

New Rules on Partnership Allocations of Foreign Taxes

By Paul C. Lau, Nora Stapleton and Brian Carter

Paul C. Lau, Nora Stapleton and Brian Carter examine the final regulations on partnership allocations of foreign income tax.

On October 18, 2006, the IRS issued final regulations on partnership allocations of foreign income tax.¹ These new rules modify and clarify the proposed and temporary regulations issued on April 21, 2004.²

The final regulations generally apply to partnership tax years beginning on or after October 19, 2006. Partnerships, however, may rely on the final regulations for partnership tax years beginning on or after April 21, 2004.

Like the temporary regulations, the final regulations generally apply to partnerships formed after April 20, 2004. Partnerships of related parties (described in Code Secs. 267(b) and 707(b)), however, are subject to the final regulations if the related parties can amend the partnership agreement without third-party consent.

Partnerships of unrelated parties that are formed before April 21, 2004, are not subject to the regulations until a material modification to the partnership agreement, which includes an ownership change. If the partnership agreement was materially modified after April 20, 2004, but before a tax year beginning on or after October 19, 2006, the temporary regulations would apply. For a partnership agreement that was materially modified after a tax year beginning on or after October 19, 2006, the final regulations apply.³

Partnership Allocations

Under Code Sec. 704(a), a partner's distributive share of income, gain, loss, deductions and credits is deter-

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mined by the partnership agreement. This means that partners are permitted to decide how a partnership's items of income, gain, loss, deductions and credits are to be allocated. However, the allocations under the partnership agreement must have "substantial economic effect" under Code Sec. 704(b). Otherwise, the allocations are determined by taking into account all facts and circumstances, in accordance with the "partners' interests in the partnership" (or Partners' interests). Partnerships typically try to provide allocations that have substantial economic effect.

An allocation has substantial economic effect only if the following applies:

- The allocation has economic effect under Reg. §1.704-1(b)(2)(ii).
- The economic effect is substantial under Reg. §1.704-1(b)(2)(iii).

An allocation has economic effect if the partnership agreement provides the following provisions throughout the term of the partnership agreement:

- The partners' capital accounts must be maintained in accordance with Reg. §1.704-1(b)(2)(iv).
- Liquidating distributions must be made in accordance with the positive capital account balances of the partners.
- Deficit capital account balances must be unconditionally restored by the partners following the liquidation of their partnership interests or be subject to the qualified income offset rules of Reg. §1.704-1(b)(2)(ii)(d).⁴

Under Reg. §1.704-1(b)(2)(iii), the economic effect of an allocation is substantial if there is a reasonable chance that the allocation will substantially affect the dollar amounts (independent of the income tax effects) to be received by

the partners. However, the economic effect cannot be substantial if (1) at least one partner's after-tax economic consequences may (in present value terms) be enhanced in comparison to the results without such allocation, and (2) no partner's after-tax economic consequences will (in present value terms) be substantially diminished in comparison to the results without such allocation.

The regulations also state that certain items, such as tax credits and nonrecourse deductions, cannot have substantial economic effect.⁵ Accordingly, these items must be allocated in accordance with the partners' interests in the partnership.

Foreign Income Tax Allocations

Code Sec. 702(a)(6) provides that each partner takes into account separately his distributive share of the partnership's foreign income taxes. Under Code Sec. 901(b)(5), a partner can, subject to certain limitations, qualify for the foreign tax credit (FTC) for his distributive share of foreign income taxes paid or accrued by the partnership. The partnership is not entitled to claim a deduction (or credit) for the foreign income taxes. Instead, each partner separately decides how to report and treat the foreign income taxes.⁶

Temporary Regulations

Temporary Reg. §1.704-1T(b)(xi)(a) provided that allocations of foreign income taxes could not have substantial economic effect. This meant that foreign income taxes must be allocated in accordance with the partners' interests in the partnership. The temporary regulations provided a safe harbor under which partnership allocations of foreign income taxes would be deemed to be in accordance with the partners' interests in the partnership. Under the safe harbor, an allocation of foreign income tax would be deemed to be in accordance with the partners' interests in the partnership where the economic effect provisions (described above) were met and the foreign tax was allocated in proportion to the partner's distributive share of income to which the tax relates. A foreign tax was related to an income item when the income, based on principles of Reg. §1.904-6, was included in the base upon which the foreign income tax was assessed.

Final Regulations

The final regulations retain the provisions that allocations of foreign income taxes cannot have substantial

economic effects under Reg. §1.704-1(b)(2). As in the temporary regulations, the final regulations provide a safe harbor under which allocations of creditable foreign tax expenditures (CFTEs) will be deemed to be in accordance with the partners' interests in the partnership. To satisfy the safe harbor, allocations of CFTEs must be in proportion to the distributive shares of income to which the CFTEs relate.⁷ Detailed rules are provided to account for CFTEs and the income to which the tax expenditures relate.

