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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9398]

RIN 1545–BD70

Partner's Distributive Share

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing rules for testing whether the economic effect of an allocation is substantial within the meaning of section 704(b) where partners are look-through entities or members of a consolidated group. The final regulations clarify the application of section 704(b) to partnerships the interests of which are owned by look-through entities and members of consolidated groups and, through an example, reiterate the effect of other provisions of the Internal Revenue Code (Code) on partnership allocations. The final regulations affect partnerships and their partners.

DATES: *Effective Date:* The final regulations are effective on May 19, 2008.

Applicability Date: The final regulations apply to partnership taxable years beginning on or after May 19, 2008.

FOR FURTHER INFORMATION CONTACT: Jonathan E. Cornwell and Kevin I. Babitz at (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 704 of the Internal Revenue Code (Code). On November 18, 2005, proposed regulations (REG–144620–04) regarding the substantiality of allocations to partners that are look-through entities or members of a consolidated group were published in the **Federal Register** (70 FR 69919). Because no requests to speak were submitted by January 25, 2006, no public hearing was held (see 71 FR 7453). The IRS did receive a number of written comments responding to the proposed regulations, and, after consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Section 704(a) provides that a partner's distributive share of partnership income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement. Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to the partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

In order for an allocation to have substantial economic effect, it must have economic effect and such economic effect must be substantial. For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive the economic benefit or bear such economic burden. See § 1.704–1(b)(2)(ii).

Allocations to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides for: (i) The proper maintenance of the partners' capital accounts, (ii) upon liquidation of the partnership (or any partner's interest in the partnership) liquidating distributions are required to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all necessary adjustments for the partnership's taxable year during which the liquidation occurs, by the end of such taxable year, or if later, 90 days after the date of such liquidation, and (iii) if such partner has a deficit balance in the partner's capital account following the liquidation of the interest after taking into account all necessary adjustments for the partnership taxable year during which the liquidation occurs, the partner is unconditionally obligated to restore the deficit balance by the end of such taxable year (or, if later, within 90 days after the date of the liquidation), which amount is paid to the partnership's creditors or distributed to the other partners in accordance with their positive capital account balances. See § 1.704–1(b)(2)(ii)(*b*).

Even if the partnership agreement does not require an unlimited deficit restoration obligation of a partner, the allocation may still have economic effect to the extent such allocation does not cause or increase a deficit balance in the partner's capital account (in excess of any limited dollar amount of such partner's deficit restoration obligation) if requirements (1) and (2) of § 1.704–1(b)(2)(ii)(*b*) are satisfied and the partnership agreement contains a ''qualified income offset.'' Section 1.704–1(b)(2)(ii)(*d*). Finally, allocations that do not otherwise have economic effect under the foregoing rules shall be deemed to have economic effect if at the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners if such rules had been satisfied regardless of the economic performance of the partnership. Section 1.704–1(b)(2)(ii)(*i*).

As a general rule, the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. See § 1.704–1(b)(2)(iii). Even if the allocation affects substantially the dollar amounts to be received by the partners from the partnership, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. See § 1.704–1(b)(2)(iii).

This test is commonly referred to as the after-tax test. In determining the after-tax economic benefit or detriment of an allocation to a partner, the tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. Finally, the economic effect of an allocation is not substantial in two situations described in § 1.704–1(b)(2)(iii)(*b*) and (b)(2)(iii)(*c*). The latter two situations are generally described as ''shifting'' and ''transitory'' allocations, respectively.

If the partnership agreement provides for an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that does not have substantial economic effect, then the partner's distributive share of the income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership. References in section 704(b) or § 1.704–1 to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated, taking into account all facts and circumstances relating to the economic arrangement of the partners. See § 1.704–1(b)(3).

Section 1.704–1(b)(1)(iii) provides that an allocation that is respected under section 704(b) nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and § 1.751–1(b)(2)(ii).

