method is not applied.

The new regulations also modify application of the gain deferral method to effectively connected income (ECI) property. Though the Treasury and IRS refused to exclude ECI property from the definition of Section 721(c) property, the regulations do turn off the remedial allocation method and consistent allocation requirements of the gain deferral method for ECI property. Other requirements of the gain deferral method continue to apply to ECI property, such as recognition of gain on an acceleration event, which includes property ceasing to be ECI property or a related foreign person claiming certain treaty benefits for ECI. These ECI property provisions would extend to property subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

The Section 721(c) regulations generally apply on a look-through basis for tiered partnership structures, as suggested in the Notice. However, the regulations provide an important exception: look-through will not apply to the deemed contribution from an “old” partnership to a “new” partnership as a result of a technical termination. In other words, a technical termination will not give rise to a Section 721(c) partnership. Likewise, a mere change in identity, form or place of organization, or a recapitalization, will not cause a partnership to become a Section 721(c) partnership.

Other aspects of the new regulations include the adoption of exceptions to the consistent allocation requirement for certain regulatory allocations and creditable foreign tax expenditures; clarification of the scope of acceleration events and exceptions (e.g., events that terminate application of the gain deferral method, such as the transfer of Section 721(c) property to a domestic corporation or incorporation of a Section 721(c) partnership into a U.S. corporation); further explanation on applying the gain deferral method to tiered partnerships; and implementation of reporting requirements consistent with the Notice’s embrace of the 2014 gain recognition agreement rules (including procedures to seek relief for failures due to nonwillfulness and reasonable cause).

Most of the recent regulations’ provisions will relate back to transfers that occurred on or after August 6, 2015, the issuance date of the Notice. (These provisions would also apply to transfers deemed to occur as a result of check-the-box elections made on or after the effective date.) Nevertheless, new rules—including substantive changes to rules described in the Notice—apply only to contributions on or after January 18, 2017, unless a taxpayer elects to apply the new rules as of the earlier general effective date.

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