Bloomberg BNA

Tax Management International Journal™

Reproduced with permission from Tax Management International Journal, 44 TMIJ 698, 11/13/2015. Copyright © 2015 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

IRS Announces Intent to Tax Transfers to Partnerships With Foreign Partners

By Peter J. Connors, Esq., and
Stephen C. Lessard, Esq.[*]
Orrick, Herrington & Sutcliffe LLP
New York, New York

On August 6, 2015, the Internal Revenue Service (IRS) issued Notice 2015-54 (the "Notice").[1] According to the Notice, the IRS and Treasury Department intend to issue regulations under §721(c)[2] to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partner related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The rules will apply whether the partnership is domestic or foreign. The Notice is significant because many transactions involving the outbound transfer of property use a partnership rather than a corporation structure to avoid application of §367, which generally turns off the corporate nonrecognition provisions for transfers to foreign corporations.[3] These rules are grounded in the belief held by Treasury and the IRS that U.S. taxpayers have been using partnership structures that adopt §704(c) methods, special allocations under §704(b), and inappropriate valuation techniques with a view toward shifting income to their foreign affiliates. However, the regulations envisioned in the Notice will apply only when property is transferred and the amount of built-in gain for the tax year is greater than $1 million, thereby limiting its scope, although built-in losses do not reduce built-in gains.[4] It is noteworthy that the Notice preceded a number of other changes issued on September 14 to the §367(d) regulations.[5]

The Notice also announces the intent to issue regulations under §482 and §6662 applicable to controlled transactions involving partnerships to ensure the proper valuation of such transactions. The regulations will be generally effective for transfers occurring on or after August 6, 2015.[6]

BACKGROUND

Generally, §721(a) provides that a transfer of property to a partnership in exchange for an interest in the partnership will be accorded non-recognition treatment such that neither the transferor (partner) nor transferee (partnership) recognizes taxable gain or loss on the transfer. Section 721(c) provides Treasury with regulatory authority to ignore §721(a) if gain realized on the transfer of property to a partnership would be includible in the gross income of a foreign

[*] Peter J. Connors is a tax partner and Stephen C. Lessard is a senior tax associate in the New York office of Orrick, Herrington & Sutcliffe LLP. The authors gratefully acknowledge the thoughtful comments of Barbara Spudis deMarigny of McGuireWoods LLP.

[1] 2015-34 I.R.B. 210.

[2] Unless otherwise specified, all section ("§") references are to the Internal Revenue Code of 1986, as amended (the "Code") or the Treasury regulations thereunder.

[3] Although §367(d)(3) provides Treasury with regulatory authority to apply §367(d)(2) to the transfer of intangible property by a "United States person" to a partnership, no such regulations have yet been issued.

[4] Notice 2015-54, §4.02.

[5] REG-139483-13.

[6] Notice 2015-54, §6.

person. Section 721(d) gives Treasury the regulatory authority to treat the transfer of intangible property to a partnership as a sale, referencing §367(d)(3). Under §367(d), a U.S. person who transfers intangible property to a foreign corporation, in an exchange described in §351 or §361, is treated as having sold such property in exchange for payments that are contingent on the use or disposition of such property and receiving amounts reasonably reflecting the amounts that would have been received annually in the form of such payments over the useful life of such property or, in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. Under §367(d)(2), the amounts taken into account must be commensurate with the income attributable to the intangible. Section 367(d)(3) provides Treasury with regulatory authority to apply the rule of §367(d)(2) to transfers of intangible property to partnerships in circumstances consistent with the purposes of §367(d).

Thus, Treasury is authorized to issue regulations under §367 and §721 treating certain transfers of property to a partnership with foreign partners as taxable. Because §367 only applies to the transfers of property to foreign corporations and no regulations have been issued under §721(c), §721(d), or §367(d)(3), a U.S. person generally has not been required to recognize gain on the transfer of appreciated property to a partnership with foreign partners. However, §704(c), although not specifically written in the international context, generally address policy concerns underlying the regulatory authority granted in §721(c), §721(d), and §367(d)(3).

Section 704(c)(1)(A) requires partnerships to allocate income, gain, loss, and deduction, with respect to property contributed by a partner to the partnership, so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.