The proposed regulations clarify several aspects of the regulations under section 704. The proposed regulations generally provide a ''look-through rule'' for purposes of testing the substantiality of an allocation. The proposed regulations provide that in determining the after-tax economic benefit or detriment of a partnership allocation to any partner that is a look-through entity, the look-through rule takes into account the tax consequences that result from the interaction of the allocation with the tax attributes of any owner of the look-through entity. Similarly, in determining the after-tax economic benefit or detriment to any partner that is a member of a consolidated group, the proposed regulations generally provide that the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. The proposed regulations provide that a look-through entity means a partnership, subchapter S corporation, trust, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs).

The proposed regulations clarify that, for purposes of § 1.704–1(b)(2)(iii)(*a*), the after-tax economic consequences of an allocation contained in the partnership agreement was compared to the after-tax economic consequences of the allocation made in accordance with the partners' interest in the partnership (within the meaning of § 1.704–1(b)(3)). For that purpose, the partners' interest in the partnership was determined as if the allocations tested were not contained in the partnership agreement. Also, the proposed regulations remove the per capita presumption in § 1.704–1(b)(3)(i). Finally, the proposed regulations include an example illustrating one circumstance where a provision other than section 704(b) may be used to reallocate partnership items.

Summary of Comments and Explanation of Provisions

The final regulations adopt the proposed regulations with clarification of certain aspects in response to the comments received.

A. Look-Through Entities and Members of a Consolidated Group

For purposes of applying the after-tax, shifting, and transitory tests to a partner that is a look-through entity, the final regulations provide that the tax consequences that result from the interaction of an allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such partner must be taken into account.

The final regulations define a look-through entity as a partnership, subchapter S corporation, trust, estate, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs). The final regulations change the look-through rule for CFCs (CFC look-through rule) to provide an ownership threshold that must be met in order to trigger look-through treatment. One comment suggested that, for administrative reasons, the look-through rule should apply only in cases involving partnerships (whether U.S. or foreign) that meet the control test in section 6038. The IRS and the Treasury Department agree that administrative concerns justify limiting the CFC look-through rule but are concerned that limiting the application of the rule as suggested would provide opportunities for abuse. Accordingly, the final regulations limit application of the CFC look-through rule to cases in which United States shareholders (within the meaning of section 951(b)) of the CFC in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.

In addition, the final regulations clarify that a CFC is treated as a look-through entity, but only with respect to allocations of items of income, gain, loss, or deduction that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. The Treasury Department and the IRS are further considering whether a CFC partner should be treated as a look-through entity in all cases and how any impact on the tax liability of a direct or indirect owner of the CFC partner resulting from actual or anticipated distributions of property by the CFC partner under section 301 should be taken into account in testing the substantiality of an allocation.

Comments were also received on other aspects of the look-through rule. One comment suggested that the definition of look-through entity be expanded to include estates. Because estates generally pass through attributes in the same manner as trusts, this comment is adopted. Another comment questioned the inclusion of disregarded entities in the list of look-through entities. The proposed regulations included disregarded entities because such entities are the actual state law partners in the partnership. The final regulations include disregarded entities in the list of look-through entities for this reason only.

Several comments requested modifications to the look-through rule based upon their contention that the rule was burdensome. One comment suggested the abandonment of the look-through rule entirely, believing the application of § 1.701–2 would protect the concerns underlying the proposed regulations and would be less burdensome. Another comment suggested that a five year presumption be included with respect to the after-tax test in § 1.704–1(b)(2)(iii)(*a*), such that the economic effect of any allocation occurring five years after the date upon which the allocation became a part of the partnership agreement would be presumed to be substantial. Finally, several comments requested either that the look-through rule apply only to partners owning more than 20 percent of the profits or capital of the partnership or that the look-through rule provide procedures to help partnerships ease the burden of considering the tax attributes of their partners and indirect owners.

One proposal to simplify the application of the look-through rule was to include a presumption that the partnership did not know and would not be required to investigate the tax attributes of any partner unless that partner directly or indirectly owns more than a 25 percent interest in the partnership's capital or profits. Alternatively, it was suggested that the final regulations provide certification procedures pursuant to which a partnership would be entitled to rely on a statement from its direct or indirect owner regarding such person's tax attributes.

