

**COMMENTS ON TEMPORARY AND PROPOSED REGULATIONS GOVERNING
ALLOCATION OF PARTNERSHIP EXPENDITURES FOR FOREIGN TAXES**

(T.D. 9121; REG-139792-02)

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

These comments were prepared by individual members of the Foreign Tax Credits and Subpart F Task Force of the Section of Taxation. Principal responsibility was exercised by Elinore Richardson, Lowell Yoder, Carol Tello and Rebecca Rosenberg. Substantive contributions were made by Carol Tello, Rebecca Rosenberg, Steven Surdell, Chip Harter, and Paul Crispino. The Comments were reviewed on behalf of Section of Taxation committees by Claude Stansbury (Corporate Tax), William Caudill (Partnerships and LLCs), Chip Harter (Financial Transactions), Rebecca Rosenberg (Foreign Activities of US Taxpayers), Mark van Casteren (Foreign Lawyers Forum), David Canale (Transfer Pricing) and Robert Gordon (Energy and Environmental Taxes). The Comments were reviewed by Robert Liles of the Section's Committee on Government Submissions and by N. Susan Stone, Council Director for the Foreign Tax Credits and Subpart F Task Force.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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A. EXECUTIVE SUMMARY

These comments address the Temporary¹ and Proposed² Regulations governing the proper allocation of partnership expenditures for foreign taxes. We address the Temporary Regulations in the comments. The comments are a response to the solicitation for comments in the notice of proposed rulemaking issued on April 21, 2004 in the Federal Register.

The Temporary Regulations address concerns identified by Notice 2004-19, 2004-11 I.R.B. 606, including the results of certain transactions that are inconsistent with the stated purpose of the foreign tax credit provisions. The Temporary Regulations amend the section 704(b) regulations to provide specific rules for the allocation of creditable foreign tax expenditures (“CFTE”). Under those rules, allocations of CFTEs cannot have substantial economic effect. Therefore, allocations of CFTEs must be allocated in accordance with the partners’ interest in the partnership (“PIP”). An allocation will be deemed to be in accordance with PIP if the allocation satisfies a new safe harbor (“Safe Harbor”). If the allocation of CFTEs does not meet the Safe Harbor requirements, only in unusual circumstances would the allocation of CFTEs be in accordance with PIP.

Our recommendations may be found in Sections V and VI in the comments. They are summarized as follows.

1. Clarify whether the absence of the economic equivalence test is intended. If this was not intended, consider whether satisfaction of the economic equivalence test could be considered as an additional method of meeting the Safe Harbor.
2. Confirm that the Safe Harbor does not require partners to allocate income based upon section 904(d) income limitation categories.
3. Clarify the manner in which foreign taxable income will be matched with a partner’s distributive share of partnership income.
4. Provide guidance as to what the principles of Treas. Reg. §1.904-6 are and how they are to be applied in the context of the Safe Harbor.
5. Provide more specific guidance to address timing and base differences that occur between U.S. and foreign tax law (as well as any potential character differences that might affect partnership allocations), even if not in the context of the section 704(b) regulations.
6. Clarify if, and how, the related party interest allocation rules under Treas. Reg. §1.906-4 should be applied to the determination of a partner’s distributive share of partnership items.

¹ T.D. 9121, I.R.B. 2004-20, 903, 69 *Fed. Reg.* 21405 (4/21/04).

² REG-139792-02, I.R.B. 2004-20, 926, 69 *Fed. Reg.* 21454 (4/21/04).

7. Provide guidance and examples that demonstrate the application of the allocation rules in the context of partnership allocations made on the basis of foreign law, including where such allocations are required under foreign law.

8. Provide guidance and a specific example that illustrate the manner in which U. S. disregarded inter-branch transactions may qualify for the Safe Harbor.

9. Provide guidance on the treatment of guaranteed payments and other non-deductible payments and confirm which of such payments are included in a partner's distributive share of the income that forms part of the foreign tax base.

10. Provide guidance on how a guaranteed payment might meet the PIP standard when it does not meet the Safe Harbor requirements.

11. Provide guidance on the application of section 704(c) principles in the context of the Safe Harbor and on the interrelationship of section 704(c) and Treas. Reg. §1.904-6.

12. Provide additional guidance and examples to illustrate how PIP should be applied in the context of CFTEs outside the Safe Harbor and as to when CFTEs are allocated on a basis such as geographic allocation.

B. DETAILED COMMENTS ON TEMPORARY AND PROPOSED REGULATIONS

I. Introduction

We write to set out our comments concerning the Temporary and Proposed Regulations governing the allocation of partnership expenditures for foreign taxes. (We will refer only to the Temporary Regulations in these comments.) These comments are a response to the solicitation for comments in the notice of proposed rulemaking issued on April 21, 2004 in the Federal Register.

Our detailed comments are set forth sections V and VI. We separately discuss the Safe Harbor requirements, the application of the Treas. Reg. §1.904-6 principles, the treatment of disregarded transactions and guaranteed payments, the interaction of section 704(c) principles with the Safe Harbor rules, and allocations that do not satisfy the Safe Harbor criteria.

II. History, Background, and Purpose of Temporary Regulations

The Temporary Regulations provide rules to address some of the concerns identified by Notice 2004-19, 2004-11 I.R.B. 606, including the results of certain transactions that are inconsistent with the purpose underlying the foreign tax credit provisions. That purpose is to mitigate double taxation of foreign source income, but to preserve U.S. taxation of U.S. source income. In Notice 2004-19, the IRS and Treasury withdrew Notice 98-5, 1998-1 C.B. 334, and its reliance on an economic profits test, which would have disallowed foreign tax credits if the reasonably expected economic profit from an arrangement was insubstantial compared to the expected foreign tax credits. Notice 2004-19 indicates the intent of IRS and Treasury to address

abusive foreign tax credit transactions through a combination of judicial, legislative, and administrative initiatives, including the issuance of regulations. In particular, Notice 2004-19 states the intent to issue regulations to address situations involving special allocations of foreign taxes among partners that are inconsistent with the allocation of the related foreign income. The Temporary Regulations implement this intent by adopting the “matching” concept articulated in Notice 2004-19. For this purpose, the principles of Treas. Reg. §1.904-6 are to be applied.

III. Scope of Temporary Regulations

According to the Preamble, the Temporary Regulations clarify the application of the section 704(b) regulations to CFTEs for which the partnership--and not the partners--bears legal liability, as described in Treas. Reg. §1.901-2(f).³ For example, the Temporary Regulations will apply to foreign taxes imposed on hybrids that are partnerships for U.S. purposes and corporations (or other taxable non-transparent entities) for foreign purposes. Such hybridity may occur by reason of the check-the-box regulations or by reason of other differences between U.S. and foreign law. The Temporary Regulations will also apply to CFTEs of non-hybrid partnerships in cases in which a foreign jurisdiction taxes partnerships (or other entities that are transparent for U.S. purposes) at the entity level.

In contrast, the Temporary Regulations do not apply to credits for foreign taxes imposed at the partner level. This result is apparent not only from the Preamble but also from the fact that Treas. Reg. §1.704-1, in which the Temporary Regulations will be included, applies to determine partners’ distributive shares of items of a partnership.⁴ Taxes which a foreign jurisdiction imposes on a partner are not items of the partnership, because the partnership is not the taxpayer for those foreign taxes for purposes of foreign tax credit rules. Treas. Reg. §1.901-2(f)(1) defines the term “taxpayer” (*i.e.*, the person entitled to claim a U.S. foreign tax credit) as the person who bears legal liability for the tax under foreign law. Therefore, such foreign taxes are not an item of the partnership, and they are not within the scope of the Temporary Regulations.