Reg. §1.704-3(a)(1) states that the purpose of §704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Section 704(c) allocations must be made using any reasonable method consistent with that purpose. Reg. §1.704-3(a)(1) describes three methods of making §704(c) allocations that are generally reasonable: the traditional method, the traditional method with curative allocations, and the remedial allocation method. Under the traditional method, the ceiling rule may cause distortions in partnership allocations of depreciation or gain or loss to partners.[7] These distortions may be corrected under either the traditional method with curative allocations or the remedial allocation method. The traditional method with curative allocations permits allocations of items of income, gain, loss or deductions from other partnership property (other than the subject §704(c) property) to correct ceiling rule distortions. This curative allocation is made solely for tax purposes and is reasonable if it does not exceed the amount required to offset the distortion caused by the ceiling rule and the income or loss allocated is of the same type and character so as to have the same effect on the partner's tax liability as the tax item affected by the ceiling rule. Alternatively, a partnership may use the remedial allocation method and allocate additional items of income, gain, loss or deduction (usually deductions) to the non-contributing partner and offset those allocations with remedial allocations of income, gain, loss, or deduction (usually income) to the contributing partner.[8] These allocations also are reflected only in the tax items allocated to the partners and have no effect on book capital accounts.

Possibly as an *in terrorem* measure, the Notice states that if a partnership's §704(c) allocation method is unreasonable, Treasury can make adjustments by exercising its authority under the anti-abuse rule in Reg. §1.704-3(a)(10). Under this rule, an allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse §704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. For this purpose, references to partners include both direct and indirect partners. However, the current regulations do not require a partnership to use the remedial allocation method and, indeed, even permit different methods to be adopted for different items of contributed property in the same partnership.[9] The Notice, however, does not address reverse §704(c) allocations — the allocations that a partnership is permitted to make to address built-in gain or loss that exists when a partner becomes a member.[10]

The absence of a requirement to use the remedial method leaves open the door for tax planning. An example in a New York State Bar Association Tax Section report notes that taxpayers could selectively use the traditional and the remedial methods to their advantage if one of the partners is a foreign partner:

> A, a U.S. person, contributes a Section 936 Intangible — "Property A" — to partnership AB. Property A has a tax basis of $30 and a fair market value of $150 on the date of contribution, is an amortizable asset in A's hands, and has 5 years remaining useful life. B, a non-U.S. person, contributes a Section 936 Intangible — "Property B" — to AB. Property B also has a tax basis of $30 and a fair market value of $150 on the date of contribution, is an amortizable asset in B's

[7] The ceiling rule provides that total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. Reg. §1.704-3(b)(1).

[8] Reg. §1.704-3(d)(1).

[9] Reg. §1.704-3(a)(2).

[10] Reg. §1.704-3(a)(6).

ISSN 0090-4600

hands, and has 5 years remaining useful life. AB elects the traditional method with respect to Property A and the remedial method with respect to Property B.

With respect to Property A, AB will have a $30 §704(b) book amortization deduction in years 1–5 ($150 fair market value/5 years remaining useful life). Tax amortization, however, will only be $6 each year ($30 tax basis/5 years). The §704(b) book amortization will be allocated equally to A and B ($15 each) under the partnership agreement. The $6 of tax amortization will be allocated entirely to B, leaving B with an annual $9 ''shortfall'' of tax amortization as a result of the ceiling limitation.

As to Property B, however, the results are different. The remedial method requires AB to ''create'' tax amortization and offsetting amounts of taxable income. To do this, AB initially treats Property B as two assets, one with a fair market value and tax basis of $30, and a second with a fair market value of $120 and a zero tax basis. The ''first'' asset will be amortized for capital accounting purposes over the remaining useful life of Property B; the ''second'' asset will be amortized over a new useful life (in this case, 15 years).