Under the final regulations, the income to which a CFTE relates is the net income in the CFTE category to which the CFTE is allocated and apportioned. A CFTE category is a category of net income from one or more activities of the partnership. The net income in a CFTE category is the net income determined for U.S. federal income tax purposes (U.S. net income) of one or more activities of the partnership that is included in the CFTE category. Income from one or more activities is included in the same CFTE category if the U.S. net income from the activities is allocated among the partners in the same proportions. If income from one or more activities is shared in different ratios, each group of income that is subject to a different allocation ratio is treated as income in a separate CFTE category. CFTEs are allocated and apportioned to CFTE categories based on Reg. §1.904-6 principles, with certain modifications. In effect, a CFTE is allocated to a CFTE category if the income on which the CFTE is imposed is in the CFTE category.

Safe Harbor

The safe harbor essentially requires the following four steps to allocate CFTEs among partners:

1. Determine the CFTE categories.
2. Determine the U.S. net income, and each partner's distributive share of such income, in each CFTE category.
3. Allocate and apportion CFTEs to the CFTE categories of net income, recognized for foreign tax purposes, on which the CFTEs are imposed.
4. Allocate CFTEs in each CFTE category among the partners in the same proportion as the allocations of U.S. net income in the applicable CFTE category.

Unlike the temporary regulations, the final regulations do not require compliance with the substantial economic effect under Reg. §1.704-1(b)(2). The safe harbor is available as long as the allocation of partnership items that have a material effect on the allocation of CFTEs to partners are valid.⁸ The partnership agreement

also does not need to have a specific provision on the allocation of CFTEs to apply the safe harbor.⁹

Creditable Foreign Tax Expenditures (CFTEs)

A CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under Code Sec. 901(a). Under Code Sec. 902 or 960, a qualified domestic corporate shareholder may also claim a credit under Code Sec. 901(a) for taxes paid or accrued by a foreign corporation. The final regulations clarify that deemed-paid taxes under Code Sec. 902 or 960 are not taxes paid or accrued by a partnership and therefore are not subject to the regulations.

The regulations do not apply to foreign taxes paid or accrued by a partner (foreign taxes for which the partner has legal liability within the meaning of Reg. §1.901-2(f)), but do apply to foreign tax paid or accrued by a partnership that is eligible for a credit under an applicable U.S. income tax treaty.¹⁰

CFTE Categories

The final regulations clarify that the safe harbor does not require the partnership to determine its CFTE categories by reference to the Code Sec. 904(d) foreign tax categories.

If a partnership agreement allocates all partnership items in the same manner, the partnership will have a single CFTE category, regardless of the number of activities in which the partnership is engaged. However, if the partnership agreement provides for an allocation of U.S. net income from one or more activities that differs from the allocation of U.S. net income from other activities, U.S. net income from each activity or group of activities that is subject to a different allocation is treated as net income in a separate CFTE category.¹¹ Therefore, a partnership agreement that provides for different allocations of net income from one or more activities will have multiple CFTE categories. Special allocations such as guaranteed payments, gross income allocations or other preferential allocations will result in multiple CFTE categories if the payment or allocation is determined by reference to income from less than all of the partnership's activities.¹²

All facts and circumstances must be considered in determining whether a partnership has different income sharing ratios and therefore has more than one CFTE category. Once it is determined that there are more than one CFTE category, the partnership's activities may be aggregated or segregated into

separate CFTE categories. In evaluating whether the aggregation and /or segregation of activities and the scope of each activity are reasonable, the principal consideration is whether or not the method has the effect of separating CFTEs from the related foreign income. Facts that are relevant in making this determination include (1) whether the partnership conducts business or investment operations in more than one geographic location or through more than one entity or branch, and (2) whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. A partnership's activities must be determined and aggregated or segregated consistently from year to year absent a material change in facts and circumstances.¹³ See Examples 1 and 2 for illustrations of separate CFTE categories.

CFTE Category Net Income

Net income in a CFTE category is the net income for U.S. federal income tax purposes, determined by taking into account all items attributable to the activity or activities (or portion thereof) in the CFTE category. All Code Sec. 704(c) allocations of built-in gain/loss assets (including "reverse" Code Sec. 704(c) allocations and Code Sec. 704(c) allocations that are made prior to an asset's disposition) must be taken into account in determining net income in a CFTE category.¹⁴ See Example 6 for an illustration of Code Sec. 704(c) allocation.