Under this reasoning, the Temporary Regulations should not apply to section 902 foreign tax credits claimed by a partner by reason of its partnership’s ownership of voting stock of a foreign corporation. The IRS has stated that a corporate partner may claim credits under section 902 in such circumstances, because the partner’s indirect ownership through the partnership is taken into account for purposes of section 902’s requirement that a U.S. corporation own at least 10 percent of the foreign corporation’s voting stock.⁵ The section 902 foreign tax credit derived by such a corporate partner due to its partnership’s ownership of a corporation should be treated

³ “These temporary regulations clarify the application of the regulations under section 704 to creditable foreign tax expenditures for which the partnership bears legal liability as described in §1.901-2(f).” T.D. 9121, Reg-139792-02.

⁴ See Treas. Reg. §1.704-1(a), (b).

⁵ See Rev. Rul. 71-141, 1971-1 C.B. 211; see also Treas. Reg. §1.904-4(g)(1). (“In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902(a) or (b) will be made with the respect to the partner’s indirect ownership, and not the partnership’s direct ownership, in the foreign corporation); T.D. 8708 (1997). (preamble explaining that, in recognition of the holding of Rev. Rul. 71-141, Treas. Reg. §1.902-1(a)(1) was amended to refer to ownership, rather than “direct” ownership, by a corporate shareholder).

as an item of the partner, not an item of the partnership.⁶ The Temporary Regulations therefore should not apply to such credits. We recommend that the final regulations clarify that they will not apply to such section 902 foreign tax credits.

IV. Description of Temporary Regulations

The Temporary Regulations amend the section 704(b) regulations to provide specific rules for the allocation of CFTEs. A CFTE is a foreign tax a partnership pays or accrues for U.S. tax purposes that is eligible for a credit under section 901(a).⁷ A foreign tax is related to income if the income is included in the base upon which the taxes are imposed, which is determined under the principles of Treas. Reg. §1.904-6.⁸ It is irrelevant to the application of the Temporary Regulations whether a partner receiving an allocation of CFTEs elects to claim a credit for the allocated amount.

Under the existing regulations, allocations of partnership items to partners must either have substantial economic effect or be in accordance with PIP.⁹ The Temporary Regulations provide that allocations of CFTEs cannot have substantial economic effect.¹⁰ Accordingly, such expenditures must be allocated in accordance with PIP.¹¹ An allocation of a CFTEs will be deemed to be in accordance with PIP under the Safe Harbor if the following two-part test is satisfied:

- (1) Throughout the full term of the partnership, the partnership agreement satisfies the economic effect test of Treas. Reg. §1.704-1(b)(2)(ii)(b) or (d) (the “Economic Effect Requirement”); and
- (2) The partnership agreement provides for the allocation of the CFTE in proportion to the partners’ distributive shares of income (including income allocated pursuant to section 704(c)) to which the CFTE relates (the “Income Matching Requirement”).¹²

If an allocation does not meet the Safe Harbor requirements as stated above, CFTEs are to be allocated in accordance with PIP. No further guidance is provided by the Temporary Regulations, but the Preamble states that it would only be in unusual circumstances that the allocation of a CFTE would be in accordance with the partners’ interests in the partnership under Treas. Reg. §1.704-1(b)(3). The Preamble identifies only one instance of such an unusual situation, *i.e.*, where there is substantial certainty that the U.S. partners will deduct, rather than credit, the foreign taxes. Substantial certainty might exist mainly in situations where the taxpayer has ongoing overall foreign losses or net operating losses.

⁶ *Cf.* FSA 200144006. (“Since the taxes for which a foreign tax credit is being claimed by the partners in HybridJV are claimed as deemed paid credits under section 902 or 960 and not as direct credits under section 901 the credits are not partnership items” for purposes of section 6231(a)(3)).

⁷ Treas. Reg. §1.704-1T(b)(4)(xi)(b).

⁸ Treas. Reg. §1.704-1T(b)(4)(xi)(c).

⁹ Treas. Reg. §1.704-1(b)(1)(i).

¹⁰ Treas. Reg. §1.704-1T(b)(4)(xi)(a).

¹¹ *Id.*

¹² Treas. Reg. §1.704-1T(b)(4)(xi)(a).

V. Safe Harbor

1. Comments on the General Operation of the Safe Harbor

The structure of the Temporary Regulations is similar to that of the existing regulatory scheme,¹³ *i.e.*, both contain two-part PIP Safe Harbors of a similar nature.¹⁴ In each case, the first part of the Safe Harbor generally requires that partnership allocations be made in accordance with the underlying economic arrangement among the partners, although, as discussed below, there is clearly a difference between the two Safe Harbors in this regard. The second part of each Safe Harbor requires that allocations of CFTEs be made in proportion to the partners' respective distributive shares in the item that gives rise to the credit.

The Temporary Regulations do not refer to the economic equivalence test of Treas. Reg. §1.704-1(b)(2)(ii)(i), which provides that an allocation is deemed to have economic effect if, as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year, or at the end of any future year, would produce the same economic results to the partners as would occur if the general economic effect test of Treas. Reg. §1.704-1(b)(2)(ii)(b) had been satisfied. While this may be an oversight, it may instead be intentional because of the less predictive nature of the economic equivalence test relative to the general economic effect or alternative economic effect tests (*i.e.*, the partners must wait until after the year in question to determine whether the economic equivalence test has been satisfied). We recommend that the final regulations clarify whether the absence of the economic equivalence test is intended. Given that the section 704(b) regulations treat the economic equivalence test as an acceptable substitute to the more predictive economic effect provisions, we can think of no reason why the Safe Harbor should not be available if the partners rely on the economic equivalence test.

¹³ Under the existing regulations, allocations of CFTEs cannot have economic effect because the allocations are not reflected in an adjustment to the partners' capital accounts. Treas. Reg. §1.704-1(b)(4)(ii). Accordingly, the existing regulations require that allocations of CFTEs be made in accordance with PIP as of the time the CFTE arises. Under that rule, an allocation of a CFTE, other than an investment tax credit, is made in accordance with PIP if the following two-part safe harbor is satisfied:

1. The partnership expenditure (regardless of deductibility) that gives rise to the tax credit also gives rise to valid allocations of partnership loss or deduction, or other downward capital account adjustment, in the same year (*e.g.*, the allocation of the expenditure satisfies the substantial economic effect test); and

2. The allocation is made in the same proportion as the partners' respective distributive shares of such loss, deduction or other adjustment.

The existing regulations also provide that “[i]dentical principles shall apply in determining the partners’ interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).”

¹⁴ The IRS and Treasury could have addressed this problem directly through regulations governing the application of the substantiality test, as suggested in the Preamble, rather than issuing a new set of regulations to govern allocations of tax credits that are already effectively covered under the existing regulations. The Preamble states that the IRS and Treasury believe that ignoring the tax consequences of allocations on the owner of a partner is inconsistent with the policies underlying the substantial economic effect rules, because it would allow a partnership to make tax-advantaged allocations if the tax advantages of the allocations were to accrue to an owner of a partner, rather than to the partner itself. The IRS and Treasury have indicated that they plan to issue guidance on the application of the section 704(b) regulations to these situations.

