Message from the Chair

The Taxation Committee continues to grow and organize presentations, panel discussions and meetings via webinar and at the ABA meetings in the US and abroad.

At our recent meeting in New Orleans, we sponsored a CLE program with the Intellectual Property and International Business Law committees on Intellectual Property and Transfer Pricing - a hot button issue in many tax audits these days. The panel members consisted of IP lawyers, economists, state and federal tax lawyers, as well as transfer pricing specialists. We also had a lively discussion at our committee meeting on choice of entity.

We are planning a full schedule at the ABA Business Law Section Meetings September 14-16 in Chicago. Your Taxation Committee intends to host or co-sponsor the following programs:

1. Choice of Entity, Thursday September 14 at 10:30 am
2. Taxation Committee Meeting Saturday September 16 at 9:00 am
3. CLE program, Saturday September 16 at 10:30 am on the Ethics of Tax Practice;
4. CLE program, Legal Issues in a Digital Economy, Saturday September 16 at 2:00 pm

If you are interested in getting more involved in the Taxation Committee, perhaps as a subcommittee leader, writer or webinar speaker, we have plenty of opportunities. Please let me know at rroyse@rroyselaw.com.

Roger Royse
Chair, Taxation Committee

Message from the Editor

We are pleased to bring you our Spring-Summer issue of Business Tax Quarterly. We have always tried to run a mix of topics-including important news from the IRS and Congress, as well as articles focusing on recurring issues confronting business lawyers-and this issue is no exception.

Monte Jackel's article on the President's executive order on tax regulations helps to explain the relative dearth of new administrative guidance during the past few months. Also from "inside the Beltway," Paul Schmidt and Jeff Paravano write about the possible path forward on tax reform, focusing on President Trump's tax reform outline and the House Blueprint; now that health care legislation seems to be put aside for the time being, the Fall seems likely to be active on this front.

We offer two articles involving estate planning: Michael Kosnitzky writes about maximizing tax benefits for real estate investors, and Howard Vigderman shares a checklist of matters to consider "on the deathbed." Phyliss Horn Epstein writes about the common and important problem of misclassification of employees and obtaining Section 530 relief. And finally, Ron Creamer, Andrew Mason, David...
Spitzer, Eric Wang and Michael Orchowski write about a topic that has been of interest to both practitioners and the IRS, examining the challenging tax issues encountered where a US taxpayer makes a contribution to a partnership with related foreign partners.

Finally, I hope you all have an enjoyable summer and look forward to seeing many of you at the Business Law Section Annual Meeting in September.

Michael Kliegman
Editor

**Feature Articles**

**The Estate Planning Conundrum: Maximizing Tax Benefits for Real Estate Investors with Significant Portfolios**
*By Michael Kosnitzky*

There are two reasons why borrowing has become the tax-preferred method of financing a sophisticated real estate investment portfolio.

First is the ability to finance improvements with debt, which offers depreciation deductions. Second is the ability to make leveraged distributions through refinancing without paying immediate tax on the proceeds. The tax basis of assets steps up to fair market value at the time of the holder's death, eliminating the deferred gain, so the income tax deferral upon a refinancing is even more attractive for heirs.

Naturally, there are caveats. When the assets are held until death, the basis step-up is mitigated by the potential estate tax to be paid by the decedent's estate. If the real estate is gifted while its owner is alive, the basis step-up is lost entirely; instead, gift recipients generally receive a so-called carryover basis, which is the basis the transferor had in the gifted asset. So estate planning usually balances the benefit of shifting the value growth of an asset out of the estate against the loss of the basis step-up for heirs.

The holy grail of tax planning for leveraged real estate is to achieve the basis step-up while transferring the appreciation before the holder dies. It isn't easy to achieve: income and estate tax rules don't coordinate well when real property has liabilities that exceed the tax basis of the property, what's known as "negative capital." Negative capital can occur when property is refinanced after it has increased in value or when depreciation causes the tax basis to decline below the debt associated with the property.

Some transfers may trigger taxable gain, so traditional estate planning techniques, such as grantor-retained annuity trusts or gifting directly to children or grandchildren, don't work well. The gain on such transfers may result in income tax imposed on the transferor greater than any estate tax savings. Transferring real property with negative capital to a REIT won't work either-such transfers also generate taxable gain.

So how can you minimize the tax impact of transferring real estate with negative capital? Owners can transfer properties with negative capital to an "umbrella partnership real estate investments trust," or UPREIT. That transfer will continue the deferral of the taxable gain associated with their negative capital. An UPREIT is a combination of a traditional REIT and a limited partnership, referred to as the operating partnership (OP), and formed by having the owners contribute their interests in the appreciated property to the partnership in exchange for limited partnership interests in the OP. In contrast to a traditional REIT, which invests in real estate assets directly, an UPREIT holds the real estate assets in the OP, and the REIT conducts most of its operations through the OP. Umbrella partnership
agreements generally provide limited partners with liquidity; after an initial holding period, they may either exchange their OP interests for shares in the REIT on a one-to-one basis, or be redeemed for an equivalent amount of cash. Although this conversion of OP interests to REIT shares will be a taxable event, the OP partner has the ability to time his exchange thus allowing for more efficient income and estate tax planning. OP holders also have the ability to separately borrow against their interest in the OP, without incurring immediate taxation, based upon the market value for the interests that is established from the redemption or conversion feature.

From an estate planning perspective, UPREITs are a wonderful tool. While the holy grail of tax planning may not be obtainable, sophisticated real estate investors should consider using an UPREIT to provide liquidity and flexibility to their income and estate tax planning.

**Misclassification of Employees and Section 530 Relief**
*By Phyllis Hon Epstein*

From housekeepers to corporate directors, people who are compensated for their labor are, for tax purposes, treated as either employees or independent contractors. The distinction is significant for several economic reasons. For example, employees, unlike independent contractors, are covered by workers' compensation insurance for on-the-job injuries. They may share in company benefits like retirement or health insurance. Their compensation is subject to withholding for Social Security and Medicare benefits, unemployment insurance, and of course income tax. Independent contractors share none of those benefits, although they still are required to report their income and pay tax. That responsibility may require the payment of self-employment tax and the filing of quarterly returns. The employer's obligation to withhold tax from the wages of employees and to provide a matching contribution for part of Social Security and Medicare taxes is an added business expense that motivates some to classify their workers as independent contractors rather than employees. The IRS has been targeting employers for the misclassification of workers as independent contractors. If the IRS determines that workers have been misclassified, the employer can be assessed large penalties and compelled to reclassify its workers as employees.

Read more....

**The Latest Presidential Executive Order on Tax Regulations**
*By Monte A. Jackel*

*Please note that following preparation of this article, the IRS issued Notice 2017-38, which reflected the interim report by the Secretary of the Treasury on the status of the regulatory review, and listed eight specific regulations to be reviewed.*

Read more....

**Checklist of Tax and Non-Tax Considerations for Someone on His/Her Deathbed**
*By M. Howard Vigderman*

I am often asked by family members of a loved one who is on his/her death bed what steps should be taken from an estate planning, tax and non-tax perspective that will make the individual more comfortable, save taxes, preserve assets and make settling the estate easier for the family.

Read more....

**The Path to Tax Reform 2017: The Intersection of President Trump™s Plan and the House Blueprint**
*By Paul M. Schmidt and Jeffrey H. Paravano*
With a Republican President and GOP majorities in both chambers of Congress, there is a likelihood that Washington may pass comprehensive tax reform in 2017. The President has identified tax reform as one of his top three priorities, and some would argue that tax reform is a "must do" given the slow economy and the dreadful state of the tax system. The Republicans' false starts earlier this year on repealing and replacing the Affordable Care Act illustrate that advancing legislation is challenging and often unpredictable, notwithstanding Republican control.

**Read more....**

**Taxation of Contributions to Partnerships with Related Foreign Partners**

*By Robert J. Kovacev, Lisa M. Zarlenga, Cameron Arterton, Caitlin Tharp*

The IRS and Treasury Department recently issued temporary regulations (the "Temporary Regulations") that can affect partnership contributions if: (i) a partnership receives a contribution of "built-in gain" property from a U.S. person and (ii) the partnership has one or more foreign partners that are related to the U.S. transferor. In general, the new regulations require U.S. persons that contribute assets to such a partnership to either recognize any "built-in gain" at the time of the transfer or apply a "gain deferral method" that-among other requirements-involves having the recipient partnership use the "remedial allocation method" to allocate items of "built-in" gain, income and deduction. A requirement to use the "remedial allocation method" means that although a U.S. transferor applying the "gain deferral method" will not need to immediately recognize "built-in gain", such a transferor will often be subject to tax on the entire amount of any "built-in gain" over time.

