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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON NOTICE 2015-54, TRANSFERS OF PROPERTY TO PARTNERSHIPS WITH RELATED FOREIGN PARTNERS AND CONTROLLED TRANSACTIONS INVOLVING PARTNERSHIPS

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Report on Notice 2015-54, Transfers of Property to Partnerships with Related Foreign Partners and Controlled Transactions Involving Partnerships[1]

I. INTRODUCTION

This report provides comments on Notice 2015-54 (the "Notice"),[2] which announced that the United States Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") intend to issue regulations under Section 721(c) (the "Section 721(c) Regulations") to address certain transactions in which a United States person transfers appreciated property to a partnership that has foreign partners related to the transferor. These regulations are intended to combat what the Notice describes as potential abuses in which either inappropriately low valuations or partnership allocations are employed to shift built-in gain on contributed property to foreign partners or otherwise defer recognition of that gain by the U.S. contributor. As announced in the Notice, the Section 721(c) Regulations generally will be effective for transactions entered into after the date of the Notice. Our comments are limited to the provisions in the Notice relating to the forthcoming Section 721(c) Regulations proposed to be issued pursuant to Section 721(c). We intend to address the regulations to be proposed under Sections 482 and 6662 in a separate report.

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[1] The principal drafters of this Report were Stuart L. Rosow and Martin T. Hamilton, with substantial assistance from Jamie Bowles. Significant contributions were made by David Sicular, Philip Gall and Eric Sloan. Helpful comments were received from David Levere, Michael Schler and Kimberly Blanchard. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 2015-34 I.R.B. 210 (Aug. 6, 2015). Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treasury Regulations Section" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

Our principal recommendations include the following:

1. Regulations should be issued promptly in temporary and proposed form. Because the Notice is currently effective, there is a critical need for guidance to permit taxpayers to proceed with transactions that are motivated by legitimate business needs and to be able to determine the tax consequences of those transactions.

2. While we generally support the rules setting forth the partnerships to be covered, we believe the definition of a Section 721(c) Partnership should exclude those partnerships in which there is limited or no opportunity for abuse. These exempted partnerships would include partnerships where all or substantially all of the income is effectively connected income or where there is a relatively small interest held by related foreign partners and there is also a sufficient economic interest of an unrelated party with an adverse tax interest to prevent a shifting of built-in gain.

3. We recommend that the rules governing the Gain Deferral Method should be revised.

(a) We believe that the regulations should replace the proportionate allocation rule with an anti-abuse rule, under which allocations would be presumed to be abusive in any taxable year if either (i) the U.S. transferor's distributive share of partnership income is not at least equal to the difference between the Section 704(b) depreciation or amortization from the Section 721(c) property and the tax depreciation or amortization with respect to such property (such difference, the "Minimum Inclusion Amount") or (ii) the U.S. transferor's distributive share of partnership income does not exceed its share of Section 704(b) income by an amount at least equal to the Minimum Inclusion Amount. The presumption can be overcome if the U.S. transferor can establish that the failure to meet the tests was attributable to unforeseen events or circumstances.

(b) To the extent that the proportionate allocation rule is retained in the regulations as a requirement under the Gain Deferral Method, the application of the rule should be clarified through examples and the rule should have certain exceptions. For example, certain regulatory allocations (e.g., allocations of creditable foreign tax expenditures) should generally not cause violations of the rule.

(c) Finally, the rules need to address the interaction between the Gain Deferral Method's required use of the remedial allocation method under section 704(c) and the anti-churning rules under section 197.

4. While we support defining Acceleration Events broadly to include any transaction that would avoid or defer recognition of the built-in gain, the regulations should contain certain limits and exceptions. For example, partnership terminations under section 708(b)(1)(B) should not generally cause an Acceleration Event. In addition, the amount of built-in gain recognized as a result of an Acceleration Event should be limited to the amount of the positive basis adjustments under section 734 made with respect to the Section 721(c) property, rather than the entire remaining built-in gain. Certain members also believe that a distribution of the Section 721(c) property to an unrelated partner should not be an Acceleration Event.

5. We support enhanced reporting requirements and suggest that the reporting rules require detailed disclosure of the value, method used to determine value and the basis of computation of the remedial allocation method for property contributed with built-in gain.

III. SUMMARY OF NOTICE 2015-54

A. Background

1. Legislative History

Section 721(c) was added to the Code as part of the Taxpayer Relief Act of 1997 (the "1997 Act").[3] The Joint Committee Report on the 1997 Act[4] (the "1997 JCT Report") describes the provision as intended as a backstop to the provision of the 1997 Act repealing the excise tax that had been imposed on certain transfers of appreciated property by a U.S. person to a foreign partnership under (now former) Sections 1491 through 1494. The repeal of former Sections 1491 through 1494 was explained in the legislative history to the 1997 Act and the 1997 JCT Report as having been based on the expectation that the enhanced reporting requirements contained in the 1997 Act for foreign partnerships[5] would eliminate the need for former Sections 1491 through 1494.[6]

In addition to the foreign partnership information reporting rules, the 1997 Act also contained several provisions that provided the Secretary of the Treasury regulatory authority

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3 Pub. L. No. 105-34, 111 Stat. 787.

4 Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, Part Two: Taxpayer Relief Act of 1997 (H.R. 2014) at 317 (December 19, 1997).

5 These provisions are codified at Sections 6038, 6038B and 6046A.

6 Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, Part Two: Taxpayer Relief Act of 1997 (H.R. 2014) at 315 (December 19, 1997). ("The Congress understood that the prior-law rules imposing an excise tax on certain transfers of appreciated property to a foreign entity unless the requirements for an exception from such excise tax were satisfied operated as a trap for the unwary. The Congress further understood that the special source rule of prior law for deemed royalty payments with respect to a transfer of an appreciated intangible to a foreign corporation was intended to discourage such transfers. The Congress believed that the imposition of enhanced information reporting obligations with respect to both foreign partnerships and foreign corporations would eliminate the need for both these sets of rules."); *see* H. Rep. No. 105-148, at 537 (Jun. 24, 1997). The 1997 JCT Report notes that the 1997 Act contains detailed information reporting rules in the case of foreign partnerships. Foreign partnerships are generally required to file a U.S. partnership return for a taxable year if such foreign partnership has U.S. source income or engages in a U.S. trade or business. In addition, the 1997 Act requires a U.S. partner that controls a foreign partnership to file an annual information return with respect to such partnership. Furthermore, the 1997 Act imposed reporting requirements with respect to certain transfers by U.S. persons to foreign partnerships, which apply 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 exceeds $100,000. 1997 JCT Report at 315-317.

