Final regs address partnership's allocation of creditable foreign tax expenditures

The IRS recently issued final regulations on the operation of a safe harbor rule that's used in determining whether allocations of partnership creditable foreign tax expenditures (CFTEs) to partners are deemed to be in accordance with the partners' interests in the partnership.

The final regs issued in July adopt the proposed regs from 2016 with one modification: They add a cross reference to the disregarded payment rule for assigning income to an activity. Here are some notable areas affected by the final regs.

Section 743(b) adjustments

In the case of a transfer of a partnership interest that results in an adjustment under Internal Revenue Code Section 743(b) — because the partnership has a Sec. 754 election in effect or because there's a substantial built-in loss in the partnership — the partnership must adjust the basis of partnership property with respect to the transferee partner only. (This is known as a Sec. 743(b) adjustment.)

No adjustment is made to the common basis of partnership property, and the Sec. 743(b) adjustment has no effect on the partnership's calculation of any item under Sec. 703. The current final regs don't state whether a Sec. 743(b) adjustment is considered in calculating the partnership's net income in a CFTE category.

The regs provide that, for purposes of computing a partnership's net income in a CFTE category, the partnership determines its items without regard to any Sec. 743(b) adjustments that its partners may have to the basis of property of the partnership. The IRS believes that a transferee partner's Sec. 743(b) adjustment with respect to its interest in a partnership shouldn't be considered in calculating the partnership's net income in a CFTE category because the basis adjustment is unique to the transferee partner and ordinarily wouldn't be considered by a foreign jurisdiction in calculating its foreign taxable base.

However, the IRS also notes that a partnership, which is a transferee partner, may have a Sec. 743(b) adjustment in its capacity as a direct or indirect partner in a lower-tier partnership. Under regulations, such a Sec. 743(b) adjustment of the partnership is considered in determining the partnership's net income in a CFTE category.

Nondeductible guaranteed payments

Under the safe harbor, the regulations provide a special rule that reduces the partnership's net income in a CFTE category to the extent foreign law allows a deduction for an allocation (or payment of an allocated amount) to a partner. Accordingly, no special rule is necessary for deductible guaranteed payments under Sec. 707(c), which reduce the partnership's net income in a CFTE category.

However, to the extent that foreign law doesn't allow a deduction for a guaranteed payment that's deductible under U.S. law, the regulations provide another special rule that requires an upward adjustment to the partnership's net income in a CFTE category. (This rule and the previously mentioned special rule are collectively known as the "special rules.")

An additional rule treats the guaranteed payment as a distributive share of the partnership's net income in a CFTE category to the extent of the upward adjustment. However, the regs don't expressly address situations in which an allocation or distribution of an allocated amount or guaranteed payment gives rise

to a deduction for purposes of one foreign tax but is made out of income subject to another tax imposed by the same or a different foreign jurisdiction.

The regs do provide that a partnership's net income in a CFTE category from which a guaranteed payment that isn't deductible in a foreign jurisdiction is made must be increased by the amount of the guaranteed payment that's deductible for U.S. federal income tax purposes. It also provides that that amount must be treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' shares of income in the CFTE category — but only for purposes of testing allocations of CFTEs attributable to a foreign tax that doesn't allow a deduction for the guaranteed payment.

For purposes of testing allocations of CFTEs attributable to a foreign tax that does allow a deduction for the guaranteed payment, a partnership's net income in a CFTE category is increased only to the extent that the amount of the guaranteed payment that's deductible for U.S. federal income tax purposes exceeds the amount allowed as a deduction for purposes of that foreign tax. The excess is treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' shares of income in the CFTE category.

Similarly, the regs provide that, to the extent that a foreign tax allows a deduction from its taxable base for an allocation (or distribution of an allocated amount) to a partner, then, solely for purposes of testing allocations of CFTEs attributable to that foreign tax, the partnership's net income in the CFTE category from which the allocation is made is reduced by the amount of the foreign law deduction. This amount isn't treated as an allocation for purposes of determining the partners' shares of income in the CFTE category. For purposes of testing allocations of CFTEs attributable to a foreign tax that doesn't allow a deduction for an allocation (or distribution of an allocated amount) to a partner, the partnership's net income in a CFTE category isn't reduced.

In addition, the regs clarify that a guaranteed payment or preferential allocation is considered deductible under foreign law for purposes of the special rules if the foreign jurisdiction allows a deduction from its taxable base either in the current year or in a different tax year.

Interbranch payments

For tax years beginning before January 1, 2012, the regs confirm that certain interbranch payments as described in the regs under the "interbranch payment rule" weren't subject to the special rules. On February 14, 2012, temporary regs dealing with situations in which foreign income taxes have been separated from the related income were issued. As part of those regs, the interbranch payment rule was removed because it allowed taxpayers to separate foreign income taxes and related income, and the cross-reference to the eliminated rule was removed as well.

The final regs clarify that the special rule for preferential allocations applies only to allocations (or distributions of allocated amounts) to a partner that are deductible under foreign law, and not to other items that give rise to deductions under foreign law. For example, this special rule doesn't apply to reduce income in a CFTE category by reason of a disregarded interbranch payment — even if the income out of which the interbranch payment is made isn't subject to tax in any foreign jurisdiction. Because an interbranch payment isn't made to a partner, it can't be treated as a distributive share and is outside the scope of the special rules. The inclusion and subsequent removal of the cross-reference didn't change the purpose of the current applicable reg or expand its scope to provide for reductions in income in a CFTE category if a partnership makes a disregarded payment that's deductible under foreign law.

In addition, the IRS is aware of transactions involving serial disregarded payments in which taxpayers take the position that withholding taxes assessed on the first payment in a series of back-to-back

disregarded payments don't need to be apportioned among the CFTE categories that include the income out of which the payment is made. The final regs include new examples clarifying that, under the regs, withholding taxes must be apportioned among the CFTE categories that include the related income.

Transition rule

The final regs also modify an existing transition rule (for certain interbranch payments for partnerships whose agreements were entered into before February 14, 2012). This rule provides that, if there has been no material modification to their partnership agreements on or after February 14, 2012, then, for tax years beginning on or after January 1, 2012, the partnerships may apply the applicable regs (revised as of April 1, 2011).

The transition rule has been modified to provide that, for tax years that both begin on or after January 1, 2016, and end after February 4, 2016, these partnerships may continue to apply both applicable regs. For purposes of this transition rule, any change in ownership constitutes a material modification to the partnership agreement. This transition rule doesn't apply to any tax year (and all subsequent tax years) in which related persons collectively have the power to amend the partnership agreement without the consent of any unrelated party.

Important update

These final regs are an important update to foreign partnerships. If you believe they may affect your tax situation, discuss the matter with your CPA. •