The substantiality test in its present form was adopted in 1986. The Treasury Department and the IRS believe that the final regulations merely confirm the proper application of the substantiality test in those instances in which the partnership is owned by one or more look-through entities. In that respect, the look-through rule in the final regulations is not a change to the substantiality test. The Treasury Department and the IRS do not believe that it is necessary at this time to simplify the application of the substantiality test as suggested by the comments. However, to address the concerns expressed regarding the burden of the substantiality test as it applies to partnerships with look-through entity partners, the final regulations include a de minimis rule that provides that, for purposes of determining substantiality, the tax attributes of de minimis partners need not be taken into account. A de minimis partner is any partner, including a look-through entity, that owns less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item. Because of the inclusion of this de minimis rule, the final regulations do not provide for a certification procedure.

Some comments requested that the final regulations clarify what constitutes a ''tax attribute'' and an ''interaction.'' The IRS and the Treasury Department believe that this issue is sufficiently addressed under the current regulations, and, therefore, no further guidance is provided in the final regulations.

Finally, one comment requested that the final regulations provide guidance for situations in which the interaction of an allocation to a look-through entity, such as a trust or estate, and the tax attributes of the beneficiary of the entity are dependent on other factors such as the timing and amount of distributions from the trust or estate to the beneficiary. For example, it may be difficult to evaluate an allocation to a partner that is a trust where it is not known what distributions the trust will make. The IRS and the Treasury Department believe that this issue is addressed by the ''strong likelihood'' language of the substantiality test and, therefore, the final regulations do not provide additional guidance.

B. The Baseline for Comparison in § 1.704–1(b)(2)(iii)

Section 1.704–1(b)(2)(iii)(*a*) provides that the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement. Because taxpayers have suggested that the baseline comparison required by this provision is unclear, the proposed regulations clarified this rule, consistent with the provisions of § 1.704–1(b)(1)(i), by explaining that the after-tax economic consequences that result from the allocation must be compared to such consequences that would result if the allocations were not contained in the partnership agreement and were determined in accordance with the partners' interests in the partnership.

One comment suggested that an inconsistency existed between identifying the partners' interests in the partnership as the baseline for comparison in § 1.704–1(b)(2)(iii)(*a*)(*1*) and (2) and the conclusions reached by § 1.704–1(b)(5) *Example 5*. According to this comment, paragraph (ii) of § 1.704–1(b)(5) *Example 5* provides that the sharing percentages under the partners' interests in the partnership standard was 36 percent for one partner and 64 percent for the other partner. Comparing the after-tax economic consequences of the allocations contained in the partnership agreement with the 36/64 sharing percentages results in the after-tax economic consequences of one partner being enhanced and those of the other partner being substantially diminished. Thus, according to the comment, the conclusion in paragraph (i) of § 1.704–1(b)(5) *Example 5* cannot be correct. The after-tax test, however, is applied by comparing the allocations contained in the partnership agreement with the consequences determined in accordance with the partners' interests in the partnership had the allocations not been part of the partnership agreement. In *Example 5*, aside from the allocations being tested, the partners shared all other items equally and made equal capital contributions. To apply the substantiality test to the special allocations in that example, the results were compared to what would have occurred if the partners had 50/50 sharing percentages. This comparison revealed that one partner's after-tax economic return was enhanced and no partner's after-tax return was substantially diminished. Thus, the specially allocated items had to be reallocated under the partners' interests in the partnership. Under the facts of *Example 5*, the partners' interests in the partnership were the 36/64 sharing percentages, which were the same percentages in which they actually shared the partnership's total income for the year. The reallocation did not change the percentages in which the partners shared total income, but rather, required that each item of income (that is, tax-exempt income and taxable interest and dividends included in total income) be shared in those same percentages. Thus, in *Example 5* the partners' interests in the partnership for purposes of reallocating the items that lacked substantial economic effect was determined to be different than the partners' interests in the partnership used to test substantiality.

