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J. Allen Sullivan Jr.

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The Tax Credit Three-Step[1]: Partnerships Liable for Foreign Taxes and Allocations of the Attendant Foreign Tax Credits

J. ALLEN SULLIVAN, JR.[2]

In recent years, the U.S. Department of the Treasury has begun a campaign to combat perceived abuses in the international tax arena. As a part of this campaign, the Treasury promulgated regulations attempting to bring clarity to allocations of foreign tax credits by entities treated as partnerships for U.S. tax purposes that are taxed at the entity level in a foreign jurisdiction. One set of regulations was issued in 2004 in temporary and proposed form, and, after a fairly brief comment period, the much improved finalized version of the regulations was issued in 2006. This article analyzes and compares the two sets of regulations. The regulations are a part of the distributive share rules of Section 704(b) of the Internal Revenue Code that govern whether a partnership's allocations of income, loss, expense, etc. will be respected for federal tax purposes. Therefore, the article offers the reader a brief journey through the Section 704(b) rules before illustrating the role played by the new regulations within such rules. This brief journey is followed by a discussion of the new regulations including an example of the application of the safe harbor afforded by the new regulations.

I. Introduction

This article analyzes and compares two sets of regulations (collectively the "New Regulatory Scheme") recently issued by the U.S. Department of the Treasury ("Treasury") regarding the allocation of eligible foreign tax credits by partnerships to U.S. partners. The first set of regulations was issued by Treasury in proposed and temporary form (the "Pro-

1. This title refers to the three-step approach delineated in the Preamble for meeting the Proportionality Requirement of the Safe Harbor to the New Regulations discussed in part IV-C of this article. The choice of title was undoubtedly affected by the author's recent move to Texas.

2. Allen Sullivan is an associate with Meadows, Collier, Reed, Cousins & Blau, L.L.P. in Dallas, Texas. He received his Juris Doctor from Cumberland School of Law at Samford University in Birmingham, Alabama and his L.L.M. in taxation from the University of Florida's Levin College of Law. Mr. Sullivan would like to thank Aaron "Ernie" Harris of Brock, Clay, Calhoun & Rogers, P.C. in Atlanta, Georgia for his editorial contributions to the form and language usage of this article and his general support and friendship.

posed/Temporary Regulations") in 2004.[3] After commentary from various bar associations, Treasury issued a finalized version in 2006 (the "New Regulations"), replacing the 2004 version.[4] Both sets of regulations were promulgated to provide guidance on allocations to partners, via the distributive share rules, of eligible foreign tax credits that arise from an entity level tax on a partnership in a foreign jurisdiction.[5] Additionally, both sets of regulations provide a Safe Harbor for practitioners to get these allocations respected for tax purposes.[6] The differences between the two will be analyzed as well as the possible reasons for any changes.

The two sets of regulations discussed herein are a part of the general regulatory scheme dealing with a partner's distributive share of partnership items for U.S. tax purposes promulgated under Section 704(b) of the U.S. Internal Revenue Code (the "Code"). Because this article's audience is likely attorneys with minimal tax expertise, a short discussion of the layout of this very complicated distributive share regulatory scheme will serve as a precursor to the main topic. Readers already comfortable with the partnership distributive share rules are encouraged to skip to the analysis of and comparisons between the Proposed/Temporary Regulations and the New Regulations.

II. Capital Accounts and Book Allocations—The Basics

A. Introduction

A partnership's books are used to keep track of each partner's capital account in the partnership. Both the books and capital accounts are used to measure the economics of the partnership arrangement. A partner's beginning capital account represents his/her initial investment in the partnership as reflected on the partnership's books. Generally, each partner in a partnership is then allocated his/her distributive share of income, expense, credits, and so forth ("Partnership Items") by the partnership as a percentage (i.e., 50 percent income interest, etc.) that aids in the maintenance of the partnership's books and the capital accounts of the partners. Allocations to a partner of receipts, such as income, increase a partner's capital account, while allocations of expenses and/or distributions to the partner decrease it.

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3. I.R.S. Notice 04-19, 2004-11 I.R.B. 606. The Proposed/Temporary Regulations apply to partnership taxable years beginning on or after April 21, 2004, and before October 19, 2006. Temp. Treas. Reg. § 1.704-1T(b)(1)(ii)(b)(1); Prop. Treas. Reg. § 1.704-1(b)(4)(xi), 69 Fed. Reg. 21405, 21407-08 (Apr. 21, 2004). The Proposed Regulations refer to the text of the Temporary Regulations as the effectuating text; therefore, the latter will be cited to throughout this article. Proposed Regulations, while certainly indicative of the Service's interpretation of the law, are not effective until finalized, generally after an "advise and consent" period. Temporary Regulations, on the other hand, are effective when promulgated but limited in duration unless extended or finalized.

4. Treas. Reg. § 1.704-1(b)(4)(viii) (2006). These New Regulations are effective for partnership taxable years beginning after October 19, 2006. Thus, the Proposed/Temporary Regulations may still be utilized for a taxpayer's 2006 taxable year. Starting in the 2007 taxable year, the New Regulations will control.

5. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(b), (". . . by a partnership . . ."); Treas. Reg. § 1.704-1(b)(4)(viii)(b) (". . . by a partnership . . ."). These are known in the New Regulations as "creditable foreign tax expenditures" and in the Proposed/Temporary as "creditable foreign taxes."

6. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a), 69 Fed. Reg. 21405, 21408 (Apr. 21, 2004); Treas. Reg. § 1.704-1(b)(4)(viii).