The extent to which the Temporary Regulations modify the existing regulations governing the allocation of tax credits is not entirely clear. Under the existing regulations, the allocation of a credit does not have economic effect because the allocation does not affect the partner's capital account.¹⁵ Under a special rule, however, an allocation of credit will be deemed to be in accordance with the partner's interest in the partnership if the allocation is in proportion to the allocation of the item giving rise to the credit.¹⁶ This latter allocation, of a partnership expense or receipt, may have economic effect and, assuming that it does, it would form the basis for the allocation of the credit. In light of this, the Temporary Regulations provision that an allocation of CFTE does not have substantial economic effect is not entirely clear. It would be appropriate if an allocation of CFTEs equated with the allocation of a credit (rather than an allocation of an expense). The IRS and Treasury may have assumed that all partners intend to claim a credit for their distributive shares of CFTEs.¹⁷ We assume that this is the reason why the Temporary Regulations provide that partnership allocations of CFTEs cannot have substantial economic effect and, therefore, must be allocated in accordance with PIP.

The Safe Harbor applies in a relatively straightforward manner in simple fact patterns. The Temporary Regulations specifically provide examples to demonstrate allowable allocations where there are (i) special allocations of taxable active income and nontaxable passive income from the same country;¹⁸ (ii) special allocations of income from high tax and low tax jurisdictions,¹⁹ and (iii) special allocations where income is taxable for US purposes in a different year than the tax is imposed by the foreign jurisdiction.²⁰

As an example of a simple case, assume Partner A and Partner B form an eligible entity, AB, that is treated as a partnership for U.S. tax purposes, and that AB earns both operating income subject to a 40 percent local tax and passive income exempt from local tax.²¹ Consistent with the intent of subchapter K to permit taxpayers to conduct joint business activities through a flexible economic arrangement,²² the Temporary Regulations would allow Partner A and Partner B to allocate the local tax expense related to the operating income in any manner they choose so long as the allocation satisfies the Income Matching Requirement, *e.g.*, the CFTE allocation is proportional to the allocation of the related operating income and the Economic Effect Requirement. Accordingly, the AB partnership agreement could allocate the operating income and associated taxes 60 percent to Partner A and 40 percent to Partner B, 80 percent to Partner A and 20 percent to Partner B, and so forth. The AB partnership agreement could not, however, allocate the operating income 60 percent to Partner A and 40 percent to Partner B, but then allocate the local tax 80 percent to Partner A and 20 percent to Partner B. Such an allocation would fail the Income Matching Requirement of the Safe Harbor because the allocation of the

¹⁵ Treas. Reg. §1.704-1(b)(4)(ii).

¹⁶ Treas. Reg. §1.704-1(b).

¹⁷ See T.D. 9121 ("Unlike most other trade or business expenses, foreign taxes described in section 901 or 903 are fully creditable against a partner's U.S. tax liability, subject to certain limitations, including primarily the foreign tax credit limitation under section 904.") See also discussion above regarding substantial economic effect, under section IV.

¹⁸ See Treas. Reg. §1.704-1T(b)(5), Example 25.

¹⁹ See Treas. Reg. §1.704-1T(b)(5), Example 26.

²⁰ See Treas. Reg. §1.704-1T(b)(5), Example 27.

²¹ See Treas. Reg. §1.704-1T(b)(5), Example 25.

²² Treas. Reg. §1.701-2(a).

CFTE would not be proportional to the allocation of the income upon which the foreign tax is imposed.

In more complex fact patterns, the application of the Safe Harbor is not always clear, as for example, in the case of the application of the Safe Harbor in the context of a section 704(c) allocation and in other fact patterns involving guaranteed payments or disregarded payments.

The Temporary Regulations also illustrate the application of the Safe Harbor in the context of a special allocation of gross income.²³ Presumably, this is the fact pattern at which the Temporary Regulations were aimed.²⁴ In Example 28 of the Temporary Regulations, Partner A and Partner B form AB, an eligible entity treated as a partnership for U.S. tax purposes, and the AB partnership agreement satisfies the first part of the Safe Harbor. The AB partnership operates a business that is subject to a creditable local tax at the rate of 20 percent on the business' net income. The AB partnership agreement allocates all partnership items, including CFTEs, equally between the partners except that the first \$100 of gross income is allocated to Partner A. In the year in question, the AB partnership earns \$300 of gross income, has deductible expenses, exclusive of CFTEs and the gross income allocation, of \$100, and pays or accrues \$40 of local tax (*i.e.*, \$200 of net income at the local 20 percent rate). In this case, the Example concludes that the partnership agreement's equal allocation of the \$40 of CFTE fails the Safe Harbor because a portion of the local tax is related to the gross income that is specially allocated to Partner A. As stated in the Example, a necessary predicate for this conclusion is that the gross income allocation is not a deductible payment for local tax purposes. Under the Principles of Treas. Reg. §1.904-6, the CFTE is related to \$200 of local net income because this is the income base upon which the local tax is imposed.²⁵ Presumably, the AB partnership agreement could be amended to permit the CFTE allocation to fall within the Safe Harbor by allocating a proportionate share of the local tax against the gross income allocation, *i.e.*, \$20, with the remaining unallocated amount being shared equally between Partner A and Partner B.

Unlike the Safe Harbor contained in the existing regulations, which allocates CFTEs in accordance with allocations of partnership expenses or income that satisfy the substantial economic effect or PIP rules, the Temporary Regulations' Safe Harbor allocates CFTEs in accordance with the partners' distributive shares of income to which the foreign tax relates. The Temporary Regulations' Safe Harbor does not expressly provide that the allocation of the partners' distributive shares of income to which the foreign tax relates must be a valid allocation under the partnership rules, as the existing regulations require, but we assume that this is clearly intended. The Temporary Regulations appear to assume that if a partnership agreement conforms to the general economic effect test of Treas. Reg. §1.704-1(b)(2)(ii)(b) or (d), the partnership's allocation of its foreign income to which the CFTE relates must be valid. This may

²³ See Treas. Reg. §1.704-1T(b)(5), Example 28.

²⁴ Example 28, on which this discussion is based, is the only example in the Temporary Regulations in which an allocation of a CFTE fails the Safe Harbor.

²⁵ If the gross income allocation had been deductible for local tax purposes, the equal allocation of the CFTEs presumably would have satisfied the Safe Harbor.

not always be the case, *e.g.*, the partnership's allocation of its income could fail the substantiality test.²⁶

The Temporary Regulations provide little guidance with respect to the Income Matching Requirement of the Safe Harbor. The guidance is essentially limited to four examples and a reference to Treas. Reg. §1.904-6 principles for assistance in determining whether a CFTE is related to income. The Temporary Regulations provide that a CFTE is related to income if the income is included in the base upon which the CFTEs are imposed, determined by taking into account the principles of Treas. Reg. §1.904-6.²⁷ Treas. Reg. §1.904-6 provides rules for the allocation of taxes to separate categories of income. Similar to the Temporary Regulations, Treas. Reg. §1.904-6 generally allocates CFTEs to income that is included in the base upon which the foreign tax is imposed.²⁸ As Treas. Reg. §1.904-6 already provides rules for determining whether a CFTE is related to income, it is appropriate for the Temporary Regulations to reference these rules.²⁹

The Temporary Regulations continue to permit a certain level of flexibility to partners in structuring CFTE payments, even while satisfying the Safe Harbor. Thus, for example, there does not appear to be a requirement that partners allocate income derived from separate section 904(d) categories,³⁰ or separate business units,³¹ in the same ratio or in some other special manner. If this is the intended rule, and we suggest that the final regulations confirm that it is, it is in our view appropriate in light of the check-the-box regulations and the concomitant ability to create foreign partnerships with multiple disregarded entities as branches. To do otherwise could have caused unnecessary complexity.³²

We have assumed that the "income" referred to in Treas. Reg. §1.704-1T(b)(4)(xi) means the income, determined under U.S. tax principles, on which partnership allocations and distributive shares are based. Treas. Reg. §1.704-1T(b)(4)(xi)(c) then appears to us to attempt to trace which parts of such U.S.-perceived income are included in the foreign tax base on which

²⁶ In light of this, an alternative would have been to modify the Safe Harbor of the existing regulations to provide a third rule that CFTEs could only be allocated in accordance with a valid allocation of partnership foreign income to which the CFTEs relate.