Items of gross income of an activity included in a CFTE category must be determined in a consistent manner under a reasonable method based on all the facts and circumstances. Expenses, losses or other deductions generally are allocated and apportioned to gross income of an activity in accordance with Reg. §1.861-8 and Temporary Reg. §1.861-8T. Under these regulations, special rules contained in Reg. §1.861-9 through Temporary Reg. §1.861-13T and Reg. §1.861-17 are applicable for allocating and apportioning interest expense and research and development (R&D) costs. These special rules require that such expenses be allocated and apportioned at the partner level and do not provide rules for allocating and apportioning these expenses at the partnership level. See Temporary Reg. §1.861-9T(e) and 1.861-17(f). For purposes of determining net income in a CFTE category, the final regulations allow a partnership to allocate and apportion interest and R&D expenses under any reasonable method, including but not limited to the rules in Reg. §1.861-9 through Temporary Reg. §1.861-13T and Reg. §1.861-17.¹⁵

In determining the net income attributable to an activity of a branch, only items of gross income that are recognized by the branch for U.S. federal income tax purposes are included. A payment from one branch to another does not increase the gross income attributable to the activity of the recipient. Similarly, because U.S. tax principles apply to determine net income attributable to an activity of a branch, the inter-branch payment does not reduce the gross income of the payor.¹⁶

Special rules apply in determining net income when there are (1) preferential income allocations, (2) guaranteed payments, or (3) income of certain partners not subject to foreign tax. If a preferential income allocation or a guaranteed payment to a partner results in a deduction under foreign law, then no CFTE is related to that income because it is not included in the foreign tax base. Therefore, Reg. §1.704-1(b)(4)(viii)(c)(3)(ii) provides that income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) to a partner results in a deduction under foreign law. By excluding income associated with a preferential income allocation or a guaranteed payment that is deductible under foreign law from the net income in a CFTE category, no CFTE will be related to such income.

If a preferential income allocation or a guaranteed payment to a partner is not deductible under foreign law, a CFTE is related to such income since the allocation or payment does not reduce the foreign tax base. Any CFTEs related to such payments are allocated to the partners receiving the preferential income allocations or guaranteed payments. See Examples 3, 4, 10 and 11 for illustrations of special allocations.

Similarly, net income does not include income allocated to a partner that is excluded from the foreign tax base under the foreign law.¹⁷ This ensures that CFTEs will be related only to income of those partners whose income is subject to the foreign tax.

Distributive Share of CFTE Category Net Income

A partner's distributive share of income generally is the portion of the net income in a CFTE category that is allocated to the partner. A guaranteed payment is treated as a distributive share of income if it is not deductible under foreign law. In cases where one or more partners receive positive income allocations from a CFTE category that exceeds the net income in the CFTE category because one or more other partners

is allocated a net loss, the distributive share of income of each partner that receives a positive income allocation is adjusted solely for purposes of allocating CFTEs under the safe harbor. The partner's distributive share of income is adjusted to an amount of the net income in the CFTE category that is in proportion to the partner's share of positive income allocation relative to the aggregate positive income allocation.¹⁸

The Preamble provides the following example: Assume that the partnership has \$100 of net income (\$130 of gross income and \$30 of expenses) in a CFTE category and that partner A is allocated \$65 of gross income, partner B is allocated \$45 of gross income and partner C is allocated \$20 of gross income and \$30 of expenses. In this case, solely for purposes of the safe harbor, partner A's distributive share of income is \$59 ($\$65/\$110 \times \100) and partner B's distributive share of income is \$41 ($\$45/\$110 \times \100).

Allocate and Apportion CFTEs

Reg. §1.904-6, which contains rules for allocating and apportioning foreign taxes to the categories of income described in Code Sec. 904(d), provides generally that a foreign tax is related to income if the income is included in the base upon which the foreign tax is imposed. Reg. §1.904-6(a)(1)(ii) contains rules for apportioning taxes among categories of income when the income is included in more than one category. It also provides rules for allocating a foreign tax that is imposed on income that is recognized under U.S. tax principles in another year (timing difference) or an item that does not constitute income under U.S. tax principles (base differences).

Under the final regulations, the principles of Reg. §1.904-6(a)(1)(ii) apply, with certain modifications. Foreign taxes are apportioned among CFTE categories based on the relative amounts of net income (as determined under foreign law) in each category.¹⁹

One modification to Reg. §1.904-6(a)(1)(ii) is that the special rule for related party interest expense under Reg. §1.904-6(a)(1) does not apply for the purposes of apportioning CFTEs to CFTE categories. Another modification is that if foreign law does not provide rules for allocating and apportioning expenses, losses or other deductions, then such expenses, losses or other deductions must be allocated and apportioned to gross income (as determined under foreign law) in a manner that is consistent with the allocation and apportionment of such items for purposes of determining CFTE category net income for U.S. tax purposes.²⁰

Timing differences occur when income is recognized and taxed for foreign purposes in one year, but is recognized in another year under U.S. tax principles. With respect to timing differences, the temporary regulations included an example which indicated that a current year CFTE attributable to an income item recognized in a prior year for U.S. tax purposes related to, and thus must be allocated in accordance with, the income allocated under the partnership agreement in the prior year. To provide for a more administrable rule, the final regulations allocate CFTEs attributable to timing differences among the partners in the same proportion as the allocations of the CFTE category income, recognized for U.S. tax purposes, in the year such taxes are paid or accrued. This approach is intended to provide allocations of CFTEs that are generally in proportion to the partners' distributive shares of U.S. taxable income over time.

