May 23, 2016

Dear Commissioner Koskinen:

Enclosed please find comments on Notice 2015-54 regarding the partnership tax issues (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs: Marjorie Rollinson, Associate Chief Counsel (International), Internal Revenue Service
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Kenneth Jeruchim, Attorney-Advisor, Office of the Associate Chief Counsel (International), Internal Revenue Service
Curtis Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service.
Hon. Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON NOTICE 2015-54 ON TRANSFERS OF
PROPERTY TO PARTNERSHIPS WITH RELATED FOREIGN
PARTNERS AND CONTROLLED TRANSACTIONS INVOLVING
PARTNERSHIPS (PARTNERSHIP TAX ISSUES)

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by H. Grace Kim, Elizabeth Amoni Hall, Ari Berk, Megan Stoner, Drew Tidwell, Christopher Trump, and Risa Trump. Substantive contributions were made by Kimberly Blanchard, Cory Perry, and Jonathan Grossberg. The Comments were reviewed by Thomas Yearout, Chair of the Partnerships and LLCs Committee, James Wreggelsworth, Chair of the Subcommittee on the Committee on Government Submissions of the Partnerships and LLCs Committee, and Paul Crispino, of the Committee on Foreign Activities of U.S. Taxpayers. The Comments were further reviewed by Jeanne Sullivan, of the Section’s Committee on Government Submissions, Roberta Mann, the Council Director for the Partnerships and LLCs Committee, and Peter H. Blessing, Vice Chair (Government Relations) of the Section.

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

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Date: May 23, 2016
EXECUTIVE SUMMARY

On August 6, 2015, the Internal Revenue Service (the “Service”) released Notice 2015-54\(^1\) (the “Notice”), announcing that the U.S. Department of the Treasury (“Treasury”) and the Service intend to issue regulations under section 721(c)\(^\text{2}\) to ensure that when a U.S. person transfers appreciated property to a partnership that has one or more foreign partners related to the transferor, income or gain attributable to the transferred property will be taken into account by the U.S. transferor either immediately upon the transfer, or periodically thereafter.

As explained in the Notice, Treasury and the Service’s reason for exercising regulatory authority is based on their awareness that certain taxpayers purport to be able to contribute, consistently with sections 704(b), 704(c), and section 482, property to a partnership that allocates income or gain from the contributed property to related foreign partners that are not subject to U.S. taxation.

As discussed more fully in the Discussion portion of these Comments, the Notice indicates that future regulations will generally override the application of section 721(a) nonrecognition to certain transfers of appreciated property that occur on or after August 6, 2015. The transfers targeted in the Notice are of appreciated property by a U.S. person to a foreign or domestic partnership that has a foreign person related to the U.S. transferor as a direct or indirect partner and the U.S. transferor and one or more related persons own more than 50% of the interest in partnership capital, profits, deductions or losses. The future regulations will also permit the U.S. transferor of appreciated property to such a partnership to continue to apply the section 721(a) nonrecognition rule to the contribution of the appreciated property to the partnership and to defer the recognition of the built-in gain in such property by complying with a set of requirements collectively named in the Notice as the “Gain Deferral Method.”

The requirements of the Gain Deferral Method generally are that (i) the partnership adopt the remedial allocation method under section 704(c) with respect to any and all built-in gain property contributed by the U.S. transferor (and all other related U.S. transferors) pursuant to the same plan, (ii) the partnership make allocations of section 704(b) income, gain, loss and deduction with respect to the contributed built-in gain property in the same proportion, (iii) certain new reporting requirements are satisfied, (iv) the U.S. transferor recognizes the remaining built-in gain on the contributed property upon certain events that cause acceleration of the gain; and (v) the Gain Deferral Method is adopted for all built-in gain property subsequently contributed to the partnership by the U.S. transferor (and all related U.S. transferors) until the earlier of the date that no built-in gain remains with respect to any built-in gain property to which the Gain Deferral Method first applied or 60 months after the date of the initial contribution of the built-in gain property to the partnership to which the Gain Deferral Method first applied.

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\(^1\) 2015-34, I.R.B. 210.
\(^2\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
The regulations will provide, as an additional requirement for applying the Gain Deferral Method, that the U.S. transferor (and in some cases the partnership) must extend the statute of limitations of assessment of tax with respect to all items related to the contributed built-in gain property through the close of the eighth full taxable year following the taxable year of the contribution. The regulations will include certain information reporting requirements concerning the contributed appreciated property that is subject to the Gain Deferral Method.

The regulations will contain acceleration rules that will end the continued deferral permitted under the Gain Deferral Method upon the occurrence of certain events. The Notice sets forth several situations that are exceptions to acceleration.

The Notice includes an anti-abuse rule if a U.S. transferor of appreciated property engages in a transaction or series of transactions with a principal purpose of avoiding the application of the future Section 721(c) regulations.

The Notice also announces the intent of Treasury and the Service to issue regulations under section 482, which will provide specified valuation methods and periodic adjustment rules for controlled transactions involving partnerships, and the intent to issue regulations under section 6662, which will require additional documentation for such controlled transactions involving partnerships. Comments regarding the future regulations under section 482 have been addressed in a separate comment letter previously submitted by the Section of Taxation.³

We agree that it is generally appropriate for Treasury and the Service to establish rules to limit the deferral of built-in gain on appreciated property transferred to a partnership where that built-in gain may ultimately be included in the income of a foreign partner that is related to the U.S. contributor. In support of the efforts of Treasury and the Service in this regard, we welcome the opportunity to provide our comments on the rules outlined in the Notice and on other aspects of the future regulations, in particular on their scope. To this end, we make the following recommendations:

1. With respect to the requirement under the Gain Deferral Method to adopt the remedial allocation method, we recommend that the regulations provide guidance:
   a. Clarifying how the requirement to use the remedial allocation method interacts with the section 197 anti-churning rules.
   b. Confirming that, under the Gain Deferral Method, the remedial allocation method is not required to be used for “reverse” section 704(c) layers of built-in gain or loss with respect to the contributed built-in gain property.

³ Comm. on Transfer Pricing, ABA Tax Sec., Comments on Notice 2015-54 (Section 482 Issues) (2016).
c. Clarifying how the requirement to use the remedial allocation method applies in the context of allocating creditable foreign tax expenditures ("CFTEs") of a partnership to which section 721(c) applies (a “Section 721(c) Partnership”).

2. With respect to the requirement to make proportionate allocations under the Gain Deferral Method, we recommend that the regulations provide guidance:

   a. Clarifying that yearly changes in the partners’ allocation percentages with respect to the contributed built-in gain property are permissible and do not violate this requirement.

   b. Clarifying that regulatory allocations under section 704(b) do not violate this requirement.

   c. Confirming that a preferred return funded by net income of the partnership does not violate this requirement.

   d. Confirming that guaranteed payments are not considered distributive shares of partnership income under section 704(b) for purposes of this requirement.

3. We recommend that the rule requiring use of the Gain Deferral Method for a subsequent contribution of appreciated property by the same U.S. transferor (or a related U.S. transferor) in order to maintain continued deferral under the Gain Deferral Method with regard to the U.S. transferor’s prior contribution not be included in the regulations.

4. With respect to any reporting requirements proposed to support the Gain Deferral Method described in the Notice, we recommend that the regulations:

   a. Include a duplicative reporting exception similar to that provided for Form 8938, (Statement of Specified Foreign Financial Assets), so that taxpayers are not overburdened with new reporting requirements where such information is reported elsewhere.

   b. Adopt a willfulness standard with regard to noncompliance with the reporting requirements so that, to the extent the regulation provides that the failure of a partnership or its partners to comply with the Gain Deferral Method’s reporting requirements is an acceleration event, such failure should constitute an acceleration event under the regulation only if the failure to comply or timely file is willful.

5. With respect to the events ("acceleration events") that result in an acceleration of the recognition of the remaining built-in gain on contributed property as
to which the Gain Deferral Method is being applied, we recommend that the regulations provide the following:

a. A broad catch-all provision that would allow for the avoidance of gain recognition, provided that the remaining built-in gain of the U.S. transferor will not, following the transaction, be recognized by a non-U.S. person, and adding descriptions of situations, or features of situations, that would not trigger acceleration. We believe that a transaction that merely defers the Built-in Gain but retains the potential for future recognition in the hands of a U.S. person should not be a triggering event.

b. A technical termination of a partnership under section 708(b)(1)(B), a partnership conversion, or a partnership recapitalization will not cause an acceleration of the remaining built-in gain with regard to the contributed property.

c. A distribution of previously contributed appreciated property to a foreign person who is unrelated to the U.S. transferor who contributed the property to the partnership after the seven-year period of section 704(c)(1)(B) will not cause the remaining built-in gain to be accelerated.

d. A description of events that trigger termination of the partnership’s obligation to comply with the requirements of the Gain Deferral Method, but that do not trigger the immediate recognition of the remaining deferred built-in gain in the contributed property by the U.S. transferor (“terminating events”). In this respect, such terminating events generally would include:

   i. Distribution of the contributed built-in gain property from the partnership to the U.S. transferor (or a substituted U.S. transferor).

   ii. Transfer of the contributed built-in gain property that is subject to the Gain Deferral Method to a U.S. taxpayer (e.g., a domestic corporation), regardless of whether such taxpayer is the original U.S. transferor.

   iii. Any transaction in which the foreign partner that was related to the U.S. transferor is no longer a partner in the partnership, provided the related foreign partner was not redeemed through the partnership’s distribution of the contributed built-in gain property to that related foreign partner.

6. With respect to correlative adjustments that are to be made:

   a. If there is current gain recognition under section 721(c) upon the transfer of appreciated property by the U.S. transferor to a partnership due to the Gain Deferral Method not being adopted, the regulations should provide for basis
adjustments similar to those that arise upon a transfer subject to section 721(b) pursuant to sections 722 and 723.

b. The regulations should provide that correlative adjustments in gain acceleration situations are to be prospective only and should mirror the rules under sections 704(c)(1)(B) and 737.

7. With respect to the scope of the rules described in the Notice, we recommend that the ownership standard for a Section 721(c) Partnership be reviewed for potential overbreadth and that the standard be modified by:

a. Increasing the combined ownership standard that under the Notice is currently set at more than 50% (the “Ownership Threshold”). If the Ownership Threshold is retained, the regulations should create a rebuttable presumption that the partnership is not a Section 721(c) Partnership up to a relatively high combined ownership level (e.g., 80%) for the U.S. transferor and the related foreign person, provided there is no abuse.

b. Adding a rule that if the related foreign person has a de minimis ownership interest in the partnership (e.g., five to ten percent), the rules of the Notice would not apply.

c. Providing definitions of terms for purposes of these rules, such as capital and profits, and refining the disjunctive approach of the ownership standard to ensure that the rules are better tailored to the situations that the Notice was targeting.

8. The application of the regulations should be limited in situations where the property in issue would be subject to U.S. federal income taxation (e.g., property subject to the Foreign Investment in Real Property Act of 1980, or “FIRPTA”; property that produces income that is effectively connected with a U.S. trade or business, or “ECI”).

9. If a partnership does not receive any actual contributions of property on or after the effective date of the Notice (August 6, 2015), but undergoes a technical termination, a conversion, or recapitalization after the effective date, the regulations should not apply.
DISCUSSION

I. Background

A. Enactment of Section 721(c)

Section 721(c) provides that the Secretary may provide by regulations that the nonrecognition rule of section 721(a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person. Prior to the enactment of section 721(c) in the Taxpayer Relief Act of 1997 (the “1997 Act”), a transfer of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust was subject to an excise tax under (former) sections 1491 to 1494. The 1997 Act repealed the excise tax regime and replaced it with provisions potentially requiring gain recognition on transfers of appreciated property to certain entities. With regard to partnerships, regulatory authority was granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. Various reporting provisions were also enacted in the 1997 Act.