A partner's distributive share of Partnership Items is generally determined by the partnership agreement for both economic and tax purposes.[7] This determination is respected for tax purposes if it passes muster under the Section 704(b) Treasury Regulations.[8] A basic partnership will allocate all Partnership Items, whether acting to increase or decrease the partners' capital accounts, in the same proportion for all partners. This basic situation is not the type of situation targeted by the Section 704(b) rules. Instead, the regulations seek to limit the degree to which partners can vary allocations of specific partnership items and receive the possible tax breaks connected with those items yet maintain the partnership arrangement as a flexible one by which taxpayers can do business without incurring an entity level tax.[9]

The Internal Revenue Service (IRS) has set forth its own ways that partnerships are to maintain their books and capital accounts.[10] Partnerships abiding by these rules get a stamp of approval from Treasury for any special allocations—those that are not in sync with a partner's usual share of partnership items—made by the partnership.[11] One special allocation of importance to this article is that of eligible foreign tax credits, formerly termed "creditable foreign taxes" in the Proposed and Temporary Regulations but now termed "creditable foreign tax expenditures" in the New Regulations.[12] A competent application of the rules governing allocations of eligible foreign tax credits is dependent on an understanding of this allocation's role within the matrix of partnership allocations in general.

Partnerships utilizing special allocations will seek to have these allocations respected for tax purposes. Book allocations that are respected for tax purposes will be matched on the tax side of the balance sheet (i.e., the allocations can be used to calculate the tax consequences of the partnership arrangement).[13] If a special allocation is not respected under the regulations, the allocation will be reallocated, for tax purposes only, so that it follows the partner's economic interest in the partnership, taking into account all of the facts and circumstances.[14] Consequently, partnership agreements are engineered so that any special allocations will be respected and reallocation is avoided.[15]

The Section 704(b) regulations provide three ways that book allocations can garner respect for tax purposes.[16] First, a partnership's allocations will be respected if the alloca-

7. I.R.C. § 704(b) (2007).

8. Treas. Reg. § 1.704-1(b)(1)(i) (2006) (also known as the "Partners' Distributive Share" Regulations).

9. Treas. Reg. § 1.701-2(a).

10. Treas. Reg. § 1.704-1(b)(2)(iv).

11. Treas. Reg. § 1.704-1(b)(1)(i). Without special allocations, partnerships rarely need the protection of the § 704(b) regulations.

12. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi); Treas. Reg. § 1.704-1(b)(4)(viii). These definitions are explained *infra*.

13. Treas. Reg. § 1.704-1(b)(1)(i). When referring to the "tax side," this article is recognizing the typical balance sheet of a partnership. Bookkeepers and other tax practitioners will often place the capital accounts on one side and the tax books on the other. This can be seen in various examples found in the § 704(b) regulations.

14. *Id.*; Treas. Reg. § 1.704-1(b)(3). It is axiomatic that if the allocations are already following the partner's interests in the partnership, the reallocation will have no real consequences. Yet partnership arrangements are frequently utilized because of the flexibility afforded by them. Thus, special allocations abound.

15. The prudent practitioner will almost always avoid being subject to the cryptic reallocation rules under Sections 1.704-1(b)(3)(i) and (ii). This cryptic nature is described *infra* in Part II-C.

16. Treas. Reg. § 1.704-1(b)(1)(i).

tions have "Substantial Economic Effect."[17] Second, allocations deemed to be in accordance with the partners' interests in the partnership will be respected.[18] Finally, allocations actually in accordance with the partners' interests in the partnership, naturally or by reallocation, are afforded their due respect.[19]

B. Substantial Economic Effect

As stated above, partnership allocations that have Substantial Economic Effect are respected for tax purposes.[20] This method of respect includes Economic Effect, Alternate Economic Effect—both of which must be substantial—and Economic Effect Equivalence.[21] There are three basic requirements for allocations of a partnership to have Economic Effect with one substituted requirement for Alternate Economic Effect.[22] For purposes of later discussion, note that if the allocations of a partnership have Economic Effect or Alternate Economic Effect they meet the first requirement of the Safe Harbor under the Proposed/Temporary Regulations and would likely be considered valid for purposes of the Safe Harbor in the New Regulations, discussed *infra*.[23]

Partnership allocations have Economic Effect if the partnership agreement provides three things:[24]

1. The partner's capital accounts must be maintained in accordance with rules set forth in the regulations.[25]
2. Upon liquidation of the partnership or any partner deciding to leave the partnership, the distributions attendant to that liquidation must be made in accordance with the "positive capital account balances" of the partners, after taking into account any adjustments made in the year of liquidation, by a specified time period.[26] (A positive capital account balance signifies that the partner will be owed

17. *Id.*

18. *Id.*

19. *Id.*

20. I.R.C. § 704(b) (2007); Treas. Reg. §§ 1.704-1(b)(1)(i), (2)(ii), (2)(iii).

21. Treas. Reg. §§ 1.704-1(b)(1)(i),(2)(ii), (2)(iii). If an allocation is not "insubstantial," it is substantial. The reader should take a moment to realize that this section of the article is dealing only with Substantial Economic Effect, one of the three ways a partnership can get its allocations of partnership items respected. The three ways in which a partnership can get Substantial Economic Effect should not be confused with the three ways in which a partnership gets its allocations of partnership items respected for tax purposes.

22. Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(1)-(3), 1.704-1(b)(2)(ii)(d). Note that both must also meet the substantiality requirement of § 1.704-1(b)(2)(iii) as well, if the issue arises. The reader should also now take another breath and realize that the three requirements for Economic Effect should not be confused with the two sets of desiderata contained in the previous footnote. This is why I called this a "very complicated regulatory scheme." My thanks to the readers who have made it this far, especially to those reading the footnotes!

23. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1); Treas. Reg. § 1.704-1(b)(4)(viii). *See* Part III *infra*.

24. Treas. Reg. § 1.704-1(b)(2)(ii)(b).

25. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1). Section 1.704-1(b)(2)(iv) of the Treasury Regulations provides the rules for capital account maintenance. The rules describing the maintenance of such capital accounts will not be analyzed in detail in this article unless necessary.