**Read more....**
From housekeepers to corporate directors, people who are compensated for their labor are, for tax purposes, treated as either employees or independent contractors. The distinction is significant for several economic reasons. For example, employees, unlike independent contractors, are covered by workers’ compensation insurance for on-the-job injuries. They may share in company benefits like retirement or health insurance. Their compensation is subject to withholding for Social Security and Medicare benefits, unemployment insurance, and of course income tax. Independent contractors share none of those benefits, although they still are required to report their income and pay tax. That responsibility may require the payment of self-employment tax and the filing of quarterly returns. The employer’s obligation to withhold tax from the wages of employees and to provide a matching contribution for part of Social Security and Medicare taxes is an added business expense that motivates some to classify their workers as independent contractors rather than employees. The IRS has been targeting employers for the misclassification of workers as independent contractors. If the IRS determines that workers have been misclassified, the employer can be assessed large penalties and compelled to reclassify its workers as employees.
In 1947 the U.S. Supreme Court said *Silk*,\(^1\) that someone is classified as an employee or independent contractor based on “the total situation, including the risk undertaken, the control exercised, [and] the opportunity for profit from sound management.” The drivers in *Silk*, owned their own trucks and paid the expenses of operating them, hired their own helpers, were paid on a per-job basis and did not account to anyone for their time. Based on these facts, the Court concluded, that the drivers were independent contractors. Since *Silk*, the IRS, the Department of Labor, and the courts have tried to create guidelines for understanding the differences between employees and independent contractors. Generally, someone is an independent contractor if his employer has the right to control or direct the result of his work, but not the means and method of accomplishing that result.\(^2\) Therefore, if an employer, has the right to direct what will be done by workers and how it will be done, there is an employer-employee relationship.

The employment relationship is described in section 3401(c) and reg. section 31.3401(c)-1 for tax withholding purposes; section 3306 and reg. section 31.3306(i)-1 for (FUTA) purposes; and section 3121 (d) and reg. section 31.3121(d) - 1 for Social Security (FICA) purposes.

Under section 3121(d), it is clear that some workers are employees by statute for FICA purposes. In short, that list includes corporate officers\(^3\), employees under section 218 of the Social Security Act, and a list of specific types of employees such as drivers, life insurance salespeople, and some housekeepers. Common law employees are considered statutory employees for this purpose as well.

For purposes of section 3401(c), an employee is any officer, employee, elected government official, or corporate officer. The regulations are more expansive and indicate that in

---

\(^1\) *United States v. Silk*, 331 U.S. 704 (1947).
\(^3\) Reg. Section 31.3121(d)-1(b).
general, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public
stenographers, auctioneers, and others who follow an independent trade, business, or profession
are not employees, while superintendents, managers, and other supervisory personnel are
employees. The regulations caution that a facts and circumstances analysis may override the
designation of statutory employees because an employee’s “services may be of such a nature, or
performed under such circumstances, that the remuneration paid for such services does not
constitute wages within the meaning of section 3401(a).”

Section 3306 and the corresponding regulations contain language similar to section
3121, providing a presumption that certain classes of employees such as corporate officers,
superintendents, managers, and other supervisory personnel are employees with the proviso that
the facts or circumstances may prevail in otherwise “doubtful cases.”

IRS Regulations also make it clear that corporate directors are not “employees” simply
because they hold that position and that corporate officers who perform minor services for their
companies may be independent contractors. The regulation states:

All classes or grades of employees are included within the relationship of employer and
employee. Thus, superintendents, managers, and other supervisory personnel are
employees. Generally, an officer of a corporation is an employee of the corporation. However,
an officer of a corporation who as such does not perform any services or
performs only minor services and who neither receives nor is entitled to receive, directly
or indirectly, any remuneration is not considered to be an employee of the corporation. A
director of a corporation in his capacity as such is not an employee of the corporation.

In Seeds, a district court found that based on the facts and circumstances, the corporate
treasurer was an independent contractor. The individual maintained offices away from the

---

4 Reg. section 31.3401(c)-1(h).
5 Reg. section 31.3306(i) -1; reg. section 31.3306(c)-2.
6 Reg. section 31.3401(c)-1(f)
company; infrequently visited the company plant and operations; “did not make extensive, required or detailed reports”; wasn’t trained by the company; and did not receive regular payments. Also, the treasurer received no additional fringe benefits, including workers’ compensation or retirement.

For nonstatutory employees or nonstatutory independent contractors, the IRS suggests an examination of the working relationship under the following common law rules.

*Behavioral Control Test:* The more control the company has over how a worker performs her work the more likely it is that that person is an employee. Behavioral control is demonstrated by directing when and where to work, what tools and equipment to use, what assistants may be hired, where to purchase supplies or other services, what work must be performed by the individual rather than delegated, what order or sequence of work to follow, and the level of training provided by the employer to do the job.

*Financial Control Test:* The more control over the business relationship, the more likely it is that the worker is an employee. The courts will consider whether the worker has a personal investment in his tools or his trucks, is paid a regular wage, can realize a profit or loss, and is reimbursed for expenses.

*Relationship Test:* Other indicators shed light on the type of relationship involved for example, the existence of a written contract describing the working relationship, the permanency of the relationship, and the provision of work benefits.

An employer may seek to document the employment relationship with an independent contractor” agreement. While these types of agreements are relevant to employer and employee intent, they are not determinative. The IRS articulated its position in two private letter rulings that stated:
A written agreement describing a worker as an independent contractor is viewed as evidence of the parties' intent to create a non-employee relationship. However, a contractual designation, in and of itself, is not sufficient evidence to base a determination of worker status. It is the substance of the relationship, rather than the label, that governs this determination.8

The U.S. Tax Court reached a similar conclusion, holding that those contracts may be “set aside” if they contradict the common law principles defining the relationship.9 Therefore, while the agreement is evidence of the type of relationship that was intended, the actual circumstances surrounding the relationship will be controlling and may contradict the agreement.

**Voluntary Classification Settlement Program**

Under the Voluntary Classification Settlement Program (VCSP), taxpayers not currently in a worker classification or employment tax dispute with the IRS or under examination with the Department of Labor or a state agency may reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from past due federal employment taxes. The taxpayer is not in a dispute with the IRS simply because there has been a request to reconsider the determination of worker status by submitting a Form SS-8. However, a dispute with IRS by a member of a consolidated group will make the taxpayer ineligible to participate. An employer may apply for the VCSP by filing Form 8952, “Application for VCSP.”

Under the VCSP, employers agree to treat their workers as employees going forward and for the first three years agree to a six-year statute of limitations on assessments instead of a three-year limit. In return, the employer pays a reduced amount of federal employment taxes for prior years and no interest or penalties. The tax is equal to 10 percent of the past year’s employment taxes for the reclassified workers. Part IV of the application provides the calculation for the

---

8 *LTR 199923014; LTR 199923015.*
assessment. The employer must demonstrate that it has consistently treated a class of workers as independent contractors, has timely issued Forms 1099 within the past three years to those workers, and agrees to treat them as employees.

A VCSP application concludes with a voluntary closing agreement that provides for the payment of the assessment and the reclassification of workers as employees as of a specific date. The opportunity to set that date is on the application form and must be at least 60 days after the filing date. This date may be significant to employers who will need to shift workers from Form 1099 to Form W-2 status. Included with the application is a list of names of all workers and their Social Security numbers. The agreement also states, “Nothing in this agreement shall entitle the taxpayer to relief under Section 530 of the Internal Revenue Act of 1978 as amended.”

**Section 530 Relief**

Section 530 of the Revenue Act of 1978 allows an employer to continue treating its workers as independent contractors without liability for penalties for nonpayment of employment taxes retroactively or prospectively. To qualify for section 530 safe harbor relief, an employer should demonstrate that it 1) consistently treated such workers as independent contractors, 2) issued Forms 1099-MISC when required, and 3) had a reasonable basis for classifying the workers as independent contractors, even if that reasonable classification is judicially determined to be incorrect. Section 530 relief applies to employers already under audit who have not applied for or are ineligible for that VCSP program.