The final regulations expressly adopt the timing difference rule of Reg. §1.904-6(a)(1)(iv). Accordingly, a CFTE attributable to a timing difference is allocated to the CFTE category in which the income would have been assigned if the income were recognized for U.S. tax purposes in the year the foreign tax is imposed.²¹ See Example 5 for an illustration of timing differences.

A base difference occurs when an item subject to foreign tax is not income under U.S. tax principles. For a CFTE attributable to a base difference, it is treated as related and allocated to the relevant CFTE category net income in the year such taxes are paid or accrued. For this purpose, the relevant CFTE category is the category that includes the activity on which the foreign tax is imposed.²²

If CFTEs are allocated and apportioned to a CFTE category that has no net income for U.S. tax purposes, the CFTEs will be deemed to relate to the aggregate net income (if any) recognized by the partnership in the CFTE category during the preceding three-year period (not taking into account years in which there is a net loss in the CFTE category for U.S. tax purposes). The CFTEs are allocated among the partners in the same proportion as the allocations of such net income for the prior three-year period to satisfy the safe harbor. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the preceding three tax years, the CFTEs must then be allocated among the partners in the same proportion that the partnership reasonably expects to allocate net income in the applicable CFTE category over the succeeding three

years. If the partnership does not reasonably expect to have net income in the applicable CFTE category in the succeeding three years, the CFTEs must be allocated among the partners in the same proportion as the partnership net income for the year is allocated. If the CFTE cannot be allocated under any of the foregoing rules, it must be allocated in proportion to the partners' outstanding capital contributions.²³

Interbranch Transactions

In determining the net income attributable to an activity of a branch, only items of gross income that are recognized by the branch for U.S. federal tax purposes are included. Therefore, a payment from one branch to another branch neither increases the gross income of the recipient nor reduces the gross income of the payor. If a branch (including a disregarded entity owned by the partnership) is taxed under foreign law for a payment (interbranch payment) it receives from the partnership or another branch of the partnership, any CFTE imposed on the payment relates to the CFTE category that includes the payment. If the recipient partnership has more than one CFTE category, the tax is allocated to the CFTE category that includes the items relating to the interbranch payment. A similar rule applies to payments received by the partnership from a branch of the partnership.²⁴ See Example 7 for an illustration of interbranch payments.

Partners' Interest in the Partnership

If an allocation of CFTEs does not satisfy the safe harbor, then the general test of partners' interest applies. The partners' interests standard is obviously difficult to rely upon to specially allocate foreign taxes. The Preamble to the final regulations specifically states that a partnership's allocation of a CFTE that does not satisfy the safe harbor, may in unusual circumstances (such as when U.S. partners will deduct, rather than credit, foreign taxes) be in accordance with partners' interests in the partnership.

In the Preamble, the IRS indicates that allocations of foreign taxes, based on a tracing approach for timing differences or inter-branch payments, may constitute unusual circumstances where the safe harbor is not satisfied, but the allocations are in accordance with the partners' interests in the partnership. See Examples 8 and 9 for the applications of the partners' interest in the partnership.

The IRS also stated that it will not reallocate other partnership items in the year in which a CFTE is reallocated. If the reallocation of a CFTE causes

the partners' capital accounts not to reflect their contemplated economic arrangement, the partners, and not the government, should determine what allocations should be changed to reflect their economic arrangement.

Examples

Example 1—Different tax rates for different types of income.²⁵

A&B form AB, a partnership for U.S. tax purposes. AB operates business M and earns income from passive investments in country Y. Country Y imposes a 40-percent income tax on business M, but exempts the passive income from taxation. Under the partnership agreement, all partnership items (including the CFTEs) from business M are allocated 60 percent to A and 40 percent to B. For all items from passive investment (including any CFTEs), 80 percent is allocated to A and 20 percent is allocated to B. In year 1, AB earns \$100 of income from business M and \$30 from passive investments and pays \$40 of country Y income taxes. Pursuant to the partnership agreement, A is allocated 60 percent of business M income (\$60) and 60 percent of Country Y's taxes (\$24) and B is allocated 40 percent of business M income (\$40) and 40 percent of Country Y's taxes (\$16). The \$30 of passive income is allocated 80/20 to A and B, respectively. Since the partnership agreement provides for different allocations of net income for business M and the passive investment, the net income for each is income in a separate CFTE category. AB must determine the net income in each CFTE category and the CFTEs allocable to each CFTE category. The net income in business M CFTE category is \$100 and the net income in the passive investment CFTE category is \$30. The \$40 of Country Y taxes is allocated to the business M CFTE category and is related to the \$100 of net income in business M CFTE category. Since the allocations of the CFTEs to A and B are in proportion to the distributive shares of income to which the CFTEs relate, the allocations of Country Y's taxes fall within the safe harbor.

