# Client Alert

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# IRS Issues Notice Announcing Intention to Require Gain Recognition on Certain Transfers of Property to Partnerships with Related Foreign Partners

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## I. Overview

On August 6, 2015, the Internal Revenue Service (the "IRS") and the Treasury Department announced their intention in Notice 2015-54 (the "Notice") to issue regulations (the "Future Regulations") under Sections 721(c), 482, and 6662 of the Internal Revenue Code (the "Code")[1] to address certain partnership transactions involving a partnership (domestic or foreign) between a U.S. taxpayer and a related foreign partner that are designed to shift income or gain to the foreign partner. The Notice specifically addresses transactions where a U.S. taxpayer contributes appreciated property to a partnership that adopts Section 704(c) methods, special allocations under Section 704(b), and/or inappropriate valuation techniques to shift gain or income to related foreign partners. The Future Regulations will generally deny non-recognition treatment for a contribution by a U.S. taxpayer of appreciated property to a partnership with a foreign affiliate unless the parties comply with certain requirements designed to ensure that any built-in gain will be recognized by the contributing partner. In addition, new regulations under Section 482 will be issued to specify transfer pricing methods applicable to controlled transactions involving related-party partnerships.

The Future Regulations are proposed to apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections made under Treasury Regulation Section 301.7701-3 that are filed on or after August 6, 2015, and that are effective on or before August 6, 2015. The reporting requirements (described in Part III.D of this Client Alert) are proposed to apply to transfers and controlled transactions occurring on or after the date of publication of the Future Regulations.

## II. Historical Background

Repealed Sections 1491 through 1494 levied an excise tax on certain transfers of appreciated property by a U.S. person to a foreign partnership equal to 35 percent of the amount of gain inherent in the property at the time of transfer. Congress repealed Sections 1491 through 1494 in 1997 because it believed that the excise tax operated as a trap for the unwary and that the imposition of enhanced reporting obligations with respect to both foreign partnerships and foreign corporations would eliminate the need for such excise tax. In addition, when Sections 1491 through 1494 were repealed, Congress enacted Section 721(c), granting the Secretary regulatory authority to enact regulations to provide that tax-free treatment under Section 721(a) shall not apply to the contribution of property to a partnership if such gain, when recognized, will be includible in the gross income of a non-U.S. person.

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

## III. Summary of Future Regulations

### *A. The General Rule*

The Future Regulations will generally deny non-recognition treatment under Section 721(a) for a contribution by U.S. persons (other than U.S. partnerships) of appreciated property to a partnership in which a related foreign person and the U.S. person own more than 50% of the interests unless the parties apply the "Gain Deferral Method" (described in Part III.B of this Client Alert) with respect to such property. The Future Regulations will include a *de minimis* exception providing that Section 721(a) will continue to apply to certain contributions where the built-in gain at the time of contribution does not exceed $1 million.

### *B. The Gain Deferral Method*

The Gain Deferral Method has the following five requirements:

1. The partnership must adopt the remedial allocation method under Section 704(c) with respect to all property that had built-in gains at the time of contribution.
2. During any taxable year in which there is remaining built-in gain with respect to the contributed property, the partnership must allocate all items of Section 704(b) income, gain, loss, and deduction with respect to that property in the same proportion.
3. Certain additional reporting requirements (described in Part III.D of this Client Alert) must be satisfied.
4. The U.S. transferor must recognize the built-in gain with respect to the contributed property upon an "Acceleration Event" (described in Part III.C of this Client Alert). An Acceleration Event is deemed to occur if the partnership or any party fails to comply with all requirements of the Gain Deferral Method.
5. The Gain Deferral Method must be adopted for all appreciated property subsequently contributed to the partnership by the U.S. transferor and all related persons until the earlier of: (i) the date that no built-in gain remains with respect to any contributed property, or (ii) the date that is 60 months after the initial contribution of the built-in gain property.

### *C. Acceleration Events*

An Acceleration Event is defined as any transaction that either would reduce or could defer the amount of remaining Built-In Gain that a U.S. contributor would recognize under the Gain Deferral Method if the transaction had not occurred. Examples of Acceleration Events could include a distribution of the contributed property to the related foreign partner after seven years or a nontaxable contribution of the contributed property to a foreign corporation. Upon an Acceleration Event, a U.S. contributor must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to the U.S. contributor if the partnership had sold the property immediately before the Acceleration Event for its fair market value.

However, an Acceleration Event will not occur if a U.S. person transfers an interest in the partnership to a domestic corporation in a tax-free transaction, or the partnership transfers an interest in a lower-tier partnership to a domestic corporation in a tax-free transaction, if the parties continue to apply the Gain Deferral Method by treating the domestic corporation as the original U.S. transferor for all purposes of the Notice. Furthermore, an

Acceleration Event will not occur if a partnership transfers the property to a domestic corporation in certain circumstances in a tax-free transaction.

*D. Reporting Requirements*

For the 2015 taxable year, a U.S. transferor contributing property subject to the Notice to a foreign partnership must satisfy new reporting requirements under Sections 6038, 6038B, and 6046A. Additionally, Future Regulations will include additional reporting requirements for a U.S. transferor for each taxable year in which the Gain Deferral Method applies. As an additional requirement for applying the Gain Deferral Method, the Future Regulations will provide that a U.S. transferor must extend the statute of limitations with respect to all property to which the Future Regulations apply through the close of the eighth full taxable year following the contribution. The additional reporting requirements and extended statute of limitations will not take effect until the Future Regulations are published.

*E. Rules Regarding Controlled Transactions Involving Partnerships*

The Notice also announces an intention to issue regulations under Sections 482 and 6662 applicable to controlled transactions involving partnerships to ensure the appropriate valuation of such transactions. In particular, the Future Regulations will be based on rules regarding cost-sharing arrangements under Section 1.482-7 and will permit the IRS to make periodic adjustments to partnership items if there is a significant divergence of actual returns from projected returns. Moreover, the Future Regulations may include regulations under Section 1.6662-6(d) requiring additional documentation for certain controlled transactions involving partnerships.

## IV. Conclusion

In issuing the Notice, the IRS and Treasury Department are continuing to exert regulatory authority to target transactions that they believe inappropriately shift income and gain of U.S. taxpayers offshore. Although their intent is to put an end to a fairly specific set of transactions involving the contribution by a U.S. person of appreciated intellectual property to a partnership with a foreign affiliate, the Future Regulations would also adversely affect taxpayers engaging in routine partnership transactions. U.S. taxpayers that intend to contribute appreciated property to a partnership currently will need to consider the potential effects of the Future Regulations, particularly given the retroactive effective date. Moreover, existing partnerships with related U.S. and foreign partners that hold appreciated property will need to consider whether transactions that result in a "deemed" contribution of property to a new partnership for U.S. federal income tax purposes, such as a "technical termination" of a partnership or reorganization of a partnership, could cause such partnership to become subject to the Future Regulations.

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