

## Temporary Regulations Provide Rules for Allocating a Partnership's Foreign Taxes

On April 20, 2004, the IRS and Treasury released Treasury Decision 9121 containing temporary and final regulations under Section 704 of the Internal Revenue Code clarifying partnership allocations of foreign taxes.<sup>1</sup> These regulations are part of the IRS and Treasury's continuing focus on "inappropriate" foreign tax credit transactions. Similarly, Notice 2004-19<sup>2</sup> recently withdrew infamous Notice 98-5 and its promise of regulations potentially disallowing foreign tax credits under a nebulous "economic profit" test.<sup>3</sup> In Notice 2004-19 the IRS and Treasury stated that they "remain concerned about transactions that involve inappropriate foreign tax credit results" and that "[i]n appropriate circumstances, the IRS will challenge the claimed tax consequences of such transactions under the following principles of existing law: the substance over form doctrine, the step transaction doctrine, debt-equity principles, section 269, the partnership anti-abuse rules of §1.701-2, and the substantial economic effect rules of §1.704-1."

As explained more fully below, the new regulations are generally aimed at allocations of foreign taxes paid by partnerships that differ from the allocations of the underlying foreign income. These regulations apply only to entities treated as partnerships for U.S. federal income tax purposes, but viewed as taxable entities in a foreign jurisdiction. Also as explained more fully below, the regulations provide a "safe harbor" for partnership allocations of foreign taxes. Unfortunately, these regulations do not directly answer the question as to how a partnership allocates indirect taxes when it receives a dividend from a foreign corporation. We are hopeful this additional guidance will be provided when the regulations are finalized.

These regulations are effective for partnership taxable years beginning on or after April 21, 2004, although a transition rule is also provided. Under the transition rule, if a partnership agreement was entered into before April 21, 2004, the partnership may elect not to apply the amendments to the Section 704(b) regulations made by Treasury Decision 9121 until any subsequent material modification to the partnership agreement. A material modification will, for these purposes, include any change in ownership of the partnership. This very favorable transition rule does not apply, however, if as of April 20, 2004, persons that are related to each other (within the meaning of Section 267(b) and Section 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

### Partnership Allocations in General

The partnership rules of subchapter K generally permit taxpayers to conduct joint business activities without incurring an entity-level tax. The absence of an entity-level tax is, of course, one of the primary reasons business owners choose to conduct their affairs through partnerships. Under the rules of subchapter K, partners are generally permitted – within limits – to decide how the tax benefits and burdens attributable to partnership operations are to be shared by the partners. Section 704(a) specifically provides that the distributive share of income,

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gain, loss, deduction, or credit allocable to any partner shall, except as otherwise provided, be determined by the partnership agreement.

A partnership's ability to allocate its income according to its partnership agreement is not absolute, and Section 704(b) places significant limitations on partnership allocations. Specifically, Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement lacks "substantial economic effect". The statute generally provides that partnership allocations either must have substantial economic effect or must be in accordance with the partners' interests in the partnership.

Whether an allocation of income, gain, loss, deduction or credit to a partner has substantial economic effect essentially involves a two-part analysis that is made as of the end of the taxable year of the partnership making the allocation. First, the partnership allocation must have "economic effect" under Treas. Reg. section 1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be "substantial" within the meaning of Treas. Reg. section 1.704-1(b)(2)(iii).

An allocation has economic effect if it is consistent with the underlying economic arrangement of the partners. In other words, if there is an economic benefit (or burden) that relates to the allocation in question, the partner to whom the allocation is made must also receive such economic benefit (or bear such burden).<sup>4</sup> An allocation of income, gain, loss, deduction or credit (or item thereof) to a partner will, generally speaking, have economic effect only if the partnership agreement provides throughout the full term of the partnership: (i) for the determination and maintenance of the partners' capital accounts in accordance with Treas. Reg. section 1.704-1(b)(2)(iv); (ii) for liquidating distributions to be made in accordance with the positive capital account balances of the partners; and (iii) for each partner to be unconditionally obligated to restore any deficit balance in his or her capital account following the liquidation of such partner's interest in the partnership.<sup>5</sup>

Treas. Reg. section 1.704-1(b)(2)(iii)(a) generally provides that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. However, even if the allocation affects substantially the dollar amounts involved, the economic effect of the allocation is not substantial if, at the time the allocation becomes part of the partnership agreement: (i) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (ii) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