to regulate certain transfers to partnerships, among them Section 721(c). Section 721(c) grants the Secretary of the Treasury regulatory authority to deny nonrecognition under Section 721(a) to the contribution of property to a partnership (domestic or foreign) if the gain, when recognized, would be includible in the gross income of a person other than a U.S. person.[7] The 1997 Act also contained Section 367(d)(3), granting the Secretary of the Treasury regulatory authority to apply the rules of Section 367(d)(2) to transfers of intangible property to partnerships in circumstances consistent with the purposes of Section 367(d).[8] Since the enactment of the 1997 Act, Treasury has not exercised its grant of authority to promulgate regulations under either Section 721(c) or Section 367(d)(3).

2. <u>Applicable Law</u>

(a) Section 721

Section 721(a) provides that generally no gain or loss is recognized to a partnership or any of its partners upon the contribution of property to the partnership in exchange for an interest in the partnership. Under current law and regulations, a U.S. person generally does not recognize gain on the contribution of appreciated property to a partnership with foreign partners. The nonrecognition of gain rule is justified in part on the basis that section 704(c) requires that the contributing partner generally recognize that built-in gain. Specifically, Section 704(c)(1)(A) provides that partnerships must allocate income, gain, loss and deduction with respect to property contributed by a partners to the partnership 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. These allocations must be made in a manner consistent with the purpose of Section 704(c) to prevent shifting the tax consequences of a pre-contribution gain or loss among the

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[7] Pub. L. No. 105-34, 111 Stat. 787.

[8] *Id*.

partners.[9] Generally, allocations of income, gain, loss and deduction with respect to contributed property must be made using a reasonable method.[10] Treasury Regulations Section 1.704-3 describes three methods that are generally considered reasonable: the traditional method, the traditional method with curative allocations and the remedial allocation method.[11] Under the first two of these methods, the ceiling rule (as described in Treasury Regulations Section 1.704-3(b)(1)) may prevent allocations from fully achieving the purpose of Section 704(c). Only the remedial allocation method ensures that a contributing partner will not be able to shift the built-in gain to another partner.[12] Although the IRS may make adjustments to a Section 704(c) allocation method if the partnership's selection of such method is unreasonable, current Treasury Regulations do not permit the IRS to require a partnership to use the remedial allocation method.[13] As discussed above, Section 721(c) contains a broad grant of regulatory authority to Treasury to promulgate regulations that deny the nonrecognition benefits of Section 721(a) in circumstances where the gain ultimately would be recognized by a non-U.S. person.

(b) Section 367

Section 367 was enacted generally to prevent U.S. persons from avoiding U.S. tax by transferring appreciated property to foreign corporations in a variety of

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9 Treas. Reg. § 1.704-3(a)(1).

10 *Id*.

11 Treas. Reg. § 1.704-3(b) (traditional method), Treas. Reg. § 1.704-3(c) (traditional method with curative allocations), Treas. Reg. § 1.704-3(d) (remedial allocation method).

12 T.D. 8585, 1995-1 C.B. 120; *see also* Treas. Reg. § 1. 704-3(d). Special rules under Section 704(c)(1)(C) apply to contributions of property with a built-in loss.

13 Treas. Reg. § 1.704-3(a)(10). We believe that Treasury should consider strengthening the anti-abuse rule of Treas. Reg. § 1.704-3(a)(10) to apply to any method under section 704(c), including those specifically permitted, the application of which results in avoidance or deferral of the built-in gain, except as expressly permitted in the Code or regulations.

nonrecognition transactions.[14] Specifically, Section 367(d) was enacted to prevent U.S. persons from transferring intangible property offshore to defer U.S. tax on the profits generated by the intangibles.[15]

Section 367(d) provides that a U.S. person that transfers intangible property to a foreign corporation in an exchange described in Section 351 or Section 361 is treated as having sold such property in exchange for payments that are contingent upon the productivity, use or disposition of such property, and receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property, or, in the case of a disposition, following such transfer at the time of the disposition.[16] The amounts taken into account pursuant to Section 367(d) must be commensurate with the income attributable to the intangible.[17] While Section 367(d) on its terms applies only to transfers to foreign corporations, the 1997 Act added Section 367(d)(3) to the Code, granting Treasury the authority to apply the rules of Section 367(d)(2) to transfers of intangibles to foreign partnership in a manner consistent with the purposes of Section 367(d).

3. Reasons for Exercising Regulatory Authority

(a) Section 721(a)

The Notice states that Treasury and the IRS are aware that certain taxpayers maintain that the allocations of income or gain with respect to contributed property may be made to related foreign partners that are not subject to U.S. tax in a manner that is

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[14] Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170) (Dec. 31, 1984).

[15] H. Rep. No. 98-432, at 1311-15 (1984).

[16] Section 367(d)(2)(A).

[17] *Id*.

consistent with Sections 704(b), 704(c) or 482.[18] According to the Notice, these allocations result from the use of Section 704(c) methods other than the remedial allocation method or result from incorrect valuations. Accordingly, Treasury and the IRS have determined that it is appropriate to use the regulatory authority granted in Section 721(c) to override nonrecognition treatment under Section 721(a) with respect to transfers of property in which the gain, when recognized, could be includible in the income of a related foreign person. The Notice states that Treasury and the IRS believe that Section 721(c) is more appropriate to act under than Section 367(d)(3) because the transactions at issue are not limited to transfers of intangible property.

(b) Section 482

The Notice also provides that Treasury and the IRS intend to issue regulations under Sections 482 and 6662 relating to controlled transactions involving partnerships and cost sharing regulations. According to the Notice these regulations are motivated, at least in part, by Treasury's view that taxpayers are using incorrect valuations for transferred property. As noted above, we intend to address the issues presented under those provisions in a subsequent report.