26. *Id.* § 1.704-1(b)(2)(ii)(b)(2).

money by the partnership if he/she or it chooses to leave the partnership (i.e., cash-out) at that moment in time.)[27]

3. If a partner has a "deficit capital account balance," that partner must be unconditionally obligated to restore the amount of that deficit to the partnership in a timely manner upon the liquidation of the partnership or the partner's interest in the partnership. (A "deficit capital account balance" is the converse of a positive one. Partners with a deficit owe the partnership money upon liquidation of the partnership or upon that partner leaving.)[28]

The obligation to unconditionally restore deficits is what forces the partners to think before making any special allocations because it ties the economic burden (obligation to pay a deficit) to the benefit (tax deduction) of a special allocation of loss. Under state law, or any foreign law under which the partnership is organized, most limited partners, as well as members of limited liability companies, will be protected from paying on partnership recourse liabilities and therefore, without some contractual mechanism, will not have an unconditional deficit restoration obligation. Consequently, allocations to most limited partners will not have Economic Effect.[29] The Alternate Economic Effect test partially alleviates this harsh treatment.[30]

Instead of the "unconditional deficit restoration obligation" requirement above, the Alternate Economic Effect test requires that the partnership agreement contain a "qualified income offset" (a "QIO").[31] A QIO provision ensures that if a partner receives an unexpected distribution, such as one to take care of a sick child, creating a deficit in his/her/its capital account in excess of the amount the partner is obligated to restore, the partnership will allocate items of income and gain to that partner in an amount that will eliminate this deficit as quickly as possible.[32] So, in general, a QIO acts to keep the limited partners' capital accounts at or above zero, or at or above the amount that the partner is obligated to restore, in the event the capital account unexpectedly drops below this amount. If a partnership agreement provides for a QIO and the first two requisites of the Economic Effect test, allocations to limited partners will have Alternate Economic Effect so long as those allocations do not act to cause or increase an "impermissible deficit" in that partner's capital account.[33] An impermissible deficit is one that a partner, usually a limited partner, is not obligated to restore upon the liquidation of the partner's interest in the partnership. Consequently, an allocation to a limited partner, completely protected from

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27. Note that the Economic Effect test and the Alternate Economic Effect test have these first two requirements in common and only differ with respect to the third. But also note that each test is found under the heading of "Substantial Economic Effect" in the regulations because each is a way of gaining Economic Effect (one being an alternative) for a partnership's allocations. Each must still be substantial. But with respect to our discussion of the allocation of creditable foreign taxes, it does not become an issue because such allocations can gain protection under the Safe Harbor, discussed *infra*, without actually being substantial under Section 1.704-1(b)(2)(iii) because they garner respect only by being "deemed to be in accordance with the partner's interests in the partnership."

28. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3).

29. See Treas. Reg. § 1.704-1(b)(2)(ii)(c) for ways in which a partner can be treated as obligated to restore a deficit in his/her capital account without explicitly placing such obligation in the partnership agreement and without having to amend an existing partnership agreement.

30. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

31. *Id.*

32. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(6) (see flush language).

33. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (see flush language).

liability for debts of the partnership, will have Alternate Economic Effect to the extent such allocation leaves the limited partner with a capital account at or above zero.[34]

Allocations having either Economic Effect or Alternate Economic Effect must still be substantial under the distributive share regulations.[35] This means that allocations of Partnership Items must substantially affect the dollar amounts to be received by the partners independent of tax consequences.[36] This substantiality issue is only mentioned in passing because allocations of eligible foreign tax credits made by partners coming within the Safe Harbor in the New Regulations are not afforded Substantial Economic Effect but are instead "deemed to be in accordance with the partners' interests in the partnership."[37]

In addition to "simple" Economic Effect and Alternate Economic Effect, a very basic partnership may be able to hang its hat on the Economic Effect Equivalence test.[38] Economic Effect Equivalence is a way in which allocations can be deemed to have Economic Effect.[39] Allocations will have Economic Effect Equivalence if, as of the end of each partnership taxable year or any future year, a liquidation of the partnership would produce the same results that would occur if the partnership agreement had provided for the three provisions necessary to have Economic Effect, discussed above.[40] This mostly acts to protect partnerships that do not conform to the Section 704(b) regulations, through either ignorance, lack of funds, or otherwise, but are making all allocations and distributions in direct proportion to the partners' interests in the partnership. Therefore, upon audit, the partnership arrangements that have Economic Effect Equivalence will generally be respected for tax purposes. This form of respect for allocations appears to have been improperly ignored by the drafters of the Safe Harbor in the Proposed/Temporary Regulations because the New Regulations take it into account.[41]

C. Allocations Deemed to Be in Accordance and Those in Accordance with a Partner's Interests in the Partnership

Economic Effect, Alternate Economic Effect, and Economic Effect Equivalence, all discussed *supra*, provide three routes a partnership can follow to gain Substantial Economic Effect for its allocations, making those allocations respected for tax purposes.[42] Two other methods are available to get partnership allocations respected for tax purposes.[43] First, allocations "*deemed* to be in accordance with [a] partner's interest in the partnership" are

34. Instruments such as promissory notes contributed by the partner can be used to increase the amount of deficit for such partner that is "permissible." Treas. Reg. § 1.704-1(b)(2)(ii)(c).

35. Treas. Reg. § 1.704-1(b)(2)(iii).

36. *Id.*

37. Treas. Reg. § 1.704-1(b)(4)(viii).

38. Treas. Reg. § 1.704-1(b)(2)(ii)(i). Look to the placement of this doctrine within the § 1.704-1 regulations. All of the regulations that come within § 1.704-1(b)(2)(ii) are under the heading "Economic Effect." Thus, it appears reasonable for one to consider references in the Code and Treasury regulations to "Economic Effect" as also references to Alternate Economic Effect and to Economic Effect Equivalence, both of which are found in Section 1.704-1(b)(2)(ii).

39. Treas. Reg. § 1.704-1(b)(2)(ii)(i). The reader should not confuse this with getting an allocation deemed to be in accordance with the partner's interest in the partnership, which is found with Section 1.704-1(b)(1)(i).