The Section 704(b) regulations indicate that the allocation of certain items such as tax credits, nonrecourse deductions, and recapture amounts generally *cannot* have substantial economic effect. The theory behind the proposition that allocations of tax credits cannot, generally speaking, have substantial economic effect is that tax credits do not affect a partner's capital account, and thus cannot impact the amount of cash a partner is entitled to with respect to current or liquidating distributions from the partnership. The Section 704(b) regulations accordingly provide guidance on allocating those items in a manner that will be deemed to be in accordance with the partners' interests in the partnership.<sup>6</sup> As explained above, the IRS's view is that the new temporary regulations contained in TD 9121 "clarify" existing law: because the allocation of creditable foreign taxes and, by extension, foreign tax credits can never have substantial economic effect, such amounts must be allocated in accordance with the partners' interest in the partnership. The IRS does not explicitly provide its rationale for the conclusion – now embodied in the temporary regulations – that allocations of creditable foreign taxes (as opposed to allocations of tax credits) do not have substantial economic effect. "Clarification" language notwithstanding, the preamble to the temporary regulations states that *no inference* is intended regarding the allocation of foreign taxes prior to the amendments made by the temporary regulations.

Section 901(b)(5) provides that an individual partner will, subject to certain limitations, qualify for the foreign tax credit for his or her proportionate share of foreign taxes paid or accrued by the partnership during the taxable year. Generally speaking, an entity treated as a partnership for U.S. federal income tax purposes will not “pay” foreign taxes within the meaning of Section 901 unless such entity is viewed as a taxable entity by the foreign country (*i.e.*, the partnership is a hybrid entity).

Section 702(a)(6) provides that each partner shall take into account separately his or her distributive share of the partnership’s taxes, described in Section 901, paid or accrued to foreign countries and to possessions of the United States. Section 703(a)(2)(B) provides that the partnership is not entitled to the deduction for taxes provided in Section 164(a) with respect to taxes described in Section 901 paid or accrued to foreign countries and to possessions of the United States. Section 703(b)(3) provides that elections affecting the computation of partnership taxable income shall be made by the partnership, except that any election under Section 901 (relating to foreign taxes) shall be made by each partner separately.

### The Temporary Regulations

Temp. Treas. Reg. section 1.704-1T(b)(4)(xi) reads as follows:

**Allocations of creditable foreign taxes --(a) In general. Allocations of creditable foreign taxes cannot have substantial economic effect and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. An allocation of a creditable foreign tax will be deemed to be in accordance with the partners' interests in the partnership if--**

**(1) The requirements of either paragraph (b)(2)(ii)(b) or (b)(2)(ii)(d) of this section are satisfied (i.e., capital accounts are maintained in accordance with paragraph (b)(2)(iv) of this section, liquidating distributions are required to be made in accordance with positive capital account balances, and each partner either has an unconditional deficit restoration obligation or agrees to a qualified income offset); and (2) The partnership agreement provides for the allocation of the creditable foreign tax in proportion to the partners' distributive shares of income (including income allocated pursuant to section 704(c)) to which the creditable foreign tax relates.**

**(b) Creditable foreign taxes. A creditable foreign tax is a foreign tax paid or accrued for U.S. tax purposes by a partnership and that is eligible for a credit under section 901(a). A foreign tax is a creditable foreign tax for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such amount.**

**(c) Income related to foreign taxes. A foreign tax is related to income if the income is included in the base upon which the taxes are imposed, which determination must be made in accordance with the principles of §1.904-6.**

These temporary regulations clarify the application of the regulations under Section 704 to creditable foreign taxes for which the partnership bears legal liability as described in Treas. Reg. section 1.901-2(f).<sup>7</sup> As noted above, unlike most other trade or business expenses, foreign taxes described in Sections 901 or 903 are fully creditable against a partner’s U.S. federal income tax liability, subject to certain limitations, including primarily the foreign tax credit limitation under Section 904. For this reason, the temporary regulations provide that partnership allocations of creditable foreign taxes cannot have substantial economic effect and, therefore, must be allocated in accordance with the partners’ interests in the partnership.