[18] The Notice does not provide illustrations of arrangements that give rise to this concern. Nevertheless, it would appear that the tax avoidance sought to be prevented by the Notice could be present in situations in which the ceiling rule would prevent allocations of tax items to match the book allocations and transactions employing low valuations of the contributed property to give the contributing partner an inappropriately small interest in the partnership. Consider, for example, the contribution of property with a value of $1000 and tax basis of $100, which is amortizable over 10 years. If the non-contributing partners have a 90% interest in the partnership, and the partnership uses the traditional method, they would be entitled to an allocation of book depreciation of $90 but can be allocated only $10. In that case, a portion of the section 704(c) gain will be deferred until the ultimate liquidation of the partnership. In the case of partnership largely among related parties, that liquidation may be postponed until far in the future and perhaps beyond through a distribution of the contributed property after 7 years. This allocation may also be distorted if, under arms-length principles, the contributing partner would be entitled to a larger interest in the partnership.

B. Section 721(c) Regulations

1. General Rule – Current Gain Recognition

The Section 721(c) Regulations will turn off nonrecognition of gain under Section 721(a) for the following transactions unless the exception set forth in the following sentence applies: a United States person (within the meaning of Section 7701(a)(30)) (the "U.S. Transferor") contributes property with built-in gain ("Section 721(c) Property")[19] to a partnership in which, after the contribution, (a) a related foreign person is either a direct or indirect partner of the Section 721(c) Partnership and (b) the U.S. Transferor and one or more related persons own more than 50% of the interests in partnership capital, profits, deductions or losses (a "Section 721(c) Partnership").[20] The nonrecognition rules will continue to apply, however, to transfers of appreciated property if the partnership conforms to the requirements of the Gain Deferral Method," described below.[21]

2. Gain Deferral Method

The Notice announces that the Section 721(c) Regulations will propose a single method for avoiding the requirement of immediate recognition by the transferring partner on transfers of Section 721(c) Property to a Section 721(c) Partnership, called the "Gain Deferral Method." The requirements for the application of the Gain Deferral Method will include

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[19] Section 721(c) Property does not include (a) cash equivalents, (b) any asset that is a security within the meaning of Section 475(c)(2) (without regard to Section 475(c)(4)) or (c) any item of tangible property with built-in gain that does not exceed $20,000.

[20] For purposes of the Notice, parties are considered related if they are related within the meaning of Section 267(b) or Section 707(b)(1).

[21] The regulations will contain a de minimis rule providing that Section 721(a) (if otherwise applicable) will continue to apply without regard to whether the requirements of the Gain Deferral Method are satisfied if, during the U.S. Transferor's taxable year, (i) the sum of the built-in gain with respect to all Section 721(c) Property contributed in that year to the Section 721(c) Partnership by the U.S. Transferor and other U.S. Transferors that are related persons does not exceed $1 million and (ii) the Section 721(c) Partnership is not applying the Gain Deferral Method with respect to a prior contribution of Section 721(c) Property by the U.S. Transferor or a related person.

provisions that are intended to ensure that the contributing partner will recognize the built-in gain associated with the Section 721(c) Property either as a result of partnership allocations of income or upon disposition of the property or partnership interest. The specific requirements set forth in the Notice are as follows:

(a) The Section 721(c) Partnership must adopt the remedial allocation method described in Treasury Regulations 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.

(b) During any taxable year in which there is remaining built-in gain with respect to an item of Section 721(c) Property, the Section 721(c) Partnership must allocate all items of Section 704(b) income, gain, loss and deduction with respect to that Section 721(c) Property in the same proportion.[22]

(c) Certain reporting requirements intended to ensure adequate disclosure of the transactions involving the contributed property must be satisfied.

(d) The U.S. Transferor must recognize any remaining built-in gain with respect to any item of Section 721(c) Property upon an "Acceleration Event," which, as described below, includes certain dispositions of interests in the Section 721(c) Property or the Section 721(c) Partnership;

(e) The Gain Deferral Method must be employed consistently 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

22 Section 4.03(2) of the Notice provides an example of a proportional allocation: "if income with respect to an item of Section 721(c) Property is allocated 60 percent to the U.S. Transferor and 40 percent to a related foreign person in a taxable year, then gain, deduction and loss with respect to that Section 721 Property must also be allocated 60 percent to the U.S. transferor and 40 percent to the related foreign person."

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.

3. Acceleration Events

Under the Notice, an Acceleration Event is any transaction that would either 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 built-in gain. This broad rule is subject to exceptions, detailed below, which generally apply where the remaining amount of built-in gain will continue to be subject to U.S. tax. The Notice also provides that if a Section 721(c) Partnership fails to comply with all of the requirements of the Gain Deferral Method, an Acceleration Event is deemed to occur for the taxable year in which the failure occurs with respect to all Section 721(c) Property. When an Acceleration Event occurs, a U.S. Transferor must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to such 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.[23]

There are several exceptions to the general definition of an Acceleration Event. An Acceleration Event will not occur if a U.S. Transferor transfers an interest in a Section 721(c) Partnership to a domestic corporation in a transaction to which 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, however, that in each case the parties must continue to apply the Gain Deferral

[23] The Section 721(c) 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.

Method by treating the domestic corporation that receives the interest as the U.S. Transferor for all purposes of the Notice. In addition, an Acceleration Event will not occur if a Section 721(c) Partnership transfers Section 721(c) Property to a domestic corporation in a transaction to which Section 351(a) applies. Finally, if a Section 721(c) Partnership transfers Section 721(c) Property to a foreign corporation in a transaction described in Section 351(a), an Acceleration Event will not occur 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 Treasury Regulations Section 1.367(a)-1T(c)(3)(i) or (ii).[24]

4. Reporting Requirements

The Notice sets forth a number of new reporting requirements for taxpayers engaging in transfers of Section 721(c) Property to Section 721(c) Partnerships and taxpayers applying the Gain Deferral Method. Beginning in the 2015 taxable year, a U.S. Transferor that transfers Section 721(c) Property to a foreign partnership must satisfy the reporting requirements set forth in Sections 6038, 6038B, 6046A and the Treasury Regulations thereunder. In addition, the IRS intends to modify Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, Schedule O, *Transfer of Property to a Foreign Partnership*, or its instructions, to require additional information with respect to contributions of Section 721(c) Property to Section 721(c) Partnerships.