40. *Id.*

41. *See* Part III, *infra.*

42. Treas. Reg. § 1.704-1(b)(2).

43. Treas. Reg. § 1.704-1(b)(1)(i).

respected.[44] The key word here is "deemed." Thus, allocations respected under this method are not necessarily in accordance with a partner's economic interest in the partnership but have instead been deemed to be so by some section in the regulations.[45] The special rules that allow allocations to be deemed to be in accordance with a partner's interests in the partnership are found in Sections 1.704-1(b)(4) and 1.704-2 of the Treasury Regulations.[46] This method of gaining respect for partnership allocations is particularly important to this article because it is the only method allowed to get respect for allocations of "creditable foreign tax expenditures" under the New Regulations.[47]

Finally, an allocation will be respected if that allocation is actually in accordance with a partner's interest in the partnership.[48] This third way of gaining respect for tax purposes is more like a punishment for not utilizing one of the other two methods and acts as a backstop to the other two ways of gaining respect for tax purposes. Consequently, if a partnership's allocations do not have Substantial Economic Effect and are not deemed to be in accordance with the partners' interests in the partnership, all Partnership Items will be reallocated so that the allocation is actually in accordance with the partners' economic interests in the partnership.[49] A similar punishment will be imposed on allocations of creditable foreign taxes that fail to meet the Safe Harbor provided in the New Regulations.[50] This avenue should be avoided because the form that any reallocation might take is not very predictable.[51] In fact, allowing this reallocation is tantamount to allowing the Service to draft the partnership agreement.

III. Allocations of Creditable Foreign Tax Expenditures—Prior Rules and Applicable Definitions

A. INTRODUCTION

The New Regulations provide a "Safe Harbor", just like the Proposed/Temporary Regulations before them, in which a partnership can get its allocations of eligible foreign tax credits deemed to be in accordance with the partners' interests in the partnership.[52] The Proposed/Temporary Regulations altered the landscape of eligible foreign tax credit allocations by affirmatively adopting the statement that these allocations cannot have Sub-

44. *Id.* (emphasis added).

45. *See, e.g.*, Treas. Reg. §§ 1.704-1(b)(4), -2.

46. *Id.*

47. *See* Part III, *infra.*

48. Treas. Reg. §§ 1.704-1(b)(1)(i), (b)(3).

49. *Id.*

50. Treas. Reg. §§ 1.704-1(b)(1)(i), (b)(3), (b)(4)(viii).

51. In fact, unless one is under the rules found in Treasury Regulation Section 1.704-1(b)(3)(iii), there is almost no guidance from the Service as to how this reallocation will be effectuated. The applicable regulations do nothing more than delineate a few factors that will be considered and give a few elementary examples. See Treasury Regulation 1.704-1(b)(3)(ii) and the examples mentioned in the flush of that section. These examples involve only the most basic partnership arrangement; therefore, they are not helpful at all to those involved in sophisticated partnership arrangements. *See also* Part IV-A, *infra.*

52. This is the second of the three discussed ways of getting partnership allocations respected for tax purposes. *See* Part II-C, *supra.*

stantial Economic Effect, and the New Regulations take a similar stance.[53] By doing so, the New Regulations help put an end to the abusive use of the Substantial Economic Effect rules in allocations of foreign tax credits accrued by partnerships.[54] The New Regulations are merely a part of a larger and long -running campaign of the Service to end cross-border tax avoidance and evasion.[55]

The following sections contained in Parts III and IV will explore the prior rules, the various definitions associated with the Safe Harbors, and the operation of both Safe Harbors.

B. Prior Rules

Generally, allocations of tax credits, not just foreign tax credits, do not have Economic Effect because they do not affect the partners' capital accounts.[56] Yet tax credit allocations can be made in the same proportion as "valid allocations" of partnership expenditures that give rise to them or in the same proportion as the income and receipts from which they arise.[57] By the term "valid allocations," the regulations mean those allocations that are respected for tax purposes in one of the three ways delineated herein. These rules have been the source of some uncertainty regarding allocations of foreign tax credits accrued by a partnership because it is difficult to determine whether the foreign tax credit arises from expenditures (the payment of the foreign tax liability) or from income (specifically, foreign income which causes the foreign tax liability to arise).[58]

When allocating eligible foreign tax credits accrued by a partnership under the general tax credit rules (i.e., the old rules), taxpayers generally followed the expenditure approach.[59] Thus, prior to the promulgation of the New Regulatory Scheme, it was not difficult to meet the Substantial Economic Effect test when allocating foreign tax credits.[60] For example, if the partnership validly allocated the foreign tax payment that gave

53. Treas. Reg. § 1.704-1(b)(4)(viii); Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1). It has been the subject of discussion and disagreement between the Service and tax practitioners as to whether the statement found in Treasury Regulation 1.704-1(b)(4)(ii)—that tax credits generally cannot have Substantial Economic Effect because they do not affect the partners' capital accounts—is applicable to foreign tax credits. That is because foreign tax credits can and do affect the partners' capital accounts as is discussed *infra* in the discussion of "Prior Rules and Abuse." *See also* Joel D Kuntz & Robert J. Peroni, *Treatment of U.S. Partners of Partnerships With Foreign Activities*, U.S. Int'l Taxation (2006), reprinted in 2000 WL 530186 [hereinafter Kuntz]. The New Regulations have apparently preempted any arguments as to whether allocations of creditable foreign tax expenditures could have Substantial Economic Effect.

54. It was previously thought that these allocations could gain respect for tax purposes via Substantial Economic Effect because they were said to be expenditures with credits associated with them. *See generally* Kuntz, *supra* note 53. Thus, if the expenses had Substantial Economic Effect, the credit associated with them would also have it. Treas. Reg. § 1.704-1(b)(4)(ii).

55. *See* Alison Bennett, *I.R.S. Moves to Stop Highly Engineered Deals Designed to Generate Foreign Tax Credits*, The Daily Tax Report (BNA), Mar. 30, 2007, at GG-1.

56. Treas. Reg. § 1.704-1(b)(4)(ii).

57. *Id.*

58. New York State Bar Ass'n Tax Section, Report on Temporary and Proposed Regulations Concerning Allocation of Creditable Foreign Tax Expenditures, Part III, Sept. 30, 2004, reprinted in 2004 TNT 198-18 (Oct. 13, 2004), *available at* http://www.nysba.org/content/contentgroups/section_information1/tax_section_reports/1069rpt.pdf [hereinafter NYSBA Report].

59. *Id.*; *see also* Treas. Reg. § 1.704-1(b)(4)(ii).