As noted above, the temporary regulations establish a safe harbor under which partnership allocations of foreign taxes will be deemed to be in accordance with the partners' interests in the partnership. Under this safe harbor, if the partnership agreement satisfies the requirements of Treas. Reg. section 1.704-1(b)(2)(ii)(b) or (d) (*i.e.*, capital account maintenance, liquidation according to capital accounts and either a deficit restoration obligation or a qualified income offset provision), then an allocation of foreign taxes that is proportionate to a partner’s distributive share of partnership income to which such taxes relate (including income allocated pursuant to Section 704(c)) will be

deemed to be in accordance with the partners' interests in the partnership. The IRS believes this rule is consistent with the underlying purposes of the foreign tax credit and the foreign tax credit limitation, which is, respectively, to avoid double taxation of foreign source income and to prevent foreign tax credits from offsetting the U.S. tax on U.S. source income. The IRS also believes that this rule achieves greater parity between entities that are taxed under foreign law at the partner level and entities that are taxed under foreign law at the entity level. If a partnership were taxed under foreign law at the partner level, then the amount of foreign taxes imposed on a partner generally would be proportionate to the partner's share of the income subject to the foreign tax. The partner would take into account this amount of foreign tax in computing U.S. tax liability. Likewise, for partnerships that are taxed under foreign law at the entity level, the safe harbor provides that a partner is allowed to take into account in computing U.S. tax liability the share of the partnership's foreign taxes that is proportionate to the partner's share of the income to which such taxes relate.

If the partnership does not satisfy this safe harbor, then the partnership's allocations will be tested under the partners' interests in the partnership standard set forth in Treas. Reg. section 1.704-1(b)(3). The determination of a partner's interest in a partnership is generally made by taking into account all facts and circumstances relating to the economic arrangement of the partners. Among the facts to be considered are: (i) the partners' individual and combined contributions to the partnership; (ii) the interests of the partners in economic profits and losses (if different from their interests in taxable income or loss); (iii) the interests of the partners in cash flow and other non-liquidating distributions; and (iv) the rights of the partners to distributions of capital upon liquidation. Each partner's interest in the partnership ultimately is the way the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. The sharing arrangement with respect to a particular item may or may not correspond to the overall economic arrangement of the partners. For example, where a partnership's allocation of foreign taxes does not satisfy the safe harbor contained in the temporary regulations, the allocation may in certain circumstances (such as where there is substantial certainty that U.S. partners will deduct, rather than credit, foreign taxes) be in accordance with partners' interests in the partnership under Treas. Reg. section 1.704-1(b)(3).

#### Examples of the Application of the Temporary Regulations

The application of the temporary regulations in simple situations is generally straightforward. For example, assume two U.S. persons, A and B, form a limited liability company ("LLC") treated as a partnership for U.S. tax purposes. LLC's operating agreement provides that the members' capital accounts will be determined and maintained in accordance with paragraph Treas. Reg. Section 1.704-1(b)(2)(iv), and that liquidation proceeds will be distributed in accordance with the members' positive capital account balances. The LLC's operating agreement also has a qualified income offset provision. LLC operates a widget business in Canada and also earns income from passive investments in Canada. Assume that Canada imposes a 30 percent tax on the widget business income (a creditable foreign tax) but exempts from tax passive investment income. In year 1, LLC earns \$100 of income from the widget business and \$30 from passive investments and therefore pays (or accrues) \$30 of Canadian taxes. Under Section 904(d), the income from the widget business is general limitation income and the income from the passive investments is passive income. Pursuant to LLC's operating agreement, all partnership items, including creditable foreign taxes, from the widget business are allocated 70 percent to A and 30 percent to B, and all partnership items, including creditable foreign taxes, from passive investments are allocated 60 percent to A and 40 percent to B. Accordingly, A is allocated 70 percent of the widget business income (\$70) and 70 percent of the Canadian taxes (\$21), and B is allocated 30 percent of these items (widget business income of \$30, and \$9 of Canadian taxes).

Under Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), the \$30 of taxes is related to the \$100 of general limitation income and no portion of the taxes is related to the passive income. Because LLC's operating agreement allocates the general limitation income 70/30 and the Canadian taxes 70/30, the allocations of Canadian taxes are in proportion to the allocation of the Canadian income to which the foreign tax relates. Because LLC satisfies the requirement of Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), the allocations of the Canadian taxes are deemed to be in accordance with the members' interests in the partnership.

