



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9919]

RIN 1545-BO86

Gain or Loss of Foreign Persons from Sale or Exchange of Certain Partnership Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document contains regulations that provide guidance for certain foreign persons that recognize gain or loss from the sale or exchange of an interest in a partnership that is engaged in a trade or business within the United States. The regulations also affect partnerships that, directly or indirectly, have foreign persons as partners.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability dates: For dates of applicability, see §§1.864(c)(8)-1(j) and 1.897-7(c).

FOR FURTHER INFORMATION CONTACT: Chadwick Rowland or Ronald M. Gootzeit, (202) 317-6937 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

### Background

On December 27, 2018, the Department of the Treasury (the “Treasury Department”) and the IRS published proposed regulations (REG-113604-18) under

section 864(c)(8) in the **Federal Register** (83 FR 66647) (the “proposed regulations”). Section 864(c)(8) was added to the Internal Revenue Code (the “Code”) by the Tax Cuts and Jobs Act, Public Law 115-97 (2017) (the “Act”), which was enacted on December 22, 2017. The proposed regulations provide rules for determining the amount of gain or loss treated as effectively connected with the conduct of a trade or business within the United States (“effectively connected gain” or “effectively connected loss”) under section 864(c)(8), including certain rules that coordinate section 864(c)(8) with other relevant sections of the Code.

The Treasury Department and the IRS received written comments with respect to the proposed regulations. All written comments received in response to the proposed regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request. No public hearing on the proposed regulations was requested or held.

The Treasury Department and the IRS have also published proposed regulations (REG-105476-18) in the **Federal Register** relating to the withholding of tax and information reporting with respect to certain dispositions by a foreign person of an interest in a partnership that is engaged in the conduct of a trade or business within the United States (the “proposed withholding regulations”). See 84 FR 21198 (May 13, 2019). The Treasury Department and the IRS plan to publish final withholding and information reporting regulations in a later issue of the **Federal Register**.

## **Summary of Comments and Explanation of Revisions**

### **I. Overview**

The final regulations retain the basic approach and structure of the proposed regulations with certain revisions. This Summary of Comments and Explanation of

Revisions section discusses the comments received in response to the solicitation of comments in the proposed regulations and explains the revisions made in response to those comments.

## II. Comments and Revisions to Proposed §1.864(c)(8)-1

### A. Determining deemed sale EC gain or deemed sale EC loss

Section 864(c)(8)(A) provides that gain or loss of a nonresident alien individual or foreign corporation (a “foreign transferor”) from the sale, exchange, or other disposition (“transfer”) of an interest in a partnership that is engaged in any trade or business within the United States is treated as effectively connected gain or loss to the extent such gain or loss does not exceed the amount determined under section 864(c)(8)(B). In general, section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor’s distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value (the deemed sale limitation). The proposed regulations illustrate how to determine the deemed sale limitation described in section 864(c)(8)(B), which the proposed regulations refer to as the aggregate deemed sale EC (“ADSEC”) amount. Once the ADSEC amount has been determined for each applicable category of gain or loss, the foreign transferor’s outside gain or loss in each category is compared to the relevant ADSEC gain or ADSEC loss amount for that category to determine the amount of effectively connected gain or effectively connected loss under section 864(c)(8). In general, this amount is determined through a three-step process. Step one determines the amount of gain or loss from each partnership asset as if the partnership conducted a deemed sale of all of its assets on the date of transfer (these amounts, deemed sale

gain or deemed sale loss). Step two determines the amount of the deemed sale gain or loss that would be treated as effectively connected gain or loss with respect to each asset (these amounts are referred to as deemed sale EC gain or deemed sale EC loss). Finally, step three determines the foreign transferor's distributive share of the deemed sale EC gain or deemed sale EC loss amounts determined in step two.

As noted in the preceding paragraph, step two requires the gain or loss from the deemed sale of each partnership asset to be analyzed to determine if the gain or loss is properly characterized as effectively connected gain or effectively connected loss. Sourcing determinations are often material in determining whether gain or loss is effectively connected with the conduct of a trade or business within the United States. See, for example, sections 864(c)(2) and (3). Because the sourcing rules in the Code and regulations are generally fact-specific, the application of these rules in the context of the deemed sale required by section 864(c)(8)(B) is unclear. For example, it is unclear how to apply the sourcing rules and principles contained in sections 865(e)(2)(A) and (e)(3) (and the regulations implementing those sections) (the U.S. office rule) to the deemed sale of partnership property required by section 864(c)(8)(B). Specifically, the application of the U.S. office rule depends upon factual determinations made regarding the underlying sale; that is, whether it is attributable to an office or other fixed place of business in the United States, and, with respect to inventory property, whether it is sold for use, disposition, or consumption outside the United States and whether an office or other fixed place of business maintained by the taxpayer in the foreign country materially participated in the sale. In a deemed sale, however, the required facts are generally not determinable because a sale has not actually occurred.

Therefore, to address this lack of required facts and provide guidance on how to apply the sourcing provisions to deemed sales, the proposed regulations provide rules that serve as a proxy for the factual determinations that apply for purposes of sourcing deemed sale gain and loss and, in turn, for determining deemed sale EC gain and loss.

In general, proposed §1.864(c)(8)-1(c)(2)(i) treats all deemed sale gain and loss as attributable to an office or other fixed place of business maintained by the partnership in the United States, and does not treat inventory property as sold for use, disposition, or consumption outside the United States in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participates. Thus, the rule in proposed §1.864(c)(8)-1(c)(2)(i) provides simplifying factual assumptions that generally treat deemed sale gain and loss as U.S. source. An exception to this rule is provided in the proposed regulations if, during the ten-year period ending on the date of transfer, the asset in question produced no income or gain that was taxable as income that was effectively connected with the conduct of a trade or business within the United States by the partnership (or a predecessor), and the asset has not been used, or held for use, in the conduct of a trade or business within the United States by the partnership (or a predecessor) (the “ten-year exception”). Proposed §1.864(c)(8)-1(c)(2)(ii).

A comment on the interaction between section 864(c)(8) and the sourcing rules suggested that the simplifying factual assumptions supplied by the rule in proposed §1.864(c)(8)-1(c)(2)(i) may overstate the amount of effectively connected gain or loss on a deemed sale of the partnership’s assets, as compared to an actual asset sale, by treating all gain or loss from the deemed sale as attributable to a U.S. office of the

partnership, subject only to the ten-year exception. As a result, the proposed regulations would similarly overstate the amount of the deemed sale limitation. To address this concern, the comment suggested that in determining deemed sale EC gain and loss, the final regulations should aim to provide a result that is no better or worse than the result that would occur upon an actual asset sale by the partnership, but the comment acknowledged the difficulty in achieving this objective because the underlying source rules largely rely on fact-specific determinations.

The Treasury Department and the IRS generally agree with the broad principles described in the comment regarding proposed §1.864(c)(8)-1(c)(2). While these final regulations retain the basic framework of the proposed regulations, including the factual determinations regarding office attribution provided in proposed §1.864(c)(8)-1(c)(2)(i), these final regulations adjust their effects by adding rules for sourcing gain or loss from specific assets that may be particularly difficult to source in a deemed sale.

§1.864(c)(8)-1(c)(2)(ii)(B) through (E).

#### 1. Ten-year exception

The final regulations provide that deemed sale EC gain and loss is determined by applying section 864 and the regulations thereunder. §1.864(c)(8)-1(c)(2)(i)(A). These final regulations retain the ten-year exception as an exception to the determination of deemed sale EC gain and loss under §1.864(c)(8)-1(c)(2)(i)(A). The ten-year exception is intended to remove assets that have no nexus to the United States from the deemed sale EC gain and loss determination; therefore, for these assets, a foreign transferor does not need to apply the rules described in §1.864(c)(8)-1(c)(2)(ii) to determine deemed sale EC gain and loss. One comment requested that the final regulations

clarify that the ten-year exception applies to assets that were not held by the partnership for the full ten-year period. As requested by the comment, these final regulations modify the relevant testing period for the ten-year exception to account for a partnership (including a predecessor of the partnership) that has not existed for at least ten years, or that has not held an asset for at least ten years, by shortening the relevant testing period to the lesser of the ten-year period ending on the date of the transfer or the period during which the partnership (and a predecessor of the partnership) held the asset. §1.864(c)(8)-1(c)(2)(i)(B). In addition, to ensure that the ten-year exception is properly applied, these final regulations also modify the relevant testing period to include any period during which the foreign transferor (and a predecessor of the foreign transferor) held the asset. *Id.* Accordingly, an asset will not qualify for the ten-year exception if it generated effectively connected income or effectively connected gain for the foreign transferor (or a predecessor of the foreign transferor), or if the asset was used in the conduct of a trade or business within the United States by the foreign transferor (or a predecessor of the foreign transferor), within the relevant testing period. *Id.*

## 2. Rules for Sourcing Deemed Sale Gain and Loss for Purposes of Determining Deemed Sale EC Gain and Loss

Proposed §1.864(c)(8)-1(c)(2)(i) treats all gain or loss from the deemed sale of an asset as attributable to an office or other fixed place of business maintained by the partnership in the United States, and does not treat inventory property as sold for use, disposition, or consumption outside the United States in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participated. These final regulations make several changes to the general rule

provided in proposed §1.864(c)(8)-1(c)(2)(i) in response to the comment described in section II.A of this Summary of Comments and Explanation of Revisions; these final regulations also clarify the scope of this rule. First, these final regulations clarify that the general rule applies only for purposes of applying section 865(e)(2)(A) to personal property held by the partnership on the date of the deemed sale. §1.864(c)(8)-1(c)(2)(ii)(A). Second, these final regulations provide additional sourcing rules for determining the foreign source portion of deemed sale gain and loss attributable to specific assets included in the deemed sale. §1.864(c)(8)-1(c)(2)(ii)(B) through (E). The specific assets are inventory, intangibles, and depreciable personal property. Additional sourcing rules are needed because gain or loss from actual sales of each of these assets would be subject to specific sourcing rules under the Code, but sourcing deemed sale gain or loss under those rules would generally require facts that are not determinable in a deemed sale. These final regulations also clarify that if the partnership does not maintain an office or other fixed place of business in the United States (within the meaning of section 864(c)(5)(A) and §1.864-7), neither the U.S. office attribution described in §1.864(c)(8)-1(c)(2)(ii)(A), nor the additional sourcing rules described in §1.864(c)(8)-1(c)(2)(ii)(B) through (E), will apply. §1.864(c)(8)-1(c)(2)(ii)(A). Finally, the final regulations reorganize the proposed regulations to account for the changes described in this section II.A.2 of this Summary of Comments and Explanation of Revisions, and the phrase in proposed §1.864(c)(8)-1(c)(2)(i) regarding use, disposition, or consumption outside the United States is removed to conform with changes made to the general rule and the addition of a specific inventory sourcing rule.