²⁷ Treas. Reg. §1.704-1T(b)(4)(xi)(c).

²⁸ Treas. Reg. §1.904-6(a)(1).

²⁹ Example 27 of the Temporary Regulations provides an example illustrating the interaction between the Safe Harbor and the base and timing difference rules of Treas. Reg. §1.904-6(a)(1)(iv). In the Example, the partnership is treated as earning income in an earlier year for U.S. tax purposes than for foreign tax purposes. In the subsequent year when the partnership is treated as earning the income for local tax purposes and the local tax is paid, the allocation of the CFTE is found to be proper under the Economic Effect Requirement of the Safe Harbor because the subsequently imposed CFTE foreign tax is allocated in the same manner as the underlying income had been allocated in the prior year, *i.e.*, both the income and the tax were allocated equally between partners A and B, even though the income arose in Year 1 and the foreign taxes arose in Year 2.

³⁰ *See* Treas. Reg. §1.704-1T(b)(5), Example 25. In this Example, the partners allocate the partnership's general limitation and passive income in different ratios.

³¹ *See* Treas. Reg. §1.704-1T(b)(5), Example 26. In this Example, the partners allocate the partnership's general limitation income derived from its two geographic operations in different ratios.

³² In addition, had the Temporary Regulations restricted the ability of partners to allocate income derived from separate business units among the partners, *e.g.*, requiring that the income be pooled or requiring that each partner take a proportionate share of each type of income, the partners may have been able to avoid this result through the creation of multiple partnerships.

the foreign taxes (leading to CFTEs) were imposed. To the extent that this is true, as seen from the comments set out below, the Income Matching Requirement could give rise to anomalous results in situations where entities subject to foreign tax at the entity level but transparent for U.S. purposes are used to conduct foreign operations. However, we believe that so long as this principle is consistently applied in the Temporary Regulations, it will produce results which are in conformity with the principles of the foreign tax credit and partnership rules. In some cases the result will favor the taxpayer and in others the fisc, but the primary consideration in our view is not the result of these rules in any fact patterns but the appropriateness of the approach when considered in the context of the U.S. tax rules. We recommend, therefore, that clarification be provided in the final regulations as to the way in which U.S. distributive share or gross income concepts will be matched with the foreign tax base so as to provide for an integrated and consistent construction of the rules.

2. Treas. Reg. §1.904-6 Principles

a. Application of Treas. Reg. §1.904-6 Principles in the Section 704(b) Context

Under the Temporary Regulations, the Safe Harbor requires that CFTEs must be allocated in proportion to the partners' distributive shares of income to which the foreign tax relates. Treas. Reg. §1.704-1T(b)(4)(xi)(c) provides that a CFTE is related to income if the income is included in the foreign base upon which the CFTEs are imposed. That relationship of income to CFTEs is to be determined consistent with the principles of Treas. Reg. §1.904-6, which assigns foreign taxes to the appropriate separate income limitations under section 904(d).

The reference to the principles of Treas. Reg. §1.904-6 does not answer the question of what the principles of Treas. Reg. §1.904-6 are. Further, despite the directive to apply the principles of Treas. Reg. §1.904-6, no clear guidance is provided as to how those principles are to be applied for purposes of the Temporary Regulations.

The “principles” of Treas. Reg. §1.904-6 are to be applied in this case to determine if a CFTE is related to income for purposes of allocating the CFTE to a partner when the foreign taxes are imposed on partnership-- and not partner-- income. In both the partnership case and the section 904(d) case, foreign taxes that have been imposed on income determined under foreign law are being allocated to particular income that is identified under U.S. tax principles. In essence, Treas. Reg. §1.904-6 provides a hybrid system. Although the CFTEs are allocated by reference to the foreign tax base, the CFTEs are allocated to U.S. income categories.³³ In the partnership case, CFTEs must be matched with parts of the foreign tax base which are allocated to particular partners, rather than (as Treas. Reg. §1.904-6 was intended to do) with parts of the tax base which are assigned to particular section 904(d) separate limitation income categories (“baskets”). Presumably this “disconnect” is the reason that the Temporary Regulations refer to the “principles” of Treas. Reg. §1.904-6. We strongly urge that the final regulations provide guidance as to whether that difference, *i.e.*, distributive share income as opposed to section 904(d) limitation income categories, would require any modifications and if so, what those modifications might be.

³³ See Treas. Reg. §1.904-6(a).

b. Defining the principles of Treas. Reg. §1.904-6

Treas. Reg. §1.904-6 provides several discernable basic guidelines or principles that determine when foreign taxes are related to separate limitation income. First, and probably most important, foreign taxes are treated as related to income if the income is included in the foreign tax base on which the tax is imposed.³⁴ Treas. Reg. §1.904-6 provides some helpful examples: (i) no foreign taxes may be allocated to foreign income that is exempt from foreign tax;³⁵ (ii) income subject to a special rate of tax will be treated as subject to that foreign tax imposed at that special rate;³⁶ and (iii) withholding tax will be related to income on which the withholding tax is imposed.³⁷ When foreign taxes are related to more than one category of income under foreign law, the taxes must be allocated between those categories of income on the basis of proportionate net income.³⁸ Implicit in that principle is that taxes can relate to more than one category of income.

c. Illustration of Treas. Reg. §1.904-6 Principles in the 704(b) Temporary Regulations

The Examples provided by the Temporary Regulations illustrate the Treas. Reg. §1.904-6 principles to a certain extent. For example, Example 25 illustrates the principle that no foreign taxes are to be allocated to income that is exempt from foreign tax and Example 27 illustrates a straightforward timing difference similar to one illustrated by Example 5 under Treas. Reg. §1.904-6(c). However, the Temporary Regulations are silent with respect to differences between U.S. and foreign base income. As illustrated by the examples in the discussion of the effect of disregarded transactions below, the Temporary Regulations highlight the unsolved dilemmas of the base and timing differences rule under Treas. Reg. §1.904-6(a)(1)(iv). Although the issues presented are difficult, we suggest that more specific guidance be provided to address these issues.

Treas. Reg. §1.904-6, in the case of a “base difference,” allocates the taxes to the general limitation category under section 904(d), but it is unclear how this principle can be applied by analogy to the different question of to which partner the foreign tax credits should be allocated. A base difference occurs in situations in which a foreign country taxes an item that the U.S. does not treat as income (*e.g.*, a gift or, arguably, a circular cash payment).

Base differences are distinguished, in Treas. Reg. §1.904-6(a), from timing differences. Timing differences occur when a foreign country taxes income in one year but the income to which the foreign tax relates is recognized for U.S. purposes in a different year.³⁹ Such foreign taxes are placed in the section 904(d) basket in which the related income would have been placed if the income had been recognized for U.S. purposes in the same year as the foreign taxes are paid or accrued.⁴⁰ The distinction between a base difference (allocated to the general basket) and

³⁴ Treas. Reg. §1.904-6(a)(1)(i).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ Treas. Reg. §1.904-6(a)(1)(ii).