Accordingly, the ''first'' asset will generate $6 of §704(b) book amortization for 5 years and zero thereafter. The ''second'' asset will generate $8 of §704(b) book amortization for 15 years ($120 fair market value/15 years). The amounts of §704(b) book amortization will then be combined and allocated under the partnership agreement. Thus, in years 1–5, the §704(b) book amortization with respect to Property B will be $14 ($6 + $8); in years 6–15, the §704(b) book amortization will be $8. In each year, the §704(b) book amortization with respect to Property B will be allocated equally to A and B under the AB partnership agreement. Thus, in each of years 1–5, each of A and B will be allocated $7 of §704(b) book amortization. A will be allocated $6 of tax amortization, and B will be allocated no tax amortization. In addition, in each of those years, AB will be required to create and allocate to A $1 of ''notional'' amortization deductions and simultaneously create and allocate to B $1 of ''notional'' income to ''remediate'' what would otherwise be a shortfall in tax amortization to A as a result of the ceiling rule. In years 6–15, AB will allocate $4 of §704(b) book amortization to each of A and B. AB will not have any tax amortization to allocate, because Property B will have been fully amortized for tax purposes. Thus, in each of those years, AB will be required to create and allocate to A $4 of ''notional'' amortization deductions and simultaneously create and allocate to B $4 of ''notional'' income.[11]

The failure to require use of the remedial method allows A, the U.S. transferor, to defer income associated with Property A. On the other hand, adopting use of the remedial method permits A to receive tax deductions associated with the contribution of Property B, without causing a tax impact to B because the offsetting remedial allocations of income items to B would likely not be recognized as taxable income in B's country. The ceiling rule also affects gain on sale of property, which can be limited, for example, by loss on the sale of other property in the same year. The remedial method would correct this.

THE NOTICE

The Notice denies deferral for transfers of appreciated property to partnerships, domestic or foreign, where there is a related foreign partner (other than another partnership) and the transferor controls the partnership. Additional regulations, which are discussed below, will be issued under §482 regarding transfers involving partnerships.

The Notice states that it will apply to a ''Section 721(c) Partnership.'' A partnership (domestic or foreign) is a Section 721(c) Partnership if a ''U.S. Transferor'' contributes ''Section 721(c) Property'' to the partnership, and, after the contribution and any transactions related to the contribution: (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 Persons'' own more than 50% of the interests in partnership capital, profits, deductions or losses.[12] ''Related'' is defined by reference to §267(b) or §707(b)(1).[13] A ''U.S. Transferor'' is a United States person within the meaning of §7701(a)(30), other than a domestic partnership.[14] Thus, publicly traded partnerships would not be transferors, but their underlying members would likely be.

''Section 721(c) Property'' is property with ''Built-In Gain,'' other than ''Excluded Property.''[15] ''Excluded Property'' is: (1) cash equivalents; (2) any asset that is a security within the meaning of

[11] N.Y. State Bar Ass'n Tax Sec., ''Report on Section 367(d),'' Rep. No. 1222 at 83–84 (Oct. 12, 2010).

[12] Notice 2015-54, §4.01(5). Of course, determining when this threshold will be met in circumstances where allocations can vary during the course of a partnerships term is challenging.

[13] *Id.*, §4.01(6).

[14] *Id.*, §4.01(1).

[15] *Id.*, §4.01(3).

ISSN 0090-4600

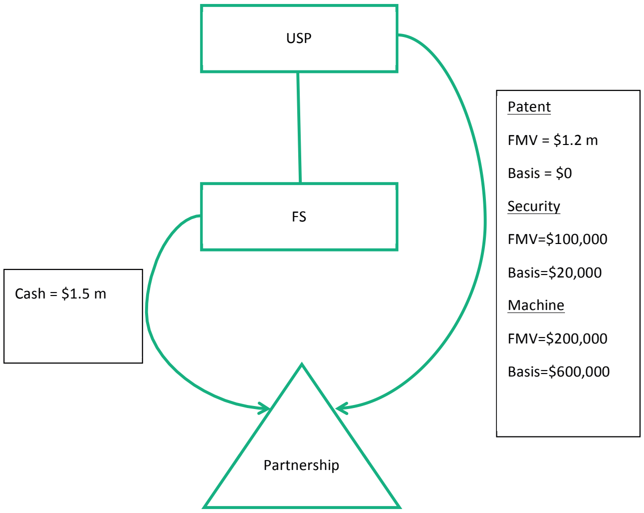
§475(c)(2), without regard to §475(c)(4); and (3) any item of tangible property with Built-In Gain that does not exceed $20,000.[16] A publicly traded partnership interest would be excluded as a §475(c)(2) security. ''Built-In Gain'' is determined based on the property's book value; it is the excess §704(b) book value of the property over the contributing partner's adjusted tax basis in the property at the time of the contribution (and does not include gain created when a partnership revalues partnership property).[17] Presumably book value and fair market value will be the same.