The asset-specific rules provided in §1.864(c)(8)-1(c)(2)(ii)(B) through (E) utilize available facts as a proxy for the sourcing results, and the attendant effectively connected determinations, that would occur in an actual sale by the partnership of inventory, intangibles, or depreciable personal property. These asset-specific rules use existing sourcing rules and principles to provide fair, administrable rules that can be applied consistently. Specifically, the foreign source portion of deemed sale gain or loss attributable to inventory property (as defined in section 865(i)(1)) is determined using a proxy method that is based on historical data (as suggested by the comment); the foreign source portion of deemed sale gain and loss attributable to intangibles (as defined in section 865(d)(2)) is determined using a proxy method that is based on the partnership's historic income; and the foreign source portion for certain deemed sale gain or loss attributable to depreciable personal property (as defined in section 865(c)(4)(A)) is determined under a recapture principle and, to the extent applicable, a proxy method that is also based on historical data. Additionally, these final regulations add a material change in circumstances rule in §1.864(c)(8)-1(c)(2)(ii)(E) that applies if, based on a material change in circumstances, the asset-specific rules for inventory property or intangibles do not reach an appropriate sourcing result.

Thus, to the extent that deemed sale gain or loss is attributable to inventory, intangibles, or depreciable personal property, the sourcing result for these assets is determined by first applying §1.864(c)(8)-1(c)(2)(ii)(A) and then, to the extent applicable, the asset-specific rules provided in §1.864(c)(8)-1(c)(2)(ii)(B) through (D), or the material change in circumstances rule provided in §1.864(c)(8)-1(c)(2)(ii)(E). Accordingly, the U.S. office attribution rule described in §1.864(c)(8)-1(c)(2)(ii)(A)

applies to these assets only to the extent that the deemed sale gain or loss exceeds the relevant foreign source portion determined under the relevant rule provided in §1.864(c)(8)-1(c)(2)(ii)(B) through (E).

i. Look-back rule for inventory property

The comment on the interaction between section 864(c)(8) and the sourcing rules recommended that the Treasury Department and IRS consider a separate rule for sourcing deemed sales of inventory based on historical data showing how inventory sales were sourced by the partnership over a specified period. The Treasury Department and the IRS agree with the suggestion.

Section 1.864(c)(8)-1(c)(2)(ii)(B) provides a look-back rule for determining the foreign source portion of deemed sale gain or loss attributable to inventory property (as defined in section 865(i)(1), but not including gain sourced by reference to section 865(c)(2)) that is held by the partnership on the date of the deemed sale. Specifically, the general rule provided in §1.864(c)(8)-1(c)(2)(ii)(A) will not apply, and the deemed sale of inventory property will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States, to the extent of foreign source inventory gain or loss. This amount is determined by multiplying deemed sale gain and loss attributable to inventory by a fraction that determines the foreign source inventory ratio. The numerator of the fraction includes the gross income of the partnership that is attributable to foreign source gain or loss from inventory property (as determined under the rules of sections 865(b) and 865(e)) sold within the shorter of the period comprised of the partnership's three taxable years immediately preceding the date of the deemed sale, or the existence of the partnership (measured by partnership

taxable years); the denominator of the fraction is the total gross income of the partnership that is attributable to inventory over that period.

This approach addresses the concerns raised in the comment by looking to the partnership's past operations to determine the relevant sourcing result for inventory property, instead of assuming that all of the gain or loss from the deemed sale of inventory property is attributable to a U.S. office (unless the ten-year exception is met). That is, because sourcing the deemed sale gain or loss attributable to inventory property will require facts that are not available in a deemed sale, this approach sources the deemed sale gain or loss by reference to the actual sourcing results from prior sales of inventory property during the look-back period, as evidenced by the foreign source inventory ratio. This rule can be applied by taxpayers and administered by the government with certainty.

## ii. Look-back rule for intangibles

The comment on the interaction between section 864(c)(8) and the sourcing rules also discussed how the simplifying factual assumptions supplied by the rule in proposed §1.864(c)(8)-1(c)(2)(i) may overstate the amount of effectively connected gain or loss with respect to a deemed sale of intangibles held by the partnership. While acknowledging the difficulty of determining the source of deemed sale gain and loss attributable to intangibles, the comment described an approach that would apply a separate rule to determine the source of deemed sale gain and loss attributable to intangibles in lieu of the simplifying factual assumptions supplied by the rule in proposed §1.864(c)(8)-1(c)(2)(i) as it applies to intangibles. The Treasury Department and the IRS agree that it is difficult to source deemed sale gain or loss attributable to intangibles and

that a single, administrable rule to address this issue is preferable. To minimize the difficulty of applying the sourcing rules to intangible property and to provide more certainty, the final regulations provide a separate rule for intangibles (including going concern value) that determines the foreign source portion of deemed sale gain or loss attributable to intangibles by using a proxy method that is based on the source of the partnership's historic gross ordinary income.

Section 1.864(c)(8)-1(c)(2)(ii)(C) provides a look-back rule for determining the foreign source portion of deemed sale gain or loss attributable to an intangible (as defined in section 865(d)(2)) held by the partnership on the date of the deemed sale. This rule is similar to the look-back rule for inventory property because it provides that the deemed sale of an intangible will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States to the extent of a foreign source amount. This amount is determined by multiplying deemed sale gain or loss attributable to an intangible by the foreign source intangible ratio.

Thus, the approach for determining the foreign source amount with respect to intangibles employs the same general approach provided for inventory property, with certain modifications. Deemed sale gain or loss attributable to intangibles, like that attributable to inventory property, cannot be reliably sourced in a deemed sale because an actual sale has not occurred. However, unlike inventory property, intangibles may not have relevant historical data indicating how deemed sale gain and loss would be sourced in an actual sale (for example, some intangibles do not generate an identifiable income stream on which a sourcing proxy could be based). To address this issue, the numerator of the foreign source intangible ratio includes the foreign source gross

ordinary income of the partnership (other than from dispositions of depreciable or amortizable property) during the shorter of the period comprised of the partnership's three taxable years preceding the date of the deemed sale or the existence of the partnership (measured by partnership taxable years), to the extent that such income was not effectively connected with the conduct of a trade or business within the United States; the denominator includes the total gross ordinary income of the partnership (other than from dispositions of depreciable or amortizable property) during that period. §1.864(c)(8)-1(c)(2)(ii)(C)(1) and (2). This foreign source intangible ratio looks specifically to the historic gross ordinary income of the partnership (as opposed to all the historic gross income of the partnership) in order to more accurately reflect the partnership's income derived from the use of the intangibles in the ordinary course of its trade or business. This rule does not apply to the extent of any depreciation adjustments (as defined in section 865(c)(4)(B)) with respect to an amortizable intangible; instead, the rules regarding depreciable personal property will apply to such adjustments.

iii. Special rules for foreign source inventory ratio and foreign source intangible ratio

The foreign source inventory ratio and foreign source intangible ratio may in certain circumstances cause mathematically impossible results or unclear application if cost of goods sold exceed gross receipts. Additional rules were added to address these concerns. First, the foreign source inventory ratio and the foreign source intangible ratio cannot exceed one. §1.864(c)(8)-1(c)(2)(ii)(B) and (C). Second, if the foreign source gross income attributable to inventory or the foreign gross ordinary income is not positive, then respectively the foreign source inventory ratio or the foreign source

intangible ratio is zero. Id. Third, if the foreign source gross income attributable to inventory is positive, but the total gross income attributable to inventory is not positive, or if the foreign gross ordinary income is positive, but the total gross ordinary income is not positive, then respectively the foreign source inventory ratio or the foreign source intangible ratio is one. Id.

#### iv. Depreciable personal property

Section 1.864(c)(8)-1(c)(2)(ii)(D) provides a two-part approach for determining the foreign source portion of deemed sale gain and loss attributable to depreciable personal property: the first part applies a recapture principle to the extent of depreciation adjustments taken with respect to the property, and the second part focuses on where the property is located to the extent the property has deemed sale gain in excess of its depreciation adjustments or if the property has deemed sale loss.