B. The Rules in the Notice

As noted above, in the Notice, the Service announced that Treasury and the Service intend to issue regulations under section 721(c) to ensure that when a U.S. person transfers appreciated property to a partnership that has one or more foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The Notice explains that regulatory guidance already exists in certain other areas to prevent the avoidance of gain in certain property transfers to foreign entities (e.g., regulations under section 367(a) and (d) concerning outbound transfers of intangible property to a foreign corporation in an exchange described in section 351 or 361). Additionally, Treasury and the Service are

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6 The 1997 Act included reporting rules in the case of foreign partnerships. Reporting rules similar to those already applicable in the case of controlled foreign corporations were enacted to apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. I.R.C. § 6038(a). Reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10-percent interest. I.R.C. § 6046A. Reporting is also required in the case of a transfer to a foreign partnership if the U.S. person holds at least a 10-percent interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000. I.R.C. § 6038B(b). Certain penalties apply upon failures to comply with the reporting rules. I.R.C. §§ 6038(b), 6679, and 6038B(c). Additionally, the statute of limitations is extended in the case of a failure to report required information with respect to a foreign partnership to the date that is three years after the date on which such information is provided. I.R.C. § 6501(c)(8).
aware that certain taxpayers purport to be able to contribute, consistently with sections 704(b), 704(c) and 482, property to a partnership that allocates the income or gain from the contributed property to related foreign partners that are not subject to U.S. federal income taxation. The Notice states that many of these taxpayers choose a section 704(c) method\(^8\) other than the remedial allocation method and/or use valuation techniques that are inconsistent with the arm’s length standard. The Notice explains that, based on the Service’s experience with these taxpayer positions, Treasury and the Service have determined that it is appropriate to exercise the regulatory authority granted in section 721(c) to override the nonrecognition treatment provided in section 721(a) to gain realized on the transfer of property to a partnership, regardless of whether domestic or foreign, “in certain circumstances in which the gain, when recognized, ultimately would be includible in the gross income of a foreign person.” Further, the Notice explains that, rather than rely on the specific authority in section 367(d)(3) to address transfers of intangibles to partnerships, Treasury and the Service believe that reliance on authority under section 721(c) is more appropriate because the transactions at issue are not limited to transfers of intangible property. Thus, the rules set forth in the Notice concerning the application of section 721(c) will broadly apply to both tangible and intangible assets and to both domestic and foreign partnerships.

The regulations will turn off the nonrecognition rule of section 721(a) when a U.S. person makes a contribution to a partnership (regardless of whether domestic or foreign) of appreciated property, if after the contribution, a foreign person who is related to the domestic contributor is also a direct or indirect partner (directly or indirectly through a partnership) in the partnership, and the U.S. person and one or more related persons together own more than 50% of the interest in partnership capital, profits, deductions, or losses, unless the partnership uses the remedial allocation method for purposes of section 704(c) and the other requirements of the Gain Deferral Method are met.

The general rule (using terms defined in the Notice) is that section 721(a) will not apply when a U.S. Transferor contributes an item of Section 721(c) Property (or portion thereof) to a Section 721(c) Partnership, unless the Gain Deferral Method (discussed below) is applied with respect to the Section 721(c) Property. A U.S. Transferor is defined as a U.S. person within the meaning of section 7701(a)(3), other than a domestic partnership.\(^9\) Section 721(c) Property is defined as property, other than Excluded Property, having Built-in Gain at the time of contribution.\(^10\) Excluded Property is defined as (i) cash equivalents, (ii) any asset that is a security within the meaning of section 475(c)(4), and (iii) any item of tangible property with Built-in Gain that does not exceed

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\(^8\) The regulations under section 704(c) describe three methods of making section 704(c) allocations that are generally reasonable, including the remedial allocation method. Reg. § 1.704-3. Under the remedial allocation method, a partnership may eliminate distortions caused by the ceiling rule by making remedial allocations of income, gain, loss, or deduction to the noncontributing partners equal to the full amount of the limitation caused by the ceiling rule, and offsetting those allocations with remedial allocations of income, gain, loss, or deduction to the contributing partner.

\(^9\) 2015-34 I.R.B. 210 at 213 (§ 4.01(1)).

\(^10\) Id. at 213 (§ 4.01(5)).
$20,000. Built-in Gain is defined as the excess section 704(b) book value of an item of property over the contributing partner’s adjusted tax basis therein at the time of the contribution, and does not include gain created when a partnership revalues partnership property. A Section 721(c) Partnership is defined as a partnership (domestic or foreign) if a U.S. Transferor contributes Section 721(c) Property thereto and after the contribution and any transactions related to the contribution, (i) a Related Foreign Person is a Direct or Indirect Partner in the partnership, and (ii) the U.S. Transferor and one or more Related Persons own more than 50% of the interests in partnership capital, profits, deductions or losses (referred to in these Comments as the “Ownership Threshold”). A Related Person is defined as a person that is related (within the meaning of section 267(b) or 707(b)(1)) to a U.S. Transferor. A Related Foreign Person is defined as a Related Person (other than a partnership) that is not a U.S. person. A Direct or Indirect Partner is a person (other than a partnership) that owns an interest in a partnership directly or indirectly through one or more partnerships.

Under a de minimis rule, the usual nonrecognition rule of section 721(a) will apply if the sum of the Built-in Gain with respect to all Section 721(c) Property contributed in a taxable year to a Section 721(c) Partnership by the U.S. Transferor and all other U.S. Transferors that are Related Persons does not exceed $1 million and the Section 721(c) Partnership is not already applying the Gain Deferral Method with respect to a prior contribution of Section 721(c) Property by the U.S. Transferor or another U.S. Transferor that is a Related Person.

If an Acceleration Event occurs, the U.S. Transferor must recognize the Built-In Gain that would have been allocated to the U.S. Transferor if the Section 721(c) Partnership sold the Section 721(c) Property immediately before the Acceleration Event for its fair market value. An Acceleration Event is defined as any transaction that either would reduce the amount of the remaining Built-in Gain that a U.S. Transferor would recognize under the Gain Deferral Method if the transaction had not occurred or could defer the recognition of the Built-In Gain. Additionally, an Acceleration Event is deemed to occur with respect to all Section 721(c) Property (and not just a particular item of Section 721(c) Property) for the taxable year of the Section 721(c) Partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method.

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11 Id. at 213 (§ 4.01(4)).
12 Id. at 213 (§ 4.01(2)). The Notice’s definition of Built-in Gain largely tracks the definition of built-in gain found in Regulation section 1.704-3(a)(3)(ii).
13 Id. at 213 (§ 4.01(5)).
14 Id. at 213 (§ 4.01(6)).
15 Id. at 213 (§ 4.01(7)).
16 Id. at 213 (§ 4.01(8)).
17 Id. at 213 (§ 4.02).
18 Id. at 214 (§ 4.05(2)).
19 Id. at 214 (§ 4.05(1)).
In certain events described in the Notice, acceleration is not required. First, the transfer of an interest in a Section 721(c) Partnership by a U.S. Transferor to a domestic corporation in a transaction to which either section 351(a) or section 381(a) applies and the transfer of an interest in a lower-tier partnership that owns Section 721(c) Property to a domestic corporation in a transaction to which section 351(a) applies are not Acceleration Events, provided that in both cases the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor for all purposes of the Notice. Additionally, an Acceleration Event will not occur upon certain other transfers of Section 721(c) Property to a corporation: where a Section 721(c) Partnership transfers Section 721(c) Property to a domestic corporation in a transaction to which section 351(a) applies; and where a Section 721(c) Partnership transfers Section 721(c) Property (or an interest in a partnership that owns Section 721(c) Property) to a foreign corporation in a transaction described in section 351(a), to the extent the Section 721(c) Property is treated as being transferred by a U.S. person (other than a domestic partnership) pursuant to Regulation section 1.367(a)-1T(c)(3)(i) or (ii). The stock received in these transfers of Section 721(c) Property to a corporation will not be subject to the Gain Deferral Method.

Under the Notice, except where the de minimis rule, described above, applies, when a U.S. Transferor transfers Section 721(c) Property to a Section 721(c) Partnership, nonrecognition under section 721(a) will not apply unless the Gain Deferral Method is applied with respect to the Section 721(c) Property. To apply the Gain Deferral Method, the Section 721(c) Partnership and other relevant parties must do the following:

1. Adopt the remedial allocation method described in Regulation section 1.704-3(d) for all Section 721(c) Property contributed pursuant to the same plan by the U.S. Transferor and all other U.S. Transferors that are Related Persons (the “Remedial Method Requirement”);

2. During any taxable year in which there is remaining Built-In Gain with respect to an item of Section 721(c) Property, allocate all items of section 704(b) income, gain, loss and deduction with respect to that Section 721(c) Property in the same proportion (the “Proportionate Allocation Requirement”);

3. Satisfy certain reporting requirements set forth in the Notice (the “Reporting Requirements”) applicable to U.S. Transferors (in the case of a foreign partnership) and domestic partnerships (in which a U.S. Transferor is a direct partner or owns an interest indirectly through one or more partnerships);

4. If there is an Acceleration Event, ensure that the U.S. Transferor recognizes the remaining Built-In Gain with respect to Section 721(c) Property; and

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20 Id. at 214 (§ 4.05(3), (4)).
(5) Adopt the Gain Deferral Method for all Section 721(c) Property subsequently contributed by the U.S. Transferor and other U.S. Transferors that are Related Persons (the “Subsequent Contribution Rule”).

Also, to apply the Gain Deferral Method, the U.S. Transferor (and in certain cases, a Section 721(c) Partnership) must agree to extend the statute of limitations with regard to all items related to the Section 721(c) Property contributed to the Section 721(c) Partnership to the eighth taxable year following the taxable year of the contribution of the Section 721(c) Property.

Treasury and the Service explain that remedial allocations under section 704(c) can have the effect, in part, of ensuring that pre-contribution gain from contributed property is properly taken into account by the contributing partner and that allocating all section 704(b) book items associated with the contributed property in a consistent manner with respect to the contributing partner and any related foreign partner can help to ensure that the built-in gain associated with contributed property is properly taken into account by the contributing partner and that income is not inappropriately separated from related deductions. This reasoning explains why Treasury and the Service have determined it appropriate that the future regulations under section 721(c) allow for the continued application of section 721(a) to transfers to partnerships with related foreign partners only when the conditions described in the Notice (which include the adoption of the remedial allocation method under section 704(c)) are satisfied.

The Notice states that the regulations to be issued will apply to transactions involving tiered partnerships in a manner consistent with the purpose of the rules as described in the section of the Notice discussing the reasons for exercising regulatory authority. The Notice describes, as examples, situations where a U.S. Transferor is a Direct or Indirect Partner in a partnership and that partnership contributes Section 721(c) Property to a lower-tier partnership, and where a U.S. Transferor contributes an interest in a partnership that owns Section 721(c) Property to a lower-tier partnership. In those situations, the rules described in the Notice will apply as though the U.S. Transferor contributed its share of the Section 721(c) Property directly.

The Service also intends to issue regulations detailing reporting requirements for both foreign and domestic partnerships to whom these regulations apply (the “Reporting Requirements”). The information required to be reported will include a description of the Section 721(c) Property, information regarding the amount of income, gain, deduction, or loss with respect to the Section 721(c) Property, and a description of any Acceleration Events. The Reporting Requirements will be coordinated with the information reporting requirements under sections 6038, 6038B, and 6046A, including amending the regulations under those sections or relevant forms and instructions, as necessary. The regulations will require certain U.S. Transferors that contribute Section 721(c) Property to a Section 721(c) Partnership that is a foreign partnership to comply with the

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21 Id. at 213 (§ 4.03).
22 Id. at 214-215 (§ 4.06(3)).
information return filing requirements described in Regulation section 1.6038-3 to the extent not required under current regulations. Additionally, the Notice states that the Service intends to modify Schedule O of Form 8865 for taxable years beginning in 2015 to require supplemental information for contributions of Section 721(c) Property to Section 721(c) Partnerships.

The regulations will include an anti-abuse rule where a U.S. Transferor engages in a transaction (or series of transactions) with a principal purpose of avoiding the application of the regulations described in the Notice. In that situation, the transaction (or series of transactions) may be disregarded or the arrangement may be recharacterized (including disregarding an intermediate entity) in accordance with its substance.23

The regulations under section 721(c) generally are to apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections made under Regulation section 301.7701-3 that are filed on or after August 6, 2015, and that are effective on or before August 6, 2015.

The Service also announced its intention to issue regulations under section 482 related to contributions of intangibles in certain cost sharing arrangements. The Service is concerned that taxpayers are assigning inappropriately low values to intangibles contributed by domestic partners and then allocating income from those intangibles to foreign partners.24 Treasury and the Service are also considering issuing regulations under Regulation section 1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. These Comments will not address the regulations to be issued under section 482 and the related reporting guidance. Comments regarding the future regulations under section 482 have been provided in a separate comment letter previously submitted by the Section of Taxation.25

The Notice requests comments on regulations concerning reporting requirements, specifically on whether the regulations should provide rules similar to those in the recently finalized regulations under sections 367(a) and 6038B26 regarding failures to file gain recognition agreements (“GRAs”) or to satisfy other reporting obligations, including the standards for relief therein. The Notice also requests comments on whether an Acceleration Event should exclude a distribution of Section 721(c) Property to an unrelated foreign partner beyond the seven-year limitation of section 704(c)(1)(B).