³⁹ Treas. Reg. §1.904-6(a).

⁴⁰ *Id.*

a timing difference (allocated the same way the income would be allocated, if the income were recognized in the same year as the taxes are paid or accrued) is not always clear. The IRS and Treasury have commented and ruled on this topic without providing detailed, explicit guidelines for the many cases in the gray area, although they have noted that base differences are expected to be rare.⁴¹

FSA 200210026, dated December 3, 2001, is one example of an IRS ruling with respect to this issue. In that FSA, under U.S. law, a French corporation treated as a partnership for U.S. purposes, had no U.S. taxable income due to amortization deductions because of a section 338 election on the acquisition of a French corporation held by the French hybrid entity. For French law purposes, however, it had taxable income on which French taxes were imposed. When the French hybrid made a distribution to its U.S. parent, under French law, the distribution was treated as a dividend subject to French withholding tax. Under U.S. law, the distribution was treated as a nontaxable return of capital. The taxpayer allocated the foreign taxes to the general limitation basket. The FSA did not definitively resolve the issue as to which basket the foreign taxes should be allocated, but rather deemed the taxpayer's allocation as "not unreasonable." We understand that the IRS and Treasury may regard Treas. Reg. §1.904-6 as a more appropriate vehicle than the final regulations under section 704(b) for clarifying the rules regarding base and timing differences. We recommend, however, that in order for the rules under the Temporary Regulations to work, additional guidance regarding base and timing differences is required.

In addition to base and timing differences, character differences are also possible, for example where the foreign country perceives dividend income and the United States perceives interest income.⁴² We expect that character differences will have limited relevance to the application of the Temporary Regulations, except where it is necessary to identify which amounts are interest for purposes of the related party interest expense allocation rules described below. We suggest that the IRS and Treasury clarify that, in the case of a character difference, the U.S. characterization would generally govern for foreign tax credit purposes.⁴³

d. Application of Related Party Interest Expense Special Allocation

It is not clear which of the principles of Treas. Reg. §1.904-6 are to be applied for purposes of allocating foreign taxes imposed on partnership income to partners. More particularly, it is not clear whether the special related party interest expense allocation rule should be applied at the partner or the partnership level. For this purpose, interest expense is allocated at the partner level under Treas. Reg. §1.861-9(2)(e). We would expect that that rule would also apply in the context of the Temporary Regulations.

Although gross foreign income is the starting point for the allocation of CFTEs, CFTEs are allocated under Treas. Reg. §1.904-6 on a net taxable income basis. To determine foreign taxable income, Treas. Reg. §1.904-6 requires that related party interest expense must be allocated to passive income first, prior to allocating any other deductible expenses or losses on the basis of foreign tax law, first observing any direct allocations to specific gross income under

⁴¹ See, e.g., TD 8916 (Preamble stating that base differences are extremely rare).

⁴² See Treas. Reg. §1.904-6(c), Example 5.

⁴³ Treas. Reg. §1.904-6(c), Example 5 already indicates that this is the case, but additional guidance and clarification would be helpful.

foreign law and then applying any foreign law allocation of expenses.⁴⁴ U.S. tax allocation rules under section 864(e) are applied when foreign law provides neither for direct allocation or apportionment of expenses.⁴⁵

The Temporary Regulations do not discuss whether these rules will be applied and, if so, how. The Examples provided by the Temporary Regulations specifically identify general limitation and passive income. It is not clear whether the reference to those specific section 904(d) income categories could be construed as suggesting that the partnership must determine its partnership allocations on the basis of section 904(d) income categories. We assume that that is not the case, but we strongly urge that the point should be clarified.

Under Treas. Reg. §1.904-6, a constant variance with foreign law arises by virtue of the requirement to first allocate related party interest expense to passive income. The result may be to reduce the passive income taxable base on which foreign tax is imposed. For example, if a CFC with \$100 of foreign gross passive income and \$100 of general limitation income pays \$100 of interest expense to a sister CFC, no net taxable passive income results. Under foreign law, however, the \$100 of interest expense is allocated to the total \$200 of gross income leaving \$100 of taxable income, on which \$40 of foreign tax is imposed. Thus, \$20 of foreign tax should be allocated to the passive income and \$20 to the general limitation income. However, under Treas. Reg. §1.904-6, the \$100 of interest expense must be allocated against the passive income first. Under that rule, the CFC has \$0 income in the passive basket and \$100 in the general limitation basket. Therefore, no foreign taxes are allocated to the passive basket. Example 6 of Treas. Reg. §1.904-6(c) confirms this result. Consequently, if Partner A in the AB Partnership is allocated all of the partnership passive income, Partner A presumably would be allocated any related party interest expense as well under the Treas. Reg. §1.904-6 principles. This could result in no taxable income for U.S. purposes, but taxable income for foreign purposes with associated foreign tax liability. In that case, would all of the CFTEs be required to be allocated to Partner B? If that were the case, it does not seem that that result would be consistent with the Temporary Regulations' Safe Harbor rule. We urge that clarification be provided as to the appropriate allocation method to be used in such circumstances.

e. Allocations of Income Under Foreign Law

Many international joint ventures among unrelated partners (often non-U.S. persons) are structured as partnerships. Often, local laws limit the flexibility of the partners in agreeing on allocations and distributions of partnership profits among partners. Moreover, in some jurisdictions, investment requirements may be government-imposed with little room for alterations to those rules. In that case, the imposition of the Safe Harbor could result in CFTEs being severed from the income on which they are imposed. We would urge that rules and examples be issued to illustrate the application of the rules governing partnership allocations in the context of such partnerships where, for example, partnership income is allocated under the partnership agreement based on foreign law.

⁴⁴ Treas. Reg. §1.904-6(a)(1)(i).

⁴⁵ Treas. Reg. §1.904-6(a)(1).

3. Effect of Disregarded Transactions

Example 26 of the Temporary Regulations makes it clear that special allocations of CFTE of different operating branches of a partnership can benefit from the Safe Harbor if such allocations of CFTE are in proportion to the allocations of income of those branches to which the tax expense relates. The facts in Example 26⁴⁶ involve the simple case where the foreign income base on which the tax is imposed in each branch is the same as the income earned by the branch under U.S. tax principles. This often will not be the case. Often, multi-branch partnerships are formed to reduce the foreign tax base of high-tax branches through deductible payments of interest, rents, commissions or royalties made to lower tax branches. Although these inter-branch payments decrease the foreign tax base of one branch and increase the foreign tax base in the other branch, they do not give rise to income and expense for U.S. tax purposes. In such circumstances, an issue arises as to whether partners allocating the income and taxes of the branches may benefit from the deemed Safe Harbor, and if so, how it is to be applied. Because this issue will likely arise in a substantial number of the cases where partners are allocating CFTE, specific guidance is urgently needed.

To illustrate the issue, assume that Partner X and Partner Y operate Partnership P, which owns a disregarded entity in Country A (“Branch A”) and a disregarded entity in Country B (“Branch B”). Branch A’s only asset is a patent which it licenses to Branch B for \$100 per year. Branch A reports \$100 of income to Country A, which imposes tax at a 10 percent rate resulting in a tax of \$10. Branch B, using its rights under the patent, manufactures and sells a product, producing gross sales of \$300. It incurs \$100 of expenses in addition to its \$100 royalty expense for a net income, measured under Country B principles, of \$100. Country B imposes tax at a 50 percent rate for a tax of \$50.