Section 1.864(c)(8)-1(c)(2)(ii)(D)(1) applies a recapture principle by providing that the deemed sale of depreciable personal property (as defined in section 865(c)(4)(A)), or the deemed sale of an amortizable intangible (as defined in section 865(d)(2)), will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States to the extent the deemed sale gain is treated as sourced outside the United States after applying section 865(c)(1) at the time of the deemed sale. In contrast to the other sourcing rules that could apply to assets held by the partnership on the date of the deemed sale, the recapture rule provided in section 865(c)(1) can be applied with certainty at the time of the deemed sale because it is based on data that is available at the time of the deemed sale.

For deemed sale gain in excess of the depreciation adjustments with respect to depreciable personal property (other than an amortizable intangible), or for deemed sale loss from depreciable personal property (other than an amortizable intangible), §1.864(c)(8)-1(c)(2)(ii)(D)(2) provides that the relevant sourcing determination is made based on where the property is located. See §1.864(c)(8)-1(c)(2)(ii)(C) and section II.A.2.ii of this Summary of Comments and Explanation of Revisions for the rule that applies to gain in excess of depreciation adjustments with respect to an amortizable intangible. Although section 865(c)(2) sources the excess gain as if it were attributable to inventory property, such treatment would require further clarification for purposes of these final regulations. Specifically, in contrast to inventory property, depreciable personal property may not have historical data readily available that evidences the location of the economic activity associated with the property or that otherwise indicates how the excess gain or loss would be sourced in an actual sale. To address this issue, while also providing a clear and administrable rule, §1.864(c)(8)-1(c)(2)(ii)(D)(2) sources the excess gain or loss attributable to depreciable personal property based on the location of the property.

v. Material change in circumstances rule

Section 1.864(c)(8)-1(c)(2)(ii)(E) provides a material change in circumstances rule for inventory and intangibles. If this rule applies, the foreign source portion of deemed sale gain or loss attributable to inventory property or intangibles may be determined by applying the relevant rule of §1.864(c)(8)-1(c)(2)(ii)(B) or (C) by reference to a modified look-back period.

The Treasury Department and the IRS have determined that the general rule provided in §1.864(c)(8)-1(c)(2)(ii)(A) and the asset-specific determinations provided in §1.864(c)(8)-1(c)(2)(ii)(B) and (C) will reach an appropriate sourcing result in most cases; that is, an actual sale of the partnership's assets has not occurred, so relevant sourcing information with respect to an actual sale of the assets on the date of the deemed sale will not be readily determinable in most cases, and the look-back rules use the partnership's past operations as a proxy for reaching a sourcing determination with respect to certain assets included in the deemed sale. See sections II.A.2.i and II.A.2.ii of this Summary of Comments and Explanation of Revisions.

The Treasury Department and the IRS realize, however, that the look-back rules provided in §1.864(c)(8)-1(c)(2)(ii)(B) and (C) for inventory property and intangibles could reach incorrect sourcing results in certain cases; specifically, if a material change in circumstances occurred during the relevant look-back period described in paragraph §1.864(c)(8)-1(c)(2)(ii)(B)(1) or §1.864(c)(8)-1(c)(2)(ii)(C)(1), the partnership's historical data for the entire look-back period may not be an accurate proxy for reaching a sourcing determination with respect to deemed sale gain or loss attributable to such property. In these cases, the final regulations allow taxpayers to use this material change in circumstances rule to remedy an incorrect sourcing result with respect to inventory property and intangibles.

The application of §1.864(c)(8)-1(c)(2)(ii)(E), therefore, is limited to situations in which a material change in circumstances causes the look-back rule provided in §1.864(c)(8)-1(c)(2)(ii)(B), or the look-back rule provided in §1.864(c)(8)-1(c)(2)(ii)(C), to reach an inappropriate sourcing result; that is, a sourcing result that is materially

different from the sourcing result that would occur if the applicable look-back period began on the date on which the material change in circumstance occurred and ended on the last day of the partnership's taxable year immediately preceding the year in which the deemed sale occurs (the modified look-back period).<sup>1</sup> If the material change in circumstances rule applies, the applicable sourcing rule for inventory or intangibles may be applied by reference to the modified look-back period. §1.864(c)(8)-1(c)(2)(ii)(E). The determination of whether a sourcing result is materially different is determined by comparing the foreign source inventory ratio or foreign source intangible ratio provided in §1.864(c)(8)-1(c)(2)(ii)(B) or (C) (as applicable) with the foreign source inventory ratio or foreign source intangible ratio if that ratio were determined by reference to the modified look-back period. The sourcing result is not materially different unless the percentage point difference between the two ratios described in the preceding sentence is at least 30 percentage points. *Id.* See Example 2 in §1.864(c)(8)-1(c)(2)(iii).

#### B. Treaty coordination

A comment questioned whether the rules provided in proposed §1.864(c)(8)-1(c) for determining a foreign transferor's deemed sale EC gain or deemed sale EC loss were intended to apply in the treaty context without regard to whether the partnership in fact had a permanent establishment in the United States under the terms of an income tax treaty at the time of the transfer.

---

<sup>1</sup> The material change in circumstances rule cannot apply to a change in circumstances that occurs in the year of the deemed sale because such a change does not occur during the relevant look-back period and, in that case, there is no modified look-back period against which to measure the results that otherwise occur under §1.864(c)(8)-1(c)(2)(ii)(B) or (C).

These final regulations clarify that the U.S. office attribution rule described in §1.864(c)(8)-1(c)(2)(ii)(A) does not apply unless the partnership maintains an office or other fixed place of business in the United States. A partnership without a U.S. office or other fixed place of business will also generally not have a permanent establishment in the United States. In addition, the treaty coordination rule in §1.864(c)(8)-1(f) takes into account an applicable treaty when computing the amount of a foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss. As a result, for purposes of §1.864(c)(8)-1(c)(3) (that is, the third step in the three-step process to determine the foreign transferor's aggregate deemed sale EC items), gain or loss derived by the foreign transferor attributable to assets deemed sold that would be exempt from tax under an applicable U.S. income tax treaty if disposed of by the partnership are not taken into account.

The final regulations retain the general rule that prevents taxation of gain on assets that do not form part of a permanent establishment, but also address certain gains that may be taxed without regard to whether there is a permanent establishment (for example, gains from the disposition of certain U.S. real property interests). The final regulations also modify the structure of proposed §1.864(c)(8)-1(f) by consolidating proposed §1.864(c)(8)-1(f)(1) through (3) into a single paragraph and make three additional changes.

First, §1.864(c)(8)-1(f) clarifies that a foreign transferor is eligible for benefits under an income tax treaty only if the transferor meets the requirements of a limitation on benefits article, if any, in the treaty between the jurisdiction in which the foreign transferor is resident and the United States.

Second, §1.864(c)(8)-1(f) modifies proposed §1.864(c)(8)-1(f)(2), which stated that “[t]reaty provisions applicable to gains from the alienation of property forming part of a permanent establishment, including gains from the alienation of a permanent establishment in the United States, apply to the transfer by a foreign transferor of an interest in a partnership with a permanent establishment in the United States.” The final regulations clarify that a gains article that permits the taxation of gain from the alienation of property forming part of a permanent establishment or fixed place of business in the United States also permits the taxation of gain from the alienation of a partnership interest, to the extent the partnership’s assets deemed sold under section 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership. Thus, the final regulations remove from the description of an applicable gains provision the phrase “including gains from the alienation of a permanent establishment,” as that phrase, as used in certain treaties, merely illustrates one application of the underlying words and is not a separate rule. This approach also is consistent with the statutory framework under section 864(c)(8), which determines the amount of effectively connected gain or loss of a foreign transferor based on the amount of the transferor’s distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value.

Finally, §1.864(c)(8)-1(f) adds a rule coordinating these regulations with treaty provisions governing the disposition of United States real property interests, which allow the United States to tax gain derived from the disposition of the United States real property interest without regard to whether the U.S. real property interest forms a part of a partnership’s permanent establishment or fixed place of business in the United States.

Under this coordination rule, if, after applying treaty benefits in paragraph (c)(3) of this section, the only gains or losses that would be taken into account are gains or losses attributable to United States real property interests, the foreign transferor determines its effectively connected gain and effectively connected loss pursuant to section 897 and not under section 864(c)(8). This addition is consistent with the approach taken in the proposed regulations that the gain would be computed under section 897 rather than section 864(c)(8). See section IV of the Explanation of Provisions section of the preamble to the proposed regulations.

C. Partner-specific exclusions and exceptions

A comment requested that the final regulations more clearly address the interaction of section 864(c)(8) and §1.864(c)(8)-1 with provisions of the Code providing for an exemption from U.S. federal income tax. The Treasury Department and the IRS agree with this suggestion; accordingly, the final regulations provide that a foreign transferor's distributive share of deemed sale EC gain or loss does not include any amount that is excluded from the foreign transferor's gross income or otherwise exempt from U.S. Federal income tax by reason of an applicable provision of the Code. Section 1.864(c)(8)-1(c)(3)(i). For this purpose, the final regulations refer to sections 864(b)(2), 872(b), and 883 as examples. Id.

Similarly, §1.864(c)(8)-1(c)(3) is modified to provide that a foreign transferor's distributive share of deemed sale EC gain or deemed sale EC loss does not include any amount to which an exception under section 897 applies, such as section 897(k) or section 897(l), provided that amount is not otherwise treated as effectively connected income under a provision of the Code. This rule, which was provided in proposed

§1.864(c)(8)-1(c)(2) as part of the determination of a foreign transferor's deemed sale EC gain and deemed sale EC loss, is moved to §1.864(c)(8)-1(c)(3) in these final regulations because the exceptions under section 897(k) and section 897(l) are specific to the foreign transferor. This modification is intended to make the three step-process for determining the foreign transferor's aggregate deemed sale EC amounts more cohesive by placing all partner-specific adjustments in step 3.