Recognition of Gain on Certain Transfers

The Notice states that Treasury and the IRS intend to issue regulations providing that §721(a) will not apply when a ''U.S. Transferor'' contributes an item of Section 721(c) Property (or portion thereof) to a ''Section 721(c) Partnership,'' unless the ''Gain Deferral Method'' is applied with respect to the Section 721(c) Property.[18] The regulations will include a *de minimis* rule providing that §721(a) (if otherwise applicable) will continue to apply (without regard to whether the requirements of the Gain Deferral Method are satisfied) if, during the U.S. Transferor's taxable year: (1) the sum of the Built-In Gain, with respect to all Section 721(c) Property contributed in that year to the Section 721(c) Partnership by the U.S. Transferor and all other U.S. Transferors that are Related Persons, does not exceed $1 million; and (2) the Section 721(c) Partnership is not applying the Gain Deferral Method with respect to a prior contribution of Section 721(c) Property by the U.S. Transferor or another U.S. Transferor that is a Related Person.

Example. Example 1 in the Notice illustrates these rules. USP, a domestic corporation, wholly owns FS, a foreign corporation. USP and FS form a new partnership. FS contributes $1.5 million cash to the partnership, and USP contributes the following three assets: (1) a patent with an arm's-length price of $1.2 million and an adjusted basis of zero; (2) a security (within the meaning of §475(c)(2)) with an arm's-length price of $100,000 and an adjusted basis of $20,000; and (3) a machine with an arm's-length price of $200,000 and an adjusted basis of $600,000. Because the patent has Built-In Gain, it is Section 721(c) Property. Although the security also has Built-In Gain, it is Excluded Property because it is an asset described in §475(c)(2). The machine has a built-in loss and is therefore not Section 721(c) Property. Thus, because USP is a U.S. person and not a domestic partnership, USP is a U.S. Transferor that has contributed Section 721(c) Property. FS is related to USP under §267(b) and is not a U.S. person. Accordingly, FS is a Related Foreign Person to USP. USP and FS collectively own more than 50% of the interests in the capital, profits, deductions, and losses of the partnership. Therefore, the partnership is a Section 721(c) Partnership. The *de minimis* rule does not apply because the sum of the Built-In Gain for all Section 721(c) Property is $1.2 million, which exceeds the $1 million *de minimis* threshold. The built-in loss in the machine does not factor into determining whether the contribution is below the *de minimis* threshold. As a result, §721(a) does not apply to USP's contribution of the patent to the partnership, unless the Gain Deferral Method is applied. Example 1 is illustrated below.

Example 1



Pre-Notice:

The contribution of the patent and the security by USP does not result in gain recognition under §721(a). The timing of recognition of the Built-In Gain in the patent depends on the §704(c) method chosen. Partnership could use the traditional method, traditional method with curative allocations, or remedial method to account for the Built-In Gain on the patent in allocating items of income, deduction, gain, or loss to its partners.

Post-Notice:

To avoid gain recognition on the contribution on the patent, Partnership must use the remedial method to account for the Built-In Gain in the patent in allocating items of income, deduction, gain, or loss to USP and FS. (The security is Excluded Property because it is described in §475(c)(2). The machine is Built-In Loss property and therefore is not Section 721(c) Property.) Use of the remedial method may result in additional depreciation to FS, with additional taxable income allocated to USP, as compared to the use of the traditional method or traditional method with curative allocations. Deductions attributable to Built-In Gain property cannot be specially allocated to USP.

Gain Deferral Method

In order for a Section 721(c) Partnership to apply the Gain Deferral Method:

[16] *Id.*, §4.01(4). This amount appears to be based on a comparable provision in the partnership §704(c) allocation rules. Reg. §1.704-3(e)(1)(ii).

[17] Notice 2015-54, §4.01(2).

[18] *Id.*, §4.02.