Whether the employer’s classification of workers is reasonable may be based on 1) judicial precedent, 2) past IRS audit results, 3) industry practice, or 4) some other reasonable basis. If an employer is able to demonstrate that in its segment of industry, there is a

---

longstanding practice of treating some workers as independent contractors, the employer may prevail in continuing to treat them that way. A taxpayer has not acted reasonably if, based on relevant facts and circumstances, treating workers as independent contractors constitutes negligence, intentional disregard of rules and regulations, or fraud.

*Nelly Home Care* was a district court case involving the classification of nonmedical home care providers in which the court held that the taxpayer had a reasonable basis for classifying workers as independent contractors and was therefore entitled to section 530 relief. Finding that “a taxpayer need only satisfy one of the four safe harbors provided under section 530 to prove that it is entitled to relief,” it held that Nelly Home Care had demonstrated “other reasonable basis” facts (the fourth safe harbor) to support classifying its workers as independent contractors. The owner of Nelly Home Care had researched the industry and concluded that most home companions were treated as independent contractors. Having been through previous IRS audits in which her practice was unquestioned, the court determined that it was reasonable for the owner “to interpret the IRS’s silence on the independent contractor classification as acquiescence.”

Section 530(d) was added by the Tax Reform Act of 1986 and provides that 530 safe harbor relief does not apply for an individual who performs services as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled technology service. Instead, it requires an analysis of whether that worker is an employee or independent contractor under common law rules.

When section 530 relief is not unavailable - perhaps because the employer has not been compliant with issuing Forms 1099 - and when the employer is ineligible for the VCSP program because it is already engaged in a worker classification dispute with the IRS, there may be a
resolution through the Classification Settlement Program during the administrative process in which there is an exam in either the Small Business/Self Employed, Tax Exempt and Government Entities, Large Business and International divisions, or Appeals. Classification Settlement Program agreements that alter the prospective classification of workers will be binding on the IRS and the employer for future years. The amount of penalty assessed depends on the employer’s compliance. Therefore, if an employer has been filing all necessary returns, has been treating similarly situated workers alike, and has a reasonable basis argument for its treatment of workers, the penalty may be as low as 25 percent of the employment tax liability compared with 10 percent in the VCSP program.

Tax Court Jurisdiction

A Taxpayer may seek Tax Court review of a worker classification determination, made by the IRS in accordance with section 7436 which provides that “If the Secretary sends by certified or registered mail notice to the petitioner of a determination by the Secretary described in subsection (a)” the taxpayer has 90 days to petition the Tax Court. The restrictions on assessment and collection apply “in the same manner as if the Secretary’s determination described in subsection (a) were a notice of deficiency.”

In Notice 2002-5, 2001-1 CB 320, the IRS took the position that a notice of determination of worker classification (NDWC) was a prerequisite for Tax Court jurisdiction. Taking a contrary position in SECC Corp. and American Airlines,10 the Tax Court held that it had jurisdiction over employee classification cases without the necessity of an NDWC as long as that case arose:

1) in an exam in connection with an audit;

2) there is a determination that workers are employees or the employer is not entitled to 
530 relief;
3) there is an “actual controversy” involving the determination in exam; and
4) an appropriate pleading is filed in the Tax Court.

In a decision that elevated substance over form, the Tax Court in SECC held that a 
closing letter from Appeals on the subject of worker classification was the equivalent of a 
determination letter and that there was an actual controversy in connection with an audit. Those 
two events were sufficient for Tax Court jurisdiction. In American Airlines, the IRS had not 
issued an NDWC and argued that the Tax Court did not have jurisdiction without one. As in 
SECC, the Court found that a determination had been made in connection with an audit even 
though an NDWC had not been formally issued. In 2015 the IRS changed its position, as 
enunciated in Chief Counsel Notice 2016-002, and instructed IRS attorneys to no longer argue 
that the NDWC was a prerequisite to Tax Court jurisdiction as long as the above four conditions 
exists.

The question remains what is meant by “an exam in connection with an audit.” This is 
one of the conditions set by the Tax Court in SECC and American Airlines, Inc. For guidance, 
Revenue Procedure 2005-32 provides a list of activities that are not audits. So, for example, if 
the IRS requests the preparation of a return, that is not an exam in connection with an audit.\textsuperscript{11}

\textbf{IRS v. Tax Court}

\textsuperscript{11} The national taxpayer advocate’s annual report to Congress for 2016 offers the following: “The National 
Taxpayer Advocate has previously written about ‘real’ versus ‘unreal’ audits. IRC 7602(a)(1) grants the IRS the 
authority to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of 
any return. The IRS interprets this provision narrowly; thus Automated Underreporter (AUR), Automated 
Substitute for Return (ASFR), Substitute for Return (SFR), and math and clerical error assessments, along with the 
entire category of questionable refund and return procedures are not classified as ‘real’ audits.”
There is still some discrepancy between the IRS and the Tax Court on their approach to worker classification. For example, the IRS has allowed section 530 relief even for those workers classified as statutory employees in the code. Corporate officers, while considered statutory employees under section 3121(d), may be considered independent contractors rather than employees because they are not specifically excluded from safe harbor relief by the statute or legislative history.

In comparison, the Tax Court has held that section 530 relief is available only when a worker's status as an employee is determined under the common law rules and is unavailable for any employee covered by the statutory definition found at section 3121(d)(1) for corporate officers; section 3121(d)(3) for certain drivers, life insurance salespeople, home workers, and other salespeople; and section 3121(d)(4), state and local government workers treated as employees under section 218 agreements.\textsuperscript{12}

Upholding the Tax Court, the Third Circuit in \textit{Nu-Look} held that a common law analysis of employment was not required if an individual was already a corporate officer under section 3121(d)(1):

Mindful of these statutory provisions and Stark's status as a corporate officer, the Tax Court appropriately focused on the nature of the services Stark rendered and whether the distributions Nu-Look paid were remuneration for those services. It found that Stark performed more than minor services and that the distributions Stark received were, in fact, remuneration for his services. Those findings led the Tax Court to conclude that Stark was an employee for purposes of the FICA and the FUTA. We agree.

Nu-Look argues, however, that Stark was not an employee under the usual common law rules applicable in determining employer-employee relationships and therefore was not an employee under section 3121(d)(2). Nu-Look contends that, under section 3121(d)(2), it must exercise specific control over Stark for him to be classified as an employee and that such control was not demonstrated.

\textsuperscript{12} \textit{Joseph M. Grey Public Accountant v. United States}, 119 TC 121 (2002); \textit{Nu-Look Design, Inc. v. Commissioner}, 356 F.3d 290 (3d Cir. 2004); and sections 3111, 3121, 3301, 3401, and 3509.
because Stark himself managed Nu-Look's business affairs. This argument is without merit because it completely ignores the plain language of section 3121(d) and would render subparagraph (1) superfluous. Section 3121(d) defines employee by using the disjunctive “or” between subparagraphs (1) and (2). Thus, an individual may qualify as an employee under either set of circumstances. Here, because Stark was a corporate officer, he came within section 3121(d)(1) and the Tax Court was not required to consider whether he was an employee under the common law rules made applicable under section 3121(d)(2).

It is unclear what this means for settlement purposes because safe harbor relief depends on the willingness of the IRS and the courts to look beyond the statutory designation of any individual to the facts and circumstances analysis suggest by the regulations. A common law analysis might have led to an alternative conclusion that the corporate officer in Nu-Look could be treated as an independent contractor consistent with IRC reg. section 31.3401(c) - 1 (f) and that every case warrants that type of analysis.

More recently, SB/SE issued a memo instructing auditors to contact IRS counsel if a taxpayer raises section 530 relief during an audit concerning wage issues that might include, for example, withholding or reasonable compensation determinations. The guidance also clarifies that for “traditional” worker classification issues, auditors need not contact TE/GE counsel and should follow the usual procedures set out in IRM 4.23.10. This increased focus on section 530 relief may address the inconsistent positions taken by the IRS and the Tax Court on worker classification for statutory employees.

Prepared January 2017
Published by Tax Notes, 3/13/2017

13 SBSE-04-0916-0050, “Emergency Interim Guidance - Contact TEGEDC [0] When Taxpayers Raise Worker Classification or Section 530 Matters Concerning Wage Adjustment Issues” (Sept. 8, 2016).
LETTERS TO THE EDITOR

The Latest Presidential Executive Order on Tax Regulations

To the Editor:

On April 21 the president issued an executive order entitled “Identifying and Reducing Tax Regulatory Burdens.” The purpose of this latest executive order is to review all “significant” tax regulations issued on or after January 1, 2016, to determine which, if any, of those regulations:

(1) impose an undue financial burden on U.S. taxpayers;
(2) add undue complexity to the federal tax law; and
(3) exceed the statutory authority of the IRS.