#### D. Section 731 distributions

Under the proposed regulations, a foreign transferor determines the amount of outside gain and loss recognized on the transfer of a partnership interest under all relevant provisions of the Code and regulations, including any applicable nonrecognition provision. Proposed §1.864(c)(8)-1(b)(2). Although section 864(c)(8)(E) authorizes regulations or other guidance with respect to the application of section 864(c)(8) to nonrecognition transactions, the proposed regulations generally do not provide special rules that apply to nonrecognition transactions. But see proposed §1.864(c)(8)-1(h) (the anti-stuffing rule). However, the Treasury Department and the IRS recognized that certain nonrecognition transactions, for example certain section 731 distributions, may have the effect of reducing gain or loss that would be taken into account under the rules provided in the proposed regulations. The preamble to the proposed regulations, therefore, requested comments regarding whether sections of the Code other than section 864(c)(8) adequately address transactions that rely on section 731 distributions to reduce the scope of assets subject to U.S. federal income taxation as a result of section 864(c)(8) and proposed §1.864(c)(8)-1. A comment identified several relevant Code sections and analyzed the application of these sections to transactions involving

section 731 distributions. The Treasury Department and the IRS continue to study this issue and will, if necessary, address it through future rulemaking.

E. Information exchange between a partnership and non-controlling partners

A comment requested that foreign partners that do not own a controlling interest in a partnership be permitted to estimate their effectively connected gain or loss for purposes of section 864(c)(8) because non-controlling partners may not be able to obtain from the partnership the information required to perform the computations under these rules. The Treasury Department and the IRS have determined that such a rule is not needed under section 864(c)(8) because the proposed withholding regulations address this issue. Specifically, the proposed withholding regulations provide rules in proposed §1.864(c)(8)-2 that facilitate and encourage the transfer of information between a foreign partner and a partnership for purposes of section 864(c)(8). The information reporting requirements of the proposed withholding regulations require the partnership to provide the foreign partner with the information necessary to perform the computations under these rules, even if the foreign partner does not hold a controlling interest in the partnership. However, this comment will be considered as part of the proposed withholding regulations, which will be finalized separately in a later issue of the **Federal Register**.

F. Section 754 elections

A comment requested a special rule for any foreign transferor that has a difference between its basis in the partnership interest and its share of the partnership's inside basis that occurs because no section 754 election is in effect at the time of transfer; this special rule would, in effect, deem a section 754 election. Specifically, the

comment indicated that a foreign transferor may not have negotiated for the partnership to make a section 754 election upon acquisition of an interest in a partnership engaged in a trade or business within the United States because the transferor considered Rev. Rul. 91-32, 1991-1 C.B. 107, to be incorrect. As a result, upon a later transfer of the acquired partnership interest, the foreign transferor would have received a different result under the rules in the section 864(c)(8) proposed regulations than if the partnership had instead sold all of its assets and then liquidated. Because this result occurs due to the failure to make a section 754 election and the mismatches that follow from that failure, the Treasury Department and the IRS have determined that it would be inappropriate to adopt a special rule in these circumstances.

G. Clarification of section 897 coordination rule with respect to nonrecognition provisions

Proposed §1.864(c)(8)-1(d) coordinates the taxation of United States real property interests under section 897(g) with section 864(c)(8) by providing that when a partnership holds United States real property interests and a transfer of an interest in that partnership is subject to section 864(c)(8) because the partnership is engaged in the conduct of a trade or business within the United States without regard to section 897, the amount of the foreign transferor's effectively connected gain or loss will be determined under section 864(c)(8) and not under section 897(g). However, the proposed regulations did not provide explicit guidance on the application of the section 897 coordination rule when a foreign transferor transfers its partnership interest in a nonrecognition transaction. The final regulations clarify the interaction between the section 897 coordination rule and the nonrecognition provision described in §1.864(c)(8)-1(b)(2)(ii). Specifically, §1.864(c)(8)-1(d) provides that any transfer of an

interest in a partnership as part of a nonrecognition transaction will not be subject to section 864(c)(8) to the extent that the gain or loss on the transfer is not recognized; instead, if the partnership owns one or more United States real property interests, section 897(g) and the regulations thereunder will apply with respect to the unrecognized gain or loss.

### III. Applicability Dates

The proposed regulations were proposed to apply to transfers occurring on or after November 27, 2017. Because the provisions contained in this rulemaking are finalized after June 22, 2019, these regulations generally apply to transfers occurring on or after December 26, 2018 (that is, the date on which the proposed regulations were filed with the **Federal Register**). See sections 7805(b)(1)(B) and (b)(2) and §§1.864(c)(8)-1(j) and 1.897-7(c); see also the Applicability Dates section of the Preamble to the proposed regulations. While not subject to these final regulations, transfers occurring on or after November 27, 2017, but before December 26, 2018, are subject to section 864(c)(8). In addition, these final regulations apply to amounts taken into account on or after December 26, 2018, pursuant to an installment sale (as defined in section 453(b)) occurring on or after November 27, 2017, and before December 26, 2018. §§1.864(c)(8)-1(j) and 1.897-7(c). This rule is consistent with the manner in which installment sales are treated under existing law. See, e.g., Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938) (the tax laws in effect for the year the installment gain is recognized apply to the gain); see also Estate of Kearns v. Commissioner, 73 T.C. 1223 (1980); Klein v. Commissioner, 42 T.C. 1000 (1964); Rev. Rul. 79-22, 1979-1 C.B. 275.

## **Special Analyses**

These final regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

The Treasury Department and the IRS have assessed that the final regulations do not establish a new collection of information nor modify an existing collection that requires the approval of the Office of Management and Budget under the Paperwork Reduction Act (44 U.S.C. chapter 35).

Section 864(c)(8) and the final regulations generally apply to nonresident alien individuals and foreign corporations on the transfer of an interest in a partnership that is engaged in a trade or business within the United States, and not directly to the trade or business the partnership conducts in the United States. Under section 605 of the Regulatory Flexibility Act (5 U.S.C. chapter 6), the Treasury Department and the IRS certify that the final regulations will not have a significant economic impact on a substantial number of small business entities. The reason is that the final regulations generally apply to nonresident alien individuals and foreign corporations on the transfer of an interest in a partnership and not directly to domestic small business entities. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received.

## **Drafting Information**

The principal authors of these regulations are Chadwick Rowland and Ronald M. Gootzeit, Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

### **Statement of Availability**

Revenue rulings and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <https://www.irs.gov>.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1-- INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.864(c)(8)-1 also issued under 26 U.S.C. 864(c)(8) and 897(g).

\* \* \* \* \*

Section 1.897-7 also issued under 26 U.S.C. 897(g).

\* \* \* \* \*

Par. 2. Section 1.864(c)(8)-1 is added to read as follows:

§1.864(c)(8)-1 Gain or loss by foreign persons on the disposition of certain partnership interests.

(a) Overview. This section provides rules and definitions under section 864(c)(8). Paragraph (b) of this section provides the general rule treating gain or loss recognized by a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest as effectively connected gain or effectively connected loss. Paragraph (c) of this section provides rules for determining the limitations on the amount of effectively connected gain or effectively connected loss under section 864(c)(8) and paragraph (b) of this section. Paragraph (d) of this section provides rules regarding coordination with section 897. Paragraph (e) of this section provides rules regarding certain tiered partnerships. Paragraph (f) of this section provides rules regarding U.S. income tax treaties. Paragraph (g) of this section provides definitions. Paragraph (h) of this section provides a rule regarding certain contributions of property to a partnership. Paragraph (i) of this section contains examples illustrating the rules set forth in this section. Paragraph (j) of this section provides the applicability date.

(b) Gain or loss treated as effectively connected gain or loss--(1) In general. Notwithstanding any other provision of subtitle A of the Internal Revenue Code, if a foreign transferor owns, directly or indirectly, an interest in a partnership that is engaged in the conduct of a trade or business within the United States, outside capital gain, outside capital loss, outside ordinary gain, or outside ordinary loss (each as defined in paragraph (b)(2) of this section) recognized by the foreign transferor on the transfer of all (or any portion) of the interest is treated as effectively connected gain or effectively connected loss, subject to the limitations described in paragraph (b)(3) of this section. Except as provided in paragraph (d) of this section, this section does not apply to prevent any portion of the gain or loss that is otherwise treated as effectively connected

gain or effectively connected loss under provisions of the Internal Revenue Code other than section 864(c)(8) from being so treated.

(2) Determination of outside gain and loss--(i) In general. The amount of gain or loss recognized by the foreign transferor in connection with the transfer of its partnership interest is determined under all relevant provisions of the Internal Revenue Code and the regulations thereunder. See, e.g., §§1.741-1(a) and 1.751-1(a)(2). For purposes of this section, the amount of gain or loss that is treated as capital gain or capital loss under sections 741 and 751 is referred to as outside capital gain or outside capital loss, respectively. The amount of gain or loss that is treated as ordinary gain or ordinary loss under sections 741 and 751 is referred to as outside ordinary gain or outside ordinary loss, respectively.

(ii) Nonrecognition provisions. A foreign transferor's gain or loss recognized in connection with the transfer of its partnership interest does not include gain or loss to the extent that the gain or loss is not recognized by reason of one or more nonrecognition provisions of the Internal Revenue Code.

(3) Limitations. For purposes of applying this section, this paragraph (b)(3) limits the amount of gain or loss recognized by a foreign transferor that may be treated as effectively connected gain or effectively connected loss.