ISSN 0090-4600

(1) the partnership must adopt the remedial method for Built-In Gain with respect to all Section 721(c) Property contributed to the partnership pursuant to the same plan by a U.S. Transferor and all other U.S. Transferors that are Related Persons;[19]

(2) during each year in which there is remaining Built-In Gain with respect to an item of Section 721(c) Property, the partnership must allocate all items of §704(b) income, gain, loss, and deduction with respect to that Section 721(c) Property in the same proportion;

(3) certain reporting requirements must be satisfied;

(4) the U.S. Transferor must recognize Built-In Gain with respect to any item of Section 721(c) Property upon an Acceleration Event (discussed below); and

(5) 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 U.S. Transferors that are Related Persons until the earlier of: (i) the date that no Built-In Gain remains with respect to any Section 721(c) Property to which the Gain Deferral Method is 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 first applied.[20]

Examples. Examples 2 and 3 in the Notice illustrate application of the Gain Deferral Method rules. In Example 2, USP, a domestic corporation, wholly owns FS, a foreign corporation. In Year 1, USP, a U.S. Transferor, contributes Section 721(c) Property (''Asset 1'') with Built-In Gain of more than $1 million to a Section 721(c) Partnership in which FS, a Related Foreign Person, is also a partner. The partnership allocates all items of income, gain, deduction, and loss with respect to Asset 1 60% to USP and 40% to FS and adopts the remedial allocation method with respect to Asset 1. The parties comply with the applicable reporting requirements. The parties properly apply the Gain Deferral Method with respect to Asset 1 in Years 1 through 3. In an unrelated transaction in Year 4, USP contributes Section 721(c) Property (''Asset 2'') with a Built-In Gain of $100,000 to the partnership. The partnership allocates all items of income, gain, and loss with respect to Asset 2 20% to USP and 80% to FS, but allocates deductions with respect to Asset 2 90% to USP and 10% to FS. The partnership adopts the remedial allocation method with respect to Asset 2. In Year 4, although Asset 2 has Built-In Gain of less than $1 million, the *de minimis* rule will not apply because the parties are applying the Gain Deferral Method with respect to Asset 1. Because the deductions with respect to Asset 2 are allocated in a different proportion than the other §704(b) items with respect to Asset 2, the requirements for satisfying the Gain Deferral Method are not met with respect to Asset 2, and USP must recognize the Built-In Gain with respect to Asset 2. Additionally, because the Gain Deferral Method does not apply to Asset 2, which was contributed within 60 months of Asset 1 (the Section 721(c) Property to which the Gain Deferral Method was first applied), an Acceleration Event is deemed to occur with respect to Asset 1 and USP must recognize any remaining Built-In Gain with respect to Asset 1 (see the Acceleration Event rules below).

In Example 3, the facts are the same as in Example 2 except that USP does not contribute Asset 2. In Year 3, the partners amend the partnership agreement so that all items of income, gain, deduction, and loss with respect to Asset 1 are now allocated 30% to USP and 70% to FS. Assume the amendment is accompanied by any consideration required by §482 and has substantial economic effect as required by §704(b). Because each §704(b) item with respect to Asset 1 continues to be allocated in the same proportion to each partner, the Gain Deferral Method will continue to apply as long as the other requirements of the Gain Deferral Method are satisfied.

Acceleration Event

An ''Acceleration Event'' with respect to an item of Section 721(c) Property is any transaction that either: (1) would reduce the amount of remaining Built-In Gain that a U.S. Transferor would recognize under the Gain Deferral Method if the transaction had not occurred; or (2) could defer the recognition of the Built-In Gain.[21] An Acceleration Event will also be deemed to have occurred with respect to all Section 721(c) Property of a Section 721(c) Partnership for the taxable year of the Section 721(c) Partnership if any party fails to comply with all of the requirements for applying the Gain Deferral Method.

However, there are a number of situations that might result in a transaction qualifying for an exception to the Acceleration Event rules. An Acceleration Event will not occur if:

(1) a U.S. Transferor transfers an interest in a Section 721(c) Partnership to a domestic corporation in a transaction to which either §351(a) or §381(a) applies, provided that the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor for all purposes of the Notice;

[19] We note that, under the anti-churning rules of Reg. §1.197-2(h), the remedial method may not be used with respect to certain §197 property that is contributed. *See* Reg. §1.197-2(h)(12)(vii)(B). It is uncertain how this requirement to apply the Gain Deferral Method will apply in such cases. It is possible that this is unintended.

