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Memorandum**

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subject: Allocations consistent with partner's interest in the partnership

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

US Parent =

Foreign Parent =

JV =

Country 2 Partner =

Country 1 Partner =

US Partner =

Foreign Sub =

Country 1 =

Country 2 =

Area =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

<u>Year 4</u>	=
<u>Year 5</u>	=
<u>Year 6</u>	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
<u>q</u>	=
<u>r</u>	=
<u>s</u>	=
<u>t</u>	=
<u>u</u>	=
<u>v</u>	=
<u>w</u>	=
<u>x</u>	=
<u>y</u>	=

ISSUES

1) Should the allocation of JV's partnership loss to Country 2 Partner and Country 1 Partner be limited to their positive capital account balances?

2) Should JV be allowed to allocate its losses solely to Country 2 Partner and Country 1 Partner, up to the amount of their positive capital account balances, or should that loss be reallocated pro rata among all partners?

CONCLUSIONS

1) The allocation of JV's partnership loss to Country 2 Partner and Country 1 Partner should be limited to the amount of their positive capital accounts. Any further losses should be reallocated to US Partner and Foreign Parent, who bore the economic burden of those additional losses.

2) The allocation of JV's losses solely to Country 2 Partner and Country 1 Partner should be respected up to the amount of their positive capital account balances.

FACTS

Joint Venture Between US Parent and Foreign Parent

In Year 1, US Parent (U.S. corporation) and Foreign Parent (Country 1 corporation) announced that they would enter into a joint venture in Year 2 to develop resources in the Area in Country 1. US Parent and Foreign Parent formed JV (a Country 1 limited liability company and an eligible entity under § 301.7701-2 of the Procedure and Administration Regulations) to carry out the joint venture. Under Country 1 law, JV had two a% equity owners: Country 2 Partner (Country 2 corporation) and Country 1 Partner (Country 1 corporation). US Parent held a b% interest in Country 2 Partner. Foreign Parent held a c% interest in Country 2 Partner and was the sole owner of Country 1 Partner. Thus, under Country 1 law, US Parent indirectly held a d% interest in JV, and Foreign Parent indirectly held the remaining e% interest.

US Parent also contributed funds to JV through its subsidiary (US Partner) (a U.S. corporation). Foreign Parent also contributed funds to JV directly.

US Parent filed Form 8832, *Entity Classification Election*, on Date 2, to treat JV as a partnership for U.S. Federal tax purposes as of Date 1. The joint venture agreement for JV (JV Agreement) did not set forth any of the economic effect test provisions required under § 1.704-1(b)(2)(ii) of the Income Tax Regulations – capital account maintenance, liquidation in accordance with positive accounts, or deficit restoration obligations (DROs) – nor did it specify the allocation of partnership items among the partners. Exam calculated the partners' capital accounts during its audit of JV.

The amounts provided to JV by US Partner and Foreign Parent were treated as loans under Country 1 law. Thus, under Country 1 law, JV was treated as having two owners – Country 2 Partner and Country 1 Partner. For US Federal tax purposes, however, the amounts provided by US Partner and Foreign Parent were treated by US Parent as equity rather than debt. Exam did not challenge US Parent's treatment of these amounts as equity for U.S. tax purposes, and we do not address the validity of that treatment here. As a result, for US Federal tax purposes, JV was treated as having four partners – Country 2 Partner, Country 1 Partner, US Partner, and Foreign Parent.

The contributions from US Partner to JV from Year 2 to Year 5 totaled \$f. The amount of US Partner's contributions remaining on Date 3 was \$g. Country 2 Partner and Country 1 Partner each contributed a total of \$h to JV. Between Year 2 and Year 6, JV partners contributed the following percentages of JV capital for U.S. Federal tax

purposes: 1) Country 2 Partner and Country 1 Partner each – i to j%, 2) US Partner – k to m%, and 3) Foreign Parent – n to o%.