Example 2—Operations in Different Foreign Countries.²⁶

A and B form AB, a partnership for U.S. tax purposes. AB operates business M in Country X and business N in Country Y. Country X imposes a 40-percent tax on business M in-

come and Country Y imposes a 20-percent tax on business N income. In year 1, AB has \$100 of income from business M and \$50 of income from business N. Country X imposes \$40 of tax on the income from business M and Country Y imposes \$10 of tax on the income of business N. The partnership agreement provides that all partnership items (including CFTEs) from business M are allocated 75 percent to A and 25 percent to B, and all partnership items (including CFTEs) from business N are split 50/50 between A and B. Accordingly, A is allocated 75 percent of the income from business M (\$75), 75 percent of the Country X taxes (\$30), 50 percent of the income from business N (\$25), and 50 percent of the Country Y taxes (\$5). B is allocated 25 percent of the income from business M (\$25), 25 percent of the Country X taxes (\$10), 50 percent of the income from business N (\$25) and 50 percent of the Country Y taxes (\$5). Since the partnership agreement provides for different allocations of net income for businesses M and N, the net income from each business is income in a separate CFTE category. The net income in the business M CFTE category is \$100 and the net income in the business N CFTE category is \$50. The \$40 of Country X taxes is allocated to the business M CFTE category and the \$10 of Country Y taxes is allocated to the business N CFTE category. Since the allocations of Country X's taxes and Country Y's taxes are in the same proportions as the allocations of net income in the respective CFTE categories to which the foreign taxes related, the allocations qualify for the safe harbor.

Example 3—Special Allocations of Depreciation.²⁷

A and B form AB, a partnership for U.S. tax purposes. AB operates business M in Country X and business N in Country Y. Country X imposes a 40-percent tax on business M income and Country Y imposes a 20-percent tax on business N income. Additional facts are:

- Business M has \$120 of income before machine X depreciation of \$20, with a net income of \$100 for U.S. and Country X tax purposes.
- Business N has \$70 of gross income and \$20 of expenses, with a net income of \$50 for U.S. and country Y tax purposes.
- Depreciation for machine X used in business M is allocated 100 percent to A.

- The first \$20 of gross income from business N is allocated to B. (Under foreign law, the allocation does not result in a deduction.)
- All remaining items (except CFTEs) are allocated 50/50.

Pursuant to the partnership agreement, A is allocated \$40 of net income from business M (50 percent of \$120 of business M income less \$20 of Machine X depreciation) and \$15 of net income from business N (50 percent of \$70 of gross income after reduction for \$20 allocated to B and \$20 of expenses). B is allocated \$60 of net income from business M and \$35 of income from business N (\$20 of gross income and \$15 net income). Because of the special allocations, the net income of business M (\$100) is allocated 40 percent to A (\$40) and 60 percent to B (\$60). The net income of business N (\$50) is allocated 30 percent to A (\$15) and 70 percent to B (\$35). See Table 1 below. Since there are different allocations of net income of businesses M and N, net income from each business is a separate CFTE category. The net income of the business M CFTE is \$100 and the net income of the business N CFTE is \$50. The \$40 of Country X taxes is related and allocated to the business M CFTE category and the \$10 of Country Y taxes is related and allocated to the business N CFTE category. To meet the safe harbor, the \$40 of Country X taxes must be allocated 40 percent to A and 60 percent to B. The \$10 of Country Y taxes must be allocated 30 percent to A and 70 percent to B.

Table 1.

Business M	A		B	
	Amount	%	Amount	%
Income before Depreciation	\$60	--	\$60	--
Depreciation	(20)	--	--	--
Net Income	40	40%	60	60%
Business N				
Gross Income	--	--	\$20	--
Remaining Gross Income (\$70-\$20)	\$25	--	\$25	--
Expenses	(10)	--	(10)	--
Net Income	15	30%	35	70%

Example 4—Special Allocation of Depreciation.²⁸ Same facts as Example 3, except that business M

has \$60 of income before machine X depreciation of \$20. Country X imposes \$16 of taxes on the net income of \$40. Pursuant to the partnership agreement, the \$40 net income of business M is allocated 25 percent to A (\$10 = 50% of \$60 less \$20 depreciation) and 75 percent to B (\$30 = 50% of \$60). To meet the safe harbor, the \$16 of Country X taxes must be allowed 25 percent to A (\$4) and 75 percent to B (\$12).