[20] Notice 2015-54, §4.03. By contrast, both §704(c)(1)(B) and §737(b) are only triggered within seven years of the contribution.

[21] *Id.*, §4.05(1).

ISSN 0090-4600

(2) a Section 721(c) Partnership transfers an interest in a lower-tier partnership that owns Section 721(c) Property to a domestic corporation in a transaction to which §351(a) applies, provided that the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor for all purposes of the Notice; or

(3) a Section 721(c) Partnership transfers Section 721(c) Property to a domestic corporation in a transaction to which §351(a) applies.[22]

If a Section 721(c) Partnership transfers Section 721(c) Property (or an interest in a partnership that owns Section 721(c) Property) to a foreign corporation in a §351(a) transaction, an Acceleration Event will not occur to the extent the Section 721(c) Property is treated as being transferred by a U.S. person (other than a domestic partnership) in an outbound transfer under Reg. §1.367(a)-1T(c)(3)(i) or §1.367(a)-1T(c)(3)(ii).

Examples. Examples 4 and 5 in the Notice illustrate the Acceleration Event rules. In Example 4, in Year 1, USP, a U.S. Transferor, contributes Section 721(c) Property (''Asset 1'') with Built-in Gain of more than $1 million to a Section 721(c) Partnership in which FS, a Related Foreign Person, and USX, an unrelated U.S. person, are also partners. The parties properly apply the Gain Deferral Method with respect to Asset 1. In Year 3, USP transfers all of its assets, including its interest in the partnership, to USS, a domestic corporation, in a transaction to which §381(a) applies. In Year 9 (a year in which there is remaining Built-In Gain with respect to Asset 1), the partnership distributes Asset 1 to FS. Although USP will no longer recognize any remaining Built-In Gain with respect to Asset 1 under the Gain Deferral Method following the transfer to USS, USS is a successor U.S. Transferor. Therefore, provided the requirements of the Gain Deferral Method continue to be satisfied, including treating USS as the U.S. Transferor, the transfer of USP's interest in the partnership to USS is not an Acceleration Event. Although §704(c)(1)(B) does not apply to the distribution to FS in Year 9, the distribution is an Acceleration Event because USS will not recognize any remaining Built-In Gain with respect to Asset 1 under the Gain Deferral Method following the distribution. Therefore, USS must recognize gain in an amount equal to the remaining Built-In Gain that would have been allocated to USS if the partnership had sold Asset 1 immediately before the distribution for its fair market value. Example 4 is illustrated below.

Example 4

In Example 5, the facts are the same as in Example 4 except that in Year 3, instead of USP transferring its assets to USS, the partnership contributes Asset 1 to FC, a foreign corporation, in a transfer described in §351(a). There is no distribution in Year 9. For purposes of §367(a) and §367(d), each partner in the partnership that is a U.S. person is treated as having transferred its share of the Section 721(c) Property directly to FC. An Acceleration Event occurs, but not to the extent of USP's and USX's shares of the Section 721(c) Property. The FC stock received by the partnership in the transaction is not subject to the Gain Deferral Method.

Regulations Regarding Controlled Transactions Involving Partnerships

The Notice states that Treasury and the IRS intend to issue regulations regarding the application to controlled transactions involving partnerships of certain rules in Reg. §1.482-7 that are currently applicable to cost sharing arrangements.[23] For purposes of §482, the regulations define controlled transactions to include contributions of property to partnerships.[24]

In particular, Treasury and the IRS intend to issue regulations that will provide specified methods for such controlled transactions based on the specified methods in Reg. §1.482-7(g) as appropriately adjusted in light of the differences in the facts and circumstances between such partnerships and cost sharing arrangements. These methods are used for evaluating the arm's-length amount charged as the buy-in for a platform contribution transaction.[25] Some commentators believe that the IRS would prefer the valuation methods used for platform contribution transactions in a cost-sharing arrangement to be applied when valuing intangible property contributed to a partnership rather than the methods for determining taxable income in connection with transfers of intangibles outside the cost-sharing context contained in Reg. §1.482-4.[26] It is likely the IRS prefers the rules under Reg. §1.482-7 because they are more developed than those contained in Reg. §1.482-4.