(i) Capital gain limitation. Outside capital gain recognized by a foreign transferor is treated as effectively connected gain to the extent it does not exceed aggregate deemed sale EC capital gain determined under paragraph (c)(3)(ii)(B) of this section.

(ii) Capital loss limitation. Outside capital loss recognized by a foreign transferor is treated as effectively connected loss to the extent it does not exceed aggregate deemed sale EC capital loss determined under paragraph (c)(3)(ii)(B) of this section.

(iii) Ordinary gain limitation. Outside ordinary gain recognized by a foreign transferor is treated as effectively connected gain to the extent it does not exceed aggregate deemed sale EC ordinary gain determined under paragraph (c)(3)(ii)(A) of this section.

(iv) Ordinary loss limitation. Outside ordinary loss recognized by a foreign transferor is treated as effectively connected loss to the extent it does not exceed aggregate deemed sale EC ordinary loss determined under paragraph (c)(3)(ii)(A) of this section.

(c) Amount treated as effectively connected with the conduct of a trade or business within the United States. This paragraph (c) describes the steps to be followed in computing the limitations described in paragraph (b)(3) of this section.

(1) Step 1: Determine deemed sale gain and loss. Determine the amount of gain or loss that the partnership would recognize with respect to each of its assets (other than interests in partnerships described in paragraph (e) of this section) upon a deemed sale of all of the partnership's assets on the date of the transfer of the partnership interest described in paragraph (b)(1) of this section (deemed sale). For this purpose, a deemed sale is treated as a sale by the partnership to an unrelated person of each of its assets (tangible and intangible) in a fully taxable transaction for cash in an amount equal to the fair market value of each asset (taking into account section 7701(g)) immediately before the partner's transfer of the interest in the partnership. For rules

concerning the deemed sale of certain partnership interests, see paragraph (e) of this section.

(2) Step 2: Determine deemed sale EC gain and loss--(i) In general – (A) Effectively connected determination. With respect to each asset deemed sold in paragraph (c)(1) of this section, determine the amount of gain or loss from the deemed sale that would be treated as effectively connected gain or effectively connected loss (including by reason of section 897). Gain described in this paragraph (c)(2) is referred to as deemed sale EC gain, and loss described in this paragraph (c)(2) is referred to as deemed sale EC loss. Section 864 and the regulations thereunder apply for purposes of determining whether deemed sale gain or loss would be treated as effectively connected gain or loss. See paragraph (c)(2)(ii) of this section for sourcing rules that apply for purposes of determining deemed sale EC gain and deemed sale EC loss.

(B) 10-year exception. For purposes of applying paragraph (c)(2)(i)(A) of this section, gain or loss from the deemed sale of an asset (other than a United States real property interest within the meaning of section 897(c)) will not be treated as deemed sale EC gain or deemed sale EC loss if--

(1) No income or gain produced by the asset was taxable as income that was effectively connected with the conduct of a trade or business within the United States by the partnership (or the foreign transferor, a predecessor of the foreign transferor, or a predecessor of the partnership) during the lesser of the ten-year period ending on the date of the transfer or the period for which the partnership (and, if applicable, the foreign transferor, a predecessor of the foreign transferor, and a predecessor of the partnership) held the asset; and

(2) The asset has not been used, or held for use, in the conduct of a trade or business within the United States by the partnership (or the foreign transferor, a predecessor of the foreign transferor, or a predecessor of the partnership) during that same period.

(ii) Sourcing rules for determining deemed sale EC gain and deemed sale EC loss--(A) In general. For purposes of applying section 865(e)(2)(A) in connection with the determination of deemed sale EC gain and deemed sale EC loss under this paragraph (c)(2)(ii)(A), except to the extent provided in paragraphs (c)(2)(ii)(B) through (E) of this section, the deemed sale of an asset will be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States. However, if the partnership does not maintain an office or other fixed place of business in the United States (within the meaning of section 864(c)(5)(A) and §1.864-7), neither the office attribution described in this paragraph (c)(2)(ii)(A), nor the rules of paragraphs (c)(2)(ii)(B) through (E) of this section, will apply.

(B) Look-back rule for sale of inventory property. The deemed sale of inventory property (as defined in section 865(i)(1)) will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States to the extent of foreign source inventory gain or loss. Foreign source inventory gain or loss is determined by multiplying the deemed sale gain or deemed sale loss attributable to inventory property by the foreign source inventory ratio. The foreign source inventory ratio cannot exceed one. If the amount in paragraph (c)(2)(ii)(B)(1) of this section is not positive, the foreign source inventory ratio is zero. If the amount in paragraph (c)(2)(ii)(B)(1) of this section is positive, but the amount in in paragraph (c)(2)(ii)(B)(2) of

this section is not positive, the foreign source inventory ratio is one. The foreign source inventory ratio is--

(1) The gross income of the partnership from sources without the United States (as determined under sections 865(b) and 865(e)(2)) that was attributable to inventory property sold during the lesser of—

(i) The period comprised of the partnership's three taxable years immediately preceding the date of the deemed sale, or

(ii) The period beginning on the date the partnership (or any of its predecessors) was formed and ending on the last day of the partnership's taxable year immediately preceding the date of the deemed sale; over

(2) The total gross income of the partnership that was attributable to inventory property sold during that same period.

(C) Look-back rule for intangibles. The deemed sale of an intangible (as defined in section 865(d)(2), including going concern value) will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States to the extent of foreign source intangible gain or loss. Foreign source intangible gain or loss is determined by multiplying the deemed sale gain or deemed sale loss from an intangible, without regard to any gain described in section 865(d)(4)(A), by the foreign source intangible ratio. The foreign source intangible ratio cannot exceed one. If the amount in paragraph (c)(2)(ii)(C)(1) of this section is not positive, the foreign source intangible ratio is zero. If the amount in paragraph (c)(2)(ii)(C)(1) of this section is positive, but the amount in in paragraph (c)(2)(ii)(C)(2) of this section is not positive, the foreign source inventory ratio is one. The foreign source intangible ratio is—

(1) The gross ordinary income (other than from dispositions of depreciable or amortizable property) of the partnership from sources without the United States that was not effectively connected with the conduct of a trade or business within the United States, during the lesser of—

(i) The period comprised of the partnership's three taxable years immediately preceding the date of the deemed sale, or

(ii) The period beginning on the date the partnership (or any of its predecessors) is formed and ending on the last day of the partnership's taxable year immediately preceding the year in which the deemed sale occurs; over

(2) The total gross ordinary income (other than from dispositions of depreciable or amortizable property) of the partnership during that period.

(D) Depreciable personal property—(1) Depreciation recapture. The deemed sale of depreciable personal property (as defined in section 865(c)(4)(A)), including from the sale of an amortizable intangible (as defined in section 865(d)(2)), will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States to the extent the deemed sale gain would be treated as from sources outside the United States after applying section 865(c)(1) at the time of the deemed sale.

(2) Gain in excess of depreciation or loss with respect to depreciable personal property. For purposes of this section, if the deemed sale of depreciable personal property (other than an amortizable intangible) results in deemed sale gain in excess of the property's depreciation adjustments (as defined in section 865(c)(4)(B)), or results in deemed sale loss, attribution to an office or other fixed place of business maintained by

the partnership in the United States with respect to the excess deemed sale gain, or deemed sale loss, will be determined based on where the property is located: if the property is located outside the United States, the excess deemed sale gain, or the deemed sale loss, will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States; if the property is located within the United States, the excess deemed sale gain, or the deemed sale loss, will be treated as attributable to an office or other fixed place of business maintained by the partnership in the United States.

(E) Material change in circumstances rule. If a material change in circumstances occurred that causes the applicable rule provided in paragraph (c)(2)(ii)(B) or (C) of this section to provide a sourcing result that is materially different from the sourcing result that would occur if the applicable period described in paragraph (c)(2)(ii)(B)(1) or (c)(2)(ii)(C)(1) of this section began on the date on which the material change in circumstance occurred and ended on the last day of the partnership's taxable year immediately preceding the year in which the deemed sale occurs (the modified look-back period), the applicable rule provided in paragraph (c)(2)(ii)(B) or (C) of this section may be applied by reference to the modified look-back period. The difference between the sourcing results is determined by comparing the foreign source inventory ratio (as described in paragraph (c)(2)(ii)(B) of this section) or the foreign source intangible ratio (as described in paragraph (c)(2)(ii)(C) of this section), as applicable, with the foreign source inventory ratio or foreign source intangible ratio, as applicable, if that ratio were determined by reference to the modified look-back period. For purposes of this paragraph (c)(2)(ii)(E), the sourcing results will not be materially different unless the

percentage point difference between the ratios described in the preceding sentence is at least 30 percentage points.

(iii) Examples. This paragraph (c)(2)(iii) provides examples that illustrate the rules of paragraph (c)(2)(ii) of this section. Except as otherwise provided, the following facts apply for purposes of this paragraph (c)(2)(iii). FP is a foreign corporation and a partner in PRS, a partnership that is engaged in the conduct of a trade or business within the United States (the U.S. Business) and a business in Country A (the Country A Business). Both businesses purchase inventory property and sell the purchased inventory property to unrelated customers; this is the only income-generating activity carried on by the businesses. PRS maintains an office or fixed place of business within the U.S. (within the meaning of section 864(c)(5)(A) and §1.864-7) and, for its U.S. business, PRS sells its inventory property through its U.S. office. For the Country A business, PRS sells its inventory property through its Country A office for consumption in Country A; PRS's Country A office materially participates in each sale. The gain or loss from the inventory sold through PRS's Country A office is treated as from sources without the United States and is not effectively connected with PRS's U.S. Business. In year 4, FP sells its entire interest in PRS, thereby triggering the deemed sale described in paragraph (c)(1) of this section. In the deemed sale, PRS recognizes \$10x of gain on the sale of its inventory property (the only asset PRS holds other than goodwill and going concern value). The 10-year exception provided in paragraph (c)(2)(i)(B) of this section does not apply.

