In Notice 2015-54 (the Notice), the Internal Revenue Service (the IRS) and Treasury announced forthcoming regulations (with a 6 August 2015 effective date) under Section 721(c) that will create an exception to the general nonrecognition rule for property contributions to a partnership in exchange for a partnership interest under Section 721(a). In particular, the exception to Section 721(a) would apply when a US person (a US Transferor) contributes appreciated property (Section 721(c) Property) to a partnership, if, after the contribution and any related transactions:

- One or more Related Foreign Persons (generally defined as a person related to the US Transferor under Section 267(b) or 707(b)) is a “Direct or Indirect Partner” in the partnership and (b) the US Transferor and one or more Related Persons own more than 50% of the interests in partnership capital, profits, deductions or losses (a Section 721(c) Partnership).

- The IRS and Treasury intend that the regulations will ensure that a US Transferor of Section 721(c) Property to a Section 721(c) Partnership takes into account (either immediately or periodically) the built-in gain attributable to the Section 721(c) Property.

The IRS and Treasury also announced their intent to issue modified regulations specific to partnerships under Sections 482 and 6662 to address controlled transactions involving partnerships and the appropriate transfer pricing methods, valuation approaches, periodic adjustment provisions and documentation of those transactions.
Background

Section 721(c) grants Treasury the regulatory authority to prevent the general nonrecognition rule of Section 721(a) from applying to the “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.” Before issuing Notice 2015-54, the IRS and Treasury had not issued, or announced their intent to issue, regulations under Congress's grant of authority under Section 721(c). According to the Notice, the IRS and Treasury have become aware that some taxpayers claim to be able to contribute, consistent with Sections 704(b), 704(c) and 482, property to a partnership that allocates the income or gain from the contributed property to related foreign partners that are not subject to US income tax. The Notice specifically states that many of the taxpayers engaging in those transactions are choosing a Section 704(c) method other than the remedial allocation method and/or using valuation techniques that are inconsistent with the arm’s-length standard. To restrict taxpayers from engaging in those transactions and potentially shifting gain to a foreign person through the use of a partnership, the IRS and Treasury determined that it is appropriate to allow for the continued application of Section 721(a) to transfers to partnerships with related foreign partners only when the conditions described in the Notice are satisfied.

Proposed rules

Immediate gain recognition and exceptions to gain recognition

According to the Notice, the regulations (with an effective date of 6 August 2015) under Section 721(c) will provide that Section 721(a)’s general nonrecognition treatment will not apply (i.e., there will be immediate gain recognition) when a US Transferor contributes Section 721(c) Property to a Section 721(c) Partnership. For purposes of determining whether a partnership is a Section 721(c) Partnership, the term “Related Person” means a person that is related to the US Transferor under Sections 267(b) or 707(b)(1). A “Related Foreign Person” is a Related Person (other than a partnership) that is not a US person. A “Direct or Indirect Partner” is a person that owns an interest in a partnership directly or indirectly through one or more partnerships. In addition, the term Section 721(c) Property does not include: (i) cash equivalents, (ii) securities under Section 475(c)(2) (including stock of CFCs), and (iii) tangible property with built-in gain of $20,000 or less.

The Section 721(c) regulations will apply to transactions involving tiered partnerships in a manner consistent with the purpose of these rules as described the Notice. In this regard, (i) if a US Transferor is a Direct or Indirect Partner in a partnership and that partnership contributes Section 721(c) Property to a lower-tier partnership, or (ii) if a US Transferor contributes an interest in a partnership that owns Section 721(c) Property to a lower-tier partnership, then the rules described in the Notice will apply as though the US Transferor contributed its share of the Section 721(c) Property directly.

The Notice provides two exceptions to the application of the general rule. First, US Transferors transferring Section 721(c) Property to a Section 721(c) Partnership will be able to defer their gain if the “Gain Deferral Method” (described below) applies to the contributed Section 721(c) Property. Second,
Section 721(a) will continue to apply (i.e., there will not be immediate gain recognition) if the sum of all Section 721(c) Property contributed by the US Transferor during the tax year does not exceed $1 million and the partnership is not applying the Gain Deferral Method to prior contributions by the US Transferor or a related US Transferor (the De Minimis Rule).