60. NYSBA Report, *supra* note 58, Part III; *see also* Part IV, *infra*.

rise to the foreign tax credit, it could allocate the foreign tax credit in the same way. Consequently, it was possible to allocate all of the foreign tax expenditures to one partner (for example, a U.S. partner whose foreign partner had no need of a U.S. foreign tax credit because of the lack of U.S. tax liability) as long as the partnership met the Substantial Economic Effect requisites and the allocation of the expenditure reduced the partner's capital account.[61] Apparently, the Treasury was not content with this state of affairs, prompting the promulgation of the New Regulatory Scheme.[62] Thus, now allocations of eligible foreign tax credits are valid only if allocated in the same proportion as the income giving rise to the specific foreign tax.[63] This new rule makes sense. It ensures that taxpayers will generally enter into these types of partnership arrangements only when they think of them as being economically viable rather than merely tax-friendly. Additionally, the allocation of the credit is now tied to the economic benefit of the income associated with it.

C. Terms Utilized in the New Regulatory Scheme

A myriad of defined terms are utilized by the New Regulatory Scheme and must be explained before a complete understanding of the provisions is attainable. For example, the term "partnership" has a specialized definition in the Code. Generally, a partnership is defined as any unincorporated business entity with two or more members.[64] Under the "check the box" rules, unincorporated business entities with two or more members can elect to be taxed as a partnership or a corporation.[65] The effect of electing partnership status,[66] for U.S. tax purposes, is that the tax attributes of the partnership (the "Partnership Items") will be passed through to the partners, whether or not the partnership makes any distributions, as each partner's "distributive share" for tax purposes.[67] U.S. taxpayers doing business abroad using foreign partnerships, also known as "eligible entities" for U.S. tax purposes,[68] may encounter foreign jurisdictions that tax the partnership itself as an entity rather than the partners individually. This scheme makes the partnership legally liable for the tax rather than the partners. In this case, the partnership will accrue eligible foreign tax credits for U.S. tax purposes that it can allocate to its U.S. partners, who will then use the credits to reduce their U.S. tax burden. As discussed *supra* and *infra*, the New Regulatory Scheme provides a mechanism for partnerships to get this allocation respected by Treasury.[69]

61. NYSBA Report, *supra* note 58, Part III; *see also* Treas. Reg. § 1.704-1(b)(4)(ii).

62. I.R.S. Notice 04-19, 2004-11 C.B. 606, Background Section; I.R.S.Notice 98-5, 1998-1 C.B. 334, Part II. *See also* NYSBA Report, *supra* note 58, Part III.

63. Treas. Reg. § 1.704-1(b)(4)(viii); Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(2); NYSBA Report, *supra* note 58, Part III.

64. I.R.C. §§ 761(a), 7701(a)(2).

65. Treas. Reg. § 301.7701-3 (2006). The default is partnership taxation (i.e., the application of Subchapter K to the entity).

66. Or the effect of doing nothing if your business entity is not classified as a corporation or association under the Treasury regulations because the default classification is "partnership" for such an entity. See Treasury Regulation § 301.7701-3(b)(1)(i), for domestic entities doing business abroad, and § 301.7701-2(b)(8), for the various foreign entities designated corporations or associations.

67. I.R.C. § 704(b) (2000).

68. *See generally* Treas. Reg. §§ 301.7701-2, -3.

69. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(b); Treas. Reg. § 1.704-1(b)(4)(viii).

An eligible foreign tax credit accrued by a partnership was termed a "creditable foreign tax" under the Proposed/Temporary Regulations and is called a "creditable foreign tax expenditure" (CFTE) under the New Regulations.[70] Both definitions refer to an entirely different set of rules that deal with foreign tax credits in general and the ability of U.S. taxpayers to utilize them (i.e., whether or not such credits are eligible to decrease the U.S. taxpayer's U.S. tax liability).[71] The eligibility rules with respect to foreign tax credits are beyond the scope of this article, and, therefore, it should be sufficient to point out that paying tax in a foreign jurisdiction does not automatically mean that tax is eligible to reduce an American's U.S. tax liability.[72] These eligibility rules serve mainly to ensure that the foreign tax credit is used for the purpose for which it was enacted—to help U.S. taxpayers avoid double-taxation and nothing more.[73] The New Regulatory Scheme discussed herein is ancillary to that purpose.

IV. Explanation of the Former and Current Safe Harbors

A. Introduction

The Safe Harbor provided in the Proposed/Temporary Regulations validated a partnership's allocations of eligible foreign tax credits by deeming the allocations to be in accordance with the partners' interests in the partnership.[74] The New Regulations continue this approach.[75] Both sets of rules specifically state that allocations of eligible foreign tax credits accrued by a partnership cannot (in the case of the Proposed/Temporary Regulations), or do not (in the case of the New Regulations), have Substantial Economic Effect.[76] This change in phraseology was apparently in response to complaints by the tax bar that the term "cannot" was a bit overreaching.[77] Consequently, practitioners seeking a stamp of approval from the Treasury for allocations of eligible foreign tax credits have two choices available to them instead of the usual three. They can either 1) get the eligible foreign tax credits deemed to be in accordance with the partners' interests in the partnership by meeting the requirements of the Safe Harbor or 2) face a possible arbitrary reallocation and punishment by the Service based upon the facts and circumstances surrounding the partnership.[78] Upon considering the lack of guidance provided with respect to the

70. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(b).

71. I.R.C. § 901 (2000).

72. *See* I.R.C. §§ 901-904 (2000) (and the regulations thereunder). Note that these foreign tax credit rules are extensive and have merited numerous publications dedicated to their understanding. The tax professional will find a detailed analysis of them indispensable when advising clients on the issues involved in this article.

73. I.R.S. Notice 04-19, 2004-11 C.B. 606; I.R.S. Notice 98-5, 1998 C.B. 334.

74. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a).

75. Treas. Reg. § 1.704-1(b)(4)(viii)(a).

76. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a).

77. *See generally* American Bar Ass'n Section of Taxation's Foreign Tax Credit & Subpart F Task Force, Comments on Temporary and Proposed Regulations Governing Allocation of Partnership Expenditures for Foreign Taxes T.D. 9121; Reg - 139792-02, Aug. 10, 2004, reprinted in 2004 TNT 155-18 (Aug. 11, 2004) [hereinafter ABA Commentary]; NYSBA Report, *supra* note 58 (the NYSBA comments).