Example 5—Timing Differences.²⁹ A and B form AB, a partnership for U.S. tax purposes. AB operates business M in Country X and business N in Country Y. Country X imposes a 40-percent tax on business M income and Country Y imposes a 20-percent tax on business N income. Additional facts follow:

- AB reports taxable income on an accrual basis for U.S. tax purposes and taxable income on the cash basis for country X and country Y purposes.
- In year 1, AB has \$100 income (on cash and accrual basis) from business M.
- AB has accrued income of \$50 from business N that is not received until year 2.
- AB also accrues and receives \$100 of business N income in year 2.
- In year 1, AB pays or accrues country X taxes of \$40. In year 2, AB pays or accrues country Y taxes of \$30.
- All partnership items (including CFTEs) from business M are allocated 75 percent to A and 25 percent to B.
- All partnership items (including CFTEs) from business N are split 50/50 between A and B.

Pursuant to the partnership agreement, A is allocated 75 percent of business M income (\$75) and country X taxes (\$30) and 50 percent of business N income (\$25) in year 1. B is allocated 25 percent of business M income (\$25) and country X taxes (\$10) and 50 percent of business N income (\$25). In year 2, A and B are each allocated 50 percent of business N income (\$50) and country Y taxes (\$15).

In year 1, the \$40 of country X taxes related to the \$100 of net income in business M CFTE category. In year 2, \$20 of country Y taxes is allocated to business N CFTE category with

respect to the \$100 income accrued and received in year 2. The remaining \$10 of country Y taxes is associated with the timing difference in \$50 of business N income and is also allocated to business N CFTE category. See Table 2 below. Since the \$40 of country X taxes and the \$30 of country Y taxes are allocated in proportion to the distributive shares of income to which the taxes relate, the allocations satisfy the safe harbor.

Table 2.

Business M	A		B	
	Amount	%	Amount	%
Net income—Year 1	\$75	75%	\$25	25%
Country X taxes—Year 1	30	75%	10	25%
Business N				
Net Income				
Year 1	\$25	50%	\$25	50%
Year 2	50	50%	50	50%
Total	75	50%	75	50%
Country Y Taxes				
Year 1	--	--	--	--
Year 2	\$15	50%	\$15	50%
Total	\$15	50%	\$15	50%

Example 6—Code Sec. 704(c) Allocation.³⁰

A and B form AB, a partnership for U.S. tax purposes. AB operates business M in country X, and business N in country Y. Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively. A, a U.S. corporation, contributes a building with a fair market value (FMV) of \$200 and an adjusted tax basis of \$50 for both U.S. and Country X purposes. The building is used in business M. B, a Country X corporation, contributes \$800 cash. The AB partnership agreement provides the following:

- Allocations under Code Sec. 704(c) will be made under the traditional method under Reg. §1.704-3(b).
- All other partnership items (excluding CFTEs) will be allocated 20 percent to A and 80 percent to B.
- CFTEs will be allocated in proportion to the partners' distributive shares of net income (including Code Sec. 704(c) gain, income, loss or deductions) in each CFTE category.

In year 1, AB (1) sells the building contributed by A for \$200 and recognizes taxable income of \$150 for U.S. and Country X purposes and (2) earns \$250 of other income from business M. AB pays or accrues \$80 of Country X tax on the income. Also in year 1, business N has \$100 of taxable income for U.S. and Country Y purposes and pays or accrues \$40 of Country Y tax. Pursuant to the partnership agreement, the net income and CFTEs are allocated as shown in Table 3.

Table 3.

Business M	A		B	
	Amount	%	Amount	%
Code Sec. 704(c) income	\$150	100%	--	--
Other income	50	20	200	80
Total	200	50%	200	50%
Country X tax	\$40	50%	\$40	50%
Business N				
Net income	\$20	20%	80	80%
Country Y tax	8	20%	32	80%

As shown in the Table 3, net income from business M (\$400) is allocated 50/50 to A and B, while net income from business N (\$100) is allocated 20 percent to A and 80 percent to B. Since there are different allocations of net income, income from each business is a separate CFTE category. Business M CFTE category has net income of \$400 and Business N CFTE category has net income of \$100. The \$80 of Country X tax is related and allocated to Business M CFTE category and the \$40 of Country Y tax is related and allocated to Business N CFTE category. Since AB's partnership agreement allocates Country X taxes and Country Y taxes in proportion to the allocations of related income, the allocations of CFTEs meet the safe harbor.

