Executive summary

US temporary regulations (T.D. 9814), released 18 January 2017, under Internal Revenue Code\(^1\) Section 721(c), deny nonrecognition treatment to certain contributions of appreciated property by US persons to certain partnerships with related foreign partners unless the partnership adopts the remedial allocation method under Section 704(c) with respect to the transferred property and other requirements are satisfied. The temporary regulations generally adopt the rules outlined in Notice 2015-54 (the Notice),\(^2\) with some modifications made in response to comments to the Notice. The temporary regulations also serve as the text for simultaneously released proposed regulations (REG-127203-15). In addition, final regulations were released under Sections 197, 704 and 6038B, which make conforming changes to the regulations under those Code Sections.

The temporary regulations generally apply to contributions occurring on or after 6 August 2015, or before 6 August 2015, resulting from entity classification elections filed on or after 6 August 2015, consistent with the effective dates announced in the Notice. However, any new rules, including any substantive changes to the rules described in the Notice, apply to contributions occurring on or after 18 January 2017, or to contributions occurring before 18 January 2017, resulting from entity classification elections filed on or after 18 January 2017.
Detailed discussion

Background
Section 721(c) grants the US Treasury (Treasury) the regulatory authority to deny nonrecognition under Section 721(a) of “gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person.” In the Notice, Treasury and the Internal Revenue Service announced their intent to promulgate regulations under Section 721(c) that would deny nonrecognition treatment to certain contributions of appreciated property by US persons to certain partnerships with related foreign partners unless the partnership adopts the remedial allocation method under Section 704(c) with respect to the transferred property and satisfies other requirements.

Temporary and proposed regulations
The regulations generally adopt the rules that were described in the Notice with certain modifications made in response to comments received. Noteworthy modifications to the rules that were described in the Notice are discussed below.

Arguably, the most significant change from the Notice is that the temporary regulations increase the overlapping ownership of the partnership threshold among the US transferor and related persons from a more-than-50% test to an 80%-or-more test, thereby excluding many partnerships from the application of the temporary regulations.

Scope
In general, the regulations apply to all contributions, actual or deemed, of property to a partnership, except that a deemed contribution resulting from a technical termination of a partnership under Section 708(b)(1)(B) will not cause a non-Section 721(c) partnership to become a Section 721(c) partnership. In addition, a mere change in identity, form, or place of organization of a partnership or a recapitalization of a partnership will not cause the partnership to become a Section 721(c) partnership.

The regulations also revise the definition of “Section 721(c) property” by adding new categories of “excluded property.” For example, a partnership interest now constitutes excluded property if the partnership holds (directly, or indirectly through interests in one or more partnerships that are not excluded property) property of which 90% or more of the value consists of excluded property. Commenters also requested exclusion of income from property effectively connected with a US trade or business (ECI property) from the definition of Section 721(c) property. Although the regulations continue to include ECI property in the definition of Section 721(c) property, they modify the application of the gain deferral method to ECI property (as discussed later).

General rule of gain recognition
The regulations clarify that the general rule of gain recognition does not apply to a direct contribution of Section 721(c) property by an unrelated US transferor (i.e., a US transferor that does not, together with related persons with respect to it, satisfy the ownership requirement). In addition, the regulations modify the de minimis exception described in the Notice to focus instead on contributions during the partnership’s tax year. Under the revised de minimis exception, Section 721(c) property will not be subject to immediate gain recognition if the sum of all built-in gain for all Section 721(c) property contributed to a Section 721(c) partnership during the partnership’s tax year does not exceed US$1 million.

Gain deferral method
The regulations retain the gain deferral method, which generally must be applied in order to avoid the immediate recognition of gain upon a contribution of Section 721(c) property to a Section 721(c) partnership. The gain deferral method is similar to that described in the Notice. The regulations, however, make several changes. Specifically, the gain deferral method: (i) now applies on a property-by-property basis; (ii) is modified as applied to ECI property; (iii) contains new rules concerning antichurning property under Section 197(f)(9); and (iv) contains new rules under the “consistent allocation method” for certain required allocations.