One comment suggested that the comparison to the partners' interests in the partnership is equally applicable when testing shifting and transitory allocations under § 1.704–1(b)(2)(iii)(*b*) and (*c*) as it is to the after-tax test under § 1.704–1(b)(2)(iii)(*a*), and suggested that the final regulations so provide. This comment is adopted and, in order to further clarify that the partners' interests in the partnership (determined without regard to the allocation or allocations being tested) is the baseline for comparison when testing the substantiality of an allocation, whether under the after-tax test or the shifting or transitory allocation test, the final regulations remove the parenthetical clauses inserted by the proposed regulations and add a sentence to the end of § 1.704–1(b)(2)(iii)(*a*)(*1*) that provides that references in § 1.704–1(b)(2)(iii) to an allocation (or allocations) not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph § 1.704–1(b)(3)), disregarding the allocation (or allocations) being tested under § 1.704–1(b)(2)(iii).

C. Removal of Per Capita Presumption in § 1.704–1(b)(3)

The proposed regulations removed the per capita presumption in § 1.704–1(b)(3). Because this section generally does not contain mechanical rules to determine the partners' interests in the partnership, one comment suggested that the presumption was necessary to reduce complexity, and therefore recommended that the final regulations reinsert the presumption. However, because the per capita presumption failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, the correct result was reached in very few cases. Accordingly, the Treasury Department and IRS believe that any benefits of the presumption are outweighed by the potential for incorrect determinations.

D. Example 29

In *Example 29* of the proposed regulations, B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of a foreign jurisdiction, with equal capital contributions. B and C are both wholly owned by A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. For the first fifteen years of the partnership, gross income is allocated 10 percent to B and 90 percent to C, and all deductions and losses will be allocated 90 percent to B and 10 percent to C. After the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and all deductions and losses will be allocated 10 percent to B and 90 percent to C. The example concludes that, apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other Code sections.

One comment questioned why *Example 29* did not contain a substantial economic effect analysis. Another comment inferred from the absence of a citation to § 1.701–2 in *Example 29* that the partnership anti-abuse rule did not apply and would not be asserted by the IRS. *Example 29* was included in the proposed regulations only to reiterate the provisions contained in § 1.704–1(b)(1)(iii) regarding the effect other sections may have on partnership allocations. Accordingly, the Treasury Department and IRS do not believe that any further analysis is necessary. Moreover the list of other sections that can affect the validity of a partnership allocation in § 1.704–1(b)(1)(iii) is not an exhaustive list and, accordingly, the absence of a citation to § 1.701–2 or other potentially applicable sections does not preclude the applicability of those provisions of law in the appropriate circumstances. The Treasury Department and IRS continue to consider issuing additional guidance addressing the proper treatment of special allocations of items of a partnership that is owned primarily by related parties. *Examples 29* and *30* in the proposed regulations have been renumbered as *Examples 28* and *29*, respectively, in these final regulations.

Effective/Applicability Date

The amendments made by these final regulations apply to partnership taxable years beginning on or after May 19, 2008.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of this regulation are Jonathan E. Cornwell and Kevin I. Babitz, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in its development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of 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 continues to read in part as follows: Authority: 26 U.S.C. 7805.

* * *

■ **Par. 2.** Section 1.704–1 is amended as follows:

■ 1. A sentence is added at the end of paragraph (b)(1)(ii)(*a*).
■ 2. A sentence is added at the end of paragraph (b)(2)(iii)(*a*).
■ 3. Paragraphs (b)(2)(iii)(*d*) and (*e*) are added.
■ 4. The last two sentences of paragraph (b)(3)(i) are removed.
■ 5. Paragraph (b)(5) *Examples 28*, *29* and *30* are added.

The additions and revisions read as follows:

§ 1.704–1 Partner's distributive share.

* * * * *

(b) * * *

(1) * * *

(ii) *Effective/applicability dates.* (*a*) * * * Paragraphs (b)(2)(iii)(*a*) (last sentence), (b)(2)(iii)(*d*), (b)(2)(iii)(*e*), and (b)(5) *Example 28*, *Example 29*, and *Example 30* of this section apply to partnership taxable years beginning on or after May 19, 2008.

(2) * * *

(iii) * * * (*a*) * * * References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).