[24] Treas. Reg. §1.367(a)-1T(c)(3)(i) provides that if a partnership (whether foreign or domestic) transfers property to a foreign corporation in an exchange described in Section 367(a)(1), then a U.S. person in the partnership is treated as having transferred a proportionate share of the property in an exchange described in Section 367(a)(1). Treas. Reg. § 1.367(a)-1T(c)(3)(ii) provides that if a U.S. person transfers an interest as a partners in a partnership (whether foreign or domestic) in an exchange described in Section 367(a)(1), then that person shall have been treated as having transferred a proportionate share of the property of the partnership in an exchange described in Section 367(a)(1). In each case, a U.S. person's proportionate share is determined under the rules and principles set forth in Sections 701 through 761, and the regulations thereunder.

Treasury and IRS also intend to issue regulations describing additional reporting requirements for a U.S. Transferor for each taxable year in which the Gain Deferral Method is applied. These regulations will require taxpayers to report certain information concerning Section 721(c) Property subject to the Gain Deferral Method (whether the Section 721(c) Partnership is a domestic or foreign partnership). The information required to be reported is expected to include: (a) a description of the Section 721(c) Property; (b) information regarding the amount of income, gain, deduction or loss with respect to the Section 721(c) Property; and (c) a description of any Acceleration Events. The new reporting requirements will coordinate with existing reporting requirements under Sections 6038, 6038B and Section 6046A, including the regulations thereunder and any relevant IRS forms and instructions.

Furthermore, 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 information return filing requirements described in Treasury Regulations Section 1.6038-3 if not already required to file under the current regulations. Treasury and the IRS also intend to issue regulations providing that a U.S. Transferor that uses the Gain Deferral Method must extend the statute of limitations with respect to Section 721(c) Property contributed to the Section 721(c) Partnership through the close of the eighth full taxable year following the taxable year of contribution.

5. Effective Dates

The Notice makes the rules effective to current transactions by providing that the Section 721(c) Regulations will apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classifications made under Treasury Regulations Section 301.7701-3 on or after August 6, 2015, and that are effective on or before August 6, 2015. The reporting requirements will apply to transfers and controlled transactions occurring on or after the date of publication of the Section 721(c) Regulations.

IV. DISCUSSION

A. Introduction

We generally support Treasury's efforts to issue regulations addressing the use of partnerships with related foreign partners to avoid or defer the recognition of gain. We are also sympathetic to the use of a Notice in order to eliminate abusive practices immediately, even in advance of the issuance of proposed regulations. Nevertheless, the rules set forth in the Notice will apply not only to those transactions at which the pronouncement is targeted, but to legitimate transactions motivated by business considerations. We are concerned that the lack of detail (and inevitable ambiguity of technical rules described in summary fashion) in the Notice will unduly interfere with non-abusive transactions.

As described in greater detail below, we urge Treasury to move expeditiously and issue proposed and temporary regulations. Those regulations should include sufficient detail to identify and illustrate situations in which there is avoidance or deferral of recognition of built-in gain. Our comments include suggestions that would help with this identification. We also urge that in drafting the regulations, the Treasury and IRS exercise restraint so that application of the rules is limited to transactions in which gain is either being avoided or unduly deferred. In addition to these overriding issues, a number of our recommendations address the specific provisions to be contained in the regulations.

B. Recommendations

1. Expeditious Issuance of Proposed Regulations

We urge the Treasury to issue regulations in proposed and temporary form promptly in order for taxpayers to rely on their provisions in structuring and executing transactions. Prompt action is important because the Notice's description of the rules to be contained in proposed regulations does not contain sufficient detail for a taxpayer to determine whether a transaction would fall within the scope of the rules contemplated in the Notice. For example, as discussed in greater detail below, the proportionate allocation rule[25] contains no exceptions for allocations that are required under other provisions of the Code or Treasury regulations to differ from the proportionate allocation rule, such as allocations of creditable foreign tax credit expenditures.[26] Similarly, required allocations under a minimum gain chargeback could cause a violation of the proportionate allocation rule. Thus, some taxpayers may choose not to move forward with nonabusive transactions without clarification, since they may not be prepared to risk immediate gain recognition or acceleration of gain because of a required allocation under section 704(b).[27]

In this regard, we recognize that the proposed regulations may need to address a number of detailed issues the resolution of which may be difficult. While we believe that the regulations should ultimately address these issues, we urge Treasury not to delay issuance of rules covering the most urgent issues. For other issues, if resolution would involve a delay, we

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25 The Notice provides that for any taxable year in which there is remaining built-in gain with respect to an item of Section 721(c) Property, the Section 721(c) Partnership is required to allocate all items of Section 704(b) income, gain, loss and deduction with respect to that Section 721(c) Property in the same proportion.

26 Treas. Reg. §1.704-1(b)(4)(viii).

27 A disproportionate allocation under the minimum gain chargeback could arise for example if there had been a distribution of nonrecourse debt proceeds.

urge Treasury to reserve on such points allowing taxpayers to be given the opportunity to take a reasonable approach without risking immediate gain recognition.[28]

2. Definition of Section 721(c) Partnership

Under the Notice, a Section 721(c) Partnership includes any partnership, foreign or domestic, to which a U.S. Transferor contributes Section 721(c) Property, if the partnership has a related foreign person as a partner (directly or indirectly) and the U.S. Transferor and one or more related persons own more than 50% of the interests in partnership capital profits, deductions or losses. We support Treasury's efforts to restrict the partnerships to which the Notice and the regulations apply to those which contain sufficient indicia of potential for abuse. We believe that this potential generally is present in situations in which the significant parties involved are not dealing at arms-length with adverse interests. In particular, we believe it is appropriate for partnerships in which related parties own more than 50% of the economic interests to be subject to particular scrutiny and to be subject to the rules generally.[29] However, we also believe that this definition encompasses situations in which the abuse at Section 721(c) is directed is not present and therefore urge Treasury to make the following exceptions.

First, we believe that the Section 721(c) Regulations should exempt partnerships in which all or substantially all of the partnership's income derived or to be derived from the Section 721(c) Property is effectively connected with a U.S. trade or business.[30] In that case, the

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28 One example of an issue that might be deferred would be the consequences of a Section 721(c) Partnership ceasing to use the Section 721(c) property in a trade or business that generated income effectively connected income. See infra at note 30, infra.