II. Comments and Recommendations Regarding Technical Issues under the Notice and Its Scope

We discuss below our recommendations regarding various provisions in the Notice. First, we identify technical issues arising with regard to the Gain Deferral

23 Id. at 214 (§ 4.08).
24 Id. at 212, 215-216 (§§ 3, 5).
25 See supra note 3.
Method, the Acceleration Events, and correlative adjustments arising from applying the provisions of the Notice. We also discuss situations in which it may be appropriate to terminate the use of the Gain Deferral Method. Then we turn to the scope of the rules and identify areas where the rules appear overbroad, including technical terminations and conversions and recapitalizations with regard to partnerships that do not receive actual contributions of appreciated property on or after August 6, 2015 (or before August 6, 2015 resulting from entity classification elections made under Regulation section 301.7701-3 that are filed on or after August 6, 2015 and that are effective on or before August 6, 2015).

A. Application of the Gain Deferral Method

In this part, we discuss and make recommendations with regard to the requirements under the Gain Deferral Method to use the remedial allocation method, to make proportionate allocations for purposes of section 704(b), and to use the Gain Deferral Method upon a subsequent contribution of appreciated property.

1. The Remedial Method Requirement

The Remedial Method Requirement of the Gain Deferral Method27 raises a number of issues that are not addressed in the Notice but which should be addressed in future guidance to provide clarity on its required application. These issues, discussed below, include how the Remedial Method Requirement interacts with the anti-churning rules of section 197, whether the Remedial Method Requirement should apply to “reverse 704(c) gain” arising from revaluation events of the Section 721(c) Partnership, and whether allocations of remedial income and deductions under the Remedial Method Requirement should create separate categories under the section 704(b) regulations governing a partnership’s allocation of CFTEs.

a) Background on Section 704(c) Remedial Allocation Method

When a partner contributes property to a partnership that has a fair market value that differs from its adjusted tax basis (i.e., “forward built-in gain (or loss) property”), section 704(c)(1)(A) (“section 704(c)”) requires the partnership to allocate income, gain, loss, and deduction with respect to the contributed property among the partners so as to take into account the variation between the fair market value of the property and its adjusted tax basis at the time of contribution.28 Allocations under section 704(c) must be made using a reasonable method that is consistent with the purpose of section 704(c), which is to prevent the shifting of tax consequences among partners with respect to built-

27 As discussed above, under the Remedial Method Requirement of the Gain Deferral Method, the Section 721(c) Partnership must adopt the remedial allocation method described in Regulation section 1.704-3(d) for Built-in Gain with respect to all Section 721(c) Property contributed to the Section 721(c) Partnership pursuant to the same plan by a U.S. Transferor and all other U.S. Transferors that are Related Persons. 2015-34 I.R.B. 210 at 213 (§ 4.03(1)).
28 I.R.C. § 704(c)(1)(A).
in gain or loss. The regulations describe three methods that are generally reasonable: the traditional method, the traditional method with curative allocations, and the remedial allocation method.

The remedial allocation method permits the use of remedial allocations to the partners to ensure the contributed built-in gain or loss is not shifted to the non-contributing partners. Remedial allocations are tax allocations of income or gain created by the partnership that are offset by tax allocations of loss or deduction created by the partnership. Under the remedial allocation method, the partnership first determines the amount of section 704(b) items attributable to the contributed property and the partners’ distributive shares of those items under section 704(b), and then allocate the corresponding tax items recognized by the partnership (if any) using the traditional method. If the application of the ceiling rule results in a section 704(b) allocation to a noncontributing partner that differs from the corresponding tax allocation of the same item, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. At the same time, the partnership creates an offsetting remedial item in an identical amount and allocates it to the contributing partner. A remedial allocation is reasonable only to the extent it equals the amount necessary to offset the effect of the ceiling rule for that taxable year, and only if it has the same effect on each partner’s tax liability as the item limited by the ceiling rule.

The regulations under section 704(c) contain an anti-abuse rule, which permits the Secretary to make adjustments if a partnership’s section 704(c) allocation method is unreasonable. However, Regulation section 1.704-3(d)(5)(ii) provides that in exercising this authority to make adjustments, the Service will not require a partnership to use the

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29 Reg. § 1.704-3(a)(1).
30 Each method, however, is subject to a general anti-abuse rule under Regulation section 1.704-3(a)(10). Regulation section 1.704-3(a)(10) provides that an allocation method (or combination of methods) is not reasonable if the contribution of property (or the revaluation event) and the corresponding allocation of tax items with respect to the section 704(c) property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.
32 Regulation section 1.704-3(d)(2) provides that under the remedial allocation method, a partnership determines the amount of book items attributable to contributed property as follows: the portion of the partnership’s book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered (generally, over the property’s remaining recovery period under section 168(i)(7) or other applicable Code section). The remainder of the partnership’s book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.
33 Reg. § 1.704-3(d)(1).
34 Id.
35 Reg. § 1.704-3(d)(3).
36 Reg. § 1.704-3(a)(10).
remedial allocation method or any other method involving the creation of notional tax items.

b) Anti-Churning Rules under Section 197(f)(9)

The anti-churning rules of section 197(f)(9) are intended to prevent the amortization of “section 197(f)(9) intangibles” unless they are transferred after August 10, 1993 (i.e., the effective date of section 197) in a transaction giving rise to a significant change in ownership or use.\(^{37}\) Section 197(f)(9) intangibles are goodwill and going concern value that were held or used at any time during the “transition period” (i.e., the period beginning on July 25, 1991 and ending on August 10, 1993\(^{38}\)), and any other section 197 intangible that was held or used at any time during the transition period and was not depreciable or amortizable under prior law.\(^{39}\) A section 197(f)(9) intangible is treated as an “amortizable section 197 intangible” only to the extent permitted under the anti-churning rules of Regulation section 1.197-2(h).

Under the anti-churning rules, a section 197(f)(9) intangible acquired by a taxpayer after August 10, 1993 does not qualify for section 197 amortization if the taxpayer: (i) or a related person held or used the intangible or an interest therein at any time during the transition period; (ii) acquired the intangible from a person that held the intangible at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or (iii) grants the right to use the intangible to a person that held or used the intangible at any time during the transition period (or to a person related to that person), but only if the transaction in which the taxpayer grants the right and the transaction in which the taxpayer acquired the intangible are part of a series of related transactions.\(^{40}\) For this purpose, a person is “related” to any person if: (i) the persons have a section 267(b) or 707(b)(1) relationship (substituting “20 percent” for “50 percent” in those sections) or (ii) the persons are engaged in trades or businesses under common control (within the meaning of section 41(f)(1)(A) and (B)).\(^{41}\)

The regulations under section 197(f)(9) provide specific rules related to the application of section 197(f)(9) to property contributed to a partnership and the related section 704(c) allocations by the partnership. The regulations under section 197(f)(9) provide that, if an intangible was not an amortizable section 197 intangible in the hands of the contributing partner, a noncontributing partner generally may receive remedial allocations of amortization under section 704(c) that are deductible for U.S. federal income tax purposes; however, such a partner may not receive remedial allocations of amortization under section 704(c) if that partner is related to the partner that contributed

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\(^{37}\) Reg. § 1.197-2(h)(1)(ii). Special rules under Regulation section 1.197-2(h)(12) apply for purposes of determining whether transactions involving partnerships give rise to a significant change in ownership or use.

\(^{38}\) If the acquiring taxpayer made a retroactive election under Regulation section 1.197-1T, then the transition period is after July 25, 1991 and on or before August 10, 1993.

\(^{39}\) Reg. § 1.197-2(h)(1)(i).

\(^{40}\) Reg. § 1.197-2(h)(2).

\(^{41}\) I.R.C. § 197(f)(9)(C)(i); Reg. § 1.197-2(h)(6).
the intangible or if, as part of a series of related transactions that includes the contribution of the section 197(f)(9) intangible to the partnership, the contributing partner or related person (other than the partnership) becomes (or remains) a direct user of the contributed intangible.\textsuperscript{42}

The Notice requires the Section 721(c) Partnership to adopt the remedial allocation method with respect to Section 721(c) Property if it intends to qualify under the Gain Deferral Method. However, it is unclear how the remedial method should operate in the context of complying with the Gain Deferral Method when the contributed Section 721(c) Property is subject to the anti-churning rules under section 197(f)(9). Specifically, it is unclear whether the contributing partner is required to recognize remedial allocations of income when Regulation section 1.197-2(h)(12)(vii)(B) prevents the non-contributing partners from receiving remedial allocations of amortization from the Section 721(c) Property that are deductible for U.S. federal income tax purposes (because the non-contributing partners are related to the contributing partner).

Under these circumstances, we believe that the contributing partner should not be required to recognize remedial allocations of income while the section 704(c) remedial allocations of the amortization deductions to the related non-contributing partners are not deductible for U.S. federal income tax purposes. Therefore, we recommend that future guidance clarify that, to the extent the contributed Section 721(c) Property is non-amortizable by the partnership under section 197(f)(9) and the regulations thereunder, the contributing partner should not be required to recognize remedial allocations of income to the extent that the section 704(c) remedial allocations of the amortization deductions to the related non-contributing partners are not deductible for U.S. federal income tax purposes.

\textbf{c) Reverse Built-in Gain or Loss Property}

As discussed above, when property is contributed to a partnership with a fair market value that differs from its adjusted tax basis, section 704(c) requires the partnership to allocate income, gain, loss, and deduction with respect to the property contributed so as to take into account any variation between the fair market value of the property and its adjusted tax basis at the time of contribution. Additionally, a partnership agreement may, upon the occurrence of certain events, require or permit the partnership to adjust the section 704(b) capital accounts of the partners to reflect a revaluation of partnership property (\textit{i.e.}, a “revaluation” or “book-up”).\textsuperscript{43}

A partnership revaluation generally results in property reflected on the books of the partnership with a book value that differs from the adjusted tax basis of such property and thus creates built-in gain (or loss) in the revalued property. This built-in gain or loss is referred to as “reverse” built-in gain (or loss). Section 704(c) also applies to reverse

\textsuperscript{42} Reg. § 1.197-2(h)(12)(vii)(B).
\textsuperscript{43} Reg. § 1.704-1(b)(2)(iv)(f).
built-in gain (or loss). A single asset can have both a forward built-in gain (or loss) layer and a reverse built-in gain (or loss) layer. The section 704(c) regulations do not require partnerships to use the same allocation methods for reverse built-in gain (or loss) as the method used for forward built-in gain (or loss) in the same property. Also, the partnership is not required to use the same allocation method with respect to reverse built-in gain (or loss) layers created each time the partnership revalues its property, so long as each method is reasonable under the facts and circumstances.

It is not clear under the Notice whether the Remedial Method Requirement applies to reverse section 704(c) gain with respect to Section 721(c) Property that is revalued by the Section 721(c) Partnership. The definition of Built-in Gain states that it does not include gain created when a partnership revalues partnership property, but the Notice does not state affirmatively that the rules do not apply upon a revaluation. We do not think the application of the Remedial Method Requirement to reverse section 704(c) gain with respect to Section 721(c) Property created post-contribution is consistent with the policy of the Notice. The Notice states “[t]he Treasury Department and the IRS believe that remedial allocations can have the effect, in part, of ensuring that pre-contribution gain from contributed property is properly taken into account by the contributing partner” (emphasis added).

To require the Section 721(c) Partnership to adopt remedial allocations with respect to reverse built-in gain (or loss) layers would not be consistent with Treasury’s and the Service’s stated goal of ensuring that pre-contribution gain from contributed property is properly taken into account by the contributing partner and would appear to impose an unnecessary administrative burden on the partnership. In light of the foregoing, we recommend that future guidance clarify that the Remedial Method Requirement under the Gain Deferral Method does not apply to reverse built-in gain (or loss) layers. Instead, we recommend that the Remedial Method Requirement under the Gain Deferral Method be limited to the section 704(c) gain inherent in the Section 721(c) Property on the date of the contribution to the Section 721(c) Partnership, except where a potential for abuse exists.

d) Allocation of CFTEs

Section 704(b) provides the Service with authority to modify a partnership allocation and allocate in accordance with a partner’s interest in the partnership (i.e., “PIP”) if an allocation is not economically meaningful apart from its federal income tax consequences (i.e., if it does not have “substantial economic effect”). The allocation of CFTEs cannot have substantial economic effect and, therefore, must be allocated in accordance with PIP. The section 704(b) regulations provide a safe harbor whereby the allocation of CFTEs is deemed to be in accordance with PIP if certain conditions are

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44 Reg. § 1.704-1(b)(4)(i).
45 Reg. § 1.704-3(a)(6).
satisfied. The safe harbor generally requires that the CFTEs be allocated in proportion to the distributive shares of income to which the CFTEs relate. To ensure CFTEs are allocated and reported in proportion to the distributive shares of income to which they relate, they must first be allocated between the partnership’s CFTE categories.