* * * * *

(d) *Partners that are look-through entities or members of a consolidated group*— (*1*) *In general.* For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a member of a consolidated group (within the meaning of § 1.1502–1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) *Example 29* of this section.

(*2*) *Look-through entity*. For purposes of this paragraph (b)(2)(iii)(*d*), a *look-through entity* means—

(*i*) A partnership;

(*ii*) A subchapter S corporation;

(*iii*) A trust or an estate;

(*iv*) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§ 301.7701–1 through 301.7701–3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or

(*v*) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(*d*)(*6*) for the definition of indirect ownership.

(*3*) *Controlled foreign corporations*. For purposes of this section, the term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(*d*)(5) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(*4*) *United States person*. For purposes of this section, a *United States person* is a person described in section 7701(a)(30).

(*5*) *United States shareholder*. For purposes of this section, a *United States shareholder* is a person described in section 951(b) or section 953(c).

(*6*) *Indirect ownership*. For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase ''10 percent'' for the phrase ''50 percent'' each time it appears.

(*e*) *De minimis rule*. For purposes of applying this paragraph (b)(2)(iii), the tax attributes of *de minimis* partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(e), a *de minimis* partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(*d*)(*6*) of this section for the definition of indirect ownership.

* * * * *

(5) * * *

Example 28. (i) B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. The BC partnership agreement provides that, for the first fifteen years, BC's gross income will be allocated 10 percent to B and 90 percent to C, and BC's deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and BC's deductions and losses will be allocated 10 percent to B and 90 percent to C.

(ii) Apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other sections. See paragraph (b)(1)(iii) of this section. For example, BC's allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482.

Example 29. PRS is a partnership with three equal partners, A, B, and C. A is a corporation that is a member of a consolidated group within the meaning of § 1.1502–1(h). B is a subchapter S corporation that is wholly owned by D, an individual. C is a partnership with two partners, E, an individual, and F, a corporation that is member of a consolidated group within the meaning of § 1.1502–1(h). For purposes of paragraph (b)(2)(iii) of this section, in determining the after-tax economic benefit or detriment of an allocation to A, the tax consequences that result from the interaction of the allocation to A with the tax attributes of the consolidated group of which A is a member must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to B, the tax consequences that result from the interaction of the allocation with the tax attributes of D must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to C, the tax consequences that result from the interaction of the allocation with the tax attributes of E and the consolidated group of which F is a member must be taken into account.

Example 30. (i) A, a controlled foreign corporation, and B, a foreign corporation that is not a controlled foreign corporation, form AB, a partnership organized under the laws of country X. The partnership agreement contains the provisions necessary to comply with the economic effect safe harbor of paragraph (b)(2)(ii)(*b*) of this section. A is wholly-owned by C, a domestic corporation that is not a member of a consolidated group within the meaning of § 1.1502–1(h). B is wholly owned by an individual who is a citizen and resident of country X and is not related to A. Neither A, B, nor AB, is engaged in a trade or business in the United States. A and B each contribute 50 percent of the capital of AB. There is a strong likelihood that in each of the next several years AB will realize equal amounts of gross income that would constitute subpart F income if allocated to A, and gross income that would not constitute subpart F income if allocated to A (''non-subpart F income''). A and B agree to share bottom-line net income from AB equally; however, rather than share all items of gross income equally, A and B agree that B will be allocated all of AB's subpart F income to the extent of its 50 percent share of bottom-line net income. In year 1, AB earns $60x of income, $30x of which is subpart F income and is allocated to B, and $30x of which is non-subpart F income and is allocated to A.

(ii) Although neither A nor B is subject to U.S. tax with respect to its distributive share of the income of AB, under paragraph (b)(2)(iii)(*d*) of this section, the tax attributes of C must be taken into account with respect to A for purposes of applying the tests described in paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section. The allocations in year 1 have economic effect. However, the economic effect of the allocations is not substantial under the test described in paragraph (b)(2)(iii)(*b*) of this section because there was a strong likelihood, at the time the allocations became part of the AB partnership agreement, that the net increases and decreases to A's and B's capital accounts in year 1 would not differ substantially when compared to the net increases and decreases to A's and B's capital accounts for year 1 if the allocations were not contained in the partnership agreement, and the total tax liability from the income earned by AB in year 1 (taking into account the tax attributes of the allocations to C) would be reduced as a result of such allocations. Under paragraph (b)(3) of this section, the subpart F income and non-subpart F income earned by AB in year 1 must each be reallocated 50 percent to A and 50 percent to B.