In assessing which regulations are significant and, thus, subject to this review process, the order states that the prior executive orders dating back to EO 12866 on September 30, 1993, are not controlling. This means that the informal understanding that has existed since that time on tax regulations generally being exempt from Office of Management and Budget review (because of the view that tax regulations merely interpret the law and do not create it) was no longer controlling.

An interim report by the Treasury secretary is due on or before June 20 (60 days from the date of the April 21 order), and a final report to the president is due on or before September 18 (150 days from the date of the order). In addition, a summary of actions taken in response to the report to the president is to be published in the Federal Register within 10 days of the finalization of the actions in the presidential report. If those actions have not been finalized by March 17, 2018 (180 days from the date of the report to the president), an interim report is to be published in the Federal Register.

The order states that among the actions that may be taken in response to the Treasury secretary’s recommendations are to delay or suspend the effective date of those regulations, or to modify or rescind those regulations, all through appropriate regulatory notice and comment procedures.

What Now?

As we all know (and no offense intended), the Treasury secretary is not trained or skilled in the nuances and technicalities of the IRC and its regulations and will need to rely on others in making his recommendations to the president. It should also be apparent that no Treasury Office of Tax Policy or IRS National Office Chief Counsel attorney will acknowledge that any tax regulation put out on their watch since January 1, 2016, exceeded the statutory authority of the IRS. To admit this would be tantamount to admitting an unethical act. It just will not happen. And since the regulation preambles of all the regulations issued since that date will have statements in them about any burden and complexity of those regulations being justified for one reason or another, it is hard to see how those attorneys will or could acknowledge that the very regulations they approved for publication impose either an undue financial burden or add undue complexity to the law. Even those in government positions would be hard-pressed to form such an adverse judgment on their predecessors who may have been involved in prior regulation projects. So I have a hard time seeing how the goal of the order will be effectively administered.

Now, there are going to be exceptions to the rule noted above due to the highly political and controversial nature of a particular regulation project that cannot be hidden from public view. For example, the section 385 final regulations on debt documentation and earnings stripping are well known to the public and Congress, and it is no secret that those regulations will be very burdensome, complex, and perhaps even beyond the authority of the IRS to issue in the first place. Thus I assume that those regulations will have a short shelf life.
Another regulation that fits the description in the order are the most recent set of regulations under section 7874 on corporate inversions. There is no doubt that those regulations are burdensome and complex, and most likely exceeded the government’s authority to issue in the first place. Thus those regulations will also most likely have a short shelf life.

However, these first two sets of regulations may not end up getting delayed, suspended, modified, or rescinded because of one countervailing theme that I am sure will be prevalent in the internal government debate on this issue: that the regulations at issue serve an important public service in preventing tax avoidance and abuse or provide needed guidance to the public on how to apply the statute and, therefore, should be retained even though they could very well fit within one of the three criteria that the executive order lays out for examination of post-January 1, 2016, regulations. I would also expect that the government attorneys will argue, in the case of some regulations, that it is the fault of the statute that the regulations are complex because the regulations merely interpret the statute (in other words, blame the statute writer and not the regulation writer).

Those government personnel who will make those arguments may very well have a legitimate point because there were reasonable and thoughtful reasons for the issuance of the two regulations first mentioned above (and others that I will mention below). This tension between preventing taxpayer avoidance and abuse and providing needed guidance on how to apply the statute that Congress wrote versus undue complexity, burden, and arguable or questionable authority will be the prevailing theme in this upcoming internal debate. One can defend or attack a particular regulation depending on which camp you find yourself in. Either you believe the burden and complexity is justified or you do not, and this judgment is subjective and not generally capable of objective quantification.

What other regulations are likely to be debated and potentially subject to future regulatory rebuke in one form or another? Here is a partial list of regulations that come to mind as likely or potential targets of the executive order:

1. Final outbound intangible section 367(a) and (d) regulations. These regulations deal with the transfer of foreign goodwill and going concern value by a U.S. person to a foreign corporation in certain outbound section 351 and related transactions. The regulations eliminate the exception for foreign goodwill on outbound transfers to corporations that existed in the prior version of the regulations and were hotly contested in terms of their scope and Treasury’s authority to issue them.

2. Sections 707 and 752 proposed, temporary, and final liability allocation regulations. These regulations deal with the allocation of liabilities from a partnership to a partner under the partnership disguised sale rules of section 707 and the liability allocation rules of section 752. The regulations completely upset the allocation scheme for liabilities in disguised sales by treating all liabilities as nonrecourse liabilities and by eliminating so-called bottom dollar guarantees. The regulations also propose a new facts-and-circumstances test for determining the allocation of recourse liabilities and create uncertainties and ambiguities in current law. The regulations were issued with questionable authority in a number of instances. They will have a significant and adverse effect on the economy.

3. The section 721(c) temporary regulations. These regulations involve the outbound transfer of appreciated property by a U.S. person to a partnership with a related foreign partner when the U.S. and foreign partner control the partnership. The rules compel the adoption of an allocation method in which the built-in gain on the contributed assets by the U.S. person will remain within U.S. taxing jurisdiction. These rules were issued with a questionable effective date going back to an earlier notice and add complexity to the tax law given a limited targeted abuse that could be dealt with under existing anti-abuse regulations and authority.
4. The section 2704(b) proposed regulations. These proposed regulations deal with restrictions on the ability to control a family owned entity to prevent the reduction of the value of the assets owned by the entity for estate tax purposes. They were hotly debated in terms of Treasury authority and regulatory overreach when issued, and when and if finalized, could have a significant negative effect on certain segments of the economy.

5. The final CFC-foreign partnership section 956 regulations. These regulations impose a complex series of rules on foreign partnerships with controlled foreign corporations or related parties as partners that treat a loan by a CFC to a related foreign partnership as a U.S. asset in applying the subpart F rules even though the loan proceeds may not be repatriated into the United States. The regulations arguably exceed statutory authority given the literal status of a foreign partnership as a foreign person and the abuse targeted by them could have been dealt with by existing antiabuse rules and authority.

6. Section 987 foreign currency final and temporary regulations. These regulations deal with the computation of foreign exchange gains and losses of remittances from qualified business units of U.S. taxpayers that use a functional currency other than the U.S. dollar. They are extraordinarily complex and could have a significant impact on the economy as a whole.

7. Section 901(m) temporary regulations on covered asset acquisitions. These regulations deal with tax basis mismatches between U.S. tax basis and foreign tax basis in computing the foreign tax credit by “hyping up” foreign taxes without a corresponding increase in U.S. taxable income of the U.S. taxpayer. They are complex and address a limited subset of arguable abuses that could be dealt with under existing antiabuse rules and authority. Although statutorily authorized, the regulations are a classic case of regulatory overkill when detailed rules are written for a limited abuse and can be understood only by highly specialized tax experts.

8. Sections 367, 1248, and 6038B final regulations on indirect stock transfers and coordination rule exceptions. These regulations deal with the outbound stock transfer rules involving triangular reorganizations and the attempted avoidance of the repatriation of deferred offshore earnings and profits. They are another effort at curtailing so-called abuses under the section 367(b) rules (for example, so-called Killer B and transactions of like ilk). They add further complexity to an already complex area of the law.

9. Section 704 allocation of creditable foreign taxes temporary regulations. These regulations deal with the allocation of foreign tax expenditures by a partnership to its partners in order to compute the FTC. They perpetuate a complex regulatory regime put in place over 10 years ago and are based on an arguably incorrect assumption that partnership allocations of foreign tax expenses cannot have substantial economic effect. They should be repealed and replaced with a simpler and more rational regime.

10. Fractions rule proposed regulations. These regulations deal with the rules under section 514 on the unrelated business income tax imposed on tax exempt entities that are generally subject to tax on what is known as “debt-financed income.” Complex regulations exist today to combat the perceived abuse of allocating income to a tax-exempt entity in excess of that entity’s smallest share of partnership losses. The proposed regulations attempt to mitigate the complexities of the fractions rule and, in doing so, add more complexity. A better approach would be to repeal the existing rules and put in place a simpler although more general regulatory scheme, or get legislative relief.

11. Section 355 proposed device regulations. These proposed regulations add presumptions as to when a section 355
spin off or split up transaction (when a controlling corporation distributes stock of a controlled corporation to one or more of the distributing corporation’s shareholders) would result in gain recognition at the corporate level (which would not otherwise exist in a good section 355 spin off under the current rules). The regulations do this by deeming some transactions a device to avoid or evade tax. The rules were controversial when issued and the authority to issue the rules was questioned when they were first proposed.