**Gain deferral method**
The Gain Deferral Method has five requirements. First, the partnership must adopt the remedial allocation method described in Treas. Reg. Section 1.704-3(d) for the contributed Section 721(c) Property. Second, for any tax year in which there is remaining built-in gain with respect to the contributed Section 721(c) Property, the partnership must allocate all items of Section 704(b) book income, gain, loss and deduction for that property in the same proportion (the Proportionate Allocation Rule). Third, the partnership must comply with certain reporting requirements as described below. Fourth, the US Transferor must recognize the built-in gain upon an “Acceleration Event” in accordance with the rules described in the Notice. Finally, the partnership must adopt the Gain Deferral Method for all Section 721(c) Property subsequently contributed to the partnership by the US Transferor and all related US Transferors until the earlier of: (i) when no built-in gain remains on any Section 721(c) Property to which the Gain Deferral Method first applied; or (ii) 60 months after the initial contribution to which the Gain Deferral Method applied.

**Acceleration Events**
An Acceleration Event is any transaction that: (i) would reduce the amount of remaining built-in gain that a US Transferor would recognize under the Gain Deferral Method; or (ii) could defer the recognition of the built-in gain. Notably, an Acceleration Event is deemed to occur with respect to all Section 721(c) Property at any time that the partnership does not satisfy the requirements of the Gain Deferral Method. An Acceleration Event also occurs upon the sale by a US Transferor of a Section 721(c) Partnership interest. If a US Transferor sells only part of its interest in a Section 721(c) Partnership, the US Transferor would have an Acceleration Event only to the extent of the Section 721(c) Property attributable to the partnership interest sold.

Certain transfers are not treated as Acceleration Events under the Notice. These include: (i) transfers of Section 721(c) Partnership interests or Section 721(c) Property to a domestic corporation in a Section 351 or 381 transaction; and (ii) the transfer of Section 721(c) Property to a foreign corporation in a Section 351 transaction if the assets are treated as being transferred by a US person (other than a domestic partnership) under Treas. Reg. Section 1.367(a)-1T(c)(3)(i) or (ii). To meet the exception for a transfer of a Section 721(c) Partnership interest to a domestic corporation, the parties must continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the US Transferor.

Upon the occurrence of an Acceleration Event, the US Transferor recognizes the portion of the remaining built-in gain that would have been allocated to the US Transferor if the partnership had sold the Section 721(c) Property immediately before the Acceleration Event for its fair market value. To reflect the US Transferor’s recognition of gain, corresponding adjustments are made to the basis of the Section 721(c) Property and to the US Transferor's basis in its partnership interest.

**Anti-abuse rule**
The Notice includes an anti-abuse rule providing that, if a US Transferor engages in a transaction (or a series of transactions) with a principal purpose of avoiding the application of the regulations described in the Notice, then the Service may disregard or recharacterize the transaction (or series of transactions) in accordance with its substance.

**Reporting requirements and statute of limitations**
US Transferors contributing Section 721(c) Property to a foreign Section 721(c) Partnership must fulfill the reporting requirements of Sections 6038, 6038B, and 6046A. Also, beginning in 2015, the IRS intends to modify Form 8865 (specifically, Schedule O) related to the transfer of property to a foreign partnership.
Finally, for all partnerships, the IRS and Treasury intend to issue additional reporting requirements for future tax years.

Regarding the statute of limitations, the Notice states that the IRS and Treasury intend to issue regulations that will require a US Transferor (and, in some cases, a Section 721(c) Partnership) to extend the statute of limitations for all items related to the Section 721(c) Property through the close of the eighth tax year following the year of the contribution.

Section 482 scope
The Notice emphasizes in the Overview, Section .04 that, “for purposes of Section 482, [Treas. Reg.] Section 1.482-1 (i)(7) and (8), controlled transactions include contributions” to partnerships. As such, the Notice indicates that the IRS and Treasury believe that the provisions of Section 482 and the Internal Revenue Regulations adopted under Section 482 (including regulations that establish the arm’s-length standard, the best method rule and various specified methods applicable to intangible property) currently apply to contributions to partnerships.

Effective dates
In general, the regulations under Section 721(c) will apply to transfers occurring on or after 6 August 2015, as well as to transfers treated as occurring before 6 August 2015, resulting from check-the-box elections that are filed on or after, but are effective on or before, that date. For contributions occurring before the issuance of new regulations, the Notice states the IRS and Treasury believe that the current regulations under Sections 482 and 6662 apply to partnership contributions, distributions, partnership interests and allocation of other partnership items. The regulations on future reporting obligations and the extensions of the statute of limitations, as well as the regulations further defining the application of Sections 482 and 6662 to partnerships, will be effective on or after the date the regulations are published.

