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TREASURY ISSUES TEMPORARY REGULATIONS REGARDING THE ALLOCATION OF PARTNERSHIP FOREIGN TAX EXPENDITURES

To Our Clients and Friends:

On February 4, 2016, the U.S. Treasury Department (the "Treasury Department") and the U.S. Internal Revenue Service (the "IRS") issued temporary regulations (the "Temporary Regulations") under section 704 of the Internal Revenue Code of 1986, as amended (the "Code"),[1] regarding the allocation by a partnership of creditable foreign tax expenditures ("CFTEs"). The Temporary Regulations provide further guidance relating to the existing safe harbor for determining whether allocations by partnerships of CFTEs will be respected for tax purposes. The Temporary Regulations generally apply to taxable years beginning on or after January 1, 2016, and ending after February 4, 2016, but contain certain transition rules. The Temporary Regulations will particularly affect partners who receive guaranteed payments or preferred returns, and partnerships that have disregarded subsidiaries that engage in disregarded inter-company transactions. Existing partnerships with CFTEs should review their partnership agreements to ensure that their economic arrangement with respect to CFTEs has not been affected by the Temporary Regulations. It should be noted that the Temporary Regulations may indicate how the IRS believes all partnerships--even partnerships with agreements that do not satisfy the safe harbor--should allocate CFTEs.

Background on the Creditable Foreign Tax Expenditures Safe Harbor

An entity classified as a partnership for U.S. tax purposes generally does not pay U.S. income tax at the partnership level. Instead, the partners are liable for U.S. tax attributable to their distributive shares of partnership income, regardless of whether any cash is distributed to them. When a partnership operates in a foreign jurisdiction (directly or through passthrough subsidiaries), however, that jurisdiction may not treat the partnership (or its subsidiaries) as a passthrough entity and, therefore, may impose income tax on the partnership's income.

Partnerships generally are accorded substantial flexibility in the allocation of items of income, gain, loss, deduction, and credit among the partners. If, however, the allocations provided for by the partnership agreement lack "substantial economic effect," the allocations must instead be made in accordance with the partners' interests in the partnership ("PIP"). Existing Treasury Regulations state that allocations of certain items, including CFTEs, cannot have substantial economic effect and therefore must be allocated in accordance with PIP. The existing regulations provide a safe harbor for the allocation of CFTEs that is intended to match that allocation with the allocation of income to which the CFTEs relate. If the safe harbor provisions are followed, the allocation of CFTEs to partners will be deemed to be in accordance with PIP.

To satisfy the CFTE safe harbor, the partnership must (1) determine the partnership's "CFTE categories," (2) determine the partnership's net income in each CFTE category, (3) allocate the partnership's CFTEs among the partnership's CFTE categories, and (4) allocate CFTEs in each category among the partners in the same manner as the partnership's net income in the relevant CFTE category is allocated. For this purpose, a "CFTE category" is a grouping of the partnership's activities, based generally on whether the net income from the activities is allocated to partners in the same sharing ratios. Thus, if (as is often the case) the partners share profits and losses from different geographic regions or business lines in different proportions, the profits and losses from different geographies or business lines, as the case may be, will be in different CFTE categories.

Provisions of the Temporary Regulations

The Temporary Regulations clarify three aspects of the application of the safe harbor.

1. Special Rules for Nondeductible Guaranteed Payments and Deductible Allocations

Many partnerships make payments to their partners, either for the use of the partners' capital or for services rendered to the partnership in a partner capacity. If such a payment is made without regard to the income of the partnership, the payment (or accrual) is treated as a "guaranteed payment" under section 707(c); if the payment is dependent on the income of the partnership, the payment generally will be treated as an allocation of income and a related distribution of cash. For U.S. federal income tax purposes, guaranteed payments generally are deductible by a partnership under section 162, whereas allocations are not deductible by a partnership but instead are treated as distributive shares of underlying partnership income under section 704.

Certain foreign jurisdictions allow a deduction for amounts treated for U.S. tax purposes as guaranteed payments, as well as for amounts treated for U.S. tax purposes as allocations of income (or distribution of an allocated amount). The current CFTE safe harbor generally provides for a reduction in the net income in the CFTE category from which such a payment is sourced, but only in an amount equal to the deduction permitted under foreign law.