29 We recognize that the 50% test is somewhat arbitrary, although believe that it is an appropriate bright line. The potential for abuse would still exist in situations in which the U.S. Transferor and its foreign affiliates own 49% and a tax indifferent party owns 51%. In this context, we believe that Treasury should consider supplemental rules addressed at whether the U.S. Transferor and related persons had "control" within the meaning of section 482.

30 In those cases where it may be relevant, there would also be a requirement that the income allocated to the foreign related partner not be exempt from tax under a tax treaty.

partnership's income from the property will be subject to U.S. tax, whether allocated to the U.S. Transferor or to the foreign related parties. Therefore there is no need either to require immediate gain recognition or mandate the remedial allocation method. Moreover, in this situation, the usual rules under Section 704(c) (including the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10)[31] should be permitted to govern in the same manner as in transactions between related U.S. persons.[32]

Second, we believe that Treasury should consider an exception in those situations in which related foreign partners, in the aggregate, have a relatively small interest and the Section 721(c) partnership includes an unrelated U.S. person with a substantial economic interest in the partnership and with a material adverse tax interest to the U.S. Transferor. We believe that the two prongs address the legitimate concerns of the rule. The first is the amount of the revenue loss, which results whether the income is recognized by a related or unrelated non-U.S. person. If the related foreign party's interest in the income from the property is small, that revenue loss may be relatively small. The second requirement is intended to assure that any revenue loss facilitated by the related foreign partner (even if small) is justified because it results from negotiation between parties dealing at arm's-length. The choice of section 704(c) method is accepted by the tax rules as a consequence of arm's-length bargaining between the contributing partner and the other unrelated partners in the partnership.[33] The basis for respecting the result

[31] We have previously recommended strengthening the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) to prevent shifting gain or loss among partners. See for example, New York State Bar Association Report No. 1239 on Section 751(b) (September 9, 2015).

[32] We recognize that after 10 years gain from the sale of property that had been used in a U.S. trade or business would cease to be effectively connected income. It may be appropriate for the regulations to address this possibility for example with a rule that requires recognition of any remaining gain that would be subject to Section 864(c)(7).

[33] The section 704(c) rules were made mandatory by the Deficit Reduction Act of 1984 (P.L. 98-369). In describing the reasons for requiring, rather than permitting, section 704(c) allocations, the Joint Committee on Taxation Explanation noted that Congress was concerned with an "artificial shifting of tax consequences

of such a bargain is that the parties are presumptively dealing at arm's-length with respect to their tax interests.[34] We recognize that in partnerships where the U.S. Transferor and its related persons have more than 50%, the presumption of arm's-length bargaining may lose some vitality. However, we think that in appropriate cases—where related foreign partner's interest is small and the unrelated U.S. partner has a substantial interest and can clearly demonstrate a material adverse interest to the U.S. Transferor –the likelihood of an inappropriate shift of income or gain to the foreign related partner is substantially reduced.

Accordingly, we suggest that Treasury include an exception in the regulations for situations in which related foreign partner's interest is small (such as a 10% or lower interest in profits and capital[35]) and an unrelated partner has a substantial interest in the partnership (such as a 20% interest in profits and capital) and was expected at the time of the transfer to have adverse tax interests to the U.S. transferor. For example, we believe it would be appropriate to exclude from the definition of Section 721(c) partnership, an entity in which the U.S. transferor and the unrelated partner each owned 45% of the partnership and the related foreign partner owned only 10%, provided that the unrelated U.S. partner and U.S. transferor can demonstrate adverse tax interests.[36]

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between partners." This artificial shifting was more likely to occur when partners were in different tax positions, such as subject to different rates of tax. In other words, the concern emanates, in part, from situations in which the partners lacked adverse tax interests. Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 212.

34 If parties have adverse tax interests, the commercial terms of the transaction are likely to reflect that the non-contributing partner is not being allocated tax deductions commensurate with its economic investment. If the non-contributing partner is tax indifferent, however, no economic price may be extracted from the contributing partner. Our proposal requires that the unrelated partner not only be a U.S. person, but also in fact have an adverse tax interest.

35 In addition, the related partner should also not have a disproportionately larger share of income or gain from the contributed appreciated property.

36 We view this suggestion as a limited exception in order to accommodate transactions in which there is a business reason for including a foreign related partner in the transaction. In this context, we would expect that the regulations would place the burden to demonstrate adverse tax interests on the taxpayers using a relatively high standard, such as "clear and convincing evidence".

We note that the definition of Section 721(c) Partnership would not include an existing partnership to which appreciated property has been contributed if there is no foreign partner at the time of contribution. In substance, the Notice does not apply in situations in which there would be "reverse Section 704(c)" allocations, (as the gain in that case is excluded from the definition of "built-in gain" in the Notice). Rather, the Notice (and Section 721(c) Regulations) will apply only where there is an actual contribution of property. We believe that Treasury should consider an anti-abuse rule that would include within the definition of Section 721(c) Partnerships in which the foreign partner is admitted to the partnership after the contribution but pursuant to a prearranged plan.[37]

3. Gain Deferral Method

In general, we support the requirement that the partnership use the remedial allocation method under section 704(c) in order to insure that the contributing partner cannot avoid the recognition of gain over a reasonable period of time. We also support the issuance of rules governing the Gain Deferral Method that would insure that the partnership cannot employ other allocations in order to defer or limit the gain recognition. These approaches set forth appropriate conditions to avoid immediate gain recognition.

We believe that there are several areas of the Gain Deferral Method where further analysis should be undertaken. In particular, we urge Treasury to reconsider its approach under the proportionate allocation rule and instead adopt rules that focus on insuring that the US transferor is allocated taxable income consistent with the intent of the remedial allocation method and that the partnership cannot use other allocations to avoid that result. In addition, we

[37] For example, the anti-abuse rule could apply to a situation in which the U.S. transferor transfers property to a partnership with a domestic related party partner and within a limited period of time admits a foreign partner to the partnership.

believe that the Section 721(c) Regulations should contain sufficient detail and examples to make explicit how those rules are intended to operate. This detail should not detract from the overall purpose of the rules, and indeed should address situations in which the current formulation of the rules do not prevent avoidance of the gain. We also recommend that the Section 721(c) Regulations should address certain common business arrangements and provide that such arrangements would not fail to comply with the requirements of the Gain Deferral Method (or otherwise require immediate recognition of gain by a U.S. Transferor).

