

## US: Final regulations on US partner contributions to partnerships with related foreign partners have few changes from prior temporary regulations

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### Executive summary

The United States (US) Internal Revenue Service (IRS) released final regulations ([TD 9891](#)) under Internal Revenue Code (IRC) Section 721(c) that continue to deny nonrecognition treatment to certain contributions of appreciated property by US persons to partnerships with related foreign partners unless the partnership satisfies specific requirements. To avoid gain recognition, among other things, the partnership must adopt the remedial allocation method under Section 704(c) and the consistent allocation method under the final regulations, in each case with respect to the transferred property. The final regulations follow the expired temporary regulations, with changes or clarifications to the definition of related persons, the consistent allocation method, and reporting requirements. The final regulations request comments on whether the exclusion for securities from Section 721(c) property should continue to apply to controlled foreign corporation stock if potential exists to shift subpart F income or tested income to a related foreign partner not owned by a US shareholder.

The final regulations are effective 17 January 2020 (although they generally apply to contributions occurring on or after 6 August 2015).

## Detailed discussion

### Background

Section 721(c) grants Treasury the regulatory authority to deny nonrecognition treatment under Section 721(a) of “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.”

In January 2017, the IRS issued proposed regulations ([REG-127203-15](#)) and temporary regulations ([TD 9814](#)) under Section 721(c). The temporary regulations generally adopted the rules outlined in Notice 2015-54 (see EY Global Tax Alert, [US regulations forthcoming on partnership nonrecognition of property contributions](#), dated 19 August 2015).

### Changes in the final regulations

The final regulations adopt the provisions of the temporary regulations in most respects, and no changes were made in response to comments. There are, however, a few notable changes and clarifications.

#### New definition of related persons

The final regulations modify the related-person test in Treas. Reg. Section 1.721(c)-1(b)(12) by testing relationships without regard to the partner-to-partner attribution rule under Section 267(c)(3).

The change is taxpayer-favorable as it should reduce the number of Section 721(c) partnerships.

#### Application of consistent allocation method treatment of book items

Partnerships that adopt the gain-deferral method to avoid gain recognition under Section 721(c) generally will need to comply with the Treas. Reg. Section 1.721(c)-3(c)(1) “consistent allocation method,” among other requirements. The final regulations contain the following new language in Treas. Reg. Section 1.721(c)-3(c)(1): “upon a variation (as described in [Treas. Reg. Section] 1.706-4(a)(1)) of a [US] transferor’s interest in [an IRC Section] 721(c) partnership, book items with respect to [IRC Section] 721(c) property that are allocated under the interim closing method (as described in [Treas. Reg. Section] 1.706-4) will be treated as allocated in the same percentage for purposes of applying the consistent allocation method in a single [tax] year unless the variation results from a transaction undertaken with a principal purpose of avoiding the tax consequences of the [gain-deferral] method.”

The new language permits a Section 721(c) partnership to use the interim closing method under Section 706 without running afoul of the proportionate allocation rule for book allocations of items with respect to Section 721(c) property (within the meaning of Treas. Reg. Section 1.721(c)-3(c)), even though the partnership might allocate Section 704(b) items with respect to Section 721(c) property in different percentages for the entire tax year. For example, as a result of a revaluation of partnership property, the partnership might allocate Section 704(b) items of gain and deduction during the segment of a tax year before the revaluation in different percentages than the allocation of Section 704(b) deductions for the segment in the tax year following the revaluation. The regulations do not deem proration method allocations under Section 706 to comply with the consistent allocation method, however.

The new language is taxpayer-favorable as it should prevent taxpayers from violating the consistent allocation method due to economic changes to the partners’ interests in the partnership in certain cases.

#### New forms required for reporting

The IRS modified the reporting requirements to account for new forms that were published after the temporary regulations: Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, and Form 8838-P, *Consent To Extend the Time To Assess Tax Pursuant to the Gain Deferral Method (Section 721(c))*. The new forms are required for tax filings after 17 March 2020. Taxpayers can still use the statements that were required under the temporary regulations until that date.

### Clarifications regarding the final regulations

#### Deemed partnerships

The IRS elected not to adopt a commenter’s request that the final regulations exempt from gain recognition under Section 721(c) certain contributions to deemed partnerships when the partnership was formed unwittingly (an accidental partnership) and the partnership therefore could not have applied the gain-deferral method. The IRS noted that the contributing partner could file amended returns applying the gain-deferral method.

#### Technical terminations

The final regulations retain the rules for Section 708(b)(1)(B) technical terminations for technical terminations occurring on or after the applicability date but before the repeal of technical terminations under the *Tax Cuts and Jobs Act*.

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### Endnote

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, Partnerships and Joint Ventures Group, Washington, DC**

- ▶ Jeff Erickson                    jeff.erickson@ey.com
- ▶ Mark Opper                     mark.opper@ey.com
- ▶ John Oldak                     john.z.oldak@ey.com

**Ernst & Young LLP, International Tax and Transaction Services, Washington, DC**

- ▶ Jose Murillo                    jose.murillo@ey.com
- ▶ Joshua Ruland                 joshua.ruland@ey.com

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## **International Tax and Transaction Services**

Global ITTS Leader, **Jeffrey Michalak**, *Detroit*

ITTS Director, Americas, **Craig Hillier**, *Boston*

ITTS Markets Leader, Americas, **Laynie Pavio**, *San Jose, CA*

ITTS NTD Leader, **Jose Murillo**, *Washington, DC*

## **ITTS Regional Contacts, Ernst & Young LLP (US)**

West  
**Sadler Nelson**, *San Jose*

East  
**Colleen O'Neill**, *New York*

Central  
**Aaron Topol**, *Atlanta*

Financial Services  
**Chris J Housman**, *New York*

Canada - Ernst & Young LLP (Canada)  
**Warren Pashkowich**, *Calgary*

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