The current regulations do not expressly address situations in which a guaranteed payment (or preferential allocation) is made out of income that is subject to multiple taxes--either because the income is taxed by multiple jurisdictions or because it is subject to multiple taxes by the same jurisdiction--and is not deductible for purposes of each applicable tax. The Temporary Regulations attempt to make clear that, in this situation, as with the allocation of CFTEs generally, CFTEs in respect of each such separate tax must be traced to and matched with the income that was included in the base upon which the relevant tax was imposed. The Temporary Regulations do this by reorganizing the existing regulatory provisions, modestly expanding the language of the regulations, and including an example to illustrate the intended operation of the expanded provisions.

These tracing and matching principles are illustrated by the following example, which is drawn from Example 25 of the Temporary Regulations:

> **Example 1**. X and Y own Partnership, a German entity classified as a partnership for U.S. federal income tax purposes. X and Y share all Partnership income equally, except that X is entitled to a $100 guaranteed payment each year, which amount is deductible for both U.S. and German tax purposes. Partnership operates through a branch in another country ("Third Country").
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> In 2016, Partnership earns income only in Third Country. Specifically, Partnership earns $300 of gross income and has $100 of operating expenses, for net income of $200. Third Country imposes a tax of $30 on the income earned, with no allowance for deductions. (The tax is styled as a withholding tax.) In Germany, Partnership is treated as having $100 of net income ($300 gross income, less $100 of operating expenses, less $100 attributable to the guaranteed payment to X) and pays $20 of German income tax.

Under the existing regulations, the proper sharing of the taxes incurred by Partnership is unclear. The Temporary Regulations provide--largely by example--that the German tax and the Third Country tax may ***not*** be allocated in the same proportions because the underlying income is shared by the partners in different proportions. That is, because X and Y share the $100 of German net taxable income before tax ("NIBT") equally, the $20 of German CFTEs should be allocated equally to X and Y. (As the $100 guaranteed payment to X is deductible for German tax purposes, it reduces the taxable base upon which the German income tax was imposed and does not "pull" any German tax with it.)

The $30 of Third Country CFTEs, however, must be allocated differently. As the $100 guaranteed payment to X was not deductible in computing the Third Country tax, the $100 is first "added back" to Partnership's $200 of income to determine how the $30 Third Country CFTEs should be allocated. Then, to determine how the Third Country CFTEs should be shared, it is necessary to determine how Partnership's $300 of gross income was shared. In Example 1, X received a $100 guaranteed payment and $50 of net income, and Y received only $50 of net income. Thus, X received 75 percent ($150/$200) and Y received 25 percent ($50/$200) of Partnership's total income, which was the base on which the $30 of Third Country tax was imposed. The Third Country CFTEs must be allocated in that proportion.

The Temporary Regulations clarify that a guaranteed payment or preferential allocation is considered deductible under foreign law for this purpose if the foreign jurisdiction allows a deduction, regardless of the taxable year in which the deduction may be claimed.

2. Inter-branch Payments

Under the existing regulations, there has been some uncertainty about whether the special rules outlined in part 1 above apply to inter-branch payments. The Temporary Regulations clarify that, because an inter-branch payment is not made to a partner, it can never be treated as a guaranteed payment or distributive share, and those special rules do not apply. As a result, under the Temporary Regulations, disregarded inter-branch payments do not reduce income in a CFTE category, even if the income out of which the inter-branch payment is made is not subject to tax in any foreign jurisdiction. Consider the following example, which is drawn from Example 37 of the Temporary Regulations:

> **<u>Example 2</u>**. U.S. Parent, a domestic corporation, owns three foreign corporate subsidiaries, CFC-1, CFC-2, and CFC-3, each of which is a member in Partnership, a foreign entity classified as a partnership for U.S. federal income tax purposes. Partnership operates in Germany, Ireland, and the Cayman Islands through three subsidiaries, each of which is disregarded as an entity separate from Partnership for U.S. federal income tax purposes, but is regarded as a corporation in its country of organization. The partners share the profits and losses of the three subsidiaries as follows:
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> | | CFC-1 | CFC-2 | CFC-3 |
> |---|---|---|---|
> | Germany | 80% | 10% | 10% |
> | Ireland | 10% | 80% | 10% |
> | Cayman Islands | 10% | 10% | 80% |
>
> In 2016, Germany earns $100, makes a $90 royalty payment to Ireland, and pays $3 in income tax to the German government. In addition, Germany withholds $9 from the $90 payment to Ireland and remits the withheld amount to the German government. Ireland does not earn any other income in 2016, makes an $80 royalty payment to Cayman Islands, pays no income tax, and does not withhold on the payment to Cayman Islands. Cayman Islands does not pay tax on the $80 payment from Ireland. Each payment is disregarded for U.S. federal income tax purposes.
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> Under the partnership agreement, to give effect to the inter-branch payments, the partnership allocates Germany's $10 of NIBT, as well as the $3 of German income tax, to the partners in accordance with their German sharing ratios. Similarly, it allocates Ireland's $10 of NIBT, as well as the $9 of German withholding tax borne by Ireland, to the partners in accordance with their Irish sharing ratios. And, finally, it allocates the $80 of Cayman Islands' income to the partners in accordance with their Cayman Islands' sharing ratios.