(a) Proportionate Allocation Rule

In order for a Section 721(c) Partnership to avail itself of the Gain Deferral Method, the partnership must follow the proportionate allocation rule. We understand the rule to require that book allocations[38] of items of income or loss with respect to Section 721(c) Property be allocated on a "bottom line" basis; that the allocation reflect the net income or net loss from the property taking into account all items of income or gain, deduction or loss. We do not understand the rule to prohibit different allocations of net income or net loss that may vary from year to year, or even within a single taxable year.

We support the goal of requiring that allocations of income or loss from the Section 721(c) Property not be manipulated in a manner that would undermine or offset the impact of the use of the remedial allocation method. We do not believe, however, that the proportionate allocation requirement is the best way to achieve this goal. In certain circumstances, the requirement does not prevent taxpayers from offsetting the remedial allocations; in other circumstances, the requirement would prevent allocations of income or loss

[38] For these purposes, we understand to "book" allocations to mean allocations of income or loss or items thereof under section 704(b) and Treas. Reg. §1.704-1 and Treas. Reg. §1.704-2.

that do not offset the remedial allocations. We believe that these points can be illustrated by the following examples.

Example 1. U.S. Transferor contributes Section 721(c) Property with a value of $10,000,000 and a basis of zero to a partnership with foreign related partners in exchange for a preferred partnership interest. Under the terms of the partnership agreement, U.S. Transferor is entitled to a preferred return of 15% on invested capital payable solely out of net income. In year one, the partnership has net income of $2,000,000 of which $1,500,000, representing 75% of the partnership's net income, is allocated to the U.S. Transferor. In the year two, the partnership has net income of $7,500,000 of which $1,500,000, representing 20% of the partnership's net income, is allocated to U.S. Transferor. Because in each year there is an allocation of net income with respect to the property, the proportionate allocation rule is not violated. In such a situation, net loss would be allocated first to other partners to reflect the status of the U.S. Transferor's interest as preferred. In each year, in addition to the net income allocated to the U.S. Transferor, there would be a remedial allocation of income equal to the proportion of any amortization or depreciation deductions allocated to the other partners. The amount of such remedial allocations would vary from year to year, depending upon the amount of net income allocated to the U.S. Transferor. We understand that this series of allocations would not violate the proportionate allocation rule because all items of net income and net loss with respect to the Section 721(c) Property are allocated in the same proportions in any year.

Example 2. Assume the same facts as Example 1, except that the preferred return on invested capital is paid out of gross income. This transaction would violate the proportionate allocation requirement, as all items of income or loss from the property would not be allocated in the same proportion. However, under the facts, all of the book deductions attributable to the Section 721(c) Property would be allocated to the non-contributing partners and therefore the U.S. Transferor would be allocated remedial income equal to the full amount of the amortization or depreciation deductions attributable to the property. Thus, the use of the remedial allocation method under section 704(c) will not be undermined even though the allocations are not consistent with the proportionate allocation rule. In such a situation we do not believe that it is appropriate to require immediate gain recognition.

Example 3. Assume the U.S. Transferor contributes property with a value of $10,000,000 and a zero tax basis and that a related foreign partner contributes a second property with a $10,000,000 value and a $10,000,000 basis. Also assume that the partnership agreement allocates all items of income or loss equally between the two partners, except that 100% of the depreciation or amortization deductions with respect to the second property (which is not Section 721(c) Property) is allocated entirely to the U.S. Transferor (with a chargeback in the future using gain from the sale of the property or a book-up of partnership assets). Because all items of income or loss with respect to the Section 721(c) property are allocated in the same proportions, the proportionate allocation rule would be satisfied. However, in this situation the special allocation of deductions attributable to the second property would have the effect of offsetting the remedial income allocations to the U.S. Transferor.[39] It is not clear to us, from a policy perspective, that allocations of this nature should be permitted to satisfy the Gain Deferral Method.

As these examples demonstrate, the proportionate allocation rule is both over inclusive and under inclusive. In brief, we believe that the proportionate allocation requirement does not achieve the objective of requiring the U.S. transferor of Section 721(c)

[39] Assume the allocations have substantial economic effect and satisfy Section 482.

Property to include in income the appropriate remedial allocation with respect to the contributed property. Instead, we believe that Treasury should consider an alternative approach.

(b) Alternatives to Proportionate Allocation Rule

We believe that Treasury should consider proposing a rule that is targeted at those situations in which the allocations at issue have the purpose of deferring or avoiding the recognition of the built-in gain. The recommended rule would provide that allocations of items of income or loss that have the result of deferring or avoiding the U.S. Transferor's recognition of the built-in gain would be a violation of the Gain Deferral Method and would constitute an Acceleration Event. This approach would both expand the scope of the rules to cover other situations in which built-in gain can be avoided or deferred and limit the scope to exclude situations in which the special or disproportionate allocations would not have any impact on the U.S. Transferor's recognition of the built-in gain. In particular, the regulations should include an anti-abuse rule that would be violated if an allocation (whether with respect to the Section 721(c) Property or any other property) otherwise respected under Sections 704(b) and 482 that has the effect of preventing or deferring the recognition of the built-in gain by the U.S. Transferor.

Our suggested rule would permit allocations (including of specific items) where the allocation was not intended to prevent or defer the recognition of the U.S. Transferor's built-in gain. The rule would provide that an allocation would be presumed to violate the anti-abuse rule if, in any year, (i) the U.S. Transferor's distributive share of taxable income is not at least equal to the difference between the amount of the book depreciation or amortization with respect to the Section 721(c) Property and the amount of tax depreciation or amortization with respect to the Section 721(c) Property, or, if the Section 721(c) Property is disposed of during the year, the remaining amount of built-in gain (the "Minimum Inclusion Amount") or (ii) the U.S.