A CFTE category is a category of net income (or loss) attributable to one or more activities of the partnership. The net income (or loss) from all the partnership’s activities is included in a single CFTE category unless the allocation of net income (or loss) from one or more activities differs from the allocation of net income (or loss) from other activities, in which case income from each activity or group of activities that is subject to a different allocation is treated as net income (or loss) in a separate CFTE category. Net income in a CFTE category means the net income (or loss) for U.S. federal income tax purposes, determined by taking into account all partnership items attributable to the relevant activity or group of activities, including items of gross income, gain, loss, deduction, and expense allocated pursuant to section 704(c).

Whether a partnership has one or more activities, and the scope of each activity, is to be determined in a reasonable manner taking into account all the facts and circumstances. The principal consideration in evaluating whether aggregating or disaggregating income from particular operations is reasonable in this context is whether the proposed determination has the effect of separating CFTEs from the related foreign income. The partnership’s activities must be determined consistently from year to year absent a material change in facts and circumstances. As stated above, in order to satisfy the safe harbor, the CFTEs must be allocated between the partners in the same proportion as the net U.S. taxable income of each CFTE category is allocated between the partners.

The regulations set forth an example in which a partnership allocates all section 704(b) items from two activities in the same ratio between its two partners. However, because the partnership has section 704(c) gain from one activity that is allocated entirely to one partner under the traditional allocation method, the example concludes that the partnership has two separate CFTE categories. What is not illustrated in the example (and thus left open for interpretation) is whether annual remedial allocations of amortization, depreciation, or depletion similarly can create separate categories for purposes of allocating the partnership’s CFTEs. Specifically, it is unclear whether two (or more) activities with the same section 704(b) allocations are treated as separate categories for purposes of allocating the partnership’s CFTEs if the property of one of the activities is generating remedial income and loss.

This issue is highlighted in the context of the Notice because the Notice requires a Section 721(c) Partnership to adopt the Remedial Allocation Method with respect to Section 721(c) Property in order to qualify for the Gain Deferral Method. Therefore, it

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49 Id.
51 Id.
53 Reg. § 1.704-1(b)(5), Ex. (26).
remains unclear whether, in this context, a Section 721(c) Partnership that allocates all items of section 704(b) income, gain, loss, and deduction from one or more activities to its partners in the same ratio will have separate CFTE categories purely as a result of the remedial allocations, which are required under the Gain Deferral Method of the Notice. We recommend that future guidance specify that the section 704(b) regulations (including Regulation section 1.704-1(b)(4)(viii)(c)(2) and 1.704-1(b)(5), Ex. (26)) do not cause annual remedial allocations of amortization, depreciation, or depletion to create separate CFTE categories when section 704(b) income of the partnership is allocated to the partners in the same ratio.

In addition, as discussed further below, we recommend that future guidance clarify that the Proportionate Allocation Requirement of the Gain Deferral Method is not violated as a result of the partnership’s allocation of the CFTEs in compliance with the regulations.

2. The Proportionate Allocation Requirement

With respect to the Proportionate Allocation Requirement, we recommend below that future guidance: (i) clarify that yearly changes in the partners’ allocation percentages with respect to Section 721(c) Property are permissible and do not violate the Proportionate Allocation Requirement, (ii) clarify that regulatory allocations under section 704(b) do not violate the Proportionate Allocation Requirement, (iii) confirm that a preferred return funded by net income does not violate the Proportionate Allocation Requirement, and (iv) confirm that guaranteed payments do not violate the Proportionate Allocation Requirement.

a) Annual Changes in Partners’ Allocation Percentages

While the Proportionate Allocation Requirement specifies that during any taxable year in which there is remaining Built-in Gain with respect to an item of Section 721(c) Property, all section 704(b) allocations with respect to that Section 721(c) Property must be made in the same proportion, we recommend that future guidance confirm that changes in the partners’ respective allocation percentages with respect to Section 721(c) Property from year to year are permissible and will not violate the Proportionate Allocation Requirement, provided those items are allocated in the same proportion within a given year.

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54 As described above, the Proportionate Allocation Requirement is that during any taxable year in which the Section 721(c) Partnership has remaining Built-in Gain with respect to an item of Section 721(c) Property, the Section 721(c) Partnership must allocate all partnership items of section 704(b) income, gain, loss and deduction with respect to the Section 721(c) Property in the same proportion. Notice 2015-54, 2015-34 I.R.B. 210 at 213 (§ 4.03(2)).
b) Section 704(b) Regulatory Allocations

Regulation sections 1.704-1 and 1.704-2(b) address certain partnership allocations that cannot have substantial economic effect. The regulations provide safe harbors under which a partnership’s allocations will be deemed to be in accordance with PIP in certain circumstances (“regulatory allocations”). Compliance with these regulatory allocations is required if a partnership intends to avail itself of one or more of the safe harbors within the section 704(b) regulatory regime. The regulatory allocations require that a partnership make special allocations of income, gain, deduction, or loss to its partners in certain circumstances. In some situations, corrective allocations are necessary to realign the partners’ capital accounts to the agreed economic arrangement. Examples of these regulatory allocations and corrective allocations include, but are not limited to, allocations of nonrecourse deductions, allocations to satisfy a minimum gain chargeback, allocations made pursuant to a qualified income offset provision, and allocations of a partnership’s CFTEs (discussed above) and any related corrective allocations that are required to realign the partners’ capital accounts to the agreed economic arrangement.

As a result, in any given year in which allocations are made pursuant to the regulatory allocations, the allocations may violate the Proportionate Allocation Requirement if section 704(b) items associated with the Section 721(c) Property are allocated disproportionately among the partners. We recommend that future guidance clarify that any special allocations of income, gain, loss, or deduction with respect to Section 721(c) Property that are mandated by regulatory allocations should not cause the Section 721(c) Partnership to violate the Proportionate Allocation Requirement of the Gain Deferral Method for that taxable year. Unless such provision is included in future guidance, a partnership will be unable to comply with the Gain Deferral Method and the regulations under section 704(b), a result we believe to be unintended and inappropriate.

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55 Nonrecourse deductions are allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (for which no partner bears the economic risk of loss) that cannot have economic effect because the creditor alone bears any economic burden that corresponds to the allocations. Reg. § 1.704-2(b)(1).

56 Regulation section 1.704-2(f)(1) requires that if there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain (within the meaning of Regulation section 1.704-2(g)(2)).

57 To meet the alternate test for economic effect under the safe harbor in the section 704(b) regulations, partners can agree to adopt a qualified income offset provision (i.e., a “QIO provision”) in the partnership agreement rather than a deficit restoration obligation. A QIO provision typically provides that in the event any partner unexpectedly receives any adjustments, allocations, or distributions described in Regulation section 1.704-1(b)(2)(ii)(d)(4), (5), and (6), items of partnership income and gain for such taxable year shall be specially allocated to the partner in an amount and manner sufficient to eliminate, to the extent required by the regulations, any adjusted capital account deficit of the partner as quickly as possible. Reg. § 1.704-1(b)(2)(ii)(d). See also Reg. § 1.704-2(e)(1).

58 Allocations of a partnership’s CFTEs will be deemed to be in accordance with the partner’s interest in the partnership (PIP) under a safe harbor in the section 704(b) regulations if the CFTEs are allocated to the partners in the same proportion that partnership net income in such CFTE Category is allocated to the partners. Reg. § 1.704-1(b)(4)(viii).
c) Preferred Returns

We believe that allocations of a partner’s preferred return funded by section 704(b) net income should not violate the Proportionate Allocation Requirement of the Gain Deferral Method and recommend that future guidance confirm this point. Generally, a partner’s preferred return entitles the partner to an economic return before other partners receive their respective distributive shares of partnership income, gain, loss, deduction or credit. However, when a partner’s preferred return is payable from the partnership’s net income, its payment is contingent upon the partnership having sufficient section 704(b) net income. Therefore, in all cases, the partner receiving such a preferred return should be allocated a percentage of the partnership’s section 704(b) income and therefore should be allocated a proportionate amount of each section 704(b) item generated from Section 721(c) Property, without any special allocations of particular items.

We therefore recommend that future guidance clarify that a preferred return funded by a partnership’s net section 704(b) income should not violate the Proportionate Allocation Requirement of the Gain Deferral Method.

d) Guaranteed Payments under Section 707(c)

Under current law, it is unclear whether a section 707(c) guaranteed payment for capital is treated as a distributive share of partnership income, gain, loss and deduction, or whether it is characterized as a separate item of income, similar to interest. If, under the Notice, a guaranteed payment is treated as a distributive share of items of income generated by the Section 721(c) Property, a partner’s entitlement to the guaranteed payment could result in a violation of the Proportionate Allocation Requirement of the Gain Deferral Method.

Section 707(c) provides that guaranteed payments are treated as “made to one who is not a member of the partnership, but only for the purpose of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)” (emphasis added). The section 707(c) legislative history does not indicate clearly whether a guaranteed payment is treated as a distributive share item or as interest. Regulation section 1.707-1(c) favors distributive share treatment in providing that, other than with respect to certain enumerated provisions of subchapter K (namely sections 706(b)(3), 707(b), and 708(b)), “guaranteed payments are regarded as a partner’s distributive share of ordinary income.” Given the lack of clarity, courts and the Service have treated a guaranteed payment at times as a distributive share item, while at

59 The House of Representative’s proposed version of section 707(c) applied only to payments to a partner for services performed. H. R. Rep. No. 83-1337, at 68 (1954). The Senate’s version followed the House’s, but extended section 707(c) to the use of capital, and the Senate referred to “guaranteed interest payments on capital” in the Senate report. S. Rep. No. 83-1622, at 94 (1954). The Conference Report stated the Senate’s version of section 707(c) was adopted into law but made no reference to interest. H.R. Rep. No. 83-2543, at 59 (1954) (Conf. Rep.).
other times as an item similar to interest. Additionally, under the section 704(b) regulations, guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner’s distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment. Under the Notice, the Proportionate Allocation Requirement is tied to items of section 704(b) income, gain, loss, and deduction with respect to Section 721(c) Property, and thus looks to section 704(b) concepts in requiring proportionate allocations. Therefore, the section 704(b) capital accounting treatment of guaranteed payments is relevant and important.

We believe that in this situation, a guaranteed payment does not present the same policy concerns that prompted the introduction of the Proportionate Allocation Requirement into the Gain Deferral Method of the Notice, namely, a situation in which allocations within a tax year of section 704(b) items of partnership income, gain, deduction and loss among partners are disproportionate, as a result, for example of the U.S. Transferor being allocated section 704(b) deductions associated with the Section 721(c) Property while another partner is allocated the section 704(b) income associated with such property. Pursuant to the section 704(b) capital account treatment of a guaranteed payment, where a partnership’s section 704(b) allocations to partners are not disproportionate among partners, the allocation of items of income and deduction under section 704(b) related to the Section 721(c) Property would not be split between partners as a result of the partnership making a guaranteed payment to a partner. The deduction impact of a guaranteed payment under section 704(b) would be applied to each partner in the same proportion as each of the other items of partnership income, gain, deduction, and loss, but the income aspect of a guaranteed payment would not be within the section 704(b) allocations, analogous to the tax treatment of interest income of a lender partner where a partner makes a loan to a partnership. Therefore, a guaranteed payment should not give rise to a situation in which the U.S. Transferor would be allocated the section 704(b) deductions associated with the Section 721(c) Property while another partner would be allocated the section 704(b) income associated with the Section 721(c) Property. Consequently, we recommend that future guidance clarify that a guaranteed payment is not treated as a distributive share of partnership income for purposes of the Proportionate Allocation Requirement of the Gain Deferral Method and thereby clarify that the income inclusion under section 61 for the guaranteed payment does not violate the Proportionate Allocation Requirement of the Gain Deferral Method.


3. The Subsequent Contribution Rule

We recommend that future guidance remove the Subsequent Contribution Rule\textsuperscript{62} as a requirement of the Gain Deferral Method. The Notice permits flexibility in allowing a taxpayer to choose whether to recognize gain on a contribution of Section 721(c) Property to a Section 721(c) Partnership or whether to defer the gain by satisfying the requirements of the Gain Deferral Method. We see no justification for denying that flexibility upon a subsequent contribution of a different item of Section 721(c) Property to a Section 721(c) Partnership that opted for deferral under the Gain Deferral Method with respect to a prior contribution.