Monte A. Jackel
Apr. 23, 2017
CHECKLIST OF TAX AND NON-TAX CONSIDERATIONS
FOR SOMEONE ON HIS/HER DEATHBED

I am often asked by family members of a loved one who is on his/her death bed what steps should be taken from an estate planning, tax and non-tax perspective that will make the individual more comfortable, save taxes, preserve assets and make settling the estate easier for the family. Here is a non-exhaustive list of tax and non-tax suggestions:

TAX CONSIDERATIONS

1. Are income tax filings up-to-date?

2. Are estimated income tax payments up-to-date? If the individual who is dying cannot sign checks and there is no power of attorney so someone has to lend money to the individual to pay taxes and other expenses, be sure to keep track of the amount loaned and who loaned it.

3. Would gift-giving save estate or inheritance taxes? Funds must be debited from the dying individual’s accounts before death to be complete.

4. If the individual has an IRA or qualified retirement account and has not taken his or her required minimum distribution think about whether to take the “RMD” or not take the RMD before death. A consideration will be the tax brackets and available deductions of that individual as compared with those of the beneficiaries of the IRA or retirement account.

5. For assets which have depreciated in value between the date of purchase and a date shortly before death, consider whether it would make sense to sell the assets to realize a capital loss rather than to hold onto the assets until death and then sell them but without the capital loss because of the step-down in basis at death.

6. Consider gifts to charity, especially of tangible personal property as to which the benefit of the income tax deduction is meaningful.

7. Consider converting traditional IRAs to Roth IRAs. In addition to other benefits of Roth IRAs, this will generate an income tax liability which can be deducted for estate and inheritance tax purposes.
OTHER ESTATE PLANNING AND NON-TAX CONSIDERATIONS

8. Make sure that all life insurance premiums are paid and up-to-date and that original policies are available.

9. Are wills and revocable trust agreements up-to-date? This is of course only relevant if the individual is able to sign new documents.

10. Do you know where the original estate planning documents are located and who the estates lawyer is?

11. Are beneficiary designation forms for life insurance and retirement accounts up-to-date? – again only relevant if the individual is able to sign new forms.

12. Because powers of attorney become ineffective at death, you might consider prepaying for the funeral, interment and/or cremation before death to avoid scrambling to make payments after death.

13. Are healthcare and end-of-life instructions clearly communicated to health care providers? Has any advance directive for healthcare been provided to medical personnel?

14. Consider removing valuables and cash from residence but make clear to the executor or family where the items have been removed to.

15. Make sure homeowners insurance is paid because liability to caretakers and other “business invitees” can be heightened.

16. A responsible person should obtain computer usernames and passwords and keep them in a secure place.

17. Obtain code to house alarm.

18. Obtain password or PIN to home voicemail.

19. Make sure someone collects the mail (especially 1099s if its tax time and dividend checks if it’s anytime).

20. Make sure residence is secure and that only responsible individuals have access to keys. If the lock to the residence is a key pad, limit number of persons who know the code to enter.

21. Make sure vehicles are secure and that a responsible person has access to car keys. Move the car periodically.

22. Make sure firearms are secure and perhaps removed from residence.
23. Make sure smoke and carbon monoxide detectors are operative.

24. Consider installing a generator or otherwise make sure there are flashlights if power goes out.

25. If there is a safe deposit box, consider whether it would be appropriate to close it.

26. Determine the individual’s desires concerning funeral, burial, cremation and related issues.

As you can see there are many things to think about when the end is near – certainly more than I have outlined above. The most important non-medical aspect of preparing for the death of a loved one is to make sure that information is communicated clearly and regularly to those in that person’s inner circle, that tasks are delegated in a coordinated way and carried out efficiently and well and that the needs and comfort of the individual who is dying are the top priority for family, friends and professionals.
The Path to Tax Reform 2017: The Intersection of President Trump’s Plan and the House Blueprint.

By: Paul M. Schmidt and Jeffrey H. Paravano, BakerHostetler
June 12, 2017

With a Republican President and GOP majorities in both chambers of Congress, there is a likelihood that Washington may pass comprehensive tax reform in 2017. The President has identified tax reform as one of his top three priorities, and some would argue that tax reform is a "must do" given the slow economy and the dreadful state of the tax system. The Republicans’ false starts earlier this year on repealing and replacing the Affordable Care Act illustrate that advancing legislation is challenging and often unpredictable, notwithstanding Republican control.

On April 26, the White House released a one-page overview (the Overview) of its vision for tax reform, noting four goals: growing the economy and creating jobs, simplifying, providing tax relief to families, and lowering the business tax rate. With respect to business tax reform, the Overview suggests (i) a 15 percent tax rate for corporations and small businesses, (ii) a territorial system of taxation for American companies, (iii) elimination of "special interest" tax benefits and (iv) a one-time repatriation tax on corporate earnings held overseas. With respect to individual tax reform, the Overview suggests preserving only the charitable gift and home mortgage tax deductions and eliminating targeted tax breaks that primarily benefit wealthy taxpayers (presumably including such items as deductions for state and local income taxes); repealing the alternative minimum tax, the death tax and the 3.8 percent tax on investment income; reducing the top individual tax bracket to 35 percent and reducing the current seven tax brackets to three (10 percent, 25 percent and 35 percent); doubling the standard deduction; and providing relief to families with children and dependent care expenses.

House Republicans in 2016 advanced their own proposals for tax reform, releasing their “A Better Way” proposal, which continues to be widely regarded as the guiding blueprint for a congressional rewrite of the Tax Code (the Blueprint). The President has been actively meeting with leaders in the House and Senate and his top economic advisers to discuss the various alternatives to tax reform under consideration. Paul Ryan on April 26 noted at the BakerHostetler federal policy seminar that he is open to making changes to the Blueprint’s border adjustment tax proposal (described below), stating, “We don’t want to have severe disruptions — if you’re an importer or a retailer heavily dependent on importers, we don’t want to shock the system so much that it puts them at a disruptive disadvantage.” Speaker Ryan did not elaborate on the components of such possible changes, including whether a revised border adjustment proposal might be phased in or might allow for some partial deduction as part of cost of goods sold for the cost of imported items.

There is broad agreement among the President and congressional Republicans that the foundation of tax reform will be lowering the individual and corporate tax rates, relying in part on the premise of a growing economy to cover some of the budgetary impact of sweeping tax cuts. The Trump administration’s Overview does not include any reference to a cash flow tax, border adjustability or current expensing. Open questions remain about whether the legislation will be revenue-neutral and whether the tax cuts will be permanent.
There have been five key elements of corporate tax reform under active consideration by the Ways and Means Committee. Committee hearings have begun, and the stated goal of Congressional leaders and the Administration currently is to release legislative language later this year that generally is acceptable to the House, Senate and the Administration.

Reduce corporate tax rate

The Blueprint would reduce the corporate tax rate to 20 percent, and the President has suggested it go as low as 15 percent. A number of deductions and credits would be eliminated to broaden the tax base. Importantly, it appears that the research and development credit would remain in place in order to incentivize U.S. development of intellectual property. Other benefits such as the domestic manufacturing deduction would be repealed in favor of a lower rate. The corporate alternative minimum tax (AMT) would be repealed in an effort to simplify the tax law.

Move toward a territorial tax system

A second key component of tax reform that appears both in the Blueprint and in the President’s Overview is moving to a territorial tax system. The territorial approach would exempt foreign active business income, likely by providing a 100 percent exemption for dividends received from foreign subsidiaries. The territorial proposal would allow for future offshore earnings to be repatriated to the United States without additional tax, which would have a positive impact on a company’s ability to access its foreign cash.

The lower corporate tax rate combined with moving to a territorial system would align the U.S. tax system with the majority of the rest of tax systems throughout the world and is intended to eliminate the competitive disadvantage created by our current worldwide system and eliminate the incentive for U.S. companies to invert. Congressional Republicans and the President have been aligned in their overall criticism of inversions, such as the 2015 proposed $160 billion merger between Pfizer and Allergan – the largest tax-inversion deal in history until it fell apart the following year as a result of Treasury regulations. The new approach, however, would be different from the “stick” approach of the Treasury regulations, opting instead for a “carrot” approach by improving the U.S. tax system and removing the incentive to invert.