(A) Example 1: Determining foreign source inventory gain—(1) Facts. Based on PRS's sales records for the three taxable years immediately preceding the date of the deemed sale, PRS's gross income from sources without the United States that is

attributable to sales of inventory property is \$12x and PRS's total gross income attributable to sales of inventory property during that period is \$30x.

(2) Analysis. To determine foreign source inventory gain or loss described in paragraph (c)(2)(ii)(B) of this section, the \$10x deemed sale gain attributable to inventory property is multiplied by PRS's foreign source inventory ratio. PRS's foreign source inventory ratio is PRS's gross income from sources without the United States that are attributable to sales of inventory property within PRS's three taxable years preceding the date of the deemed sale, over PRS's total gross income attributable to sales of inventory property during the same period. Thus, based on PRS's sales records from the three taxable years preceding the date of the deemed sale, the foreign source inventory gain for PRS's inventory is \$4x (the \$10x deemed sale gain attributable to inventory multiplied by the foreign source inventory ratio of \$12x over \$30x).

(B) Example 2: Determining deemed sale EC gain attributable to inventory property under the material change in circumstances rule--(1) Facts. The facts are the same as in paragraph (c)(2)(iii)(A)(1) of this section (the facts of Example 1 in this paragraph (c)(2)(iii)), except that at the beginning of year 3 (PRS's taxable year immediately preceding the date of the deemed sale), PRS started a new business in Country B (the Country B Business) to take advantage of favorable market prospects for its products in Country B. For the Country B Business, PRS sells its inventory property through its Country B office for consumption in Country B; PRS's Country B office materially participates in each such sale. The gain or loss from the inventory sold through PRS's Country B office is foreign source gain or loss. Also, at the beginning of year 3, PRS substantially reduced its U.S. Business as a result of market factors. As a result of these changes in year 3, 95% of PRS's inventory property is sold in its Country A Business and Country B Business (collectively, the Foreign Businesses) beginning on the date in which these changes occurred; accordingly, 5% of PRS' inventory property is sold in its U.S. Business after these changes. Based on PRS's sales records for the three taxable years preceding the date of the deemed sale, PRS's gross income from sources without the United States that are attributable to sales of inventory property is \$15x and PRS's total gross income attributable to sales of inventory property during that period is \$30x; for year 3, PRS's gross income from sources without the United States that are attributable to sales of inventory property is \$9.5x, and PRS's total gross income attributable to sales of inventory property in Year 3 is \$10x.

(2) Analysis. The material change in circumstances rule described in paragraph (c)(2)(ii)(E) of this section applies if due to a material change in circumstances, the sourcing rule provided in paragraph (c)(2)(ii)(B) of this section provides a sourcing result that is materially different from the sourcing result that would occur if that sourcing rule was applied by reference to the modified look-back period; that is, the period beginning on the date in which a material change in circumstances occurred and ending on the last day of the PRS's taxable year immediately preceding the date of the deemed sale. For this purpose, the reduction in PRS's U.S. business in year 3, coupled with the creation of the Country B Business in the same year, qualifies as a material change in

circumstances. Thus, the modified look-back period consists of year 3; that is, the period starting at the beginning of year 3, the date in which the material change in circumstances occurred, and ending of the last day of year 3, the last day of PRS's taxable year immediately preceding the date of the deemed sale. Based on PRS's sales records for the three taxable years preceding the deemed sale, the foreign source inventory ratio, expressed as a percentage, is 50% (\$15x attributable to PRS's gross income from sources without the United States with respect to sales of its inventory property, over \$30x attributable to PRS's total gross income with respect to sales of its inventory property). Due to the material change in circumstances, however, 95% of PRS's inventory property is sold in its Foreign Businesses. (\$9.5x attributable to PRS's gross income from sources without the United States with respect to sales of its inventory property, over \$10x attributable to PRS's total gross income with respect to sales of its inventory property.) Accordingly, if PRS applied the sourcing rule provided in paragraph (c)(2)(ii)(B) of this section by reference to the modified look-back period, 95% (\$9.5x/\$10x), or \$9.5x, of the gain would be attributable to sales for PRS's Foreign Businesses (gain from sources without the United States), and only 5% (\$.5x/\$10x), or \$0.5x, of the gain would be attributable to sales for PRS's U.S. Business (gain from United States sources). The excess of the foreign source inventory ratio determined by reference to the modified look-back period (expressed as a percentage), over the foreign source inventory ratio (also expressed as a percentage) is 45%; that is 95% (as determined under the modified look-back period) minus 50% (as determined under the foreign source inventory ratio). Accordingly, the sourcing results are materially different because the 45 percentage point difference is greater than the 30 percentage point threshold provided in paragraph (c)(2)(ii)(E) of this section. Thus, the material change in circumstances rule of paragraph (c)(2)(ii)(E) of this section applies and the foreign source inventory gain determined under paragraph (c)(2)(ii)(B) of this section, determined by reference to the modified look-back period, is \$9.5x; that is, the deemed sale gain attributable to inventory property (\$10x), multiplied by the foreign source inventory ratio determined by reference to the modified look-back period (\$9.5x/\$10x).

(3) Step 3: Determine the foreign transferor's distributive share of deemed sale

EC gain or deemed sale EC loss--(i) In general. A foreign transferor's distributive share of deemed sale EC gain or deemed sale EC loss with respect to each asset is the amount of the deemed sale EC gain and deemed sale EC loss determined under paragraph (c)(2) of this section that would have been allocated to the foreign transferor by the partnership under all applicable Internal Revenue Code sections (including section 704) upon the deemed sale described in paragraph (c)(1) of this section, taking into account allocations of tax items applying the principles of section 704(c), including

any remedial allocations (see §1.704-3(d)), and any section 743(b) basis adjustments (see §1.743-1(j)(3)). For this purpose, a foreign transferor's distributive share of deemed sale EC gain or deemed sale EC loss does not include any amount that is excluded from the foreign transferor's gross income or otherwise exempt from U.S. Federal income tax by reason of an applicable provision of the Internal Revenue Code (including, for example, by reason of section 864(b)(2), 872(b), or 883). Similarly, a foreign transferor's distributive share of deemed sale EC gain or deemed sale EC loss does not include any amount to which an exception under section 897 applies, such as section 897(k) or section 897(l), if that amount is not otherwise treated as effectively connected under a provision of the Code. For rules regarding the determination of a foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss under an applicable U.S. income tax treaty, see paragraph (f) of this section.

(ii) Aggregate deemed sale EC items--(A) Ordinary gain or loss. A foreign transferor's aggregate deemed sale EC ordinary gain (if the net aggregate of the foreign transferor's distributive share of the deemed sale EC ordinary gain and loss is a gain) or aggregate deemed sale EC ordinary loss (if the net aggregate of the foreign transferor's distributive share of the deemed sale EC ordinary gain and loss is a loss) is determined by taking into account--

(1) The portion of the foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss that is attributable to the deemed sale of the partnership's assets that are section 751(a) property; and

(2) Deemed sale EC gain and deemed sale EC loss from the deemed sale of assets that are section 751(a) property that would be allocated to the foreign transferor

with respect to interests in partnerships that are engaged in the conduct of a trade or business within the United States under paragraph (e)(1)(ii) of this section upon the deemed asset sales described in paragraph (e)(1)(i) of this section.

(B) Capital gain or loss. A foreign transferor's aggregate deemed sale EC capital gain (if the net aggregate of the foreign transferor's distributive share of the deemed sale EC capital gain and loss is a gain) or aggregate deemed sale EC capital loss (if the net aggregate of the foreign transferor's distributive share of the deemed sale EC capital gain and loss is a loss) is determined by taking into account--

(1) The portion of the foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss that is attributable to the deemed sale of assets that are not section 751(a) property; and

(2) Deemed sale EC gain and deemed sale EC loss from the sale of assets that are not section 751(a) property and that would be allocated to the foreign transferor with respect to all interests in partnerships that are engaged in the conduct of a trade or business within the United States under paragraph (e)(1)(ii) of this section upon the deemed asset sales described in paragraph (e)(1)(i) of this section.

(iii) Partial transfers. If a foreign transferor transfers less than all of its interest in a partnership, then for purposes of paragraph (c)(3)(i) of this section, the foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss is determined by reference to the amount of deemed sale EC gain or deemed sale EC loss determined under paragraph (c)(3)(i) of this section that is attributable to the portion of the foreign transferor's partnership interest that was transferred.

(d) Coordination with section 897. If a foreign transferor transfers an interest in a partnership in a transfer that is subject to section 864(c)(8) and the partnership owns one or more United States real property interests (as defined in section 897(c)), then the foreign transferor determines its effectively connected gain and effectively connected loss under this section, and not pursuant to section 897(g). Accordingly, with respect to a transfer that is subject to section 864(c)(8), section 864(c)(8)(C) does not reduce the amount of gain or loss treated as effectively connected gain or loss under this section. For rules regarding a transfer not subject to section 864(c)(8) of an interest in a partnership that owns one or more United States real property interests, see section 897(g) and the regulations thereunder. If a foreign transferor transfers an interest in a partnership in the manner described in paragraph (b)(2)(ii) of this section, the transfer is treated as not subject to section 864(c)(8) to the extent of the gain or loss that is not recognized; instead, if the partnership owns one or more United States real property interests at the time of transfer, the rules of section 897(g) and the regulations thereunder apply to the unrecognized gain or loss.