Transferor's distributive share of taxable income does not exceed the U.S. Transferor's share of book income by the Minimum Inclusion Amount. Under our suggestion, in any taxable year that the tests are not satisfied, disclosure to the IRS would be required and it would be presumed that the allocations violate the anti-abuse rule, which would lead to an Acceleration Event if the U.S. Transferor cannot overcome the presumption. These rules can be illustrated by the following examples:

Example 4: US Parent ("USP") contributes property with a basis of $1,000,000 and value of $10,000,000, with a five-year life (for the contributed and new property). Foreign Partner ("FP") contributes cash. Also assume that all income or loss is allocated 80% to FP and 20% to USP except that all depreciation with respect to the contributed property is allocated to USP (with an appropriate chargeback). Assume that in a year, the partnership has $20,000,000 of net income before depreciation. The Minimum Inclusion Amount for the year is $1,800,000 ($2,000,000 book depreciation less $200,000 tax depreciation). Under these facts, USP would be allocated book income of $2,000,000, reflecting its 20% share of net income before depreciation, $4,000,000, less the full book depreciation of $2,000,000. USP would, however, report $3,800,000 of taxable income for the year ($4,000,000 attributable to USP's 20% share of the $20,000,000 of net income, less the entire tax deduction of $200,000 for depreciation). There is no book allocation of depreciation to FP and therefore no remedial allocation, even though the remedial allocation method has been adopted. In this case, USP would be allocated taxable income at least equal to the Minimum Inclusion Amount and the amount of taxable income allocated to the USP ($3,800,000) would exceed its share of book income ($2,000,000) by at least the Minimum Inclusion Amount. In such a situation, even though there is a special allocation of depreciation to the U.S. Transferor, the U.S. Transferor has not deferred or avoided the recognition of built-in gain in the Section 721(c) Property. In that situation, the anti-abuse rule would not be considered violated.

Example 5. Assume the same facts as in Example 4, except that the partnership was expected to have only $2,500,000 of net income before depreciation in each year. In this case, in each year, the USP would have a $1,500,000 book loss ($500,000 share of income before depreciation less $2,000,000 book depreciation) and $300,000 share of taxable income ($500,000 share of income before depreciation, less the $200,000 of tax depreciation). Although the USP's distributive share amount of taxable income exceeds its share of the book loss by the Minimum Inclusion Amount, its distributive share of taxable income is not at least equal to the Minimum Inclusion Amount. In this case, the allocations would be presumed to violate the suggested anti-abuse rule and disclosure would be required. The presumption may be overcome if the USP were able to establish that the failure to satisfy the tests were due to unforeseen circumstances. Such unforeseen circumstances would include, for example, unexpected losses or shortfalls in earnings of the partnership.[40]

(c) Suggestions if Proportionate Allocation Rule Retained

If it is determined that the proportionate allocation rule should be retained in the regulations, we believe that there are a number of issues that would need to be addressed. In particular, the Section 721(c) Regulations should exempt from the application of the proportionate allocation rule allocations that are required under various provisions of the Code and regulations to be made in a manner that is different than what would be required under the proportionate allocation rule. These include, for example: (i) allocations of creditable foreign tax credit expenditures (as well as related corrective allocations), which are required to be allocated

[40] We would expect the taxpayer to bear the burden of showing the unforeseen circumstances. In particular, the taxpayer should be required to show that absent those circumstances the allocation would not have resulted in the deferral or avoidance of the built-in gain.

based upon taxable income; (ii) allocations of partner nonrecourse deductions and allocations pursuant to the partner minimum gain chargeback; (iii) allocations of gross income pursuant to a partnership minimum gain chargeback partnership attributable to distributions of nonrecourse debt proceeds and certain other allocations not resulting from a disproportionate allocation of nonrecourse deductions; (iii) allocations pursuant to a qualified income offset; (iv) allocations of partnership level gain resulting from a Section 751(b) transaction; (v) allocations with respect to the exercise of a noncompensatory option pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(s); and (vi) allocations under Section 706 with respect to extraordinary items of a partnership on the proration method.

(d) Other Special Considerations—Anti-Churning Rule

The proposed regulations also need to address the treatment of Section 721(c) Property that is a section 197 intangible subject to the anti-churning rules. Treasury Regulations Section 1.197-2(h)(12)(vii)(B) provides that for property subject to the anti-churning rules, no deductions may be claimed by the related partner (and no remedial income would be recognized by the contributor) even if the partnership has elected the remedial allocation method. The proposed Section 721(c) regulations should not permit greater deferral for the recognition of the built-in gain with respect to property subject to the anti-churning rules. Accordingly, we recommend that the regulations override the rule in Treasury Regulations Section 1.197-2(h)(12)(vii)(B) for purposes of the Gain Deferral Method and permit the foreign related party to claim the deductions and thus require the U.S. Transferor to include the remedial income.[41]

[41] We note that the allocation of the deduction to the foreign related party is not likely in most cases to have U.S. income tax consequences. To the extent that the partnership's activities do not produce effectively connected income, the foreign related partner will not be able to use the deduction to reduce any U.S. tax. If the income is effectively connected, we have recommended that the partnership not come within the definition of Section 721(c) partnership.

4. Acceleration Events

The Notice provides for a general rule that recognition of the remaining built-in gain will be accelerated if there is any transaction with respect to the Section 721(c) property that could either avoid or defer the gain that would otherwise be recognized. In general, we agree that certain transfers of interests in Section 721(c) Property or Section 721(c) Partnerships should cause an acceleration of the built-in gain in the Section 721(c) Property in order to preserve the policy purposes of the Notice. Nevertheless, we think that specific and limited exceptions should apply in certain non-abusive situations. First, there should be no Acceleration Event merely as a result of a technical termination of a Section 721(c) Partnership under Section 708(b)(1)(B). We note, however that for tangible property, a technical termination restarts the depreciation period which would result in a deferral of recognition of the built-in gain. If that deferral is considered a major concern, an additional rule could be adopted to require that the built-in gain continue to be recognized on the same schedule as was originally adopted upon the initial contribution of the property. We question whether the complexity inherent in such a rule is worth eliminating the deferral.

We also believe that there should be a previously contributed property exception so that a distribution of the Section 721(c) Property back to the U.S. Transferor (or its successor) would not be an Acceleration Event. Such exceptions are common in Subchapter K, and we see no reason why such an exception would not be appropriate in this situation, since the Section 721(c) Property would be, once again, owned by the U.S. Transferor.

