Treasury Releases Notice Addressing Transactions Involving Related-Party Partnerships

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On August 6, 2015, the Department of the Treasury issued Notice 2015-54 (the Notice) announcing its intent to issue new regulations addressing transactions involving partnerships formed by related parties. According to the Notice, Treasury generally was concerned that U.S. taxpayers have been taking advantage of their ability under current law to contribute appreciated property to a partnership on a tax-free basis and to utilize special allocations of income in order to shift the income associated with the contributed property to a foreign partner related to the U.S. transferor. The Notice describes broad sets of new regulations intended to address situations in which Treasury believes partnership transactions among related parties can lead to inappropriate results.

The first set of regulations will provide that U.S. persons who contribute certain types of appreciated property to a partnership in which a related foreign person also is a partner generally will be required to recognize the built-in gain in the contributed assets unless certain requirements are met. The second set of regulations will apply concepts from the Section 482 regulations that specifically govern cost sharing to controlled transactions involving partnerships. Finally, Treasury also announced in the Notice that it is considering new regulations relating to penalties under Section 6662 that would require specific documentation in controlled partnership transactions in order to avoid underpayment penalties.

Of particular note, the Notice provides that when issued, the new regulations requiring gain recognition generally will apply retroactively to all contributions to partnerships on or after August 6, 2015, including contributions that are deemed to have occurred before August 6, 2015, as a result of a "check the box" election filed after August 6, 2015, with retroactive effect. Both sets of transfer pricing regulations will apply only to transactions that occur on or after the date the regulations are issued.

Regulations Related to Contributions of Appreciated Property to Partnerships

Current Law Relating to Contributions of Appreciated Property to Partnerships

Under current law, a partner generally may contribute appreciated property to a partnership in exchange for a partnership interest on a tax-free basis. However, the Internal Revenue Code grants Treasury regulatory authority to issue regulations reversing this general rule and requiring the contributor to recognize gain if the contribution of appreciated property to a partnership will result in that appreciation, when recognized, being included in the income of a person who is not subject to U.S. tax.

When a person contributes appreciated property to a partnership, Section 704(c) generally requires that any built-in gain or built-in loss in property contributed to the partnership be allocated to the contributing partner upon the sale of the property by the partnership. Where depreciable or amortizable property is contributed to a partnership, the allocation of depreciation and amortization with respect to the property also must take into consideration any built-in gain or built-in loss in the contributed property.

There are three generally permissible methods for allocating the deductions associated with appreciated property contributed to a partnership. The Notice focuses on two of these methods. The first method is the "traditional method" under which the partnership allocates depreciation and amortization deductions to the noncontributing partner only to the extent deductions are available for tax purposes. This can be illustrated with the case of a U.S. contributor of intellectual property (IP) with a basis of $10, a value of $100, and a remaining tax life of 10 years, to a partnership, while a related foreign person contributes $100 cash so that it is a 50/50 partnership. The partnership would have a "book" basis (determined by reference to fair market value at the time of contribution) of $100 with respect to the IP, and therefore $10 of annual book amortization deductions, but it would have only $1 of annual tax amortization deductions (which are determined by reference to tax basis). Since the foreign partner's share of book amortization deductions would be $5 (50 percent of the $10 of book amortization), it would be allocated the entire $1 of tax amortization deductions. This limitation (to $1, when allocable book amortization is $5) is known as the "ceiling rule," and the traditional method ends its Section 704(c) allocation process by going no further once the ceiling has been reached. In contrast, the "remedial method" is designed to overcome the limitations of the ceiling rule. The remedial method would create simply an incremental notional amortization deduction of $4 each year in favor of the foreign partner, and correspondingly, a $4 notional income item to the contributing U.S. partner. The Section 704(c) regulations also contain an anti-abuse rule that gives the Internal Revenue Service (IRS) the power to impose a Section 704(c) method (but not the remedial method) if the taxpayer's selected method is considered to reduce substantially the present value of the tax liability of the U.S. partner.

New Regulations to Require US Partners to Recognize Built-In Gain in Appreciated Property Contributed to Partnerships With Related Parties

In the Notice, Treasury expressed concern that U.S. taxpayers have been taking advantage of the flexibility afforded them under Section 704(c) to defer or escape being taxed on the appreciation inherent in property that was contributed to partnerships in which a related foreign person also is a partner. While a tax benefit for one partner typically is accompanied by a tax detriment to the other partner, Treasury apparently believes that the arm's length negotiations that typically would prevent the noncontributing partner from agreeing to a tax detriment as an economic matter are not necessarily present where the parties are related and the noncontributing partner is not subject to U.S. tax.

In particular, Treasury expressed concerns about arrangements involving special allocations that might allow the appreciation in certain types of property contributed to a partnership by a U.S. person to ultimately escape U.S. tax. According to Treasury, some taxpayers have undervalued property contributed to the partnership by the U.S. person, which has allowed the parties to artificially increase the amount of taxable income generated by the contributed property that is allocated to the related foreign partner and thereby reduce the parties' overall U.S. tax costs. Although the IRS has broad authority under Section 482 to reallocate items of income and deductions among related parties to properly reflect the economics of the transaction, Treasury believes that the IRS is at a disadvantage when reviewing these transactions because audits typically occur years after a transaction has occurred and the taxpayers have better access to information regarding the businesses contributed to the partnership.