Even when partnerships operate in more than two foreign countries, the operation of the temporary regulations are still relatively easy to understand. Assume, as in the example above, U.S. persons A and B form LLC, again treated as a partnership for U.S. tax purposes. LLC's operating agreement again provides that the members' capital accounts will be determined and maintained in accordance with Treas. Reg. Section 1.704-1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the members' positive capital account balances, and has a qualified income offset provision. LLC operates a widget manufacturing business in Canada and a widget manufacturing business in Mexico. Assume that the widget businesses are subject to a 40 percent tax in Canada and a 20 percent tax in Mexico. Both of these countries' taxes are creditable foreign taxes.

In year 1, LLC has \$100 of income from its Canadian business and \$50 from its Mexican business. As described above, Canada imposes \$40 of tax on the income from the widget business and Mexico imposes \$10 of tax on the widget business income. Pursuant to the operating agreement, all LLC items, including creditable foreign taxes, from the Canadian business are allocated 75 percent to A and 25 percent to B, and all LLC items, including creditable foreign taxes, from the Mexican business are split evenly between A and B. Accordingly, A is allocated 75 percent of the income from the Canadian business (\$75), 75 percent of the Canadian taxes (\$30), half the income from the widget business conducted in Mexico (\$25), and half the Mexican taxes (\$5). B is allocated 25 percent of the income from Canada (\$25) and a quarter of the Canadian taxes (\$10), half the income from the Mexican business (\$25), and half the Mexican taxes (\$5).

Because both the Canadian and Mexican income is general limitation income and the partnership agreement provides for different allocations with respect to such income, it is necessary to determine which foreign taxes are related to the Canadian income and which foreign taxes are related to the Mexican business income. Under Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), as one might expect, the \$40 of Canadian taxes is related to the Canadian business, and \$10 of Mexican taxes is related to the Mexican business. As LLC's operating agreement allocates the \$40 of Canadian taxes in the same proportion as the general limitation income from the Canadian operations, and the \$10 of the Mexican operation's taxes in the same proportion as the general limitation income from the LLC's Mexican business, the allocations of the Canadian taxes and the Mexican taxes are in proportion to the allocation of the income to which the foreign taxes relate. Because LLC satisfies the requirements of Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), the allocations of the Canadian and Mexican taxes are deemed to be in accordance with the members' interests in LLC.

Assume that LLC does not actually receive the \$50 accrued with respect to LLC Mexico until year 2. Also assume that A, B and LLC each report taxable income on an accrual basis for U.S. tax purposes and LLC reports taxable income on a cash basis in Canada and Mexico. In year 1, LLC pays Canada tax of \$40. In year 2, LLC pays Mexico tax of \$10. Pursuant to the partnership agreement, in year 1, A is allocated 75 percent of Canadian income (\$75) and Canadian taxes (\$30) and 50 percent of Mexico income (\$25). B is allocated 25 percent of both the Canadian income (\$25) and tax (\$10) and half of the Mexican income (\$25). In year 2, the year LLC actually pays \$10 in tax to Mexico, A and B will each be allocated 50 percent of such taxes (\$5).

Because the income from both the Canadian business and the Mexican business is general limitation income and the operating agreement provides for different allocations with respect to such income, it is necessary to determine which foreign taxes are related to the Canadian business income and which foreign taxes are related to the business conducted in Mexico. Under Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), \$40 of Canadian tax is related to the \$100 of general limitation income from the widget business conducted in Canada. Under Temp. Treas. Reg. section 1.704-1T(b)(4)(xi), the tax Mexico imposed in year 2 is allocable to the \$50 of income LLC derived from its Mexican operations that LLC *recognizes in year 2 under Mexican law*. This tax is treated as paid in year 2 on the \$50 of business income from Mexico recognized for U.S. tax purposes in year 1 because of LLC's accrual method of accounting for U.S. tax purposes. Accordingly, the \$10 of taxes Mexico imposed is related to the \$50 of general limitation income from LLC's business operations in Mexico. Because LLC's operating agreement allocates the \$40 of Canadian taxes in proportion to the general limitation income from LLC's Canadian operations, and the \$10 of taxes Mexico imposed in respect of the LLC's business operations in Mexico in proportion to the year 1 general limitation income from Mexico, the allocations of the Canadian and Mexican taxes are in proportion to the allocation of the income to which the foreign taxes relate. Therefore, LLC's operating agreement satisfies the requirement of

Temp. Treas. Reg. section 1.704-1T(b)(4)(xi)(a)(2). Because LLC also satisfies the requirements of Temp. Treas. Reg. section 1.704-1T(b)(4)(xi)(a)(1), the allocations of the Canadian and Mexican taxes are deemed to be in accordance with the members' interests in the LLC under Temp. Treas. Reg. section 1.704-1T(b)(4)(xi).