78. Treas. Reg. §§ 1.704-1(b)(1)(i), (b)(3). See also Part II-C, *supra*, and the footnotes therein that bemoan the terrible state of affairs that arises if one must resort to this reallocation under the facts and circumstances and the lack of guidance concerning this reallocation in sophisticated partnerships. .

latter choice, the prudent practitioner will likely decide that he/she has no choice at all and seek entrance to the calm waters of the Safe Harbor as it currently reads.[79]

The Safe Harbor in the Proposed/Temporary Regulations had two requirements that had to be satisfied prior to its application. First, the partnership agreement had to provide for the three conditions of the Economic Effect or Alternate Economic Effect test.[80] Second, the former Safe Harbor required that the partnership agreement state that allocations of "creditable foreign taxes" be allocated in proportion to the partners' shares of the foreign income giving rise to the foreign tax.[81] Likewise, the New Regulations have a type of proportionality requirement that requires that the affected allocations be "in proportion to the distributive shares of income to which the CFTE relates."[82] However, instead of specifically requiring that the covered allocations meet the Economic Effect test or the Alternate Economic Effect test, the New Regulations simply state that "[a]llocations of all other partnership items that, in the aggregate, have a material effect on the amount of [the eligible foreign tax credits] allocated to a partner . . . [must be] *valid*."[83]

B. The Threshold Requirement of the Proposed/Temporary Regulations and the Validity Requirement of the New Regulations

The first requirement of the Safe Harbor in the Proposed/Temporary Regulations stated that the partnership agreement must provide for either: 1) the three requisites of the Economic Effect test or 2) the three requisites of the Alternate Economic Effect test.[84] This first requirement could have been thought of as a threshold requirement because partnerships not satisfying it were banned from consideration for entrance to the Safe Harbor.[85] The effect was that partnership agreements taking this Safe Harbor into account provided, during the short time that this rule was in force, that the capital accounts of the partnership would be maintained in accordance with the applicable regulations, that liquidating distributions would be made in accordance with the partners' positive capital account balances, and that each partner must either unconditionally restore any deficit or

79. Treas. Reg. § 1.704-1(b)(3)(ii). The list of examples that illustrates this lack of guidance is found in the flush language of Subsection (ii). Those examples merely show what will happen when a partnership, whose partners have equal interests in just about everything, attempts to allocate some items in a special way without making the required provisions in the partnership agreement. Specifically, the rules fail to deal with situations where the true economic interests of the partnership are varied among the partners with respect to different items, such as when the interests in income are different from the contribution ratios, which are different from the shares of loss, which differ from the interests in liquidation, and so on. In this sort of situation, how would one determine the proper reallocation under the facts and circumstances? To be fair, however, it is necessary to point out that partnerships whose agreement provides for the first two requisites for Economic Effect enjoy more certainty than those with none of the requisites delineated. Treas. Reg. § 1.704-1(b)(3)(iii). The reallocation effectuated in that instance is done by comparing two different tax years to determine who would actually bear the burden of a loss allocation not respected for tax purposes.

80. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1). See Part IV, *infra*, for a detailed discussion of what this entails and for the further discussion of the Safe Harbor.

81. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(2).

82. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(1).

83. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(2) (emphasis added).

84. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1).

85. It could have been thought of as this because this name for the requirement has been invented for this paper.

agree to a qualified income offset.[86] Now it was not uncommon for partnership agreements to contain this language anyway due to the Section 704(b) regulations discussed above, but by specifically enumerating that only the satisfaction of the Economic Effect and Alternate Economic Effect tests would suffice for application of the Safe Harbor, the Proposed/Temporary Regulations appeared to exclude the Economic Effect Equivalence test as a way of meeting the Threshold Requirement of the Safe Harbor.[87] Alternatively, the New Regulations do not have this effect and offer some insight into the drafters' intent in the prior version.[88]

The Preamble to the New Regulations (the "Preamble") states that the purpose of the Safe Harbor, in the New Regulations expressly but likely in the Proposed/Temporary Regulations as well, is to provide practitioners with the assurance that allocations of CFTEs will garner respect if allocated in proportion to the income to which the particular CFTE relates. This shifts the focus to the Proportionality Requirement of the Safe Harbor, which is discussed in the next section.[89] In accordance with this purpose, the Validity Requirement in the New Regulations, which replaces the Threshold Requirement of the prior regulations, states that other allocations of Partnership Items "that, in the aggregate, have a material effect on [allocations] of CFTEs" must be merely "valid."[90] Thus, now partnerships that do not keep capital accounts but that liquidate in accordance with them are allowed use of the Safe Harbor.[91] The Preamble also gives guidance on what is meant by the phrase "material effect" in the New Regulations.[92]

This "material effect" phraseology was apparently put in the New Regulations to give practitioners even more leeway to meet the Safe Harbor requirement than that afforded by the inclusion of the Economic Effect Equivalence test.[93] For example, an allocation of CFTEs will still be respected even if some other allocation of the partnership is invalidated for some reason as long as that other allocation, alone or in conjunction with another allocation(s), does not materially affect the allocation of CFTEs of the partnership.[94] So the tax practitioner scratching his head over the meaning of the term "material effect" in the New Regulations can take solace in the fact that the Treasury and the Service inserted the language for his/her client's benefit. This buttresses the statement in the Pre-

86. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1).

87. This is assuming that the second requirement was met. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(1). *See also* ABA COMMENTARY, *supra* note 77. Note that the Temporary Regulations do not actually mention the phrase "Economic Effect" and instead simply refer to "[t]he requirements of either paragraph (b)(2)(ii)(b) or (b)(2)(ii)(d)." This phraseology signaled to the ABA, and to this author, that partnerships relying on Economic Effect Equivalence for substantiation of their allocations were not able to utilize the Safe Harbor in the Proposed/Temporary Regulations because they could not meet the first requirement under Section 1.704-1T(b)(4)(xi)(a)(1). So, with respect to this requirement, the New Regulations appear to allow more partnerships entrance to the Safe Harbor because the use of the term "valid" instead of referencing the Economic Effect and Alternate Economic Effect regulations takes into account all allocations that are afforded respect.

88. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(2).

89. *See* T.D. 9292, 2006-47 I.R.B. 914, Other Comments.

90. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(2).

91. *See* T.D. 9292, 2006-47 I.R.B. 914, Other Comments.

92. *Id.*

93. *Id.*

94. *Id.*

amble that the important part of the Safe Harbor is the Proportionality Requirement discussed below.

C. Requirement Two of the Safe Harbor: The Proportionality Requirement

1. *Introducing the Tax Credit Three-Step: The New Proportionality Requirement*

The Proposed/Temporary Regulations stated that the partnership agreement must provide "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))[95] to which the creditable foreign tax relates."[96] This is the "Proportionality Requirement."[97] The New Regulations have a similar requirement. In the Proposed/Temporary Regulations, a "creditable foreign tax" was defined as one "paid or accrued for U.S. tax purposes *by a partnership* [which was] eligible for a credit under Section 901(a) [of the Code]," whether or not the partner allocated the credit elected to claim a credit for the amount in lieu of a deduction.[98] The key phrase was "by a partnership." It signified that the typical foreign tax credit was not within the purview of these regulations—only a foreign tax credit accrued by a partnership via an entity level tax in a foreign jurisdiction. The New Regulations retain this "by a partnership" language in the definition of CFTEs while expanding on the definition of the eligible foreign tax credits covered by them.[99]

Rather than only applying to foreign tax credits accrued by a partnership eligible for a credit under Section 901(a) of the Code, the New Regulations also apply to foreign tax credits eligible for a credit under an applicable U.S. income tax treaty.[100] This is an understandable addition considering the prevalence of these treaties; the Proposed/Temporary Regulations should have included this language. Additionally, even though the New Regulations retain the "by a partnership" language, they clarify the definition of CFTE and the scope of the New Regulations by pointing out that a CFTE does not include: 1) foreign taxes deemed paid by a corporate partner of the partnership under Section 902 or 960 of the Code, or 2) foreign taxes for which an individual partner of the partnership has legal liability under Treasury Regulation Section 1.901-2(f).[101] Arguably, this clarification was not needed because of the "by a partnership" language, but any clarification from the Service is always appreciated.

The New Regulations also continue the proportioned approach of the Proposed/Temporary Regulations with their own, and much better, version of the Proportionality Re-

95. This Section 704(c) income is beyond the scope of this paper. Yet generally, what this means is that when property that has "built-in gain" is contributed to a partnership, this gain will be allocated to the partner who contributed it to avoid any assignment of income problems.

96. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(a)(2) (emphasis added).

97. Reader Beware: The author has heard no other tax practitioner refer to this Safe Harbor requirement in this manner. The phrase "Proportionality Requirement" merely exists for the purpose of brevity in this paper and has not climbed to the level of "tax lingo" nor has it even attempted such ascension. Thus, use of the term around colleagues will no doubt trigger perplexed looks and the occasional, "What the hell are you talking about?"

98. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(b) (emphasis added); I.R.C. §§ 703(b)(3), 901(a), 164(a) (2000).

99. Treas. Reg. § 1.704-1(b)(4)(viii)(b).

100. *Id.*

101. *Id.*; *see also* T.D. 9292, 2006-47 I.R.B. 914.

quirement.[102] The new requirement states that CFTEs must be "allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates."[103] A partner's distributive share of income is the amount of such income allocated to the partner under the Section 704(b) regulations, as discussed above. As explained in the Preamble, determining a partner's "distributive share of income to which the CFTE relates" is a three-step process.[104]

First, the New Regulations require that the partnership determine what its CFTE categories are.[105] For purposes of this article and simplicity, no partnership discussed herein will have more than two such categories. Second, affected partnerships are required to determine the "U.S. net income" in each CFTE category.[106] Generally, U.S. net income in a CFTE category is the amount of income for U.S. tax purposes from that CFTE category that is taxable in the United States after allocating and apportioning the applicable expenses or other deductions to the income.[107] Finally, the CFTEs themselves must be allocated and apportioned to the CFTE categories based on the net income in that category that is recognized for *foreign* tax purposes.[108] Upon completion of this process, the practitioner discovers that a CFTE is related to the U.S. net income that is in the same CFTE category to which the CFTE has been allocated. At this point the practitioner has met the Safe Harbor if he/she allocates and reports the CFTEs in the same proportion as the distributive shares of income to which the CFTEs relates.[109] Effectively, this process ensures that a CFTE will be related to the income in a CFTE category if the income is included in the tax base upon which the foreign tax is imposed.[110]

This three-step process is a welcomed clarification of the guidance provided under the Proposed/Temporary Regulations. The Proposed/Temporary Regulations stated merely that "[a] foreign tax is related to income if the income is included in the base upon which the taxes are imposed" and then provided four examples to illustrate the application of this rule.[111] Understandably, various commentators requested more guidance regarding the determination of whether what is now called a CFTE was related to income and whether such income meant income for foreign tax purposes or U.S. tax purposes.[112] The drafters of the New Regulations responded with the aforementioned three-step approach to meeting the Proportionality Requirement, which incorporates both U.S. and foreign income calculations.[113]

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102. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(1). Also see note 97, concerning the general acceptance of the phrase "Proportionality Requirement." The same proviso applies.

103. Treas. Reg. § 1.704-1(b)(4)(viii).

104. *See generally* T.D. 9292, 2006-47 I.R.B. 914.

105. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2); *see generally* T.D. 9292, 2006-47 I.R.B. 914.

106. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3); *see generally* T.D. 9292, 2006-47 I.R.B. 914.

107. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3).

108. Treas. Reg. § 1.704-1(b)(4)(viii)(d); *see generally* T.D.9292, 2006-47 I.R.B. 914.

109. Treas. Reg. § 1.704-1(b)(4)(viii)(a)(1).

110. Treas. Reg. § 1.704-1(b)(4)(viii)(d)(1).

111. Temp. Treas. Reg. § 1.704-1T(b)(4)(xi)(c).

112. *See generally* T.D.9292, 2006-47 I.R.B. 914; *see also* NYSBA REPORT, *supra* note 58; ABA COMMENTARY, *supra* note 77.