Change rules on foreign earnings brought home

Third, as part of a transition to a territorial system, Republicans will likely provide rules to allow foreign earnings that have accumulated overseas under the old system to be brought home at rates significantly lower than the current 35 percent rate, which would raise significant revenue from the estimated $2.6 trillion in corporate profits that are trapped offshore under the current system. The Blueprint has proposed taxing the foreign earnings at 8.75 percent for accumulated earnings that are held in cash or cash equivalents and at 3.5 percent for reinvested earnings held in illiquid assets, such as factories, payable over eight years. When discussing the Overview, Treasury Secretary Mnuchin did not propose any particular rate or rates.

Allow capital expense deduction to stimulate growth and interest deductibility

A fourth tenet of the Blueprint is an allowance of a current deduction for certain capital expenses as a means of stimulating economic growth. Paired with this proposal, however, is a denial of the deduction for net interest expense. This trade-off would cause the loss of a permanent benefit (interest deduction) in order to gain a timing benefit (a capital expense deduction that otherwise would have been recovered over time through depreciation or amortization). The President’s Overview is silent on full expensing and denial of deductions for net interest expense. Regardless of the outcome with respect to currently deducting capital expenses, tax reform likely will include some limitation on corporate interest deductions, particularly if a territorial system is adopted. Under a territorial system, foreign income is exempt from taxation. Accordingly, the system cannot allow a deduction in the U.S. for debt that supports what is essentially zero-taxed income. Moreover, foreign companies and inverted companies benefit significantly from over-leveraging U.S. operations and reducing tax on U.S. income through the earnings stripping afforded by intercompany debt. Tax reform will address that issue.
Adopt destination-based border-adjustable tax

Perhaps the most controversial Blueprint proposal is the move toward a destination-based border-adjustable tax. A destination-based approach means that tax jurisdiction follows the location of consumption rather than the location of production. Under the Blueprint as originally drafted, revenue from exports would be exempt, and imports would be taxable, likely by denying a deduction for cost of goods sold. As a result, it would not matter where a company manufactures its products – U.S. sales would be taxable; non-U.S. sales would not. House Republicans believe this will raise significant revenue given our trade imbalance and will remove certain incentives for companies to locate production facilities offshore. They also believe that the revenue associated with this change is a necessary component of achieving a corporate tax rate low enough to make reform meaningful. Although economists argue that the approach will strengthen the dollar sufficiently to make everyone whole, on its face it creates winners (such as large net exporters) and losers (such as big-box retailers) and, therefore, is being hotly debated. President Trump’s Overview was silent on any border-adjustable tax, and as noted above, Speaker Ryan has stated that the House is willing to consider changes to this proposal to help avoid disruptions. The Blueprint itself is light on details, and it is unclear how it would impact income from services or intangibles. Many questions remain, such as whether it is compliant with our trade obligations – or whether that even matters – or our treaty obligations, to name a few. A number of leaders in Washington have declared this particular proposal a non-starter.

House Speaker Paul Ryan (R-Wis.) indicated that the border adjustable tax “needs to be modified,” at BakerHostetler’s 28th Annual Legislative Seminar on April 26, 2017.

Timing and process

The Republicans are highly incented and motivated to move quickly on tax reform in order to show progress on their legislative agenda, particularly given the earlier false starts in connection with repealing and replacing the Affordable Care Act. Most in Washington still believe health care reform must precede tax reform, though some consideration is being given to combining health care reform with tax reform. The window for achieving tax reform will not be open for very long. 2018 is a congressional election year, and there is considerable pressure to complete health care reform legislation and tax reform in 2017. The hearings in the Ways and Means Committee have begun and the markup process will begin in the coming months. We expect it will take Congress until fall to approve a tax overhaul bill, and, if they are successful, the most common effective date for major changes is expected to be Jan. 1, 2018. The bill would need only 51 votes in the Senate because Republicans likely will rely on the budget reconciliation process.

For additional information, please contact Paul Schmidt, Tax Group chair, at 202.861.1760 or pschmidt@bakerlaw.com, or Jeff Paravano, Washington, D.C., managing partner, at 202.861.1770 or jparavano@bakerlaw.com.
April 26, 2017.

* For additional information, please contact Paul Schmidt, Tax Group chair, at 202.861.1760 or pschmidt@bakerlaw.com, or Jeff Paravano, Washington, D.C., Managing Partner, at 202.861.1770 or jparavano@bakerlaw.com.
TAXATION OF CONTRIBUTIONS TO PARTNERSHIPS WITH RELATED FOREIGN PARTNERS

IRS Issues Temporary Regulations That Accelerate Gain Recognition on Certain Contributions of “Built-In Gain” Property to Partnerships With Related Foreign Partners

I. Summary

The IRS and Treasury Department recently issued temporary regulations (the “Temporary Regulations”) that can affect partnership contributions if: (i) a partnership receives a contribution of “built-in gain” property from a U.S. person and (ii) the partnership has one or more foreign partners that are related to the U.S. transferor. In general, the new regulations require U.S. persons that contribute assets to such a partnership to either recognize any “built-in gain” at the time of the transfer or apply a “gain deferral method” that—among other requirements—involves having the recipient partnership use the “remedial allocation method” to allocate items of “built-in” gain, income and deduction. A requirement to use the “remedial allocation method” means that although a U.S. transferor applying the “gain deferral method” will not need to immediately recognize “built-in gain”, such a transferor will often be subject to tax on the entire amount of any “built-in gain” over time.

The Temporary Regulations implement a proposal that was first outlined in Notice 2015-54 (the “Notice”) and are generally consistent with the Notice. However, several significant changes were made by the Temporary Regulations, including the following:
• Partnerships that are less than 80%-owned by a U.S. transferor and / or related parties are excluded from the scope of the Temporary Regulations. By contrast, the Notice applied to partnerships that were more than 50%-owned by a U.S. transferor (or related parties);

• Assets that give rise to “effectively connected income” that is fully taxed by the United States are subject to special rules under the “gain deferral method” that do not require the use of “remedial allocations”;

• By contrast to the approach outlined in the Notice, the Temporary Regulations allow the “gain deferral method” to be elected on a property-by-property basis (rather than on a contribution-by-contribution basis);

• The Temporary Regulations provide a new “reasonable cause” exception under which inadvertent noncompliance with certain procedural requirements of the “gain deferral method” can be waived by the IRS; and

• Deemed contributions that occur because of a mere technical termination of a partnership are generally excluded from the scope of the Temporary Regulations.

The Temporary Regulations apply to transfers occurring on or after the date when the Notice was published (i.e., August 6, 2015). However, taxpayers may generally elect whether or not to apply rules in the Temporary Regulations that either are new or represent a material change from the proposal in the Notice to a contribution made before January 18. In addition to the provisions discussed above, the Notice indicates that the IRS intends to issue new transfer pricing guidance for “controlled” transactions involving partnerships, but these rules are not included in the Temporary Regulations.
The Temporary Regulations do not appear to be affected by the “regulatory freeze” memorandum issued by the new administration on January 20.

II. **Background**

A contribution of property to a partnership in exchange for a partnership interest is normally a tax-free transaction to both the contributing partner and the recipient partnership.\(^1\) However, Section 721(c) of the Code authorizes the IRS to issue regulations overriding this general rule in cases where gain, when recognized for tax purposes, would be allocated to a non-U.S. person.\(^2\)

On August 6, 2015, the IRS and Treasury Department issued Notice 2015-54 (the “Notice”) announcing an intention to issue regulations under Section 721(c) of the Code in response to IRS concerns that then-current law governing partnership contributions and tax allocations may have permitted taxpayers to inappropriately defer “built-in” gains. As background, existing law generally requires partnerships to specially allocate pre-contribution items of gain, loss and deduction that are recognized with respect to contributed property back to the contributing partner.\(^3\) Therefore, for example, if a U.S. person contributes low-basis, high-value assets to a partnership, any “built-in” gain recognized by the partnership with respect to those assets is generally allocated to the

---

1. *See Section 721(a).* There are exceptions to the general recognition rule for: (i) transactions determined to be sales of property to the partnership; (ii) transactions determined to be “disguised sales” of property to the partnership, of property by the partnership to a contributing partner, or of partnership interests; (iii) transfers to the partnership of interests that are not property, but instead a lease or license; (iv) certain transfers of property to partnerships classified as “investment companies”; and (iv) certain transfers of long-term contracts to partnerships.

2. Section 721(c) was added by the Taxpayer Relief Act of 1997, and replaced an excise tax that was previously imposed on certain transfers of appreciated property by a U.S. person to a foreign partnership.