A Section 721(c) Partnership that previously elected to apply the Gain Deferral Method may decide that, based on facts and circumstances existing at the time of the subsequent contribution, it does not wish to defer gain under section 721(c) in connection with the subsequent contribution because of the complexities and additional compliance required under the Gain Deferral Method. Under these circumstances, we see no reason why a partnership should be forced to elect the Gain Deferral Method on a subsequent contribution of a different item of Section 721(c) Property to the partnership if it wishes to maintain continued deferral under the Gain Deferral Method with respect to a prior contribution of Section 721(c) Property. Therefore, we recommend that future guidance remove this requirement from the Gain Deferral Method.

4. Reporting Requirements

The Notice includes changes to existing reporting requirements (e.g., Form 8865) as well as new Reporting Requirements for a U.S. Transferor for taxable years in which the Gain Deferral Method applies. We recommend that, to the extent duplicative information must be reported on Form 8865 and also on other new reporting form(s), an exception be granted if the information is already reported by a taxpayer on Form 8865. For example, a duplicative reporting exception, similar to that provided for Form 8938, \textit{Statement of Specified Foreign Financial Assets}, could reduce excess compliance burdens when the same or similar information is required to be reported on different forms with respect to contributed Section 721(c) Property.

The Notice requested comments on whether the regulations should provide rules similar to those in the recently finalized regulations under sections 367(a) and 6038B regarding failures to file GRAs or to satisfy other reporting obligations, including the

\textsuperscript{62} As described above, under the Subsequent Contribution Rule, the Section 721(c) Partnership must adopt the Gain Deferral Method for all Section 721(c) Property subsequently contributed to the Section 721(c) Partnership by the U.S. Transferor and all other U.S. Transferors that are Related Persons until the earlier of: (i) the date that no Built-in Gain remains with respect to any Section 721(c) Property to which the Gain Deferral Method first applied, or (ii) the date that is 60 months after the date of the initial contribution of Section 721(c) Property to which the Gain Deferral Method first applied (the “Subsequent Contribution Rule”). Notice 2015-54, 2015-34 I.R.B. 210 at 213 (§ 4.03(5)).
standards for relief therein. The Service and Treasury believe that full gain recognition under section 367(a)(1) should apply only if a failure to timely file an initial GRA or a failure to comply with the section 367(a) GRA regulations with respect to an existing GRA is willful. Similarly, the Gain Deferral Method rules also provide for full gain recognition under the Notice if an Acceleration Event occurs, which includes failure to timely file under the Reporting Requirements. We believe that the principles governing the Gain Deferral Method and GRA gain recognition are substantially similar, and comparable rules and standards of relief are appropriate.

We do not believe that taxpayers should be required to demonstrate reasonable cause regarding failures to file or satisfy other reporting obligations. The existing reasonable cause standard requires interpretation under relevant case law, and may not be satisfied by a U.S. Transferor in common situations even though the failure was not due to willful neglect. For example, isolated, accidental oversights may not satisfy the reasonable cause standard, but are not considered willful. Accordingly, we recommend that, if the event giving rise to an Acceleration Event is a failure to timely comply with the Reporting Requirements, full gain recognition from an Acceleration Event should apply only if a failure to comply or timely file under the Reporting Regulations is willful.

B. Acceleration Events

In this portion of the Comments, we first discuss our views on the general construct of the Notice and then discuss the exceptions to acceleration of the remaining Built-in Gain with respect to an item Section 721(c) Property as well as recommendations for additional exceptions, in particular for technical termination situations and partnership conversions and recapitalizations. We also make recommendations concerning events that should operate to permit a Section 721(c) Partnership to terminate use of the Gain Deferral Method (and related provisions) with regard to an item of Section 721(c) Property without resulting in an acceleration of the remaining Built-in Gain.

1. General Construct of Notice and Recommendations

It appears that when drafting the Notice, the Service and Treasury intended to adopt a regime substantially similar to the rules applicable to GRAs under section 367(a). First, there are specific requirements that must be met in order to avoid the

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63 See Treas. Reg. § 1.367(a)-8(p), as amended by T.D. 9704, 2014-50 I.R.B. 922, applicable to GRAs required to be filed on or after November 19, 2014. For GRAs required to be file prior to that date, a reasonable cause standard applied.  
64 T.D. 9704, 2014-50 I.R.B. 922; REG-140649-11, 2013-12 I.R.B. 666, 668 (March 18, 2013). The preamble to the proposed GRA regulations indicates that for this purpose for GRAs, the term willful is to be interpreted consistent with the meaning of that term in the context of other penalties, and would include a failure due to gross negligence, reckless disregard or willful neglect. 
65 Reg. § 1.367(a)-3(b) and (c). See also Reg. § 1.367(a)-8. Regulation section 1.367(a)-8(j) lists a series of transactions that are considered “triggering events.” A triggering event is similar in concept to an Acceleration Event under the Notice, in that the recognition of gain can be deferred if certain procedures are followed until a specific type of transaction is executed. Regulation section 1.367(a)-8(k) provides for a series of “Exceptions” to such triggering events; if specifically listed, such transaction will not be
immediate recognition of any gain on an outbound transfer, including substantial and presumably significant filing requirements. Further, should the taxpayer engage in any subsequent transactions with respect to such property, or with respect to the Section 721(c) Partnership, such transaction could trigger the immediate recognition of gain unless explicitly excluded.

Assuming the Service and Treasury continue to utilize this regime when regulations are promulgated, it appears that there will be a need to incorporate rules similar to those currently found in the GRA provisions, including a list of transactions which if undertaken would trigger the remaining Built-in Gain in the Section 721(c) Property and those that would be excepted from such a triggering event.

In adopting these provisions, at least two approaches would be reasonable. First, in a manner similar to the rules applicable to GRAs, the regulations could include a comprehensive list of events that trigger the gain, that allow for the continued deferral of gain (provided certain filing and the Reporting Requirements are met), or that terminate the Gain Deferral Method (the “GRA Approach”). The benefits of the GRA Approach would be to provide certainty to the Service and taxpayers as to the transactions that could be undertaken without risk of triggering the precontribution built-in gain. Alternatively, the regulations could provide for a general principles-based approach, similar to the approach of the Notice, and provide an illustrative and non-exclusive list of situations in which the Built-in Gain would be recognized or could continue to be deferred.

It is important to note that, if the Service and Treasury decide to adopt the GRA Approach, there is almost certainly a risk that transactions that should not trigger the recognition of Built-in Gain might not be included in an exclusive list, thereby leading to inappropriate gain recognition. In order to minimize this risk, and regardless of the approach adopted, we recommend that the regulations provide for a broad catch-all that would allow for the avoidance of gain recognition, provided the Built-in Gain in the Section 721(c) Property will not, following the transaction, be recognized by a foreign person. Additionally, to the extent possible, we suggest including guidance on the situations, or features of situations, that would not constitute Acceleration Events. It is our belief that this rule should apply irrespective of whether the Built-in Gain in the Section 721(c) Property is deferred.

Importantly, deferral of the Built-in Gain is simply not envisioned by the statutory authority granted under section 721(c), which was focused solely on situations in which considered a triggering event, provided certain requirements are met. Sections 4.05(3) and 4.05(4) of the Notice, discussed above, provide a similar list with respect to Acceleration Events. Finally, Regulation section 1.367(a)-8(o) provides a list of transactions that are considered “terminating events.” If a terminating event occurs, the transaction will be considered to fall outside of the scope of the regulations or reduce the amount of gain subject to the GRA.

66 Interestingly, the Service and Treasury have appeared to move away from the need for specific exceptions by including the “catch-all” exception to triggering GRAs in Regulation section 1.367(a)-8(k)(14).
gain would be recognized by a person other than a U.S. person. Accordingly, we believe that a transaction that merely defers the Built-in Gain but retains the potential for future recognition in the hands of a U.S. person should not be a triggering event under regulations adopted pursuant to the provisions of the Notice. Such a rule would not only have the effect of avoiding the over-application of the Gain Deferral Method to innocuous and common business transactions, but would also avoid the need to provide a comprehensive list of detailed transactions.

In addition, we recommend that the Service and Treasury include within the rules provisions that allow for the termination of the Gain Deferral Method whenever the Section 721(c) Property is acquired in a tax-free transaction by a domestic corporation, provided the Built-in Gain inherent in the Section 721(c) Property (as it exists at the time of such acquisition, less any income taken into account by the U.S. Transferor under the remedial allocation method while such property is owned by the Section 721(c) Partnership) is preserved in the hands of the acquiring domestic corporation. This is appropriate given that in such a case, the Built-in Gain in the Section 721(c) Property cannot, regardless of any methods of amortization or depreciation chosen with respect to such property, be recognized by a person other than a U.S. person.

Although as discussed above, we believe that the Service and taxpayers will be better served through the inclusion of a catch-all exception to the triggering event rules, we believe it is appropriate to address, either in examples or the operative provisions of the regulations, a number of common business transactions which should not under the provisions of the Notice trigger recognition of the Built-in Gain in the Section 721(c) Property. We have provided a suggested list of certain of those transactions below. Certain of the transactions are discussed later in the scope section of these Comments.

2. Specific Acceleration Event Exceptions

Under the Notice, acceleration of remaining Built-in Gain with respect to an item of Section 721(c) Property is to occur upon any transaction that either would reduce the amount of remaining Built-in Gain that a U.S. Transferor would recognize under the Gain Deferral Method if the transaction had not occurred or could defer the recognition of the Built-in Gain. The exceptions from acceleration for the transfer of an interest in a Section 721(c) Partnership to a domestic corporation seem eminently reasonable, as following such a transfer the remaining Built-in Gain in the Section 721(c) Property will be taken into account by the acquiring domestic corporation. Additionally, the exceptions for certain transfers of Section 721(c) Property by a Section 721(c) Partnership to a domestic corporation also are appropriate, notwithstanding that the original U.S. Transferor will no longer include in income any amount attributable to the Built-in Gain under the remedial allocation method (due to the stock in the transferee

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67 See H. Conf. Rep. 105-220, at 628-29 (explaining that, instead of the excise tax that applied under prior law to transfers to foreign partnerships, regulatory authority was being granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain “otherwise would be transferred to a foreign partner”).

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corporation not being amortizable or depreciable), as the remaining amount of the Built-in Gain will be taken into income by a U.S. person at some point in the future. These examples seem to illustrate that the mere deferral of gain alone ought not to be viewed as being sufficient to constitute an Acceleration Event, particularly where a U.S. taxpayer will ultimately recognize such gain. Additionally, certain transactions that do not involve actual, but, rather, deemed or arguably deemed, transfers (i.e., technical terminations under section 708(b)(1)(B) and conversions or recapitalizations) should not be considered Acceleration Events.

a) Technical Terminations

If there is a technical termination of a partnership under section 708(b)(1)(B), the partnership is deemed to transfer all of its assets and liabilities to a “new” partnership in exchange for interests in the new partnership, and then to distribute the interests in the new partnership to its partners in liquidation of their interests.

The resulting consequences of a technical termination are two-fold in the context of the Notice. First, to the extent any Section 721(c) Property was also depreciable property, the recovery period for such property is restarted. As a result, the recovery period for Built-in Gain would also be extended, leading to a technical termination qualifying as an Acceleration Event by virtue of deferring the recognition of Built-in Gain. Second, since the contribution of assets and liabilities to a “new” partnership is governed by section 721, it should be considered whether a technical termination would result in any U.S. Transferors reassessing whether the assets contributed to the “new” partnership are Section 721(c) Property. However, no new section 704(c) built-in gain is created upon a technical termination, and property deemed contributed to a new partnership as a result of a technical termination is treated as section 704(c) property in the hands of the new partnership only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination. Thus, reassessing and treating property deemed transferred to a new partnership upon a technical termination as Section 721(c) Property appears inconsistent with existing authorities concerning section 704(c) and technical terminations. If new

68 As discussed further below, this approach is consistent with Congressional intent underlying section 721(c), which only mandates the recognition of gain when it is certain that such gain will not be taken into account by a U.S. person.
69 Reg. § 1.708-1(b)(4). The deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership, although it is treated as a sale or exchange for purposes of section 743. Reg. § 1.761-1(e). Thus, the deemed distribution will not trigger an endless cycle of technical terminations. Similarly, the deemed distribution of an interest in a resulting partnership by a terminating partnership in an assets-over merger under section 708(b)(2)(A) is not treated as a transfer of interests in the resulting partnership for purposes of section 708(b)(1)(B). Rev. Rul. 1990-17, 1990-1 C.B. 119. A partnership that terminates under section 708(b)(1)(B) retains its employer identification number and generally is required to file (i) a short-year final return for the taxable year ending with the date of its termination and (ii) a second short-year return beginning after the date of termination of the terminated partnership. Notice 2001-5, 2001-1 C.B. 327.
70 I.R.C. § 168(i)(7).
71 Reg. § 1.704-3(a)(3).
Section 721(c) Property is nonetheless deemed to arise upon a technical termination, it may be necessary to determine the timing of such assessment (i.e., at the time of original contribution, even if prior to the effective date of the Notice, or at the time of contribution to the “new” partnership).