Example 7—Interbranch payments.³¹

A and B form AB, a partnership for U.S. tax purposes. AB operates business M in Country X through DE1 and business N in Country Y through DE2. Both DE1 and DE2 are corporations for Country X and Y tax purposes but are disregarded entities for U.S. tax purposes. Country X imposes a 40-percent tax and Country Y imposes a 20-percent tax. In Year 1, DE1 has \$100 of income from business M before the payment of \$75 to DE2. DE2 has \$50 of income from business N

before payment of \$75 from DE1. The payment of \$75 is deductible by DE1 for Country X tax purposes and includible as income by DE2 for Country Y purposes. As a result of the \$75 payment, DE1 has taxable income of \$25 for Country X purposes and \$10 of Country X taxes. DE2 has taxable income of \$125 (\$50 of business N income and \$75 payment) for Country Y purposes and \$25 of Country Y taxes. For U.S. tax purposes, the interbranch payments of \$75 is disregarded. Therefore, AB's income attributable to DE1 is \$100 and income attributable to DE2 is \$50. The AB partnership agreement provides that (1) all partnership items (including CFTEs) from business M are allocated 75 percent to A and 25 percent to B, and (2) all partnership items (including CFTEs) from business N are allocated 50/50 to A and B. Under this agreement, the allocation of income and foreign taxes are shown in Table 4. The net income from each of business M and business N is income of a separate CFTE category due to different income allocations. Pursuant to Reg. §1.704-1(b)(4)(viii)(d)(1) and (3), the allocations of foreign taxes to CFTE categories are shown in Table 5.

Table 4.

	A		B	
	Amount	%	Amount	%
Business M income	\$75	75%	\$25	25%
Country X taxes	7.5	75	2.5	25
Business N income	25	50	25	50
Country Y taxes	12.5	50	12.5	50

Table 5.

	CFTE Category	
	Business M	Business N
Net income	\$100	\$50
Country X Taxes	10	--
Country Y taxes	--	25

In effect, \$10 of Country X taxes is related and allocated to the \$100 of net income in business M CFTE category and \$25 of country Y taxes is related and allocated to \$50 of net income in business N CFTE category. As shown above, the partnership agreement allocates the foreign country taxes in the same proportion as the distributive shares of income to which the taxes relate. Therefore, the allocations meet the safe harbor.

Example 8—Interbranch Payments.³² Same facts as Example 7, except that the partnership agreement provides that the \$15 of Country Y tax imposed on the inter-branch payment of \$75 is allocated 75 percent (\$11.25) to A and 25 percent (\$3.75) to B and that the remaining \$10 of country Y tax is allocated 50/50 to A (\$5) and B (\$5). Pursuant to the partnership agreement, the net income and foreign tax allocations are shown in Table 6.

Table 6.

	A		B	
	Amount	%	Amount	%
Business M income	\$75	75%	\$25	25%
Country X taxes	7.5	75	2.5	25
Business N income	25	50	25	50
County Y taxes	16.25	65	8.75	35

The County Y taxes are allocated 65 percent to A and 35 percent to B while Business N income is allocated 50/50 to A and B. Therefore, the allocations of CFTEs of Business N income fail the safe harbor. However, if AB can sufficiently substantiate that the \$15 of Country Y tax paid by DE2 on the interbranch payment of \$75 is related to income recognized by DE1 for U.S. tax purposes, the allocations of Country Y taxes may be established to be in accordance with the partners' interest in the partnership. In other words, the allocation may be respected if the Country Y taxes on the interbranch payments were allocated on the same ratio that A and B would share DE1's income that funded the inter-branch payments.

Example 9—Interbranch Payments.³³ Same as Example 7, except that the partnership agreement allocate \$75 of business M income equally between A and B to account for the inter-branch payment from DE1 to DE2. This results in the allocations shown in Table 7.

Table 7.

	A		B	
	Amount	%	Amount	%
Business M income	\$56.25*	56.25%	43.75**	43.75%
Country X taxes	7.5	75	2.5	25
Business N income	25	50	25	50
County Y taxes	12.5	50	12.5	50

* (75% of \$25 plus 50% of \$75)
 ** (25% of \$25 plus 50% of \$75)

The Country X taxes are allocated 75 percent to A and 25 percent to B, while Business M income is allocated 56.25 percent to A and 43.75 percent to B. Therefore, the allocation of CFTEs of Business M are not proportional to the allocations of related income and do not meet the safe harbor. However, if AB can sufficiently substantiate that the \$10 of Country X taxes paid by DE1 relates to the \$25 of DE1's income that is also shared in the same 75/25 ratio, the allocations of Country X taxes may be established to be in accordance with the partners' interest in the partnership. In other words, if DE1's income (computed for Country X's tax purposes) of \$25 and Country X's taxes of \$10 are both allocated in the same ratios, the allocations could be respected.

Example 10—Special Allocation of Income.³⁴

A and B form AB, a partnership for U.S. tax purposes. AB operates business M in Country X, which imposes a 20-percent tax on the net income from business M. In year 1, AB earns \$300 of gross income, has deductible expenses (exclusive of CFTEs) of \$100, and pays or accrues \$40 of Country X tax. 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 CFTEs) are split evenly (50/50) between A and B. The gross income allocation to A is not deductible for Country X purposes. AB has a single CFTE category since all of AB's net income is allocated in the same ratio. The net income in the single CFTE category is \$200. The \$40 of Country X tax is related to the net income of \$200.