To address these perceived abuses, the Notice provides that regulations will be issued that generally will subject to immediate tax the appreciation in certain types of property contributed by a U.S. person to a partnership in which a related foreign person is a partner (provided that the U.S. contributor and persons related to the U.S. contributor together own more than a 50 percent interest in the partnership), unless several conditions are satisfied. First, the partnership must choose the remedial method under Section 704(c). This first requirement is based on Treasury's belief that the use of the remedial method can help ensure that the U.S. contributor recognizes the precontribution gain in the contributed property. In effect, the remedial method, through the creation of notional income allocations, generally causes the contributing partner to over time recognize a portion of the built-in gain inherent in the contributed property. Second, the partnership agreement must provide that all items of income, gain, loss and deduction with respect to the contributed property will be allocated in the same proportion in any year. The second requirement appears intended to prevent partnerships from issuing to the U.S. contributor a preferred interest that receives a fixed return based upon its liquidation preference. However, it would seem that it should still be possible under the Notice for a partnership to issue an interest with a priority position in the capital structure so long as that interest receives a fixed percentage of overall partnership income.

Notably, contributions to partnerships of cash equivalents, shares of stock in a corporation, debt instruments and certain types of derivatives will be exempt from the new gain recognition rules. In addition, the regulations will contain two rules that will exempt contributions of *de minimis* amounts of property to a partnership.

The Notice also announced that regulations will be issued creating additional reporting requirements for U.S. contributors of appreciated property to partnerships, and compliance with these reporting obligations will be a requirement for tax-free treatment. Further, as a condition of obtaining tax-free treatment, the U.S. contributor also will be required to extend the statute of limitations with respect to items relating to the appreciated property through the close of the eighth taxable year following the year of the contribution. These additional reporting requirements and the requirement to extend the statute of limitations will apply only to contributions that occur on or after the date regulations are actually issued.

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Regulations Related to Transfer Pricing

Section 482 and Partnership Transactions Under Current Law

Section 482 provides the government with broad authority to allocate income and deductions between commonly controlled persons in order to prevent evasion of taxes or to clearly reflect income. The determination of how income and deductions are to be allocated takes into account the functions performed, assets employed and risks undertaken by the parties to the transaction. As shown in the Notice, Treasury has asserted that it has broad authority to make Section 482 allocations in the partnership context, including with respect to partnership contributions, distributions and allocations (including Section 704(c) allocations).

Forthcoming Regulations Regarding Application of Section 482 to Partnerships

The Notice indicates that Treasury intends to issue regulations relating to the application of Section 482 to partnership transactions. These regulations will include specified transfer pricing methods for partnership transactions as well as rules regarding periodic adjustments in the context of partnership contributions. The Notice is explicit that a partnership's decision to use the remedial method under Section 704(c) does not insulate the partnership from adjustments under Section 482.

With respect to new specified transfer pricing methods for partnership transactions, the Notice says that the new specified methods will be based upon the platform contribution transaction (PCT) valuation methods set forth in Treasury Regulation Section 1.482-7(g), subject to certain adjustments. Pairing the promulgation of new specified methods based on Treasury Regulation Section 1.482-7(g) methods with new periodic adjustment rules (described below) strongly suggests that the new partnership methods will be based, to some extent, upon the income method and/or residual profit split method, both of which are based on forecasted results rather than observed actual pricing data. However, it remains to be seen how the cost-sharing arrangement (CSA) transfer pricing methods will be adjusted for use in the partnership context and how the methods may interact with established partnership allocation principles. For example, while certain provisions of the PCT regulations address the impact of foreign taxes on a licensee's reasonable alternatives, the implications of different Section 704(c) allocation methods under these regulations is far from clear.

The Notice also indicates that Treasury will issue rules pertaining to periodic adjustments in partnership transactions based on the rules found in the CSA regulations. Like those found in the CSA regulations, the partnership periodic adjustment rules will delineate the circumstances under which the IRS is permitted to make adjustments to consideration charged in a controlled transaction if there is a "significant divergence" between the actual returns attributable to an intangible and projected returns. The Notice is explicit that periodic adjustments made on the basis of the new rules may result in corresponding adjustments to allocations under Sections 704(b) or 704(c).

Penalties Under Section 6662

Under current law, a taxpayer will not be subject to penalties under Section 6662 in the event of a Section 482 adjustment if the taxpayer has reasonably concluded that its valuation was reliable and has sufficiently documented that conclusion in accordance with Treasury Regulation 1.6662-6(d), which includes certain documentation and contemporaneity requirements. The Notice states that Treasury is considering issuing regulations under Section 6662 that would require specific documentation in controlled partnership transactions, potentially including projections relating to returns attributable to contributed property and partnership allocations.

Observations

U.S. taxpayers currently planning to contribute appreciated property to a partnership will need to consider the potential effects of any new regulations on their proposed transactions given the retroactive effective date. In particular, U.S. contributors of property will need to assess whether the use of remedial allocations, a condition to tax-free treatment under the new regulations, produces an acceptable result in light of the intended economic arrangement between the partners. Moreover, even existing partnerships 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, a merger or division of a partnership, or even the mere conversion of a partnership into a different form of state law partnership, could cause such partnership to become subject to the new regulations.