Generally, after a section 721 contribution, a partnership transferee continues to depreciate the property’s remaining adjusted tax basis over the remaining recovery period for the property. However, when a partnership technically terminates, the contribution of assets to the “new” partnership is treated as an actual contribution for federal income tax purposes. Though the general “step-in-the-shoes” rule set forth in section 168(i)(7) for depreciation of tangible property under section 168 would apply, the flush language of section 168(i)(7) creates an exception to the general rule and states that subparagraph (A) does not apply in the case of a termination of a partnership under section 708(b)(1)(B). Because step-in-the-shoes treatment is not available for the new partnership resulting from a technical termination, for depreciation purposes (and for the applicable convention purposes in particular) under section 168, the property should be treated as if it were disposed of by the old partnership and then acquired by the new partnership. As a result, the recovery period will be reset. Resetting the recovery period will result in an extension of the period of time in which the depreciation deductions are to be claimed though the total amount of depreciation allowable will be the same whether or not the depreciation period is reset. In other words, the recognition of gain inherent in the tangible depreciable property would be drawn out over a longer period of time. It is important to note that for amortization purposes under section 197, the step-in-the-shoes rule, rather than a reset, applies with respect to the transferee’s basis in both section 721 transactions and section 708(b)(1)(B) terminations.

Arguments in favor of specifically excluding technical terminations from being considered an Acceleration Event are two-fold. First, a technical termination is more akin to the transactions already specifically excluded from qualifying as Acceleration Events in that the partnership’s property would not be altered by operation of a technical

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72 Section 168(i)(7)(A) provides special rules for property acquired in the transfers covered by section 168(i)(7)(B) and states that the transferee is treated as the transferor for purposes of computing the depreciation deduction under section 168 with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. Thus, the transferee of property steps into the shoes of the transferor to the extent the property’s basis is not increased as a result of a transfer in a covered transaction. The transactions listed in 168(i)(7)(B) include contributions to partnerships under section 721 and distributions subject to section 731.

73 In addition, this characterization was confirmed in the preamble to proposed regulations under section 708 published in 1996, which stated that “the proposed regulations will not change the effect of a termination on the depreciation of partnership property by the new partnership. Property deemed contributed to the new partnership will continue to be subject to the anti-churning provisions of section 168(f)(5), which generally require the new partnership to depreciate the property as if it were newly acquired property under the same depreciation system used by the terminated partnership. This result is required by statute and is not affected by the specific mechanics of a termination under section 708(b)(1)(B). See I.R.C. § 168(f)(5); 168(i)(7); 168(e)(4) and (f)(10) (repealed 1986).” PS-5-96, 61 Fed. Reg. 21985, 21987 (May 13, 1996), 1996-28 I.R.B. 17, 18.

74 I.R.C. § 197(f)(2).
termination. Second, though it is clear that any Built-in Gain with respect to tangible depreciable property would be deferred by operation of a longer recovery period, such gain will ultimately be recognized in full by a U.S. Transferor. As stated above, we do not believe triggering income recognition upon the deferral of gain is consistent with Congressional intent at the time of the enactment of section 721(c).

We recognize that some may view the deferral associated with a technical termination as akin to the avoidance of gain. However, so long as that gain is not recognized by a non-U.S. person, that deferral is no different than what would have happened had there not been any Related Foreign Persons in the partnership. Further, we believe that providing a blanket exception for technical terminations should not be troubling from a policy perspective as there is an inherent limitation in extending the recovery period for tangible depreciable property to an unreasonable length and/or manipulating it such that technical terminations become a form of abuse simply to defer gain, since tangible property has a fixed, useful life.

In addition, the Notice also relies on the Secretary’s authority to issue regulations under section 367, which only grants authority to address transactions involving intangible property. As technical terminations do not restart the recovery period with respect to section 197 property, no apparent policy reason exists for treating technical terminations as giving rise to recognition of Built-in-Gain.

For the reasons discussed above, we recommend that future guidance exclude technical terminations of partnerships under section 708(b)(1)(B) from being considered an Acceleration Event.

b) Partnership Conversions and Recapitalizations

Where a partnership conversion takes place under the local law, a tax construct similar to that of a partnership termination under section 708(b)(1)(B) could apply and could implicate concerns similar to those arising under a technical termination. Revenue Rulings 84-52,75 95-3776 and 95-5577 (the “Conversion Rulings”) set forth the federal income tax consequences of three separate partnership conversions. Broadly, the Conversion Rulings conclude that a conversion constitutes an exchange under section 721, but such exchange generally results in no gain or loss recognition or any other meaningful federal income tax consequences. Rather, the Conversion Rulings and numerous private letter rulings make clear that the resulting entity is simply viewed, for federal income tax purposes, as a continuation of a converting partnership.

Because the Conversion Rulings reference section 721, one way to read the rulings is that conversions of general into limited partnership interests, as well as conversions of limited into general partnership interests, are treated as interests-over or

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75 1984-1 C.B. 157.
76 1995-1 C.B. 130.
assets-over transfers to a new partnership with nonrecognition pursuant to section 721. If the Service followed this approach, then conversions would be subject to the Notice. However, most practitioners seem to agree that the better view is that a conversion is a “tax nothing” with the old partnership simply continuing to exist.\textsuperscript{78} This view is consistent with section 708(b)(1)(A) and Rev. Rul. 66-264,\textsuperscript{79} and the fact that the members, assets, operations and overall capital structure of the partnership remain unchanged.

Accordingly, it seems that treating a partnership conversion or recapitalization as an Acceleration Event would be inconsistent with the Conversion Rulings, which do not otherwise contemplate a meaningful federal income tax consequence (in particular, recognition of gain) from the transaction. Thus, we recommend that in future guidance conversions and recapitalizations of partnerships be explicitly excluded from Acceleration Events.

In contrast, in cases where a partnership conversion results in the conversion of a U.S. or foreign partnership to a foreign corporation, it seems reasonable to conclude that such transaction should be considered an Acceleration Event, subject to the exceptions contained in the Notice. In such case, if the transferee is a foreign corporation, the U.S. Transferor will be required to take into account an amount under either section 367(a) or (d), as applicable. Further, to the extent the transferee is a domestic corporation, as discussed further below, we believe that such transaction should also result in a termination of the use of the Gain Deferral Method, provided any remaining Built-in Gain will be taken into account by the domestic transferee corporation.

c) Distribution to Unrelated Foreign Partner After Seven-Year Period of Section 704(c)(1)(B) or Distribution to U.S. Transferor

The Notice requested comments on whether an Acceleration Event should exclude a distribution of Section 721(c) Property to an unrelated foreign partner beyond the seven-year limitation of section 704(c)(1)(B). Such a distribution could technically

\textsuperscript{78} The view seems consistent with a recent private letter ruling, PLR 201605004 (Oct. 19, 2015), in which the Service concluded that a conversion did not result in the assets of the partnership being contributed or distributed to the partners of the partnership. In this ruling, PRS 2 owned all of the interests in PRS 1, a disregarded entity for federal income tax purposes. PRS 1, along with PRS 4, owned all the interests in PRS 3. Subsequently, PRS 4 exchanged its interest in PRS 3 for an interest in PRS 1, causing PRS 3 to become a disregarded entity and PRS 1 to become a partnership for federal income tax purposes. Based on these facts, the Service concluded that PRS 1 is a continuation of the partnership, PRS 3, and that there was no termination of the partnership under section 708. The Service ruled that: (1) the conversion of PRS 3 into PRS 1 did not cause the taxable year of the partnership to close under section 706, (2) the basis of the assets held by PRS 1 is the same as the basis of the assets in the hands of PRS 3 prior to the conversion, and (3) the conversion of PRS 3 into PRS 1 did not result in the assets of the partnership being contributed or distributed to the partners of the partnership.

\textsuperscript{79} 1966-2 C.B. 248 (holding that a partnership did not terminate when three partners of a five-partner partnership purchased the partnership’s assets at a judicial sale, and then continued the partnership’s business through a new three-person partnership).
result in a reduction of the amount of any remaining Built-in Gain that a U.S. Transferor would recognize under the Gain Deferral Method. Given that Treasury and the Service are using section 704(c) to implement section 721(c) and only in a related party context, we do not believe that a rule that an Acceleration Event arises upon a transfer of Built-in Gain Property beyond the seven-year period of section 704(c)(1)(B) to an unrelated foreign person is necessary to achieve Treasury and the Service’s purpose. Accordingly, we recommend that a distribution of Section 721(c) Property to an unrelated foreign partner that is beyond the seven-year period not be treated as an Acceleration Event.

We have a further comment on the distribution of Section 721(c) Property by a partnership. In general under a plain reading of the Notice, a distribution of Section 721(c) Property by a partnership to a contributing partner would be considered an Acceleration Event since the property will no longer be considered partnership property, and, as such, the partnership can no longer continue to apply the remedial allocation method with respect to such property.

However, we believe that the distribution of the Section 721(c) Property to the U.S. Transferor, or a substituted U.S. Transferor, should not constitute an Acceleration Event, but rather, should be treated as an event that terminates the requirement to apply the Gain Deferral Method (a “terminating event”) for purposes of the Notice. In particular, the provisions of subchapter K have specific rules addressing the concerns regarding whether such a distribution should otherwise trigger gain, including the anti-mixing bowl rules of sections 704(c)(1)(B) and 737. We believe that these rules, coupled with the provisions of section 707, sufficiently protect against any inappropriate federal income tax structuring that could be achieved through such distributions to the contributing partner.

Moreover, and regardless of whether section 737 (or another provision) applies, the original Built-in Gain, less any prior remedial items of income, would be retained in full by the U.S. Transferor (or another U.S. taxpayer). Further, to the extent that as a result of the distribution the Built-in Gain in the Section 721(c) Property has been reduced, the Service and Treasury could require as a condition for termination that the original Built-in Gain less any remedial allocations of income be preserved by mandating a basis reduction approach similar to that contained in the current regulations under section 367(a).

We believe it is important to recognize that a similar rule is already provided by Section 4.05(3) of the Notice which specifically excludes certain transactions in which there is a transfer of a partnership interest to a domestic corporation (i.e., where the U.S. Transferor transfers an interest in a Section 721(c) Partnership to a domestic corporation in a transaction to which either section 351(a) or section 381(a) applies, or a Section 721(c) Partnership transfers an interest in a lower-tier partnership that owns Section 721(c) Property to a domestic corporation in a transaction to which section 351(a) applies, provided that in both cases the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor for all purposes of the Notice).

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80 See, e.g., Reg. § 1.367(a)-8(o)(1)(i) and -8(o)(5)(iii).
d) Other Transfers to U.S. Persons

In addition to distributions, we believe that a terminating event should include any transaction that results in the transfer of Section 721(c) Property to a U.S. taxpayer, regardless of whether such taxpayer is the original U.S. Transferor as defined under the Notice. Accordingly, in addition to situations in which a Section 721(c) Partnership converts to a domestic corporation as discussed above, we believe that a transfer of the Section 721(c) Property to a domestic corporation should not merely be an exception to an Acceleration Event, but should instead be treated as a terminating event. In such a case, any remaining Built-in Gain in the Section 721(c) Property will be taken into account by a U.S. person and the policies underlying section 721(c) are appropriately addressed.

e) Redemption or Removal of the Related Foreign Person

For similar reasons, we believe that a terminating event should also include a situation in which the Related Foreign Person is no longer a partner in the Section 721(c) Partnership. In such a case, assuming that the Related Foreign Person’s exit was not achieved through a distribution of the Section 721(c) Property, the potential for recognition of the Built-in Gain by a related person other than a U.S. person has been removed, and there is no reason for the Gain Deferral Method to continue to apply. In addition, under the provisions of subchapter K, the partnership will continue to apply the remedial allocation method of section 704(c) to the contributed property and, thus, the Built-in Gain should continue to be taken into account under those provisions. Accordingly, the primary effect of treating this transaction as a terminating event will be to remove the Section 721(c) Partnership and its partners from burdensome and unnecessary filing requirements and to avoid the continued potential application of an Acceleration Event in unwarranted situations.