The regulations do not include the Notice’s “unified application” requirement. The Notice required the gain deferral method to be adopted for all Section 721(c) property subsequently contributed to the Section 721(c) partnership by the US transferor and all other related US transferors until the earlier of:

- The date that no built-in gain remains for any Section 721(c) property to which the gain deferral method first applied
- 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

Instead, under the regulations, the gain deferral method now applies on a property-by-property basis.
Although ECI property continues to be considered Section 721(c) property, it is no longer subject to the remedial allocation method or the consistent allocation method, if certain strict requirements are satisfied.

The regulations modify the remedial allocation method as to related partners when a Section 721(c) partnership is applying the gain deferral method to certain goodwill and going concern value described in Section 197(f)(9), known as antichurning property. Specifically, the Section 721(c) partnership amortizes the excess of the Section 704(b) book value of such property over the tax basis as if the property were newly purchased. In lieu of a remedial deduction for amortization, the partnership creates a special basis adjustment for the property (akin to a Section 743(b) adjustment) for the benefit of the related noncontributing partner only. The basis adjustment is not amortizable by the related noncontributing partner and will be recovered only upon a sale or exchange of the property by the partnership. The contributing partner is allocated remedial income.

Finally, the regulations mandate that the Section 721(c) partnership’s Section 704(b) allocations satisfy the consistent allocation method, which requires a Section 721(c) partnership to allocate the same percentage of each Section 704(b) book item of income, gain, deduction, and loss “with respect to the Section 721(c) property” to the US transferor and applies on a property-by-property basis. The regulations provide guidance for making the determination whether partnership items are “with respect to Section 721(c) property.” In response to comments, the regulations provide exceptions to the consistent allocation method for certain regulatory allocations (including allocations required upon a Section 751(b) event) and allocations of creditable foreign tax expenditures. Allocations of partnership nonrecourse deductions are not included in the definition of regulatory allocations for these purposes.

To satisfy the consistent allocation method, partnership deductions must be allocated to classes of gross income with respect to each Section 721(c) property. The regulations provide that a Section 721(c) partnership must apply the principles of Regulations Sections 1.861-8 and 1.861-8T to allocate all items of deduction other than interest expense and research and experimental expenditures. A Section 721(c) partnership may allocate and apportion interest expense and research and experimental expenditures using any reasonable method, including, but not limited to, the methods prescribed by Regulations Sections 1.861-9 and 1.861-9T and 1.861-17, respectively.

Remaining built-in gain
The regulations state that revaluations of Section 721(c) property generally do not affect the remaining built-in gain in such property.

Tiered-partnership rules
The regulations include special rules for applying the gain deferral method to tiered-partnership structures. The regulations employ two general principles in this regard. First, if the Section 721(c) property is an interest in a partnership, the contribution of that partnership interest, and not the indirect contribution of the underlying property of the lower-tier partnership, to a Section 721(c) partnership is subject to Section 721(c), and the gain deferral method applies to the contribution of the interest. Second, the gain deferral method must also be adopted at all levels of the ownership chain.

Acceleration events
The regulations follow the acceleration event provisions of the Notice. When an acceleration event occurs with respect to Section 721(c) property, the remaining built-in gain in the property must be recognized and the gain deferral method will no longer apply. Acceleration events now apply on a property-by-property basis and may be triggered only partially (including as a result of certain regulatory allocations). The regulations clarify the exceptions to acceleration events but retain the Notice’s broad general rule; however, a failure to comply with a procedural or reporting requirement of the gain deferral method is not an acceleration event if the failure is not willful and relief is sought.