(e) Tiered partnerships--(1) Transfers of upper-tier partnerships. Assets sold in a deemed sale described in paragraph (c)(1) of this section do not include interests in partnerships that are engaged in the conduct of a trade or business within the United States or interests in partnerships that hold, directly or indirectly, partnerships that are engaged in the conduct of a trade or business within the United States. Rather, if a foreign transferor transfers an interest in a partnership (upper-tier partnership) that owns, directly or indirectly, an interest in one or more partnerships that are engaged in the conduct of a trade or business within the United States, then--

(i) Beginning with the lowest-tier partnership that is engaged in the conduct of a trade or business within the United States in a chain of partnerships and going up the chain, each partnership that is engaged in the conduct of a trade or business within the United States is treated as selling its assets in a deemed sale in accordance with the principles of paragraph (c)(1) of this section; and

(ii) Each partnership must determine its deemed sale EC gain and deemed sale EC loss in accordance with the principles of paragraph (c)(2) of this section, and determine the distributive share of deemed sale EC gain and deemed sale EC loss for each partner that is either a partnership (in which the foreign transferor is a direct or indirect partner) or a foreign transferor, in accordance with the principles of paragraph (c)(3)(i) of this section.

(2) Transfers by upper-tier partnerships. If a foreign transferor is a direct or indirect partner in an upper-tier partnership and the upper-tier partnership transfers an interest in a partnership that is engaged in the conduct of a trade or business within the United States (including a partnership held indirectly through one or more partnerships), then the principles of this section (including paragraph (e)(1) of this section) apply with respect to the gain or loss on the transfer that is allocated to the foreign transferor by the upper-tier partnership.

(3) Coordination with section 897. For purposes of this paragraph (e), a lower-tier partnership that holds one or more United States real property interests is treated as engaged in the conduct of a trade or business within the United States.

(f) Treaty coordination. This paragraph (f) describes how paragraph (c)(3) of this section applies in the case of a transfer of an interest in a partnership by a foreign

transferor that is eligible for benefits under an applicable U.S. income tax treaty. As a general matter, a foreign transferor must satisfy the requirements of the limitation on benefits article, if any, in the treaty between the jurisdiction in which the transferor is resident and the United States to be eligible for treaty benefits. In the case of a foreign transferor that is entitled to treaty benefits, in determining the foreign transferor's distributive share of deemed sale EC gain and deemed sale EC loss, gain or loss derived by the foreign transferor attributable to assets deemed sold that would be exempt from tax under an applicable U.S. income tax treaty if disposed of by the partnership are not taken into account under paragraph (c)(3) of this section. In general, gain or loss on the alienation of a partnership interest will be treated as effectively connected gain or loss under section 864(c)(8) to the extent that the gain or loss is either attributable to assets forming part of a U.S. permanent establishment or fixed place of business, or taxable under a provision governing the disposition of United States real property interests. Gain or loss from the alienation of a partnership interest will be considered gain or loss attributable to the alienation of assets forming part of a permanent establishment or fixed place of business in the United States to the extent the assets deemed sold under section 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership. If, however, after applying treaty benefits in paragraph (c)(3) of this section, the only gains or losses that would be taken into account are gains or losses attributable to United States real property interests, the foreign transferor determines its effectively connected gain and effectively connected loss pursuant to section 897 and not under this section.

(g) Definitions. The following definitions apply for purposes of this section.

(1) Effectively connected gain. The term effectively connected gain means gain that is treated as effectively connected with the conduct of a trade or business within the United States.

(2) Effectively connected loss. The term effectively connected loss means loss treated as effectively connected with the conduct of a trade or business within the United States.

(3) Foreign transferor. The term foreign transferor means a nonresident alien individual or foreign corporation.

(4) Section 751(a) property. The term section 751(a) property means unrealized receivables described in section 751(c) and inventory items described in section 751(d).

(5) Transfer. The term transfer means a sale, exchange, or other disposition, and includes a distribution from a partnership to a partner to the extent that gain or loss is recognized on the distribution, as well as a transfer treated as a sale or exchange under section 707(a)(2)(B).

(h) Anti-stuffing rule. If a foreign transferor (or a person that is related to a foreign transferor within the meaning of section 267(b) or 707(b)) transfers property (including another partnership interest) to a partnership in a transaction with a principal purpose of reducing the amount of gain treated as effectively connected gain, or increasing the amount of loss treated as effectively connected loss, under section 864(c)(8) or section 897, the transfer is disregarded for purposes of section 864(c)(8) or section 897, as appropriate.

(i) Examples. This paragraph (i) provides examples that illustrate the rules of this section. Except as otherwise provided, the following facts are presumed for purposes of

this paragraph (i). FP is a foreign corporation. USP is a domestic corporation. PRS is a partnership that was formed on January 1, 2018, when FP and USP each contributed \$100x in cash. PRS has made no distributions and received no contributions other than those described in the preceding sentence. FP's adjusted basis in its interest in PRS is \$100x. X is a foreign corporation that is unrelated to FP, USP, or PRS. Upon the formation of PRS, FP and USP entered into an agreement providing that all income, gain, loss, and deduction of PRS will be allocated equally between FP and USP. PRS is engaged in the conduct of a trade or business within the United States (the U.S. Business) and an unrelated business in Country A (the Country A Business). In a deemed sale described in paragraph (c)(1) of this section, gain or loss on assets of the U.S. Business would be treated as effectively connected gain or effectively connected loss, and gain or loss on assets of the Country A Business would not be so treated (including by reason of paragraph (c)(2)(i)(B) of this section). PRS has no liabilities.

(1) Example 1. Deemed sale limitation--(i) Facts. On January 1, 2019, FP sells its entire interest in PRS to X for \$105x. FP does not qualify for the benefits of an income tax treaty between the United States and another country. Immediately before the sale, PRS's balance sheet appears as follows:

|                                  | <u>Adjusted Basis</u> | <u>Fair Market Value</u> |
|----------------------------------|-----------------------|--------------------------|
| U.S. Business section 1231 asset | \$100x                | \$104x                   |
| Country A Business capital asset | 100x                  | 106x                     |
| <u>Total</u>                     | <u>\$200x</u>         | <u>\$210x</u>            |

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor (within the meaning of paragraph (g)(3) of this section) and transfers (within the meaning of paragraph (g)(5) of this section) its interest in PRS to X. For purposes of this example, for simplicity, PRS is assumed to hold no section 751(a) property and depreciation recapture is assumed to be zero. FP recognizes a \$5x capital gain under section 741, which is an outside capital gain within the meaning of paragraph (b)(2)(i) of this section. Under paragraph (b)(1) of this section, FP's \$5x capital gain is treated as effectively connected gain to the extent that it does not exceed the limitation described in paragraph (b)(3)(i) of this section, which is FP's aggregate deemed sale EC capital

gain.

(B) Deemed sale. FP's aggregate deemed sale EC capital gain is determined according to the three-step process set forth in paragraph (c) of this section. First, the amount of gain or loss that PRS would recognize with respect to each of its assets upon a deemed sale described in paragraph (c)(1) of this section is a \$4x gain with respect to the U.S. Business section 1231 asset and a \$6x gain with respect to the Country A Business capital asset. Second, under paragraph (c)(2) of this section, PRS's deemed sale EC gain is \$4x. Third, under paragraph (c)(3)(ii)(B) of this section, FP's aggregate deemed sale EC capital gain is \$2x (that is, the aggregate of its distributive share of deemed sale EC gain attributable to the deemed sale of assets that are not section 751(a) property, which is 50% of \$4x).

(C) Limitation. Under paragraph (b)(3)(i) of this section, the \$5x outside capital gain recognized by FP is treated as effectively connected gain to the extent that it does not exceed FP's \$2x aggregate deemed sale EC capital gain. Accordingly, FP recognizes \$2x of capital gain that is treated as effectively connected gain.

(2) Example 2. Outside gain limitation--(i) Facts. On January 1, 2019, FP sells its entire interest in PRS to X for \$110x. FP does not qualify for the benefits of an income tax treaty between the United States and another country. Immediately before the sale, PRS's balance sheet appears as follows:

|                                  | <u>Adjusted Basis</u> | <u>Fair Market Value</u> |
|----------------------------------|-----------------------|--------------------------|
| U.S. Business section 1231 asset | \$100x                | \$150x                   |
| Country A Business capital asset | 100x                  | 70x                      |
| Total                            | \$200x                | \$220x                   |

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor (within the meaning of paragraph (g)(3) of this section) and transfers (within the meaning of paragraph (g)(5) of this section) its interest in PRS to X. For purposes of this example, for simplicity, PRS is assumed to hold no section 751(a) property and depreciation recapture is assumed to be zero. FP recognizes a \$10x capital gain under section 741, which is an outside capital gain within the meaning of paragraph (b)(2)(i) of this section. Under paragraph (b)(1) of this section, FP's \$10x capital gain is treated as effectively connected gain to the extent that it does not exceed the limitation described in paragraph (b)(3)(i) of this section, which is FP's aggregate deemed sale EC capital gain.