C. Correlative Adjustments

1. In General

When the Gain Deferral Method is applied, a U.S. Transferor must recognize gain upon an Acceleration Event with respect to an item of Section 721(c) Property in an amount equal to the remaining Built-in Gain that would have been allocated to the U.S. Transferor if the Section 721(c) Partnership had sold the item of Section 721(c) Property immediately before the Acceleration Event for its fair market value.\textsuperscript{81} The Notice, moreover, specifically states that the regulations will provide for corresponding adjustments to the basis of the Section 721(c) Property and the U.S. Transferor’s partnership interest to reflect the recognition of the remaining Built-in Gain.\textsuperscript{82}

\textsuperscript{81} 2015-34 I.R.B. 210 at 214 (§ 4.05(2)).
\textsuperscript{82} \textit{Id.}
2. Correlative Adjustments Resulting from Current Gain Recognition

As stated above, Section 4.02 of the Notice provides that Treasury and the Service intend to issue regulations providing that section 721(a) will not apply when a U.S. Transferor contributes an item of Section 721(c) Property (or a portion thereof) to a Section 721(c) Partnership, unless the Gain Deferral Method is applied with respect to the Section 721(c) Property. Section 721(a), in turn, provides that neither a partnership nor any of its partners shall recognize gain or loss upon a contribution of property to the partnership in exchange for a partnership interest. Accordingly, if a U.S. Transferor contributes an item of Section 721(c) Property (or a portion thereof) to a Section 721(c) Partnership and the Gain Deferral Method is not applied with respect to the Section 721(c) Property, then both the U.S. Transferor and Section 721(c) Partnership must recognize gain because section 721(a) does not apply (“Current Gain Recognition”).

Under current law, section 721(a) also does not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated. If section 721(b) applies, other sections of the Code require both the contributing partner and partnership to make certain basis adjustments to avoid replicating gain in the contributing partner’s interest and the contributed property. Specifically, (i) section 722 requires the contributing partner to increase the basis of its partnership interest by the amount of gain the contributing partner recognized under section 721(b) and (ii) section 723 requires the partnership to increase the basis of the contributed property by the amount of gain the contributing partner recognized under section 721(b).

Because section 721(b) also turns off non-recognition treatment under section 721(a), we recommend that Treasury and the Service adopt regulations under section 721(c) requiring similar basis adjustments as described directly above in the case of Current Gain Recognition.

Example 1: Parent, a U.S. corporation, owns all of the issued and outstanding stock of X and Y. Under the terms of the Notice, X is properly classified as a U.S. Transferor and Y is properly classified as a Related Foreign Person. X and Y form a partnership, PRS, as equal partners. Specifically, X contributes Property A with a value of $10 million and an adjusted basis of $5 million. Y contributes $10 million in cash. X, Y, and PRS do not adopt the Gain Deferral Method with respect to Property A.

Because a U.S. Transferor contributes an item of Section 721(c) Property to a Section 721(c) Partnership, section 721(a) does not apply to X’s contribution of Property A.

83 See also Reg. § 1.721-1(a).
84 It is not necessary to determine whether the U.S. Transferor or the Section 721(c) Partnership will recognize loss because Section 4.01(3) generally defines Section 721(c) Property as property with a Built-in Gain.
85 I.R.C. § 721(b).
Property A. Although X recognizes $5 million in gain, unless an adjustment is made, X would still have a basis in its interest of $5 million under section 722 and PRS would have a basis in Property A of $5 million under section 723. In other words, absent an adjustment, X and PRS would replicate the $5 million built-in gain in both X’s interest and Property A. However, if, as we recommend, Treasury and the Service adopt regulations similar to the basis adjustments resulting from section 721(b), X’s adjusted basis in its PRS interest would increase to $10 million, as would PRS’s adjusted basis in Property A.

3. Correlative Adjustments Resulting from an Acceleration Event

As discussed above, a U.S. Transferor must recognize gain upon an Acceleration Event in an amount equal to the remaining Built-in Gain that would have been allocated to the U.S. Transferor if the Section 721(c) Partnership had sold the item of Section 721(c) Property immediately before the Acceleration Event for its fair market value. If there is an Acceleration Event, however, the Notice specifically states the regulations will provide for corresponding adjustments to the basis of the Section 721(c) Property and the U.S. Transferor’s partnership interest to reflect the recognition of the remaining Built-in Gain. For the reasons discussed below, we recommend that the basis adjustments resulting from an acceleration event (i) should be prospective only and (ii) generally should mirror sections 704(c)(1)(B) and 737, which also address the effect of a subsequent distribution of partnership property on a prior contribution of the same or different property.

3a) The Basis Adjustments Resulting from an Acceleration Event Should Be Prospective Only

Under section 367(a), certain otherwise tax-free exchanges may nevertheless be wholly or partially taxable in the United States. Specifically, section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Accordingly, a U.S. person will recognize gain on the exchanges described in section 367(a)(1) unless an exception set forth in another paragraph of section 367(a), or the regulations thereunder, applies.

Congress originally adopted the predecessor to current section 367(a) in 1932, citing concerns that a transfer of appreciated property to a foreign corporation would otherwise be a “serious loophole.” In particular, the legislative history states that

[p]roperty may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for avoidance of taxes. Taxpayers having large

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86 2015-34 I.R.B. 210 at 214 (§ 4.05(2)).
87 Id.
unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided.\textsuperscript{89}

When issuing the Notice, the government also cited similar concerns. Specifically, Section 3 of the Notice states that “[t]he Treasury Department and the IRS are aware that certain taxpayers purport to be able to contribute, consistently with sections 704(b), 704(c), and 482, property to a partnership that allocates the income or gain from the contributed property to related foreign partners that are not subject to U.S. tax.” Given the similarity of the policy considerations, it is likely that Treasury and the Service will look to section 367(a) when drafting regulations under section 721(c).

In particular, if a U.S. transferor owns at least five percent of the transferee foreign corporation after the outbound transfer of stock or securities, the U.S. transferor can avoid immediate gain recognition under section 367(a) provided that the U.S. transferor enters into a GRA.\textsuperscript{90} The term of a GRA generally runs for five full taxable years following the close of the taxable year of the initial transfer.\textsuperscript{91} However, if the foreign corporation disposes of the transferred stock or securities during the term of the GRA (a “triggering event”), the U.S. transferor must recognize the amount of built-in gain in the transferred stock or securities at the time of contribution. In other words, a GRA is very similar to the Gain Deferral Method because a U.S. transferor can avoid current gain recognition under section 367(a) provided there is not a subsequent triggering event that reduces the amount of built-in gain the U.S. transferor would have recognized had it not entered into a GRA.

Unlike the Notice, however, the regulations under section 367(a) provide rules for basis adjustments resulting from a triggering event.\textsuperscript{92} Specifically, when a U.S. transferor recognizes gain as a result of a triggering event, Regulation section 1.367(a)-8(c)(4) requires an increase in the adjusted basis of the stock or securities that the U.S. transferor transferred to, and received from, the foreign corporation as of the date of the initial transfer. It is therefore possible that Treasury and the Service would make the basis adjustments resulting from an Acceleration Event retroactive as well. It is our suggestion, however, that the government should not make the basis adjustments resulting from an Acceleration Event retroactive for reasons of administrability as demonstrated by the following example.

\textit{Example 2:} Parent, a U.S. corporation, owns all of the issued and outstanding stock of W and Z. Under the terms of the Notice, W is properly classified as a U.S. Transferor and Z is properly classified as a Related Foreign Person. In 2016, W and Z form a partnership, PRS, as equal partners. Specifically, W contributes Property B with a value of $20 million and an adjusted basis of $10

\textsuperscript{89} Id.
\textsuperscript{90} Reg. § 1.367(a)-3(b)(1)(ii).
\textsuperscript{91} Reg. § 1.367(a)-8(c)(1)(i).
\textsuperscript{92} Reg. § 1.367(a)-8(c)(4).
million. Z contributes $20 million in cash. Because W, Z, and PRS adopt the Gain Deferral Method with respect to Property B, section 721(a) applies with respect to W’s contribution of Property B. Accordingly, under section 722, W has a substituted basis in its interest of $10 million and Z has a substituted basis in its interest of $20 million. In addition, PRS holds Property B with a basis of $10 million under section 723.

In 2020, when W’s basis in its interest is still $10 million, PRS distributes $15 million of cash to W. Accordingly, (i) W recognizes $5 million of gain under section 731(a) and (ii) W’s basis in its interest is reduced to zero under section 733. If there is an Acceleration Event with respect to Property B in 2024 at a time when PRS still holds Property B with a basis of $10 million, W would be required to recognize $10 million of gain under Section 4.05(2) of the Notice.

If the Notice would provide W with a correlative adjustment of $10 million to the basis of its interest and this correlative adjustment would be retroactive to the time that W contributed Property B to PRS in 2016, it is possible that W would not have recognized gain under section 731(a) when PRS distributed $15 million to W in 2020 because W would have had a basis in its interest of $20 million. However, it is likely that W would not be allowed to file an amended return in 2024 for 2020 because the three year statute of limitations on filing a refund claim under section 6511 would have expired.

Therefore, we recommend that Treasury and the Service not make the correlative adjustments resulting from an Acceleration Event retroactive because this would create numerous administrative difficulties, as demonstrated in Example 2. Accordingly, we recommend that the basis adjustments resulting from an Acceleration Event be made prospective only.

b) The Basis Adjustments Resulting from an Acceleration Event Generally Should Mirror Sections 704(c)(1)(B) and 737

If, at the time of contribution, a property’s fair market value differs from the contributing partner’s adjusted tax basis, the contributed property is section 704(c) property and allocations with respect to that property are subject to section 704(c). Section 704(c)(1)(A), in turn, requires a partnership to allocate income, gain, loss, and deduction with respect to section 704(c) property so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.

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93 It is possible that W could take advantage of the mitigation provisions under sections 1311 through 1314 but this is beyond the scope of the Comments.
95 I.R.C. § 704(c)(1)(A) and Reg. § 1.704-3(a)(1).
96 Reg. § 1.704-3(a)(1).
To reduce opportunities for circumventing section 704(c)(1)(A) through partnership distributions, Congress enacted sections 704(c)(1)(B) and 737. For instance, prior to 1989, a contributing partner did not recognize any gain on a distribution of the contributed property to a non-contributing partner. Accordingly, when the partnership distributed the section 704(c) property to a non-contributing partner, the contributing partner would not recognize any pre-contribution gain and therefore could avoid application of section 704(c)(1)(A). To prevent this result, Congress added section 704(c)(1)(B) as part of the Omnibus Budget Reconciliation Act of 1989. Very generally, it provides that if a partnership distributes section 704(c) property to a partner other than the contributing partner within seven years of the section 704(c) property’s contribution, the contributing partner is required to recognize any remaining pre-contribution gain or loss.

However, Congress’s enactment of section 704(c)(1)(B) in 1989 was not entirely successful in eliminating a contributing partner’s ability to avoid section 704(c)(1)(A) because section 704(c)(1)(B) only addressed distributions of section 704(c) property to a non-contributing partner. As a result, the contributing partner could receive a distribution of property other than the originally contributed section 704(c) property and avoid section 704(c)(1)(A) gain. Accordingly, the Energy Policy Act of 1992 added section 737. The Conference Report accompanying this legislation noted:

[T]he committee is concerned that a partner who contributes appreciated property to a partnership may be able to avoid or defer the recognition of gain [under section 704(c)(1)(A) and (c)(1)(B)] with respect to that property through the mechanism of having the partnership distribute other partnership property to him in partial or complete redemption of his interest while the partnership continues to own the contributed property.

Very generally, section 737(a) provides that a distribution of property to a partner results in gain recognition to the partner in an amount equal to the lesser of (i) the “net precontribution gain” or (ii) the excess of the fair market value of the property received in the distribution (other than money) over the adjusted tax basis of the distributee’s partnership interest immediately before the distribution (reduced by the amount of money received in the distribution). Section 737(b) defines “net precontribution gain” as the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) if all property that had been contributed to the partnership by the distributee

97 I.R.C. § 731(b).
98 Pub. L. No. 101-239, 103 Stat. 2106. See also H.R. Rep. No. 101-247 (1989), which indicates that Congress intended section 704(c)(1)(B) to eliminate the inconsistent treatment of sales and distributions by a partnership and thereby prevent partners from circumventing the rule requiring pre-contributing gain or loss on contributed property to be allocated to the contributing partner by distributing the property to another partner.
102 I.R.C. § 737(a).
partner within seven years of the distribution, and is held by the partnership immediately before the distribution, had been distributed by the partnership to another partner.\(^\text{103}\)

Based on the above, it appears that Congress enacted section 704(c)(1)(B) to prevent taxpayers from avoiding the recognition of built-in gain on appreciated property contributed by a partner by distributing the property to a non-contributing partner. Section 737, in turn, serves as a backstop to the gain recognition provisions under section 704(c)(1)(B). Given that these provisions and the Notice are both aimed at preventing a partner from avoiding recognizing built-in gain on property in connection with a contribution of the property to a partnership and a distribution of that (or different) property by the partnership, we believe that the basis adjustments resulting from an Acceleration Event generally should mirror the existing basis adjustments under sections 704(c)(1)(B) and 737, especially because, as we have recommended, the basis adjustments resulting from an Acceleration Event should not be retroactive as under the GRA regime.