Additionally, the regulations will provide periodic adjustment rules for controlled transactions involving partnerships. The regulations will provide that, in the event of a trigger based on a significant divergence of

[22] *Id.*, §4.05(3)–(4).

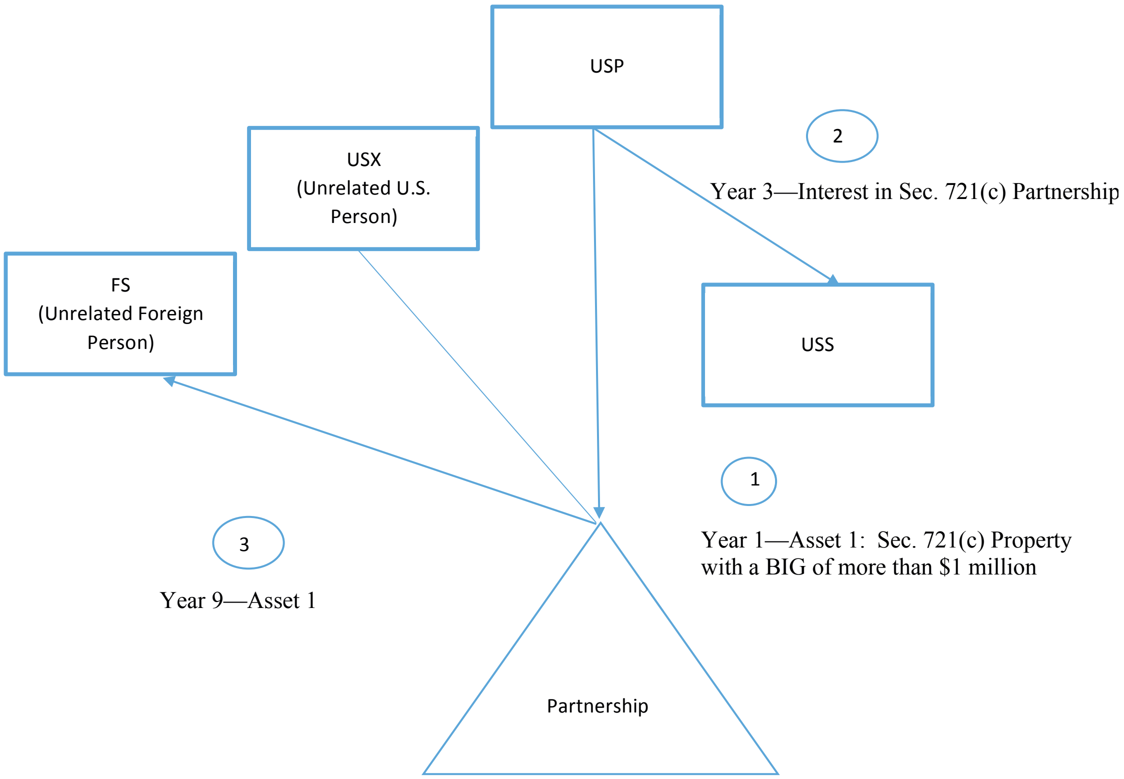
[23] *Id.*, §5.01.

[24] Reg. §1.482-1(i).

[25] These methods are: (1) the comparable uncontrolled transaction method or the comparable uncontrolled services price method; (2) the income method; (3) the acquisition price method; (4) the market capitalization method; (5) the residual profit split method; and (6) unspecified methods.

[26] *See, e.g.,* Marie Sapirie, *New Offshore Property Transfer Guidance Targets Partnerships*, 2015 TNT 163-1, 148 Tax Notes 807 (Aug. 24, 2015).

ISSN 0090-4600


USP
USX (Unrelated U.S. Person)
FS (Unrelated Foreign Person)
USS
Partnership
2
Year 3—Interest in Sec. 721(c) Partnership
1
Year 1—Asset 1: Sec. 721(c) Property with a BIG of more than $1 million
3
Year 9—Asset 1

Post-Notice Results:

□ To defer recognition of gain, the Gain Deferral Method has been elected.

