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US Treasury may require gain recognition on certain transfers of appreciated property to partnerships on or after 6 August 2015

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On 6 August 2015, the US Treasury Department issued Notice 2015-54 outlining its intent to issue regulations under US Internal Revenue Code Section 721 (c) to ensure pre-existing ('built-in') gain in assets that are contributed to a partnership is recognized by the contributing partner under certain circumstances.

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 property will be allocated to the US transferor rather than to the foreign partner who may not be subject to any US tax.

The new rules are effective for any transfers occurring on or after 6 August 2015, *and* for any transfers occurring before this date, resulting from an entity classification ('check the box') election filed on or after, or effective on or before, 6 August 2015. This latter rule may be particularly critical if, for example, planning has been implemented on the basis that a check the box election will be filed to treat a non-US company as a partnership but that election has not yet been filed.

The new rules are designed to ensure that under certain circumstances, a US person that transfers appreciated assets to a partnership with related non-US partners will be subject to US tax on the built-in gain in those assets either immediately or under a specified 'gain deferral' method. The Treasury Department is concerned that in the absence of the new rules, this income or gain could be allocated to the non-US partner(s) and permanently escape US tax.

Typically, a contribution of property to a US or non-US partnership in exchange for an interest in the partnership is non-taxable to the contributing partner and the partnership. However, the Treasury Department has the authority to issue rules requiring immediate (or in certain cases, deferred) tax on certain partnership contributions, which it has exercised in Notice 2015-54.
In some ways, the new partnership contribution rules parallel existing 'outbound transfer' recognition rules that apply to certain contributions by US persons of appreciated assets to non-US companies. However, the new partnership rules are both more narrow and broader in important respects.

Generally, under the new partnership rules, a US person must recognize gain (and pay tax) immediately if:

- They contribute specified property with pre-existing ('built-in') gain to a US or non-US partnership;
- After the contribution and any other contributions that are part of the same 'plan', a non-US person that is related to the US transferor (under certain relationship rules) is a partner in the partnership;
- Post-contribution(s) the US transferor and all related parties, whether US or non-US, own more than 50% of the interests in the partnership; and
- The partnership does not follow prescribed rules to ensure the US transferor remains subject to US tax on the built-in gain (the 'gain deferral rules').

'Specified property' for this purpose is any property except (i) cash equivalents, (ii) specified 'securities' including stock, interests in publicly traded partnerships or trusts, debt instruments, notional principal contracts, and many types of derivatives and hedges, and (iii) any tangible property with a built-in gain of $20,000 or less. Therefore, these new rules could clearly apply to contributions to partnerships of intellectual property and real estate assets but not to contributions of stock in companies holding intellectual property or real estate.

Subject to a *de minimis* exception, a US transferor can only defer gain on the contribution if the recipient partnership:

- Adopts the 'remedial method' of allocating built-in gain to all of its partners with respect to all specified property contributed by the US transferor and any related US transferors in the same or related transactions (the 'remedial method' is a specific regulatory method of allocating 'built-in' gain);

- Allocates each partner's share of income with respect to that property in the same proportion during all subsequent years in which there is any remaining built-in gain in the contributed property;
- Satisfies certain new reporting requirements, including additional reporting under Schedule O of Form 8865, *Return of US Persons With Respect to Certain Foreign Partnerships*; and
- Adopts the 'remedial allocation method' for any specified property that is contributed by the US transferor (and any related US transferors) for 5 years following the first contribution of specified property.

Further, a US transferor must recognize any remaining built-in gain with respect to his contributed property when an 'acceleration event' occurs. Broadly, an acceleration event is any transaction or event that would reduce or eliminate the amount of built-in gain a US transferor would recognize, including a failure to comply with all of the requirements set out at (i) to (iv) above.

Under a *de minimis* exception, a US transferor does not recognize gain (even if the above 'gain deferral' rules are not followed) if the US transferor (and all related US transferors) do not contribute assets with built-in gain exceeding $1 million in any year, provided the recipient partnership is not already applying the gain deferral rules to any assets contributed by any of the US (or related) transferor(s).

The application of the rules set out in the Notice is limited to 'related person' situations but they also apply to 'tiered' partnerships, such as when a US transferor contributes an interest in a partnership holding specified property or a partnership with a US partner contributes specified property.

The new rules, which significantly curtail the general rule that contributions of property to partnerships are non-taxable, will require increased due diligence on the part of taxpayers and their advisors including with respect to arm's length valuations, reporting obligations, and relationships between partners in US and non-US partnerships. Further, any structures that use partnerships, whether for active business operations or as holding structures, will require detailed advice from qualified US tax advisors to ensure US transferors are not subject to immediate US tax under these new partnership gain recognition rules.

Please click here for a more technical discussion of Notice 2015-54.

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