3. *See Section 704(c).*
U.S. transferor. However, the so-called “Section 704(c)” regulations implementing this rule describe three “generally reasonable” methods that taxpayers may use to specially allocate “built-in” tax items, two of which (the “traditional method” and the “traditional method with curative allocations”) are subject to a “ceiling rule” or other provisions that limit the degree to which special allocations are required.\(^4\) For example, if USP (a U.S. person) were to contribute land with a tax basis of $25 and a fair market value of $100 to a partnership in exchange for a 50% interest and the partnership were to subsequently sell the land for $75, the “ceiling rule” would only allow $50 of “built-in” gain to be specially allocated to USP, notwithstanding that USP would receive property worth $87.50 if the partnership were to subsequently liquidate (at a time when the partnership’s other assets had not changed in value). While a third approach (the “remedial allocation method”)\(^5\) avoids this result by creating notional “remedial” allocations (e.g., in the previous example, USP would have been allocated $50 in actual gain plus an additional $12.50 in “remedial” gain, while the other partners would have been allocated a $12.50 “remedial” loss), the regulations specifically provide that the IRS may not require partnerships to use the “remedial allocation method”\(^6\).

The proposal in the Notice required U.S. contributors of “built-in gain” assets to a controlled partnership with related foreign investors to choose between: (i) immediately recognizing gain on the transfer and (ii) complying with a “gain deferral method” that, among other conditions, required covered partnerships to apply the “remedial allocation

\(^4\) See Treas. Reg. § 1.704-3(b) (traditional method); Treas. Reg. § 1.704-3(c) (traditional method with curative allocations).

\(^5\) See Treas. Reg. § 1.704-3(d).

method”. Because the “remedial allocation method” can create “notional” allocations in respect of depreciation and amortization deductions that are recognized for “book” purposes but not “tax” purposes (which are offset by “notional” income allocations to the contributing partner), a U.S. person that contributes high-value, low-basis depreciable or amortizable assets to a partnership using the “remedial allocation method” is generally required to—in essence—recognize any “built-in” gain over the property’s cost-recovery period.7 In addition to these rules, the Notice stated that the IRS and Treasury Department intend to issue new transfer pricing rules (under Sections 482 and 6662 of the Code) governing “controlled” transactions that involve partnerships.8

III. Discussion

The Temporary Regulations generally track the structure of the IRS’s Section 721(c) proposal in the Notice, but make a number of significant changes, many of which will reduce the impact of the new rules. The Temporary Regulations do not include any new transfer pricing guidance, although the preamble to the Temporary Regulations indicates that the IRS and Treasury Department intend to issue transfer pricing

7 By contrast, if the “remedial allocation method” is not used, a contribution of appreciated depreciable or amortizable property to a partnership could allow “built-in” gains to be allocated to a related foreign partner because “book” depreciation and amortization reduce “built-in gain”, even if such “book” depreciation is not allocated to the contributing partner for “tax” purposes. Although such allocations to a foreign related partner are in a sense temporary because the relevant reduction in “built-in gain” does not increase a contributor’s outside basis, such allocations have the potential to facilitate significant (and possibly indefinite) deferral of “built-in gain”.

8 For additional background on the Notice, please see the Sullivan & Cromwell LLP publication entitled “New Restrictions on Property Transfers to Controlled Partnerships with Foreign Related Partners: Regulations to Require Current Gain Recognition on Certain Transfers of Property to Controlled Partnerships with Foreign Related Partners” (August 12, 2015).
regulations that are consistent with the transfer pricing guidance foreshadowed by the Notice in the future.

A. **Scope of the Temporary Regulations**

In general, the Temporary Regulations apply to transfers (including deemed transfers) of certain “built-in gain” assets (which the Temporary Regulations refer to as “Section 721(c) property”) by a U.S. person (other than a domestic partnership) to a domestic or foreign partnership. A partnership will be within the scope of the new rules (and therefore will be what the Temporary Regulations refer to as a “Section 721(c) partnership”) if: (i) at least 80% of the capital, profits, deductions or losses of the partnership are owned by a U.S. transferor or a related person and (ii) a “related foreign person”\(^9\) to the U.S. transferor is a direct or indirect partner. The use of an 80% ownership threshold in this definition represents a departure from the approach outlined in the Notice, which would have applied Section 721(c) in cases where a partnership is more than 50%-owned by a U.S. transferor (or a related party).

“Section 721(c) property” is generally defined as any “built-in gain” property that is contributed by a U.S. person to a partnership, other than certain “excluded property”.\(^{10}\) Because “excluded property” includes cash equivalents, stock in a corporation, debt obligations and other financial instruments that are considered “securities” under the mark-to-market rules, the Temporary Regulations apply primarily to contributions of

---

\(^9\) Whether a foreign person is “related” to a U.S. transferor is determined under Sections 267(b) and 707(b) of the Code. See Treas. Reg. § 1.721(c)-1T(b)(12). Very generally, these provisions treat two parties as “related” if: (i) one party directly or constructively owns more than 50% of the other party, (ii) more than 50% of both parties is directly or constructively owned by the same persons or (iii) certain family or fiduciary relationships exist between both parties.

\(^{10}\) See Treas. Reg. § 1.721(c)-1T(b)(15).
depreciable or amortizable assets such as intangibles, depreciable real estate and equipment, as well as non-depreciable property such as land.

An interest in a partnership can be “Section 721(c) property”, and under a look-through rule, a lower-tier partnership can become a “Section 721(c) partnership” if an upper-tier partnership has a U.S. partner and the lower-tier partnership would have been a “Section 721(c) partnership” had the U.S. partner contributed its share of any property transferred by the upper-tier partnership. However, the Temporary Regulations provide (in a new rule that was added to the Temporary Regulations in response to public comments) that an interest in a partnership is treated as “excluded property” if 90% or more of that partnership’s assets consist of “excluded property”. The Temporary Regulations also include a de minimis rule, under which tangible (but not intangible) property with $20,000 or less of built-in gain at the time of contribution is treated as “excluded property”. Property that gives rise to “effectively connected income” (i.e., income subject to U.S. tax; such property, “ECI Property”) is not excluded from the definition of “Section 721 property”. However, as discussed further below, the “gain deferral method” has been modified to allow ECI Property to be contributed to a partnership without requiring the use of the “remedial method”.

Under a further de minimis rule, Section 721(c) does not apply to a partnership if the sum of all built-in gain with respect to “Section 721(c) property” received during a

---

11 See Treas. Reg. § 1.721(c)-2T(d).
12 See Treas. Reg. § 1.721(c)-1T(b)(6)(iv).
13 See Treas. Reg. § 1.721(c)-1T(b)(6)(iii).
taxable year is less than $1 million. Additionally, although as noted above, deemed contributions to a partnership are generally within the scope of Section 721(c), the Temporary Regulations include a new exception for deemed transfers that occur as a result of a “technical termination” of a partnership.

B. **Gain Deferral Method**

Under a default rule, contributions within the scope of the Temporary Regulations are treated as taxable transactions. However, in lieu of immediately recognizing gain, the Temporary Regulations allow taxpayers to elect a “gain deferral method” under which “built-in gain” is recognized over time. By contrast to the approach taken by the Notice, the Temporary Regulations allow the “gain deferral method” to be elected on an asset-by-asset basis (rather than a contribution-by-contribution basis). Under the Temporary Regulations, the “gain deferral method” will apply only if the following requirements are met:

- Either:
  - Both: (i) the “Section 721(c) partnership” adopts the “remedial allocation method” (discussed above) with respect to the “Section 721(c) property”; and (ii) during any taxable year in which there is remaining built-in gain with respect to the “Section 721(c) property”, the “Section 721(c) partnership”

---

14 *See* Treas. Reg. § 1.721(c)-2T(c).

15 *See* Treas. Reg. § 1.721(c)-2T(d)(2). Notwithstanding the above, an anti-abuse rule may apply to transactions and arrangements engaged in with a principal purpose of avoiding the Temporary Regulations. *See* Treas. Reg. § 1.721(c)-1T(d).

16 *See* Treas. Reg. § 1.721(c)-3T(b).

17 Special rules (which were added by the Temporary Regulations) modify the “remedial allocation method” for intangibles subject to the “anti-churning” rules of Section 197(f)(2) that are contributed to a “Section 721(c) partnership”.