113. *See generally* T.D. 9292, 2006-47 I.R.B. 914.

2. *The Tax Credit Three-Step: Satisfying the New Proportionality Requirement of the Safe Harbor*

The first step in meeting the Proportionality Requirement of the New Regulations is determining the CFTE categories of the partnership.[114] A CFTE category is defined as "a category of net income (or loss) attributable to one or more activities of the partnership."[115] If all of the net income (or loss) associated with the partnership's activities is allocated in the same manner, the partnership will have only one CFTE category; but if the allocation of income from one partnership activity differs from the allocation of income of another activity, the partnership will have at least two CFTE categories.[116] The activities of the partnership are determined by taking into account all of the facts and circumstances of the partnership.[117] The New Regulations point out that the most relevant facts include the source jurisdiction of the income (i.e., the country that is taxing it) and the tax rates, or preferential tax treatment, afforded particular types of income.[118] For example, assume that Partnership AB has business income in Country X, taxed at 30 percent, that is allocated 60 percent to partner A and 40 percent to partner B, and passive income in Country X not subject to tax, that allocated 20 percent to partner A and 80 percent to partner B. Well, then under the New Regulations Partnership AB has two activities with differing allocations and, therefore, two CFTE categories (one for each activity).[119] A similar result occurs when income from another country is substituted for one of the activities and is allocated differently from the income of the retained activity.[120]

Since the ultimate goal is to allocate CFTEs in the same proportion to the distributive shares of the net income in the CFTE category to which the CFTEs are allocated, the second step in the Preamble provides that partnerships must determine the net amount of U.S. taxable income in each CFTE category.[121] The net amount of income in a CFTE category means "the net income for U.S. Federal income tax purposes, determined by taking into account all partnership items attributable to the relevant activity or group of activities."[122] The use of U.S. tax rules to determine the U.S. net income in the CFTE category makes sense because it is the U.S. income tax from the activity that will ultimately be offset after the allocation of the CFTE to the partner. Taking into account all Partnership Items attributable to the activity or activities in a CFTE category to determine U.S. net income, however, requires an allocation and apportionment of expenses and deductions to the U.S. *gross* income of the activity.[123] This invokes the allocation and apportionment rules of Treasury Regulations Sections 1.861-8 and 1.861-8T, which are

114. *See id.*; Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2). According to the Preamble, this category determination was illustrated in the examples following the definition of "creditable foreign tax" in the Proposed/Temporary Regulations, and thus the portions of the New Regulations are intended for clarification of the rules rather than an outright change. *See generally* T.D. 9292, 2006-47 I.R.B. 914.

115. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(i).

116. *Id.*

117. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(iii).

118. *Id.*; *see also* Treas. Reg. § 1.704-1(b)(4)(viii)(d)(5)., exs. 20-27.

119. Treas. Reg. § 1.704-1(b)(4)(viii)(d)(5), ex. 20.

120. *Id.*, ex. 21.

121. *See generally* T.D. 9292, 2006-47 I.R.B. 914; Treas. Reg. § 1.704-1(b)(4)(viii)(c)(1).

122. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(i).

123. *Id.*

generally used by practitioners to determine the amount of expenses and deductions allocated and/or apportioned between U.S. and foreign income.[124] In this case, expenses and deductions will be allocated and apportioned between the U.S. gross incomes attributable to activities in accordance with the same rules.[125]

Partnership AB above has two CFTE categories, one for the business activity and the other for the passive activity because the partners' distributive shares in each varied. Each CFTE category would have an amount of U.S. gross income from the activity located within it. In the second step of the Proportionality Requirement, the U.S. gross income in each CFTE category would then be decreased by any allocation or apportionment of expenses and deductions between the two sets of U.S. gross income under the rules of Sections 1.861-8 and 1.861-8T, the result of which is the amount of U.S. net income in each CFTE category. Each partner in the partnership would then be allocated a distributive share of this U.S. net income in the categories. Accordingly, partner A would be allocated 60 percent of the U.S. net income from the business activity in that CFTE category, and partner B would be allocated a 40 percent distributive share of this income. Similarly, partner A would be allocated a 20 percent distributive share of the U.S. net income from the passive activity, and partner B would be allocated 80 percent. The next step is to allocate the CFTEs to the CFTE categories so that the practitioner may allocate and report these CFTEs in the same proportion to each partner as each partner's distributive share of income from the corresponding category.

The third step in meeting the Proportionality Requirement of the New Regulations is allocating and apportioning the CFTEs to the already determined CFTE categories.[126] In this step, the income in each category for foreign purposes becomes important; because the CFTE follows the income included in the base upon which the foreign tax giving rise to the CFTE is imposed.[127] Returning to the Partnership AB example, note that there are two CFTE categories, and each has U.S. net income from the activities within it. Each CFTE category also has foreign income associated with these activities. That foreign income is subject to Country X's taxation. However, only the business income is actually taxed in Country X at a 30 percent rate. Because this business income is the only income taxed by Country X, only that income will be allocated and apportioned CFTEs under the third step. The result is that the CFTE category of the business activity will contain all of the CFTEs of Partnership AB. No CFTEs will be allocated or apportioned to the CFTE category of the passive activity because that activity is not taxed in Country X. Finally, the allocations of the CFTEs of Partnership AB in the business activity CFTE category will be respected if allocated in the same proportion as the distributive shares of income in that category. Accordingly, Partnership AB allocates the CFTEs 60 percent to partner A and 40 percent to partner B.

At this point Partnership AB has met the Proportionality Requirement of the New Regulations, and, assuming that the Validity Requirement has been met, the partnership has met the Safe Harbor provided in the New Regulations.

124. Treas. Reg. §§ 1.861-8, -8T.

125. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(i).

126. Treas. Reg. § 1.704-1(b)(4)(viii)(d); *see generally* T.D. 9292, 2006-47 I.R.B. 914.

127. Treas. Reg. § 1.704-1(b)(4)(viii)(d)(1).