Implications
Effective immediately, taxpayers transferring appreciated property to a foreign or domestic partnership meeting the definition of a Section 721(c) Partnership will need to ensure that the transfer meets the De Minimis Rule or that they properly adopt and apply the Gain Deferral Method. In that regard, the Notice may raise the stakes in determining whether an arrangement between related taxpayers is classified as a partnership for US federal income tax purposes.

Adopting the remedial allocation method (as required by the Gain Deferral Method) will generally cause the inclusion of taxable income equal to the built-in gain in the Section 721(c) Property over its applicable recovery period. Modeling of income or loss under the potential Section 704(c) methods has long been common in assessing partnership contributions, and partnerships affected by this new guidance will need to model the effect of the remedial allocation method on the US Transferor.

The Proportionate Allocation Rule (also required by the Gain Deferral Method) raises significant questions of interpretation. The intent seems straightforward – to require “straight-up” allocations of income and loss with respect to the Section 721(c) Property. But, in practice, it is likely that many questions will arise. For example, the allocation of remedial income will typically alter the allocation of foreign tax expense, which, in turn, typically requires corrective allocations to ensure that the partners’ capital accounts remain in balance. Another example is posed by nonrecourse deductions, which may be mandatorily allocated in a manner that differs from the general sharing allocations stated in the partnership agreement. We do not believe that Treasury and the IRS intended that following the above regulatory allocation rules would trigger built-in gain with respect to Section 721(c) Property, and hope that they will clarify the parameters of the Proportionate Allocation Rule promptly.

The Notice defines an Acceleration Event broadly. Until the IRS and Treasury issue regulations under Section 721(c), there will be significant uncertainty as to what transactions constitute an Acceleration Event. It is clear that distributions of Section 721(c) Property could constitute an Acceleration Event; in certain cases, it will be necessary to monitor the
property even beyond the seven-year period included in the “mixing bowl” rules of Sections 704(c)(1)(B) and 737. The sale of a partnership interest by a US Transferor would also cause an Acceleration Event. This raises the possibility of a US Transferor recognizing built-in gain even when the sale of its partnership interest would not otherwise result in a taxable gain. The rule is written so broadly that it could, in theory, apply to even a small change in the timing of the recognition of taxable income, such as an accounting method change that extends the recovery period of property. As with the Proportionate Allocation Rule, we hope that the definition of an Acceleration Event will be clarified, as the adverse consequences of an error are so significant.

Careful attention needs to be paid to the valuation of contributed property (both intellectual and in any other form) to a partnership. As discussed, the Notice emphasizes that Section 482 currently applies to partnerships between related parties, which implies that the methods specified under Treas. Reg. Section 1.482-4 or -7, including the CUT method, comparable profits method, the income method, the acquisition price method, the market capitalization method and the residual profit split method. Careful analysis of the returns from the applicable partnership interests will be required to ensure that these returns are consistent with Section 482 principles. Taxpayers should also consider: (i) the advisability of adopting adjustable payment provisions that could avoid the possibility of periodic adjustments under either Treas. Reg. Sections 1.482-4(f)(2) or 1.482-7(f)(6); and (ii) the need for documentation under Treas. Reg. Section 1.6662-6(d) to protect against penalties under Section 6662(e) and (h).

In addition, the scope of the regulations to be issued regarding the application of Section 482 principles to partnerships is uncertain. As written, the Notice does not indicate that these regulations would apply only to controlled transactions involving Section 721(c) Property. It is possible that these rules could be rules of general application to transactions between partners that are related parties. If so, similar considerations to those described above could apply to all transfers of property to partnerships between related parties.

For partnerships formed before issuance of the Notice, taxpayers should consider whether the relationship between their partnership contributions and partnership interests, as well as their ongoing interactions with the partnership, comply with Section 482. Given that the Notice emphasizes the applicability of Section 482 to partnerships, it is to be expected that the IRS will audit both pre-existing and new partnerships for compliance with Section 482, which will implicate various transfer pricing concepts, including the arm’s-length standard, the best method rule and the intangible property regulations of Treas. Reg. Sections 1.482-4 and -7.

Finally, the scope and application of the anti-abuse rule is unclear. Specifically, it is unclear what facts or conditions would lead to a conclusion that a transaction (or series of transactions) had a principal purpose of avoiding the application of the regulations described in the Notice.

Endnotes
1. Congress also provided specific authority in Section 367(d)(3) to address transfers of intangibles to partnerships. The Notice indicates, however, that Treasury and the IRS concluded that acting under Section 721(c) is more appropriate because the transactions at issue are not limited to transfers of intangible property.
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