This allocation is not valid under the Temporary Regulations. The Temporary Regulations first explain that it is inappropriate to view the income earned by Germany paid to Ireland, and then paid to the Cayman Islands as anything other than German income. Nevertheless, because the partners have agreed to share that income in different percentages, Partnership has different CFTE categories. The $10 of NIBT earned by Germany is in one CFTE category; the $10 of NIBT earned by Ireland is in a second CFTE category; and the $80 of NIBT earned by Cayman Islands is in a third CFTE category.

The Temporary Regulations go on to explain that, under the safe harbor, the $3 of income tax paid by Germany to the German government is properly allocated among the partners in the same ratio as the associated German income (*i.e.*, 80 percent to CFC-1, and 10 percent to each of CFC-2 and CFC-3). With respect to the remaining $90 of Partnership income and the $9 of German withholding tax, however, the Temporary Regulations take a more complex approach. Specifically, under the Temporary Regulations, both the income and the associated German withholding tax are properly treated as being split between the Irish CFTE category and the Cayman Islands CFTE category in the same proportion as they share the cash flow: 11.1 percent ($10/$90) for Ireland and 88.9 percent ($80/$90) for Cayman Islands. Importantly, even though Ireland claimed a deduction for the payment it made to Cayman Islands, some of the German withholding tax is allocable to the Cayman Islands CFTE category because the deduction did not reduce the $90 base upon which the German withholding tax was imposed; that is, the entire $90 was included in the base upon which the German withholding tax was imposed and properly carries with it the withholding tax even though it ultimately is paid over to Cayman Islands.

3. Section 743(b) Adjustments

Under section 743(b), a partnership must adjust the basis of its assets with respect to a transferee partner if the partnership has a section 754 election in effect for the taxable year that includes the transfer or if there is a "substantial built-in loss" with respect to the assets of the partnership. For this purpose, a partnership has a substantial built-in loss if the partnership's adjusted basis in the partnership property exceeds the fair market value of its property by more than $250,000. The existing regulations do not address whether a section 743(b) adjustment should be taken into account in calculating the partnership's net income in its CFTE categories. The Temporary Regulations provide that, for purposes of computing a partnership's net income in a CFTE category, the partnership determines its items without regard to any section 743(b) adjustments that its partners may have in the basis of property of the partnership. According to the preamble to the Temporary Regulations, this is because such an adjustment is (1) unique to the transferee partner and (2) ordinarily not taken into account by the foreign tax jurisdiction when calculating the foreign tax base.

It should be noted that, in instances in which the transferee partner is itself a partnership and has a section 743(b) adjustment in its capacity as a direct or indirect partner in a lower-tier partnership, the section 743(b) adjustment is taken into account in determining the partnership's net income in a CFTE category. The preamble to the Temporary Regulations notes that in situations in which the section 743(b) adjustment gives rise to basis differences subject to section 901(m), it may be appropriate to alter the way in which the section 743(b) adjustment is taken into account in determining the partnership's net income in a CFTE category. The IRS intends to address this issue in future guidance.

Conclusion

Although the Temporary Regulations could be viewed as applying to a relatively narrow class of partnerships, because the use of partnerships in cross-border transactions has increased markedly over the last 15 years, the impact of the Temporary Regulations could be significant. Specifically, any partnership that pays tax (directly or through a passthrough subsidiary) in one or more foreign jurisdictions and that either pays guaranteed payments or preferred returns to its partners and/or has disregarded subsidiaries that engage in inter-company transactions should carefully consider the Temporary Regulations.

[1] Unless indicated otherwise, all "section" references are to the Code, and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code.

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