(B) Deemed sale. FP's aggregate deemed sale EC capital gain is determined according to the three-step process set forth in paragraph (c) of this section. First, the amount of gain or loss that PRS would recognize with respect to each of its assets upon a deemed sale described in paragraph (c)(1) of this section is a \$50x gain with respect

to the U.S. Business section 1231 asset and a \$30x loss with respect to the Country A Business capital asset. Second, under paragraph (c)(2) of this section, PRS's deemed sale EC gain is \$50x. Third, under paragraph (c)(3)(ii)(B) of this section, FP's aggregate deemed sale EC capital gain is \$25x (that is, the aggregate of its distributive share of deemed sale EC gain attributable to the deemed sale of assets that are not section 751(a) property, which is 50% of \$50x).

(C) Limitation. Under paragraph (b)(3)(i) of this section, the \$10x outside capital gain recognized by FP is treated as effectively connected gain to the extent that it does not exceed FP's \$25x aggregate deemed sale EC capital gain. Accordingly, FP recognizes \$10x of capital gain that is treated as effectively connected gain.

(3) Example 3. Interaction with section 751(a)--(i) Facts. On January 1, 2019, FP sells its entire interest in PRS to X for \$95x. FP does not qualify for the benefits of an income tax treaty between the United States and another country. Through both its U.S. Business and its Country A Business, PRS holds inventory items and receivables that are section 751 property (as defined in §1.751-1(a)). Immediately before the sale, PRS's balance sheet appears as follows:

|   | <u>Adjusted Basis</u> | <u>Fair Market Value</u> |
|---|-----------------------|--------------------------|
| U.S. Business section 1231 asset        | \$20x                 | \$50x                    |
| U.S. Business inventory and receivables | 30x                   | 50x                      |
| Country A Business capital asset        | 100x                  | 80x                      |
| Country A Business inventory            | 50x                   | 10x                      |
| Total                                   | \$200x                | \$190x                   |

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor (within the meaning of paragraph (g)(3) of this section) and transfers (within the meaning of paragraph (g)(5) of this section) its interest in PRS to X. Under sections 741 and 751, FP recognizes a \$10x ordinary loss and a \$5x capital gain. See §1.751-1(a). Under paragraph (b)(2)(i) of this section, FP has outside ordinary loss equal to \$10x and outside capital gain equal to \$5x. Under paragraph (b)(1) of this section, FP's outside ordinary loss and outside capital gain are treated as effectively connected loss and effectively connected gain to the extent that each does not exceed the applicable limitation described in paragraph (b)(3) of this section. In the case of FP's outside ordinary loss, the applicable limitation is FP's aggregate deemed sale EC ordinary loss. In the case of FP's outside capital gain, the applicable limitation is FP's aggregate deemed sale EC capital gain.

(B) Deemed sale. FP's aggregate deemed sale EC ordinary loss and aggregate deemed sale EC capital gain are determined according to the three-step process set forth in paragraph (c) of this section.

(1) Step 1. The amount of gain or loss that PRS would recognize with respect to

each of its assets upon a deemed sale described in paragraph (c)(1) of this section is as follows:

| <u>Asset</u>                            | <u>Gain/(Loss)</u> |
|---|--------------------|
| U.S. Business section 1231 asset        | \$30x              |
| U.S. Business inventory and receivables | 20x                |
| Country A Business capital asset        | (20x)              |
| Country A Business inventory            | (40x)              |

(2) Step 2. Under paragraph (c)(2) of this section, PRS's deemed sale EC gain and deemed sale EC loss must be determined with respect to each asset. The amounts determined under paragraph (c)(2) of this section are as follows:

| <u>Asset</u>                            | <u>Deemed Sale EC Gain/(Loss)</u> |
|---|-----------------------------------|
| U.S. Business section 1231 asset        | \$30x                             |
| U.S. Business inventory and receivables | 20x                               |
| Country A Business capital asset        | 0                                 |
| Country A Business inventory            | 0                                 |

(3) Step 3. Under paragraph (c)(3)(ii)(B) of this section, FP's aggregate deemed sale EC capital gain is \$15x (that is, the aggregate of its distributive share of deemed sale EC gain that is attributable to the deemed sale of assets that are not section 751(a) property, which is 50% of \$30x) and FP's aggregate deemed sale EC ordinary loss is \$0 (that is, the aggregate of its distributive share of deemed sale EC loss that is attributable to the deemed sale of assets that are section 751(a) property).

(C) Limitation--(i) Capital gain. Under paragraph (b)(3)(i) of this section, the \$5x outside capital gain recognized by FP is treated as effectively connected gain to the extent that it does not exceed FP's \$15x aggregate deemed sale EC capital gain. Accordingly, the amount of FP's capital gain that is treated as effectively connected gain is \$5x.

(ii) Ordinary loss. Under paragraph (b)(3)(iv) of this section, the \$10x outside ordinary loss recognized by FP is treated as effectively connected loss to the extent that it does not exceed FP's \$0 aggregate deemed sale EC ordinary loss. Accordingly, the amount of FP's ordinary loss that is treated as effectively connected loss is \$0.

(4) Example 4. Coordination with income tax treaties--(i) Facts--(A) Sale of interest. On January 1, 2019, FP sells its entire interest in PRS to X for \$105x. Immediately before the sale, PRS's balance sheet appears as follows:

|                                  | <u>Adjusted Basis</u> | <u>Fair Market Value</u> |
|----------------------------------|-----------------------|--------------------------|
| U.S. Business section 1231 asset | \$100x                | \$104x                   |

|                                  |        |        |
|----------------------------------|--------|--------|
| Country A Business capital asset | 100x   | 106x   |
| Total                            | \$200x | \$210x |

(B) Treaty benefits. FP is a qualified resident of Country A under a U.S. income tax treaty between the United States and Country A that is similar or identical in all material respects to the 2006 U.S. Model Income Tax Convention (the Treaty). PRS is treated as fiscally transparent for purposes of Country A tax law. PRS does not carry on its U.S. Business through a U.S. permanent establishment (PE).

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor (within the meaning of paragraph (g)(3) of this section) and transfers (within the meaning of paragraph (g)(5) of this section) its interest in PRS to X. For purposes of this example, for simplicity, PRS is assumed to hold no section 751(a) property and depreciation recapture is assumed to be zero. FP recognizes a \$5x capital gain under section 741, which is an outside capital gain within the meaning of paragraph (b)(2)(i) of this section. Under paragraph (b)(1) of this section, FP's \$5x capital gain is treated as effectively connected gain to the extent that it does not exceed the limitation described in paragraph (b)(3)(i) of this section, which is FP's aggregate deemed sale EC capital gain.

(B) Deemed sale. FP's aggregate deemed sale EC capital gain is determined according to the three-step process set forth in paragraph (c) of this section by taking into account the treaty coordination rule under paragraph (f) of this section.

(1) Step 1. The amount of gain or loss that PRS would recognize with respect to each of its assets upon a deemed sale described in paragraph (c)(1) of this section is as follows:

| <u>Asset</u>                     | <u>Gain/(Loss)</u> |
|----------------------------------|--------------------|
| U.S. Business section 1231 asset | \$4x               |
| Country A Business capital asset | 6x                 |

(2) Step 2. Under paragraph (c)(2) of this section, PRS's deemed sale EC gain is as follows:

| <u>Asset</u>                     | <u>Gain/(Loss)</u> |
|----------------------------------|--------------------|
| U.S. Business section 1231 asset | \$4x               |
| Country A Business capital asset | 0x                 |

(3) Step 3. FP is eligible for benefits under the Treaty and derives the gain on the deemed sale of U.S. Business section 1231 asset. Under paragraph (c)(3)(i) and paragraph (f) of this section, because gain from the disposition of the U.S. Business section 1231 asset does not form part of a U.S. PE, the gain is exempt from U.S. tax under the Treaty, and is not taken into account in determining FP's distributive share of deemed sale EC gain under paragraphs (c)(3)(i) and paragraph (f) of this section. Therefore, FP's aggregate deemed sale EC capital gain is \$0x under paragraph

(c)(3)(ii)(B) of this section.

(C) Limitation. Under paragraph (b)(3)(i) of this section, the \$5x outside capital gain recognized by FP is not treated as effectively connected gain since all of it would exceed FP's \$0x aggregate deemed sale EC capital gain.

(j) Applicability date. This section applies to transfers occurring on or after December 26, 2018, and to amounts received on or after December 26, 2018, pursuant to an installment sale (as defined in section 453(b)) occurring on or after November 27, 2017.

Par. 3. Section 1.897-7 is added to read as follows:

§1.897-7 Treatment of certain partnership interests, trusts and estates under section 897(g).

(a) through (b) [Reserved]. For further guidance, see § 1.897-7T(a) through (b).

(c) Coordination with section 864(c)(8). Except as provided in §1.864(c)(8)-1, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate will, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property. See also §1.864(c)(8)-1(h) for an anti-stuffing rule that may apply to transactions subject to section 897. This paragraph applies to transfers occurring on or after December 26, 2018, and to amounts received on or after December 26, 2018, pursuant to an installment sale (as defined in section 453(b)) occurring on or after November 27, 2017.

Par. 4. Section 1.897-7T is amended by adding paragraph (c) to read as follows:

§1.897-7T Treatment of certain partnership interests as entirely U.S. real property interests under sections 897(g) and 1445(e) (temporary).

\* \* \* \* \*

(c) Coordination with section 864(c)(8). [Reserved]. For further guidance, see §1.897-7(c).

Sunita Lough,  
Deputy Commissioner for Services and Enforcement.

Approved: September 10, 2020.

David J. Kautter,  
Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2020-21165 Filed: 11/5/2020 8:45 am; Publication Date: 11/6/2020]