For U.S. tax purposes, the \$100 royalty payment is disregarded, with the effect that under U.S. tax principles Branch A has \$0 pre-tax income, on which it pays \$10 of Country A tax, and Branch B has \$200 in pre-tax income on which it pays \$50 of Country B tax.

Under their partnership agreement, Partner X and Partner Y agree that Partner X will be allocated 90 percent of the pre-tax income and tax expense of Branch A and 10 percent of the pre-tax income and tax expense of Branch B, and that Partner Y will be allocated 10 percent of the pre-tax income and tax expense of Branch A and 90 percent of the pre-tax income and tax expense of Branch B. Assume further that Partner X and Partner Y agree that, for purpose of determining the incomes of Branch A and Branch B to be allocated between them, they will *give effect* to the royalty payment from Branch B to Branch A. They are thus agreeing to apportion the total income of the partnership between Branch A and Branch B in the same manner as the foreign taxing jurisdictions.

Under these facts, Partner X would be allocated \$90 of income, corresponding to 90 percent of Branch A’s pre-tax income of \$100, and \$9 of tax expense, corresponding to 90 percent of Branch A’s tax expense of \$10. Partner X would also be allocated \$10 of income, corresponding to 10 percent of Branch B’s \$100 of pre-tax income, and \$5 of tax expense,

⁴⁶ Treas. Reg. §1.704-1T(b)(5).

corresponding to 10 percent of Branch B's \$50 of tax expense. Partner X would therefore be allocated total pre-tax income of \$100 and tax expense of \$14 by the partnership.

Partner Y would be allocated \$10 of income, corresponding to 10 percent of Branch A's pre-tax income of \$100, and \$1 of tax expense, corresponding to 10 percent of Branch A's tax expense of \$10. Partner Y would also be allocated \$90 of income, corresponding to 90 percent of Branch B's \$100 of pre-tax income, and \$45 of tax expense corresponding to 90 percent of Branch B's \$50 of tax expense. Partner Y would therefore be allocated total pre-tax income of \$100 and tax expense of \$46 by the partnership.

An issue arises as to whether the CFTE is allocated in proportion to the "partners' distributive shares of income . . . to which the CFTE relates" within the meaning of Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(2) under these circumstances. Under U.S. tax principles, there is no separate pool of income attributable to Branch A, because the inter-branch royalty is disregarded. One way to view the situation is that there is only a single pool of partnership pre-tax income of \$200, some of which is taxed at a 50 percent rate and some of which is taxed at a 10 percent rate. If the U.S. tax regime does not see separate pools of income to be allocated separately, perhaps the partners should be viewed as sharing in a single pool and should therefore divide the total taxes of the partnership in proportion to their interests in the single pool. This approach would result in Partner X and Partner Y each being allocated \$100 of pre-tax income and \$30 of tax expense. It could be argued that where partners have made check-the-box elections to allow them to disregard the existence of inter-branch transactions for subpart F purposes, they should be required to disregard the inter-branch transactions for foreign tax credit purposes as well. If the income of Branch A does not exist for U.S. tax purposes, the special allocation of that income is either an allocation of gross income or an allocation of a portion of the partnership's total net pre-tax income. One could therefore read Treas. Reg. § .704-1T(b)(4)(xi)(a)(2) as requiring that a proportionate share of the *total* tax of the partnership follow such allocation. Stated differently, one might view the allocation of the Branch A income as an allocation of a portion of the total pre-tax income of the partnership measured by reference to the amount of income subject to Country A taxation.⁴⁷

In cases like the one illustrated above, where the terms of the allocation agreement between the partners give effect to the disregarded transactions, such a focus on consistency appears to us to be misguided. Allocations like the one illustrated above do not result in the inappropriate separation of income and taxes and are consistent with the purpose and intent of the Safe Harbor. We recommend that the final regulations provide a specific example affirming that such allocations will give effect to disregarded inter-branch transactions qualify for the Safe Harbor.

The appropriate answer is less clear in cases where the partnership agreement allocates income between partners based on the income pools as determined under U.S. tax principles which do not take into account the disregarded inter-branch transactions. To illustrate this point, assume the facts of the previous example with two variations. First, the partnership agreement

⁴⁷ See, P. McCarty, "The New Temporary Regulations on Special Allocations of Foreign Tax Expenditures – Unanswered Questions," *J. of Taxation of Global Transactions* (CCH), Vol. 4 No. 2 (Summer 2004), which explores this issue.

defines the income of Branch A and Branch B to be allocated between the partners in the stated percentages solely under U.S. tax principles, giving no effect to the inter-branch royalty. Therefore, Branch A has \$0 pre-tax income and Branch B has \$200 pre-tax income to be allocated. Second, assume that both Country A and Country B impose tax at the same 30 percent rate on the income of the respective branches calculated under foreign tax principles (i.e., \$30 tax expense with respect to \$100 of pre-tax income in each case).

Under this variation, Partner X would be allocated \$0 of income, corresponding to 90 percent of Branch A's pre-tax income of \$0, and \$27 of tax expense, corresponding to 90 percent of Branch A's tax expense of \$30. Partner X would also be allocated \$20 of pre-tax income, corresponding to 10 percent of Branch B's \$200 of pre-tax income, and \$3 of tax expense, corresponding to 10 percent of Branch B's \$30 of tax expense. Partner X would therefore be allocated total pre-tax income of \$20 and tax expense of \$30 by the partnership.

Partner Y would be allocated \$0 of pre-tax income, corresponding to 10 percent of Branch A's pre-tax income of \$0, and \$3 of tax expense, corresponding to 10 percent of Branch A's tax expense of \$30. Partner Y would also be allocated \$180 of income, corresponding to 90 percent of Branch B's \$200 of pre-tax income, and \$27 of tax expense corresponding to 90 percent of Branch B's \$30 of tax expense. Partner Y would therefore be allocated total pre-tax income of \$180 and tax expense of \$30 by the partnership.

What is striking about this example is that the partners, by matching taxes imposed under foreign tax principles with income pools defined under U.S. principles, have produced separate high-tax and low-tax earnings and profits pools through the partnership allocations, even though all of the operations producing the income and incurring the tax are taking place in jurisdictions imposing the same 30 percent rate of foreign tax. The effect of such an allocation would appear to be inconsistent with the intent of the Temporary Regulations. These examples illustrate the need for additional guidance as to how one interprets, in the context of inter-branch transactions, the requirement of the Safe Harbor that the "allocation of the CFTE [be] in proportion to the partners' distributive shares of income . . . to which the tax relates."⁴⁸

4. Guaranteed Payments

Payments made to a partner for services or for the use of capital are treated as made to a non-partner to the extent that such payments are determined without regard to the income of the partnership.⁴⁹ Such payments are referred to as "guaranteed payments."⁵⁰ The Temporary Regulations do not address guaranteed payments.⁵¹

In the absence of any explicit guidance, the treatment of guaranteed payments under the Temporary Regulations (like the treatment of other items, including interest and allocations of gross income) appears to depend on whether such payments are deductible under foreign law. If guaranteed payments are deductible, they will not form part of the foreign tax base. In that case,

⁴⁸ Treas. Reg. §1.704-1T(b)(4)(xi)(a)(2).

⁴⁹ Section 707(c).

⁵⁰ See, e.g. headings of section 707(c) and Treas. Reg. §1.707-1(c).

