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Treasury issues notice of upcoming regulations pertaining to transfers of certain property to partnerships with foreign related partners

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On 6 August 2015, the US Department of the Treasury issued Notice 2015-54 (the 'Notice') outlining its intent to issue regulations under Internal Revenue Code ('IRC') Section 721 (c). These new regulations are designed to ensure that when a US person transfers certain appreciated property to a partnership with foreign partners related to the US transferor, income or gain attributable to that will be allocated to the US transferor rather than to the foreign partner who may not be subject to any US tax.

By promulgating such regulations, Treasury is attempting to, in effect, replicate the effects of IRC Section 367 (which prevents US persons from avoiding US tax by transferring appreciated property to foreign corporations) in a partnership context. IRC Section 721 (a) provides that a contribution of property to a partnership, in exchange for an ownership interest in such partnership, is a tax-free transaction. However, Section 721 (c) reserves the right of Treasury to provide regulations to nullify tax-free treatment in certain transactions involving partnerships with non-US partners.

Broadly, the new regulations would make IRC Section 721 (a) non-recognition treatment inapplicable in cases where:

- a US transferor contributes certain BIG property (referred to as '721 (c) Property,' described below) with a combined built-in gain in excess of $1 million,
- to a partnership in which (i) a foreign partner related to the US transferor holds a direct or indirect interest in the partnership, and (ii) the US transferor and any related parties (whether domestic or foreign) hold more than a 50% ownership interest in the partnership (a '721 (c) Partnership'), and
- *unless* the 721 (c) Partnership follows a specific gain allocation procedure (the "Gain Deferral Method," described below).

721 (c) Property is any type of BIG property *except* (i) cash equivalents, (ii) securities *(see footnote 1)*, and (iii) any tangible BIG property with a built-in gain of $20,000 or less. By excluding securities from the definition of 721 (c) Property, Treasury is clearly targeting the contribution of other types of assets — namely interests in intellectual property, real estate, and highly-appreciated tangible assets.

To apply the Gain Deferral Method, the 721 (c) Partnership must do the following:

- The partnership must adopt the remedial allocation method under the IRC Section 704 (c) regulations with respect to all 721 (c) Property contributed to the partnership under the same 'plan' (i.e., in the same or related transactions).
- After applying (i) above, during any year in which there is remaining built-in gain with respect to an item of 721 (c) property, the partnership must allocate each partner's distributive share of income under IRC Section 704 (b) with respect to the 721 (c) Property in the same proportion.
- Certain new reporting requirements must be satisfied. *(see footnote 2)*
- The US transferor must recognize built-in gain with respect to his contributed 721 (c) property upon the occurrence of an 'acceleration event' — essentially, any transaction that would otherwise disrupt Treasury's intended application of the Gain Deferral Method.
- The Gain Deferral Method must be adopted with respect to any subsequently contributed 721 (c) Property by the US transferor (and any other related US transferors) for 5 years following the first contribution of 721 (c) Property.

Importantly, the new regulations would also apply to so-called 'tiered' partnership structures where, for example, a US transferor contributes an interest in a partnership that is holding BIG property ('P1') to newly-formed partnership ('P2'). The Notices makes clear that Treasury would 'look through' P1 and therefore treat the US transferor as directly contributing the BIG property to P2. As a result, assuming this transaction met the other criteria for inclusion under the new regulations, P2 would need to follow the Gain Deferral Method in order for the US transferor to avoid gain recognition.

The new regulations, once approved and finalized, would be effective as to any transfers occurring on or after 6 August 2015, and to any transfers occurring before 6 August 2015, resulting from an entity-classification election filed on or after 6 August 2015, and effective on or before 6 August 2015.

The new regulations described in the Notice represent a bold step by Treasury to combat the prevalent practice of shifting built-in gains from US transferors to related non-US taxpayers who are not subject to US tax. For taxpayers who may be impacted by the new regulations, careful and intricate tax planning by highly-qualified US tax counsel will be required to ensure that gains to US transferors are not triggered or accelerated.

Footnotes

1. As defined in IRC Section 475 (c) (2), to include: stock, interests in publicly traded partnerships or trusts, debt instruments, notional principal contracts, and many types of derivatives and hedges.

2. These requirements are detailed in the Notice and will include, among other things, additional reporting under Schedule O of Form 8865, Return of US Persons With Respect to Certain Foreign Partnerships.

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