Termination events
The gain deferral method will cease to apply upon the occurrence of a number of events, including: (i) a contribution of Section 721(c) property (other than a partnership interest) to a domestic corporation to which Section 351 applies; (ii) an incorporation of a partnership other than by an actual assets-up incorporation; (iii) a distribution of the Section 721(c) property to the US transferor, when all related foreign persons cease to be direct or indirect partners in the Section 721(c) partnership; (iv) a fully taxable disposition of the Section 721(c) property; and (v) a fully taxable disposition of the Section 721(c) partnership interest.

A distribution of Section 721(c) property to a related foreign person is not a termination event.
**Successor events**

A successor event allows for the continued application of the gain deferral method and includes: (i) a Section 351 transfer of an interest in a Section 721(c) partnership to a domestic corporation; (ii) a contribution of Section 721(c) property by a Section 721(c) partnership to a “controlled partnership”; and (iii) a transfer of an interest in the Section 721(c) partnership to a controlled partnership (if certain requirements are satisfied).

**Reporting requirements and statute of limitations**

Consistent with the Notice and the regulations under Sections 367(a) and 6038B regarding failures to file gain recognition agreements or to satisfy other reporting obligations, the regulations require reporting of a gain deferral contribution and annual reporting with respect to the Section 721(c) property to which the gain deferral method applies. These reporting requirements are extensive and complex.

Similarly, a requirement of the gain deferral method is that the US transferor agree to extend the period of limitations on the assessment of tax for: (i) eight full tax years for the gain realized but not recognized on a gain deferral contribution; (ii) six full tax years for the US transferor’s distributive share of all items with respect to the Section 721(c) property for the year of contribution and two subsequent years; and (iii) five full tax years for the gain recognized on the contribution of Section 721(c) property for which the gain deferral method is not applied (if the contribution is made within five partnership tax years following a gain deferral contribution).

**Sections 482 and 6662**

The regulations do not contain the regulations under Sections 482 and 6662 that were announced in the Notice. The preamble states, “Section 482 continues to apply to controlled transactions (within the meaning of Section 1.482-1(i)(8)) that are also subject to these regulations. An adjustment pursuant to [Section] 482 does not prevent the application of these regulations.”

The regulations are quite complex, although they clarify and improve upon the rules provided in the Notice in some significant ways. The increase in the ownership threshold percentage from 50% to 80% ought to significantly reduce the number of partnerships to which Section 721(c) will apply. It is also helpful that the regulations state that Section 721(c) will not apply to certain transactions, including technical terminations under Section 708(b)(1)(B) and partnership conversions/recapitalizations. The regulations should, however, apply to a constructive partnership, raising the stakes in determining whether an arrangement between related taxpayers is classified as a partnership for US federal income tax purposes.

Although the regulations provide helpful guidance by removing certain regulatory allocations and allocations of creditable foreign tax expenditures from the application of the consistent allocation method requirement, the list of excepted regulatory allocations is limited. For example, regulatory allocations of nonrecourse deductions remain subject to the consistent allocation method. This requirement could require taxpayers to accelerate their recognition of built-in gain in unexpected circumstances. In addition, preferred interests will need to be carefully structured going forward to ensure that any preferred fill-up allocations comply with the consistent allocation method requirement.

With respect to antichurning property, the regulations represent a significant departure from the way many practitioners have thought about the remedial allocation method, requiring remedial income inclusions of the contributing partner without corresponding allocations of notional deduction to the noncontributing partner.

It should also be noted that the tiered-partnership rules in the regulations are extremely complex and of uncertain application. Taxpayers with tiered-partnership structures should pay particularly close attention to these rules when contemplating transactions to which the regulations could apply.

**Implications**

The adoption of the regulations is a major change to the treatment of transfers of property to a partnership, particularly the requirement that the partnership both apply the remedial allocation method to the Section 721(c) property and make consistent allocations of all items related to such property in order to avoid recognition of gain on the transfer.
Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.


3. For detailed coverage of the Notice, see ibid.
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