In year 1, A is allocated \$150 (75 percent) of the net income (\$100 of gross income and \$50 (50 percent) of the remaining \$100 of net income). B is allocated \$50 (25 percent) of the \$200 net income. AB's partnership agreement allocates Country X taxes in accordance with the partner's shares of partnership items remaining after the \$100 gross income allocations. The Country X taxes of \$40 are therefore allocated equally to A (\$20) and B (\$20). The allocations of net income and Country X taxes are shown in Table 8.

Table 8.

	A		B	
	Amount	%	Amount	%
Gross income	\$100	100%	-0-	-0-
Remaining net income	50	50%	50	50%
Total Income	150	75%	50	25%
Country X tax	\$20	50%	\$20	50%

Since the allocations of Country X taxes are not in proportion to the allocations of net income, Country X taxes will be reallocated according to the partners' interest in the partnership. A reallocation of country X taxes would be 75 percent (\$30) to A and 25% (\$10) to B. The above analysis equally applies to a guaranteed payment of \$100 to A within the meaning of Code Sec. 707(c).

Example 11—Special Allocation of Income.³⁵

Same facts as Example 10, except that the allocation of \$100 of gross income is deductible under Country X law and that AB pays or accrues \$20 of Country X taxes. Under these facts, the net income in the CFTE category is \$100, determined by disregarding the \$100 of gross income allocated to A and deductible under foreign law. The \$20 of Country X taxes is related to the \$100 net income. No portion of the foreign tax is related to the \$100 of gross income allocated to A. Therefore, the allocations of \$20 of Country X taxes equally to A (\$10) and B (\$10) meet the safe harbor. The above analysis also applies to a guaranteed payment of \$100 to A within the meaning of Code Sec. 707(c).

Conclusion

The final regulations provide a desirable safe harbor for the allocations of foreign taxes among partners. Special allocations of foreign tax expenditures are available, if they correspond to the allocations of the related income. The principles behind the safe harbor are sound and reasonable. The final regulations provide guidance and opportunities for taxpayers to specially allocate foreign tax expenditures. However, uncertainty remains when an allocation fails the safe harbor. The allocations of CFTEs from inter-branch transactions could be an area with a high degree of uncertainty.

ENDNOTES

- ¹ T.D. 9292, IRB 2006-47, 914.
- ² T.D. 9121, IRB 2004-20, 903, 2004-1 CB 903.
- ³ Reg. §1.704-1(b)(1)(ii)(b).
- ⁴ The qualified income offset rules basically prevent a partner's capital account from being negative through losses and/or distributions to the extent that the partner is not obligated to restore the deficit and the deficit is not derived from deductions attributable to nonrecourse debts.
- ⁵ Reg §1.704-1(b)(4) and §1.704-2.
- ⁶ Code Secs. 703(b)(3) and 703(a)(2)(B).
- ⁷ Reg. §1.704-1(b)(4)(viii)(a).
- ⁸ Reg. §1.704-1(b)(4)(viii)(a)(2).
- ⁹ Reg. §1.704-1(b)(4)(viii)(a)(1).
- ¹⁰ Reg. §1.704-1(b)(4)(viii)(b).
- ¹¹ Reg. §1.704-1(b)(4)(viii)(c)(2)(i).
- ¹² Reg. §1.704-1(b)(4)(viii)(c)(2)(ii).
- ¹³ Reg. §1.704-1(b)(4)(viii)(c)(2)(iii).
- ¹⁴ Reg. §1.704-1(b)(4)(viii)(c)(3)(i).
- ¹⁵ *Id.*
- ¹⁶ *Id.*
- ¹⁷ Reg. §1.704-1(b)(4)(viii)(c)(3)(ii).
- ¹⁸ Reg. §1.704-1(b)(4)(viii)(c)(4).
- ¹⁹ Reg. §1.704-1(b)(4)(viii)(d)(1).
- ²⁰ *Id.*
- ²¹ Reg. §1.704-1(b)(4)(viii)(d)(2).
- ²² *Id.*
- ²³ Reg. §1.704-1(b)(4)(viii)(c)(5).
- ²⁴ Reg. §1.704-1(b)(4)(viii)(d)(3).
- ²⁵ Reg. §1.704-1(b)(4)(viii)(d)(5), Example 20.
- ²⁶ *Id.*, Example 21.
- ²⁷ *Id.*, Example 22.
- ²⁸ *Id.*, Example 22(iii).
- ²⁹ *Id.*, Example 23.
- ³⁰ *Id.*, Example 26.
- ³¹ *Id.*, Example 24.
- ³² *Id.*, Example 24(iii).
- ³³ *Id.*, Example 24(iv).
- ³⁴ *Id.*, Example 25.
- ³⁵ *Id.*, Example 25(iii).

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