D. Potential Overbreadth of the Notice and Recommendations for Tightening the Scope

As discussed above, the Notice’s stated purpose is to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. Our perception is that the Notice generally is ultimately aimed at preventing the shifting of built-in gain to related foreign taxpayers, resulting in the gain not being subject to U.S. federal income taxation.

As discussed below, however, because the Notice would apply whenever the U.S. Transferor and a Related Person together merely own more than 50% of the interests in partnership capital, profits, deductions, or losses, there may be numerous partnership situations involving significant ownership held by persons unrelated to the U.S. Transferor (resulting in a relatively insignificant possibility of built-in gain being shifted to foreign persons related to the U.S. Transferor) that are subject to the rules of the Notice as currently written. There may also be situations in which, regardless of ownership, the income related to the contributed property is subject to U.S. federal income taxation. In these regards, the scope of the rules in the Notice appears overly broad.

Accordingly, below we discuss recommendations concerning the appropriate ownership standard for determining whether a partnership is subject to the rules, the definition of a partner’s interest in the partnership, and a proposal to exclude situations in which the income from the property is subject to U.S. federal income taxation, regardless of ownership. In addition, we recommend that future guidance not apply to a partnership that does not receive any actual contributions of property on or after the effective date (August 6, 2015) but undergoes a technical termination or a conversion or recapitalization after the effective date.

\(^{103}\) \textit{See also} Reg. § 1.737-1(c)(1) (repeating the definition of net precontribution gain).
1. Appropriate Ownership Threshold

One way to address the potential overbreadth of the Section 721(c) Property definition would be to remove or increase the 50% threshold in the Ownership Threshold. By placing the threshold at more than 50%, the rules described in the Notice could apply to partnerships having third party partners owning as much as 49% of the partnership (however that is defined). Before entering into a partnership, a third party, if it is not indifferent to U.S. federal income taxation, would typically negotiate, often vigorously, over which of the section 704(c) methods should be adopted by the partnership. That third party’s negotiating position would typically depend upon whether it was contributing property to the partnership having a basis different from fair market value. If the third party contributes only cash for its interest, it will often (but not always) seek the adoption of the remedial allocation method, whereas if it is contributing appreciated property it may insist that the traditional method, or at least the traditional method with curative allocations, be adopted. Whatever, the case, we believe it is problematic for the Notice to restrict the ability of a partnership to adopt a section 704(c) method other than the remedial allocation method where that choice will affect one or more unrelated persons with a substantial interest in the partnership if that or those unrelated persons are not indifferent to U.S. federal income taxation.

Treasury and the Service, in adopting a more than 50% ownership threshold to define a Section 721(c) Partnership, may have assumed that ownership of more than 50% of the interests in a partnership (however those percentages are determined) would normally allow the U.S. Transferor and its affiliates to dictate the section 704(c) method adopted by the partnership. In our experience, this assumption is unwarranted. Particularly where a partnership is large, even a 25% interest in partnership capital can be very significant and can give the prospective 25% partner meaningful leverage. Depending upon the particular facts, even persons with a smaller partnership interest that provides them with effective practical control may exert sufficient influence over the partnership’s choice of a section 704(c) method.

For these reasons, if the scope of the rules in the Notice generally is retained, we recommend that the combined more than 50% ownership threshold for the U.S. Transferor and the Related Person be increased, or that the rules create a rebuttable presumption that a partnership is not a Section 721(c) Partnership where the combined ownership by the U.S. Transferor and the Related Person is less than a relatively high level (e.g., 80%), provided the unrelated partner is not indifferent to U.S. federal income taxation and otherwise there is no obvious potential for abuse.

In addition, applying the more than 50% ownership threshold based on the U.S. Transferor and Related Person’s aggregate ownership captures arrangements where a Related Foreign Person owns a de minimis interest in the partnership. We do not believe that the rules of the Notice should apply to such a situation because any benefit obtained by the U.S. Transferor likely would be de minimis as well, indicating that the U.S. Transferor did not enter into the partnership for reasons contrary to the purpose of the
Notice. Therefore, we recommend that future guidance include a *de minimis* Related Foreign Person rule, provided there is no abuse. Depending on the facts, an ownership interest of five to ten percent of a partnership seems *de minimis*.

2. **More Than 50% Ownership Threshold**

   The disjunctive ownership standard under the Ownership Threshold can result in including in the coverage of the rules a single partner or group of partners owning more than 50% in one item but a much smaller interest in the others. For instance, in any given year, a partnership having preferred and common interests could have partners with dramatically different interests in partnership profits for that year. Take, for example, a partnership that has a partner with a net income preferred interest, but which does not earn enough income in a given year to allocate income to the preferred partner in an amount equal to the preferred partner’s preferred coupon. In such a situation, the preferred partner would be allocated all of the partnership’s income for the year, and would therefore, have a 100% interest in partnership profits that year, while it may have a considerably smaller interest in partnership capital. The same could be said for such a partnership that has only losses, which it must allocate fully to the common partner.

   Further complicating matters, partnership capital and profits are not clearly defined concepts. As described above, a partner’s interest in partnership profits can change year over year. Is this an annually tested concept or based on a partner’s expected profits over the life of the partnership? If share of profits is tested based on a partner’s expected profits over the life of the partnership, is that any different from a partner’s share of contributed capital? Often, on contribution, partners expect that they will receive partnership profits over the life of the partnership equal to the value of their contributed property discounted by some expected rate of return. This raises the related issue of how to define partnership capital. Is it a partner’s capital account, a partner’s entitlement on liquidation, or something else entirely? These issues are prevalent throughout subchapter K and it would be helpful if the rules in the Notice could be drafted to be clear in the definitions of these items.

   The potential unexpected outcomes arising due to the disjunctive ownership standard and the uncertainties in determining ownership in capital and profits also are reasons for further refining and narrowing the scope of the rules to situations that the Notice was apparently targeting: preventing the shifting of built-in-gain to related foreign taxpayers, resulting in the gain not being subject to U.S. federal income taxation.

3. **Limiting the Application of the Rules Where the Property Would Be Subject to U.S. Federal Income Taxation**

   Another approach to narrowing the scope of the rules would be to exclude from the definition of Section 721(c) Property any property whose income would be subject to U.S. federal income taxation in the hands of a foreign transferee: property whose gain is subject to FIRPTA or property that produces income that is ECI.
As discussed above, the Service issued Notice 2015-54 because of a concern that built-in gain inherent in property contributed to a partnership by a U.S. person could be shifted to a foreign person with the result that such gain when recognized would not be subject to U.S. federal income taxation.\textsuperscript{104} This purpose is consistent with the legislative history underlying section 721(c) and the repeal of the excise tax provisions of sections 1491 to 1494.\textsuperscript{105} However, as stated elsewhere in these Comments, we do not believe that the Notice and the underlying Gain Deferral Method should have any application where the gain remains subject to U.S. federal income taxation in the United States. In such a case, neither the stated purpose of the Notice nor the legislative history underlying section 721(c) support its application. As a result, it is our belief that the rules of the Notice should not apply to the extent the gain on the property remains subject to U.S. federal income taxation. In addition, because the deferral of the gain was not considered problematic by Congress when Congress enacted section 721(c), we do not believe that the analysis should be altered merely because the gain inherent in the property may not be recognized until sale or other disposition.\textsuperscript{106}

Accordingly, we recommend that Section 721(c) Property not include property the gain on which is subject to FIRPTA\textsuperscript{107} or property that produces ECI.\textsuperscript{108} In addition, we believe Treasury and the Service should strongly consider including an exception for property the gain on which would be subject to U.S. federal income taxation to a United States shareholder of the Related Foreign Person under section 951 and the provisions of subpart F of the Code.\textsuperscript{109} In particular, as with FIRPTA property and property that produces ECI, there is simply no policy justification to require the use of the remedial allocation method and the Gain Deferral Method if gain on the property contributed to the partnership would be subject to U.S. federal income taxation when recognized.

\textsuperscript{104} 2015-34 I.R.B. 210 at 212-13 (§ 3).
\textsuperscript{105} Pub. L. No. 105-34, 111 Stat. 788.
\textsuperscript{106} Although Treasury and the Service issued the Notice solely under the authority of section 721(c), we understand that concern could exist where the income from the property would not be subject to U.S. federal income taxation in the hands of the Related Foreign Person. However, in such cases, the appropriate method to address these issues would be through legislative action in Congress and not by expanding the scope of the Notice to a degree not intended by Congress upon the promulgation of section 721(c).
\textsuperscript{107} The Foreign Investment in Real Property Tax Act of 1980, enacted as Subtitle C of Title XI (the "Revenue Adjustments Act of 1980") of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980). Under the FIRPTA regime, gain or loss on the sale or exchange of certain real property located within the United States is treated as ECI, irrespective of whether the seller is actually engaged in a U.S. trade or business. In addition to interests in real property, the tax is also imposed on the sale or exchange of stock of certain domestic corporations (United States Real Property Holding Companies), if more than 50 percent of the corporation’s assets consist of interests in real property located within the United States. I.R.C. § 897. The collection of the tax under the FIRPTA provisions is accomplished through a withholding tax regime set forth in detail under section 1445 and the regulations thereunder.
\textsuperscript{108} We understand that there might be some concern with including such an exception, because following a contribution the partnership could discontinue the trade or business. However, in such cases, provisions currently exist which potentially subject such property to tax and mitigate the ability to avoid tax on historic built-in gain. See I.R.C. § 882. Accordingly, we do not believe this concern would justify the continued application of the Gain Deferral Method to such property.
\textsuperscript{109} I.R.C. §§ 951–954.
4. Application to Existing Partnerships Upon Technical Termination, Conversion, and Recapitalization

Under the terms of the Notice, a technical termination under section 708(b)(1)(B) of a partnership not currently subject to the Notice appears to result in a new partnership that qualifies as a Section 721(c) Partnership. In such a case, the deemed contribution from the terminated partnership to the new partnership of what is likely at the time of the technical termination property with built-in-gain would result in the new partnership potentially being a Section 721(c) Partnership and the property being Section 721(c) Property. In the case of existing partnerships, the technical termination would cause property that was not actually contributed by a U.S. person to a partnership on or after the effective date of the rules (i.e., August 6, 2015) to be subject to the Notice, despite there being no actual contributions of such property.

We believe such treatment would be inappropriate. If a technical termination were to cause a partnership that was not previously subject to the Notice to become subject to the Notice, appreciated property that was not Section 704(c) Property in the hands of a terminated partnership would be subject to rules in the Notice designed to enforce the policy behind section 704(c) even though under existing guidance such property would not be Section 704(c) Property in the hands of the new partnership. Accordingly, we recommend that the rules in the Notice not apply upon a termination of a partnership under section 708(b)(1)(B) with regard to property contributed to the partnership before August 6, 2015.

Similarly, subjecting any partnership that is not currently subject to the Notice but undergoes a conversion under local law would implicate concerns similar to those arising under a technical termination. In the Conversion Rulings (discussed above), the Service referenced section 721(a), implying a deemed transfer has occurred. However, conversions do not involve new contributions of property. Instead, the assets, operations and capital structure of the partnership remain unchanged. For reasons similar to those discussed above for not treating conversions as Acceleration Events, we recommend that a conversion should not cause incremental gain to be subject to section 721(c). Similarly, we recommend that recapitalizations that do not involve actual contributions of new property not cause incremental gain to be subject to section 721(c).

Subjecting a new partnership that came into existence as a result of a technical termination, or a partnership that undergoes a conversion/recapitalization, to the Notice seems to us to be inconsistent with the effective date provision in the Notice and would be a trap for the unwary.

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110 Under Regulation section 1.704-3(a)(3)(i), no new section 704(c) property arises upon the deemed transfer of assets and liabilities by the terminated partnership to the new partnership.