Requirements to Provide Additional Funding to JV

Country 1 Law requires that in order for an entity to maintain its legal status as a limited liability company, it should have net assets, as determined under Country 1 accounting principles, greater than or equal to its charter capital. If an entity's net assets are less than its charter capital at the end of the second year after its registration and every consecutive year thereafter, then the entity must either (1) decrease its charter capital, but not below a minimum statutory threshold or (2) obtain additional contributions from its owners. If the entity's owners do not take steps to improve its negative net asset position, the Country 1 governmental authority may file a claim to force the liquidation of the entity. Furthermore, where an entity improves its net asset position by reducing its charter capital in lieu of obtaining contributions from its owners, Country 1 law allows any creditor to marshal the liquidation of the entity.

The JV Agreement required the owners of JV to lend additional funds through their wholly-owned subsidiaries pro-rata to their respective ownership interests in JV whenever JV lacked sufficient assets to meet certain funding requirements under Country 1 law.

Guaranteed payments

Under the terms of their individual agreements with JV, US Partner and Foreign Parent had first rights to the cash flow of JV.

According to the JV Agreement, US Partner and Foreign Parent would receive both fixed and variable payments related to their contribution amounts. The fixed payments were computed without regard to the income and cash flow of JV while the variable payments were triggered by JV's net positive cash flow. From Year 2 to Year 5 JV never made any variable payments because it never had any net positive cash flow for those years.

US Parent characterized the fixed payments paid to US Partner by JV as guaranteed payments for the use of capital as described under section 707(c). From Year 2 to Year 5, JV deducted its payments to US Partner as guaranteed payments. JV had cumulative operating losses from Year 2 to Year 6 of \$p. JV did generate a small amount of operating income in Year 3 and Year 4, which reduced the cumulative net loss to \$q. The guaranteed payments generated approximately \$r of these losses. The loss deductions were allocated solely to Country 2 Partner; US Partner was not allocated any of the deductions.

End of the Joint Venture

After several years of disappointing production from the Area, Foreign Parent and US Parent reached an agreement on Date 4 to sell US Parent's indirect interest in JV to Foreign Parent for \$s. A Foreign Parent subsidiary, Foreign Sub, purchased

Country 2 Partner's interest in JV for \$t (u% of the purchase price) and US Partner's interest in JV for \$v (w% of the purchase price). Because no JV loss deductions had been allocated to US Partner, US Partner's basis in JV at the time of the sale was \$x. As a result, US Parent reported a loss of \$y on its U.S. consolidated return attributable to the sale of US Partner's interest in JV for \$v.

LAW AND ANALYSIS

Section 707(c) of the Internal Revenue Code provides that to the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of § 61(a) (relating to gross income) and, subject to § 263 (capital expenditures), for purposes of § 162 (relating to trade or business expenses).

Section 704(b)(2) states 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 circumstance), if---

- (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) or
- (2) the allocation to a partner under the agreement of income, gain, loss, deduction or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(2) sets forth the two-part analysis of the substantial economic effect test: first, the allocation must have economic effect (within the meaning of § 1.704-1(b)(2)(ii)); second, the economic effect of the allocation must be substantial (within the meaning of § 1.704-1(b)(2)(iii)).

Section 1.704-1(b)(2)(ii)(b) provides that an allocation of income, gain, loss, or deduction to a partner will have economic effect if, throughout the full term of the partnership, the partnership agreement provides that (1) the partnership will maintain a capital account for each partner under the rules of § 1.704-1(b)(2)(iv); (2) the partnership will liquidate according to positive capital account balances; and (3) the partners are unconditionally obligated to restore any deficit balances in their capital accounts following the liquidation of the partnership or of the partner's interest in the partnership.

If an allocation lacks substantial economic effect, the regulations require that the item be allocated in accordance with the partners' interest in the partnership.

Section 1.704-1(b)(3)(i) states that references in § 704(b) to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in

which 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 determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.