⁵¹ See Treas. Reg. §1.704-1T(b). It is understood that this may have deliberate, in order to avoid issues of the characterization of items for U.S. purposes of items in the application of the regulations.

no foreign taxes will be associated with them under the principles of Treas. Reg. §1.904-6(a). It would then appear that the partnership can allocate foreign taxes without regard to the guaranteed payments without running afoul of the Safe Harbor. For example, assume that a partnership, AB, allocated its income 50-50 to Partner A and Partner B, but only after making a guaranteed payment to Partner A. If the guaranteed payment was deductible under foreign law, the entire foreign tax would be imposed on the partnership's income less the guaranteed payment, and it would be acceptable under the Safe Harbor to distribute the foreign taxes 50-50 to Partner A and Partner B (in proportion to the income forming the foreign tax base). Such deductibility under foreign law, however, is not expected to occur often.

If guaranteed payments are not deductible under the particular foreign law (which may often be the case), such payments would instead form part of the foreign tax base. The Safe Harbor would then apply only if the partner receiving the guaranteed payment was allocated the foreign taxes attributable to that payment's share of the partnership income. In the example above, the distribution of foreign taxes 50-50 to Partner A and Partner B would fail the Safe Harbor test, because the tax base (including the guaranteed payment) is not divided 50-50 between the partners.⁵²

This presumed default treatment of guaranteed payments appears to us to be an appropriate result, because providing that CFTC's follow the distribution of the foreign tax base among the partners appears to be a reasonable means of carrying out the statutory purpose of mitigating double taxation on foreign source income. We recommend that the final regulations clarify that, under the Safe Harbor, guaranteed payments are intended to be treated in the same manner as other payments, *i.e.*, that their treatment is dependent on whether they are included in the foreign tax base.

We assume that the result in Example 28 would be the same if the allocation of gross income in that Example was instead a guaranteed payment. The guaranteed payment would most likely not be deductible under foreign law. Therefore, the guaranteed payment would be included in the foreign tax base, permitting the appropriate foreign taxes to be allocated to the guaranteed payment under Treas. Reg. §1.904-6. We also assume that the Safe Harbor would be met, in the facts of Example 28 with a guaranteed payment (or a gross income allocation) if the partner receiving the guaranteed payment were allocated the foreign taxes associated with the proportionate amount of the foreign tax base. However, there does not seem to be universal agreement among tax practitioners as to how Example 28 would apply to guaranteed payments.⁵³ We, therefore, recommend that the IRS and Treasury include an example in the final regulations to demonstrate what the result would be under Example 28 if the allocation of gross income in that Example were instead a guaranteed payment.

Guaranteed payments are treated as income to the partner and deductions to the partnership for purposes of sections 61(a) and 162(a). They are treated as distributive shares for

⁵² Cf. Example 28 of the Temporary Regulations (same result for allocation of gross income, rather than a guaranteed payment).

⁵³ See, e.g., John F. Prusiecki, "New Temporary Regulations on P'Ship Allocations: What Exactly Do They Do?," 2004 TNT 91-39 (May 3, 2004) (stating that the fact pattern in Example 28 would meet the Safe Harbor if the allocation of gross income in that example were instead a guaranteed payment).

other purposes.⁵⁴ The existing regulations, however, refer to “other provisions,” not “*all* other provisions.”⁵⁵ If guaranteed payments are not considered to form part of the distributive share, but instead treated as deductible, a partnership could meet the Safe Harbor even if it failed to allocate any foreign taxes to the recipient of a guaranteed payment. We recommend that the final regulations clarify that guaranteed payments are treated as part of a partner’s distributive share, so that they are included in the Safe Harbor concept that foreign taxes must be allocated in proportion to a partner’s distributive share of the income that forms the tax base.

We also recommend that the IRS and Treasury consider providing more guidance on how a guaranteed payment might meet the PIP standard without meeting the Safe Harbor. The Preamble says that meeting PIP without the Safe Harbor would be “unusual” but possible. But the Temporary Regulations say very little about how that might be done.

5. The Interaction of Section 704(c) Principles In the Safe Harbor

As described in detail above, the Temporary Regulations create a Safe Harbor rule under which an allocation of CFTEs is deemed to be in accordance with PIP if the requirements for economic effect (or the alternate test for economic effect) under Treas. Reg. §1.704-1(b)(2)(ii) are satisfied and the partnership agreement provides for the allocation of the CFTEs “in proportion to the partners’ distributive shares of income (including income allocated pursuant to section 704(c)) to which the CFTE relates.”

We believe that the reference in the Safe Harbor to “*income* allocated pursuant to section 704(c)”⁵⁶ was intended to refer to disposition transactions, and to provide that when a built-in gain is taxed in the foreign jurisdiction, which section 704(c) requires to be allocated to the contributing partner for U.S. tax purposes, the foreign tax credits associated with the §704(c) income must track that income. This analysis appears to be consistent with the general tracking principles of Treas. Reg. §1.904-6, which generally relates taxes to income if the income is included in the base upon which the tax is imposed.⁵⁷

The reference to “income allocated pursuant to section 704(c)” is ambiguous in those circumstances in which there are tax basis differences for US and foreign law purposes.⁵⁸ We believe that the provision is intended to state the relatively straightforward proposition that if an asset is sold, exchanged, or otherwise disposed of in a transaction (collectively “Disposition Transaction”) that attracts tax in a foreign jurisdiction, the allocation of the income associated with that Disposition Transaction must follow section 704(c) principles. That is, any pre-contribution built-in gain recognized (and thus taxed) under foreign law as a result of a Disposition Transaction must be allocated first to the partner contributing the built-in gain assets, irrespective of what the partnership agreement allocations generally provide. Section 704(c) also contains complex provisions that require the allocation of tax depreciation deductions in a

⁵⁴ See section 707(c) and Treas. Reg. §1.707-1(c).

⁵⁵ Treas. Reg. §1.707-1(c).

⁵⁶ Treas. Reg. §1.704-1T(b)(4)(ix)(2) (emphasis added).

⁵⁷ Treas. Reg. §1.904-6(a)(1).

⁵⁸ As a result of conceptual and technical differences between the tax laws of the U.S. and various foreign jurisdictions, basis differences frequently arise in multinational transactions. As a result, the ambiguity created by the Safe Harbor language will have broad implications.

manner that accelerates reduction of the so-called “book-tax disparity”⁵⁹ that occurs when built-in gain property is contributed to a partnership. We do not believe that the Safe Harbor should alter the results that would otherwise obtain in these situations. We therefore recommend that the language of the Safe Harbor be revised to clarify that the reference to section 704(c) income only applies when the section 704(c) income is taxed under foreign law purposes and thus gives rise to a possible CFTE that corresponds to an underlying foreign tax.

The example below illustrates a complex section 704(c) allocation in the international context. The application of the rules is made even more complex by the fact that different asset bases exist for U.S. and foreign law purposes.