The examples above show that in simple situations, determining if a partnership's allocation of foreign taxes falls within the safe harbor is straightforward. The temporary regulations contain an interesting example (Example 28) showing allocations of foreign taxes that are deemed to not be in accordance with the partners' interests in the partnership.

**A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership. AB operates business M in country X. Assume that country X imposes a 20 percent tax on the net income from business M, which tax is a creditable foreign tax. In year 1, AB earns \$300 of gross income, has deductible expenses, exclusive of creditable foreign taxes, of \$100, and pays or accrues \$40 of country X tax. For purposes of section 904(d), all income from business M is general limitation income. Pursuant to the partnership agreement, the first \$100 of gross income each year is allocated to A as a return on excess capital contributed by A. All remaining partnership items, including creditable foreign taxes, are split evenly (50/50) between A and B. Assume that the gross income allocation is not deductible for country X purposes.**

**Under paragraph (b)(4)(xi) of this section, the \$40 of taxes is related to the \$200 of general limitation net income. In year 1, AB's partnership agreement allocates \$150 or 75 percent of the general limitation income to A (\$100 attributable to the gross income allocation plus \$50 of the remaining \$100 of net income) and \$50 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A (\$20) and 50 percent to B (\$20). Under paragraph (b)(4)(xi) of this section, the allocation of country X taxes cannot have substantial economic effect and must be allocated in accordance with the partners' interests in the partnership. AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(xi) of this section, because they are not in proportion to the allocation of the income to which the country X taxes relates.**

While the example concludes that the allocations fail to meet the safe harbor, there is no indication as to what sort of allocation should then occur in order to ensure that the foreign taxes are allocated in accordance with the partners' interests in the partnership. While making allocations in accordance with the partners' interest in the partnership is always factually intensive, the usefulness of the example is somewhat limited by its lack of guidance on this point.<sup>8</sup>

### Conclusion

We commend the IRS and Treasury for the client guidance that has been provided in the temporary regulations under Section 704 for the allocation of foreign taxes. That said, it is unfortunate that the temporary regulations do not directly answer the question as to how a partnership allocates indirect taxes. As noted above, we are hopeful this additional guidance will be provided when the regulations are finalized. We are also hopeful that the IRS and Treasury will provide more explicit guidance as to how the partners' interests in the partnership is to be determined when allocating creditable foreign taxes in a manner outside the safe harbor of the temporary regulations.

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May, 2004

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<sup>1</sup> At the same time, proposed regulations under Section 704(b) were also issued. REG-139792-02.

<sup>2</sup> 2004-11 IRB 606.

<sup>3</sup> 1998-1 CB 334.

<sup>4</sup> Treas. Reg. section 1.704-1(b)(2)(ii).

<sup>5</sup> The partnership may satisfy the qualified income offset rules set forth in Treas. Reg. section 1.704-1(b)(2)(ii)(d) instead of satisfying condition (iii) (the deficit restoration requirement).

<sup>6</sup> Treas. Reg. section 1.704-1(b)(4) and Treas. Reg. section 1.704-2.

<sup>7</sup> Treas. Reg. section 1.901-2(f) provides, in relevant part, that "[t]he person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax".

<sup>8</sup> Presumably in this example, the IRS is looking for \$32.5 of foreign taxes to be allocated to A, and \$7.5 of foreign taxes to be allocated to B, so that the allocation of foreign taxes corresponds proportionately to the \$130 of after-tax returns to A and \$30 of after-tax returns to B. If so, then the required foreign tax allocations do not correspond to the parties' business deal of 50-50 allocations (\$20 of foreign taxes each to A and B). Thus, other reallocations (of other items of tax income and expense) are required in order to achieve the contemplated business deal.

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