LONDON:564222.1
generally allocates all "book" items of income, gain, loss, and deduction with respect to that "Section 721(c) property" to the U.S. transferor in the same percentage; or

The relevant "Section 721(c) property" is ECI Property and until the date on which there is no remaining built-in gain with respect to that property, income or gain allocated to any direct or indirect partners that are "related foreign persons" with respect to the U.S. transferor will be taxed as "effectively connected income" and without relief under a tax treaty;

- Upon an "acceleration event" (discussed below) with respect to an item of "Section 721(c) property", the U.S. transferor recognizes the required amount of gain (which will generally be equal to any remaining built-in gain with respect to the relevant asset);
- Certain procedural and reporting requirements (discussed below) are satisfied;
- The U.S. transferor agrees to extend the statute of limitations for assessing tax as follows:

---

18 The Temporary Regulations include several exceptions to the general "consistent allocation" rule, which were added in response to public comments. For example, the Temporary Regulations provide that regulatory allocations (which include allocations made to comply with the "qualified income offset" and "minimum gain chargeback" rules, but do not include allocations of nonrecourse deductions) of income to (or deduction away from) a U.S. transferor are deemed to satisfy the "consistent allocation" requirement. See Treas. Reg. § 1.721(c)-3T(c)(4).

19 Among other provisions, the reporting and procedural requirements provide that a U.S. transferor intending to rely on this rule in respect of an asset that is ECI Property must obtain a waiver of treaty benefits from both the "Section 721(c) partnership" and each direct or indirect partner that is a "related foreign person". See Treas. Reg. § 1.721(c)-6T(c).
With respect to deferred contribution gain, through the eighth full taxable year following the year of the contribution;

With respect to items of partnership income, gain and deduction that arise from “Section 721(c) property” that are allocated to the U.S. transferor during the year of the gain deferral contribution and the following two years, through the sixth full taxable year after such items are recognized; and

With respect to gain that is recognized in a contribution for which “gain deferral method” is not applied that takes place during the five years following a “gain deferral” contribution, through the fifth full taxable year after the taxable contribution; and

If applicable, the rules governing tiered partnerships (discussed below) are followed.

In general, the requirements discussed above are similar to the prerequisites to applying the “gain deferral method” that were outlined in the Notice. However, the provisions allowing the “gain deferral method” to be applied on an item-by-item basis and the special rules for ECI Property are new, and were included in response to public feedback. Additionally, although the Notice indicated that a requirement for taxpayers applying the “gain deferral method” to extend the statute of limitations through the end of the eighth full taxable year following the taxable year of the contribution (as is required of U.S. transferors of property to a foreign corporation that enter into a “gain recognition agreement” instead of recognizing any “built-in gain” on the contribution) was under

---

20 See Treas. Reg. § 1.367(a)-8(f).
consideration, the interim rules in the Notice allowed taxpayers to apply the “gain deferral method” without consenting to such an extension.

C. **Acceleration Events**

Consistent with the Notice, the Temporary Regulations generally require a U.S. transferor to recognize any remaining built-in gain if an “acceleration event” occurs and define an “acceleration event” to normally include any occurrence that either: (i) would reduce the amount of remaining built-in gain that a U.S. transferor would have recognized under the “gain deferral method” if the event had not occurred or (ii) could defer the recognition of remaining built-in gain.21 The Temporary Regulations also retain the Notice’s approach of generally treating any failure to comply with the procedural or reporting requirements as an “acceleration event”, but provide a new exception to this rule in certain cases where noncompliance is the result of reasonable cause.22

The acceleration rule in the Temporary Regulations also contains exceptions for certain enumerated “successor events” (i.e., transactions that allow a U.S. person to inherit any deferred gain),23 “termination events” (i.e., transactions after which—in the view of the IRS—no potential for gain-shifting or income shifting exists)24 and “partial acceleration events”.25 “Successor events” include a tax-free contribution of an interest in a “Section 721(c) partnership” to a domestic corporation, an intercompany sale of a

---

21 See Treas. Reg. § 1.721(c)-4T(b)(1).
22 See Treas. Reg. § 1.721(c)-4T(b)(2); Treas. Reg. § 1.721(c)-6T(f).
23 See Treas. Reg. § 1.721(c)-5T(c).
24 See Treas. Reg. § 1.721(c)-5T(b).
25 See Treas. Reg. § 1.721(c)-5T(d).
“Section 721(c) partnership interest and a “technical termination” of a “Section 721(c) partnership. After a “successor event”, the new owner is treated as the U.S. transferor under the Temporary Regulations. “Termination events” include a contribution of assets by a “Section 721(c) partnership” to a domestic corporation, a “Section 721(c) partnership” ceasing to have any direct or indirect partners that are “foreign related persons”, and a taxable sale of “Section 721(c) property”.

D. **Tiered Partnerships**

The Temporary Regulations also include new rules that apply to tiered partnerships. Under these provisions, if a U.S. person contributes an interest in a controlled partnership to a “Section 721(c) partnership” and intends to use the “gain deferral method”, the following requirements will apply:

- **First**, the lower-tier partnership must revalue all of its assets for “book” purposes (i.e., perform a “book-up”) if a revaluation would result in a separate positive difference between book value and adjusted basis in at least one asset that is not “excluded property”;

---

26 See Treas. Reg. § 1.721(c)-5T(c).

27 See Treas. Reg. § 1.721(c)-5T(b). Additionally, the “gain deferral method” will cease to apply if a “Section 721(c) partnership” contributes property to a foreign corporation. However, the U.S. transferor’s portion of any such property will remain subject to Section 367 of the Code. Additionally, the U.S. transferor will be required to recognize any remaining built-in gain that would have been allocated to the U.S. transferor if the “Section 721(c) partnership” had sold that portion of the “Section 721(c) property” immediately before the transfer for fair market value. See Treas. Reg. § 1.721(c)-5T(e).

28 See Treas. Reg. § 1.721(c)-3T(d)(1).
• **Second**, the lower-tier partnership must apply the “gain deferral method” to each asset (other than “excluded property”) with a fair market value at the time of the “book-up” in excess of that asset’s tax basis; and

• **Third**, the partnership must treat an upper-tier partnership in which a U.S. person is a direct or indirect partner as if that upper-tier partnership was a U.S. transferor when applying the requirement that “book” items of income, gain, loss and deduction be allocated consistently.

In cases where a U.S. person is deemed to have transferred property to a “Section 721(c) partnership” under the look-through rule discussed above because an upper-tier partnership has contributed assets to a lower-tier partnership, the following are also prerequisites to applying the “gain deferral method”:

• **First**, the lower-tier partnership must treat the upper-tier partnership as a U.S. transferor applying the requirement that “book” items of income, gain, loss and deduction be allocated consistently;

• **Second**, the upper-tier partnership must use the “gain deferral method” in respect of the upper-tier partnership’s interest in the lower-tier partnership if the upper-tier partnership is a controlled partnership with respect to the U.S. transferor; and

• **Third**, if the U.S. transferor is an indirect partner in the upper-tier partnership, the principles of the two preceding requirements must be applied to any other partnerships in the chain of ownership.

---

29 See Treas. Reg. § 1.721(c)-3T(d)(2).
E. **Reporting and Procedural Requirements**

The Temporary Regulations include a new and detailed list of reporting and other procedural requirements that must be satisfied by U.S. transferors electing the “gain deferral method”. These compliance obligations are broadly analogous to what is required of a U.S. transferor that contributes property to a foreign corporation and enters into a “gain recognition agreement”\(^{30}\) with the IRS in lieu of recognizing immediate gain on the contribution (including, for example, a requirement to initially elect the “gain deferral method” on a U.S. transferor’s timely filed tax return, and an annual reporting requirement).

F. **Effective Date**

In general, the Temporary Regulations are effective for contributions occurring on or after August 6, 2015 (i.e., the date of the Notice). However, taxpayers may generally elect whether or not to apply new rules in the Temporary Regulations (including, for example, the requirement that U.S. transferors consent to an extension of the statute of limitations) and substantive changes to the rules described in the Notice to contributions that took place before January 18, 2017. The Temporary Regulations are scheduled to expire on January 17, 2020, but were also published as proposed regulations.

On January 20, 2017, the White House issued a memorandum directing federal agencies to suspend certain new regulations until such regulations are reviewed and approved by a senior member of the new administration. Because the Temporary Regulations took effect on or prior to January 18 and were published in the Federal

\(^{30}\) See Treas. Reg. § 1.721(c)-6T. The requirements for a “gain recognition agreement” are described in Treasury Regulations Section 1.367(a)-8.
Register on January 19, the Temporary Regulations do not appear to be affected by this “regulatory freeze” order.