Corporation A and Corporation B, each of which has operated businesses in country X for some time, agree to form a partnership under the laws of country X. The partnership is also deemed a partnership under U.S. federal income tax principles. Corporation A contributes to the partnership assets worth \$100,000. The A assets were previously owned by Foreignco. Corporation A acquired Foreignco three years ago for \$100,000 in a qualified stock-purchase under section 338. Corporation A made a section 338 election in respect of Foreignco. As a result, the Foreignco asset bases were, on the acquisition date, stepped up to their fair market value for U.S. but not foreign law purposes. Subsequent to the Foreignco acquisition, Corporation A liquidated Foreignco and took possession of the A assets directly. As a result, Corporation A held the A assets with a fair market value and U.S. tax basis of \$100,000. The A assets are amortized over four years on a straight line basis. Corporation A contributes the assets to the Partnership three years after acquisition of the A assets. Thus the A assets currently have a basis of \$25,000 for U.S. purposes and \$0 for country X purposes. However, the value of the A assets continue to be \$100,000. Corporation B contributes cash of \$100,000. The parties agree to share all items of income, gain, loss, deduction and credit equally. For partnership book purposes, the assets are amortized over four years on a straight line basis. Country X imposes a tax of 25 percent on partnership AB’s income. Because country X does not recognized the section 338 election made in respect of the A assets, it does not allow any tax depreciation deductions in respect of those assets. In year one, partnership AB earns \$20,000 (excluding the effect of any amortization on the A assets) and pays country X tax of \$5,000. The book and tax capital accounts of Corporation A and Corporation B are as follows:

	<u>A</u>		<u>B</u>	
	<u>Book</u>	<u>Tax</u>	<u>Book</u>	<u>Tax</u>
Initial Capital Amounts	\$100,000	\$25,000	\$100,000	\$100,000
Allocation of Year 1 Income	\$10,000	\$10,000	\$10,000	\$10,000

⁵⁹ The section 704(c) regulations provide that the partners may employ any reasonable method to eliminate the book-tax disparity but identify three methods that are reasonable. Those methods are the traditional, the curative and the remedial methods.

Allocation of Year 1 Amortization	(\$50,000)	(\$0)	(\$50,000)	(\$25,000)
Allocation of Year 1 Tax Expense	<u>(\$2,500)</u>	<u>(\$2,500)</u>	<u>(\$2,500)</u>	<u>(\$2,500)</u>
Ending Capital Accounts	<u>\$57,500</u>	<u>\$32,500</u>	<u>\$57,500</u>	<u>\$82,500</u>

We believe that the allocations above should meet the Safe Harbor. The allocations of tax expense equally to Corporation A and Corporation B reflect the economic agreement between the parties. More importantly, the equal allocation of the tax expense tracks the income allocations to which that expense relates. Specifically, country X determined, under its tax principles, that the AB partnership recognized \$20,000 of taxable income on which a tax of \$5,000 was due and the \$20,000 of income was allocated equally to Corporation A and Corporation B. However, sections 704(b) and 704(c) mandate that the \$25,000 of U.S. tax depreciation associated with the A assets be allocated away from Corporation A and toward Corporation B. This is consistent with the general desire of section 704(b) to reduce the book-tax disparity as quickly as possible. Because country X does not acknowledge the existence of the \$25,000 of additional depreciation deductions, the section 704(c) allocations simply do not exist for country X purposes. As a result, Corporation B's effective tax rate for foreign tax credit purposes is greater than the statutory rate imposed by country X. We do not believe that this fact vitiates compliance with the Safe Harbor. In particular, we do not believe that the reference to section 704(c) in the Safe Harbor language should be construed to require that Corporation A should somehow be allocated more of the foreign tax expense (and thus, presumably, a greater amount of CFTEs) because it bears more of the net income for U.S. income tax purposes. We understand that the thrust of the Safe Harbor is to ensure that CFTEs track the allocation of underlying *foreign country* income. The allocations above do just that.

As noted above, the allocations may, all other things being equal, result in a higher effective foreign tax rate for Corporation B, possibly resulting in a lower tax in the U.S. for Corporation B. This results only derivatively from the foreign tax credit regime and is primarily a function of the principles underlying sections 704(b) and 704(c). Thus, Corporation B is effectively "compensated" for the fact that it contributes assets (in this case cash) with a U.S. tax basis equal to fair market value. Conversely, Corporation A is effectively "charged" for the fact that it contributed the A assets with a built-in gain. Again, in our view, this is consistent with the policy underlying section 704(c).

We would suggest that, in order to clarify the results in the example above, the language of the Safe Harbor be amended to read as follows:

"in proportion to the partners' distributive shares of income (including income allocated pursuant to section 704(c); provided, however, that section 704(c) principles shall only apply if and to

the extent that income is also subject to tax in the applicable foreign jurisdiction) to which the creditable foreign tax relates.”

We further suggest that the final regulations contain examples illustrating the interrelationship of section 704(c) and Treas. Reg. §1.904-6, such as the example outlined above.

VI. Allocations Falling Outside the Safe Harbor

As described above, the Temporary Regulations provide that allocations of CFTEs cannot have substantial economic effect. As a result, those allocations may only be respected if either (i) the Safe Harbor is met, or (ii) the allocations are deemed to be in accordance with PIP. Given the lack of guidance on the application of the PIP rule, it may be difficult to know exactly how that PIP rule would apply in a given fact pattern.

Due to the fairly limited scope of the Safe Harbor, it appears to us that taxpayers will, as a practical matter, often need to rely upon PIP in order to sustain allocations of CFTEs. From a practical perspective, this will place allocations of CFTEs in a very different position than most other allocations under section 704(b). Most practitioners consider the PIP standards too subjective to rely upon in all but the most simple partnership arrangements. As a result, in virtually any complex partnership arrangement, the taxpayers and their advisors will seek to meet the requirements of the Safe Harbor.

While amending the partnership agreement to cause allocations to fall within the Safe Harbor might appear to offer a solution, it may not be possible in all cases. In these latter cases, we recommend that the PIP rule, if it is to apply, reach the same result as an amendment of the partnership agreement.⁶⁰

Given the subjectivity of PIP, we believe that it would be helpful to provide additional guidance and examples illustrating how PIP will be administered in the context of CFTEs. It is clear under Treas. Reg. §1.704-1(b)(3)(i) that PIP may apply differently for different allocations. Thus, the Temporary Regulations note that, although a partner may have a 50 percent overall interest in a partnership, it may receive an allocation of a particular item at a level substantially above its 50 percent overall interest. For example, the Temporary Regulations indicate that a 50 percent partner who unexpectedly receives a downward adjustment to his capital account and who does not have a deficit capital account restoration obligation (“DRO”), may have a 90 percent interest in a particular item of income or deduction.

In respect of CFTE allocations, we recommend that rules should be issued to allow reference to PIP in respect of the specific CFTEs at issue. For example, assume that Partner A and Partner B generally share items of income, gain, loss, deduction, or credit equally, but that Partner A is allocated 60 percent of all income and loss associated with the partnership’s

⁶⁰ The existing regulations support this position, at least in the case where the economic effect requirement of Safe Harbor is satisfied. See Treas. Reg. §1.704-1(b)(4)(ii) (providing a special PIP rule for the allocation of tax credits). In Example 11(i) of Treas. Reg. §1.704-1(b)(5), which illustrates the application of the special PIP rule, the partnership allocates expenses that give rise to a wage credit equally, but allocates the credit to one of the partners. The Example concludes that the allocation of the credit to one partner is not in accordance with the special PIP rule contained in Treas. Reg. §1.704-1(b)(4)(ii), and, that under that rule, “since the expenses that gave rise to the credit are shared equally by the partners, the credit *will be shared equally* between [partners] U and V” (emphasis added).

operations in country X. Such a geographic allocation would not be unusual.⁶¹ Presumably, an allocation of 60 percent of the country X foreign tax expense, which is consistent with the underlying economics of the partnership, would be considered to be made in accordance with PIP. Again, given the fact that PIP will be utilized frequently in assessing CFTE allocations, further clarification will serve to enhance both understanding and enforceability of the Temporary Regulations.

⁶¹ *See, e.g.*, Treas. Reg. §1.704-1(b)(5), Example 10.