□ The transfer to USS will not be an Acceleration Event, since USS will step in the shoes of USP.

□ Because the Gain Deferral Method has been elected, the distribution of Asset 1 will be an Acceleration Event though it is outside the seven-year period contained in §737.

actual returns from projected returns for controlled transactions involving a partnership, the IRS may make periodic adjustments to the results of such transactions under a method based on Reg. §1.482-7(i)(6)(v), as appropriately adjusted, as well as any necessary corresponding adjustments to §704(b) or §704(c) allocations. When intangible property is contributed to a partnership, the IRS may consider making periodic adjustments in years subsequent to the contribution, without regard to whether the taxable year of the original transfer remains open for statute of limitations purposes.[27] The IRS has requested comments regarding the regulations described above.

The Notice also states that to the extent that controlled transactions involving a partnership, including contributions of tangible and intangible property and the provision of services by the controlled partners or their affiliates, are interrelated, an aggregate analysis of their combined effects will be necessary under Reg. §1.482-1(f)(2)(i) if the aggregate analysis provides the most reliable means of determining the arm's-length results for the controlled transactions. Further guidance is necessary to clarify when services transactions will be respected where there is a services agreement with a foreign partner to provide research and development services for the partnership.

Given that the Notice's description of the regulations is vague, it seems fair to assume that considerable work will be necessary before a draft is issued.

Possible Regulations Under §6662

Generally, §6662 imposes an accuracy-related penalty to any portion of an underpayment which is attributable to one or more specified reasons, including a substantial valuation misstatement pertaining to either a transaction between persons described in §482 (the transactional penalty) or a net §482 transfer price adjustment (the net adjustment penalty).[28] The Notice states that Treasury and the IRS also are considering issuing regulations under Reg. §1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. These regulations may require, for example, documentation of projected re-

[27] Notice 2015-54, §5.02.

[28] §6662(e).

turns for property contributed to a partnership (as well as attributable to related controlled transactions) and of projected partnership allocations, including projected remedial allocations covered by the Notice, for a specified number of years.[29]

Extension of Statute of Limitations

As an additional requirement for applying the Gain Deferral Method, the regulations will provide that a U.S. Transferor (and, in certain cases, a Section 721 Partnership) must extend the period on limitations of assessment of tax, with respect to all items related to the Section 721 Property contributed to the Section 721(c) Partnership, through the close of the eighth full taxable year following the taxable year of the contribution.[30] This provision is comparable to the requirement that a U.S. transferor who files a gain recognition agreement under §367 must extend the period of limitation on assessment of tax upon the gain realized but not recognized on the initial transfer through the close of the eighth full tax year following the tax year in which the initial transfer occurs.[31]

Effective Date

As indicated above, the Notice states that the regulations will apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections made under Reg. §301.7701-3 that are filed on or after August 6, 2015, and that are effective on or before August 6, 2015.[32]

The reporting requirements and the transfer pricing regulations will apply to transfers and controlled transactions occurring on or after the date of publication of the regulations described in those sections of the Notice.

The Notice states that no inference is intended regarding the treatment of transactions under current law, and the IRS may challenge such transactions under applicable Code provisions, Treasury regulations, and judicial doctrines. As an example, the Notice asserts that the IRS may challenge a partnership's adopted §704(c) method under the anti-abuse rule in Reg. §1.704-2(a)(10).

CONCLUSION

It is no surprise that the IRS issued the Notice. The issue has been outstanding for almost 20 years and it has been a significant source of concern, particularly in the context of intangible property transfers. It is likely that the New York State Bar Association report cited above was the impetus for the issuance of the Notice. It is noteworthy that cash, securities, and tangible property are carved out, thereby narrowing the scope of the Notice.

It is questionable as to whether the IRS will succeed in asserting an anti-abuse rule in situations where the taxpayer has not used the remedial method. The regulations are fairly clear that the use of the remedial method is elective.

The proposed regulations under §482 seem more controversial and more of a work in progress. It is appropriate that the rules will apply on a prospective basis only.

[29] Notice 2015-54, §5.01.

[30] Notice 2015-54, §5.06(3).

[31] Reg. §1.367(a)-8(f).

[32] Notice 2015-54, §6.

ISSN 0090-4600