A partner receives income, not a distributive share, from a guaranteed payment for the use of capital under § 707(c) and the partnership receives a corresponding deduction under § 162. The income from the guaranteed payment does not affect the recipient's basis in its partnership interest or its capital account (§ 1.704-1(b)(2)(iv)(o)). The partnership's deduction for the guaranteed payment reduces the partnership's income (or increases the partnership's loss) to be allocated among its partners.

Because they were determined without regard to the income of the partnership, the fixed interest payments made by JV to US Partner and Foreign Parent from Year 2 to Year 5 were guaranteed payments for the use of capital described in § 707(c). The guaranteed payments generated ordinary income for US Partner and Foreign Parent and deductions for JV. During this period JV incurred operating losses, primarily as a result of the guaranteed payment deductions. These losses were allocated entirely to Country 2 Partner and Country 1 Partner. US Partner and Foreign Parent received no allocation of loss.

Any allocation of a partnership item must have economic effect (within the meaning of § 1.704-1(b)(2)(ii)) or it will be reallocated in accordance with the partners' interests in the partnership. The allocation of JV's operating loss did not have economic effect within the meaning of § 1.704-1(b)(2)(ii) because none of the three requirements were met - JV did not maintain capital accounts consistent with § 1.704-1(b)(2)(iv), provide for the liquidation of its partners' interests in accordance with positive capital account balances, or provide a DRO. Thus, the operating loss deduction must be allocated in accordance with the partners' interests in the partnership, reflecting the manner in which the partners agreed to share the economic burden corresponding to that loss.

US Parent argues that Country 2 Partner would bear the economic risk of JV's operating losses. They argue that Country 1 law effectively subjects Country 2 Partner to a DRO (a "de facto DRO") because, if JV's capitalization falls below a certain threshold, the equity holders of JV (under Country 1 law - Country 2 Partner and Country 1 Partner, not US Partner and Foreign Parent) would need to contribute additional capital to JV to avoid its liquidation. However, these additional capital contributions were not required by law, as JV's partners could allow JV to liquidate rather than make these additional contributions.¹ While Country 2 Partner and Country

¹ Section 1.704-1(b)(5) Example 4(ii) indicates that liability under a State law right of contribution for any debts of the partnership is a reasonable alternative to a DRO.

1 Partner did contribute additional amounts to JV after Year 2, these amounts were minimal compared with the substantial additional amounts contributed to JV by US Partner and Foreign Parent.

As creditors under Country 1 law, US Partner and Foreign Parent had priority over Country 2 Partner and Country 1 Partner if JV was liquidated. However, Country 2 Partner and Country 1 Partner had no obligation to restore any shortfall in payments to US Partner and Foreign Parent upon liquidation. Consequently, JV would not have the assets to repay US Partner and Foreign Parent their positive capital account balances upon liquidation, thus placing the economic burden for the operating loss allocations to Country 2 Partner and Country 1 Partner on US Partner and Foreign Parent. Any capital contributions by Country 2 Partner and Country 1 Partner would be necessary only to keep JV a going concern and avoid liquidation in the event JV became undercapitalized. Whether to keep JV a going concern would be up to US Parent and Foreign Parent, and was not mandated by Country 1 law.

The allocation of JV's partnership loss to Country 2 Partner and Country 1 Partner should be limited to their positive capital account balances. US Partner and Foreign Parent bore the economic burden of the JV losses in excess of Country 2 Partner's and Country 1 Partner's positive capital accounts.

The allocation of JV's losses solely to Country 2 Partner and Country 1 Partner should be respected up to the amount of their positive capital account balances. US Partner and Foreign Parent, as creditors under Country 1 law, had priority over Country 2 Partner and Country 1 Partner in receiving assets from JV upon liquidation. Under the terms of their agreements, US Partner and Foreign Parent also had first rights to the cash flow of JV. Thus, Country 2 Partner and Country 1 Partner bore the burden of the economic loss of their capital contributions on liquidation up to the amount of their positive capital account balances.

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Please call (202) 317-4630 if you have any further questions.