Second, we recommend that the proposed regulations modify the Acceleration Events described in the Notice to eliminate the creation of a deemed Acceleration Event for all other Section 721(c) Properties because of a failure to comply with the Gain Deferral Method for any Section 721(c) Property. The rule as set forth in the Notice seems unduly inflexible, and we believe that as a policy matter it should be permissible for a contributing partner to choose upon contribution whether to recognize the gain with respect to the Section 721(c) Property or, assuming the Section 721(c) Partnership adopts provisions in its partnership agreement that are compliant, to take advantage of the Gain Deferral Method with respect to such Section 721(c) Property. As a practical matter, the only real obstacle to such a proposal is administrative complexity. However, this administrative complexity is no different than would otherwise be encountered in an ordinary situation where a partner contributes both built-in gain property and non built-in gain property to a partnership, since any Section 721(c) Property in respect of which gain is recognized would be simply the same as any other asset of the partnership where the book value on contribution equals its tax basis on the date of contribution (regardless of whether such property might otherwise have been Section 721(c) Property, or not). Additionally, there is no meaningful increase in audit complexity over the base Section 721(c) Partnership case, since in either event the Section 721(c) Property to which the Gain Deferral Method is elected would be subject to the reporting requirements described in Section 4.06 of the Notice. [42]

Third, the Notice specifically requests comments on whether the distribution of Section 721(c) Property to an unrelated foreign partner after the seven-year limitation described in Section 704(c)(1)(B) expires should not be an Acceleration Event. We are divided on this issue. Some of us believe that there are reasonable arguments for either permitting the distribution without gain recognition or treating such distribution as an Acceleration Event. The current seven-year limitation described in Section 704(c)(1)(B) reflects a compromise described

[42] We believe that the reporting requirements should include specific disclosure of any contributions in which gain is recognized with respect to some assets and the Gain Deferral Method is used for other assets.

in Conference Report 105-220[43] as a way to limit the inconsistency and to reduce opportunities for circumventing Section 704(c)(1)(B) by extending the five-year period to seven years, after considering a suggestion by the House of Representatives to extend the period to ten years in the same bill.[44] Based on this legislative history, it would appear that the Congress has concluded that seven years is an appropriate period to limit inconsistencies resulting from distributions to noncontributing partners. In addition, even under the Notice, such a distribution would not result in recognition of the remaining any built-in gain if the unrelated partners had more than 50% of the partnership at the time of the contribution. On this basis, a number of members of the Executive Committee believe that distributions after seven years to an unrelated foreign partner should not be an Acceleration Event.

Other Executive Committee members have a different view. Section 721(c) authorizes Treasury to adopt regulations in situations in which the built-in gain with respect to contributed property would be recognized by a foreign person not subject to U.S. tax. That situation is materially different than the domestic context. If the distribution is made to a domestic partner, the gain, while deferred, will ultimately be subject to U.S. tax. If the distributee partner takes the property with a carryover basis, that distributee partner will recognize the built-in gain. Distributions in which the distributee partner has a substituted basis will likely result in adjustments to the basis of partnership property either because a section 754 election has been made or under section 743(d) and the built-in gain may ultimately be recognized by the domestic partners.[45] If the distribution is made to a non-U.S. person with a

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43 Conference Report on the Taxpayer Relief Act of 1997, P.L. 105-34, August 5, 1997, enacting Section 704(b)(1)(C) as in effect today.

44 *See* House Report on the Taxpayer Relief Act of 1997, P.L. 105-34.

45 In this situation the amount of gain that will ultimately be subject to tax will be reduced to the extent that the distributee partner has a basis for the distributed property that is greater than the basis of the property in the hands of the partnership. In that case, Section 734(d) should apply to require a basis reduction to other

carryover basis, the built-in gain will totally avoid tax. The tax treatment of a distribution with a substituted basis to a foreign transferee will be similar to the domestic context and therefore may ultimately give rise to tax to the extent that reductions in basis will result in more income or gain being allocated to partners subject to US tax. Therefore, other members of the Committee believe that the distribution of Section 721(c) Property should be an Acceleration Event.

Fourth, we recommend that increases in basis under Section 734 and Section 755 should not trigger an automatic Acceleration Event. Section 734(b) provides that the basis of partnership assets is adjusted upon a distribution if the partnership has a Section 754 election in place or the distribution results in a substantial basis reduction, and such basis adjustment is allocated among partnership assets under the Treasury regulations under Section 755. As a result, a basis adjustment under Section 755 could be allocated to Section 721(c) Property, and as a result could cause an Acceleration Event. In this case, we suggest that the gain recognition be limited to the amount of the Section 734(b) increase in basis allocated to the Section 721(c) Property. If, however, the basis adjustment arises from a distribution to the U.S. Transferor (e.g., in connection with a distribution that causes the U.S. Transferor to recognize gain under Section 731(a)(1)), the rules would need to be coordinated to prevent duplication of the gain to the U.S. Transferor.

5. <u>Reporting Requirements</u>

We generally endorse the reporting requirements described in Section 4.06 of the Notice. The Notice provides that Treasury and the IRS anticipate that the requested information will include a description of the Section 721(c) Property; information regarding the amount of

partnership property. We believe that in such a situation, the regulations should make clear that the basis adjustment will result in the U.S. Transferor recognizing the additional income or gain, i.e., the built-in gain created by the basis adjustment would be treated as the U.S. Transferor’s built-in gain for purposes of Section 721(c).

income, gain, deduction, or loss with respect to the Section 721(c) Property; and a description of any Acceleration Events. We recommend that the requested information also include the tax basis of the Section 721(c) Property, the fair market value of the Section 721(c) Property and how the fair market value of the Section 721(c) Property was determined (for example, by appraisal).

The Notice specifically asks for comments as to whether proposed regulations should provide rules similar to the rules under Sections 367(a) and 6038B relating to failure to file gain recognition agreements, including the standards of relief set forth therein (the "GRA Non-Filing Rules").[46] We believe that the policy reasons behind the GRA Non-Filing Rules, including the standards for relief, are equally applicable in the Gain Deferral Method context. As a result, we recommend that proposed regulations under Section 721(c) provide that a Section 721(c) Partnership that would seek relief from immediate gain recognition as a result of a failure to comply with the notice requirements described in Section 4.06 of the Notice should be allowed to do so if the Section 721(c) Partnership is able to demonstrate that the failure was not a willful failure (which is the standard adopted under the GRA Non-Filing Rules), and that those provisions otherwise follow the standards and requirements of the GRA Non-Filing Rules.

[46] The GRA Non-Filing Rules were finalized in T.D. 9607, 2014-50 I.R.B. 922.