* * * * *

Approved: May 8, 2008.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E8–11176 Filed 5–16–08; 8:45 am]

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DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 165

[Docket No. USCG–2008–0219]

RIN 1625–AA00

Firework Events; Great Lake Annual Firework Events

AGENCY: Coast Guard, DHS.

ACTION: Final rule.

SUMMARY: The Coast Guard is establishing safety zones for various fireworks events in the Captain of the Port Buffalo zone. This rule consolidates current regulations establishing safety zones for annual fireworks events in the former Captain of the Port Cleveland Zone and the former Captain of the Port Buffalo Zone. In addition, it adds events not previously published in Coast Guard regulations. These safety zones are necessary to protect spectators, participants, and vessels from the hazards associated with fireworks displays or other events.

DATES: This rule is effective June 18, 2008.

ADDRESSES: Comments and material received from the public as well as documents mentioned in this preamble as being available in the docket, are part of docket USCG–2008–0219 and are available online at *http://www.regulations.gov.* This material is also available for inspection or copying at two locations: The Docket Management Facility (M–30), U.S. Department of Transportation, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue, SE., Washington, DC 20590 between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays and Coast Guard Sector Buffalo, 1 Fuhrmann Boulevard, Buffalo, NY 14203 between 8 a.m. and 4 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this rule, call CDR Joseph Boudrow, Prevention Department, Coast Guard Sector Buffalo, Buffalo, NY at (716) 843–9572. If you have questions on viewing or submitting material to the docket, call Renee V. Wright, Program Manager, Docket Operations, at (202) 366–9826.

SUPPLEMENTARY INFORMATION:

Regulatory Information

On April 3, 2008, we published a notice of rulemaking (NPRM) entitled Annual Events Requiring Safety Zones in the Captain of the Port Buffalo zone in the **Federal Register** (73 FR 18225). We received no letters commenting on the rule. No public meeting was requested, and none was held.

Background and Purpose

On July 22, 2005, the Coast Guard consolidated the Captain of the Port Cleveland zone and the Captain of the Port Buffalo zone into one zone re-defining the Captain of the Port Buffalo zone. This rule will consolidate the regulations found in 33 CFR 165.202, Safety Zones; Annual Fireworks Events in the Captain of the Port Cleveland Zone, the regulations found in 33 CFR 165.914, Safety Zones; Annual Fireworks Events in the Captain of the Port Buffalo Zone so that all the annual fireworks events in the current Captain of the Port Buffalo Zone are found in one CFR section. In addition this rule adds events not previously published in the CFR.

These safety zones are necessary to protect vessels and people from the hazards associated with fireworks displays or other events. Such hazards include obstructions to the waterway that may cause marine casualties and the explosive danger of fireworks and debris falling into the water that may cause death or serious bodily harm.

Discussion of Comments and Changes

No comments were received regarding this rule.

Regulatory Evaluation

This rule is not a ''significant regulatory action'' under section 3(f) of Executive Order 12866, Regulatory Planning and Review, and does not require an assessment of potential costs and benefits under section 6(a)(3) of that Order. The Office of Management and Budget has not reviewed it under that Order.

We expect the economic impact of this rule to be so minimal that a full Regulatory Evaluation is unnecessary.

The Coast Guard's use of these safety zones will be periodic, of short duration, and designed to minimize the impact on navigable waters. These safety zones will only be enforced immediately before, during, and after the time the events occur. Furthermore, these safety zones have been designed to allow vessels to transit unrestricted to portions of the waterways not affected by the safety zones. The Coast Guard expects insignificant adverse impact to mariners from the activation of these safety zones.

Small Entities

Under the Regulatory Flexibility Act (5 U.S.C. 601–612), we have considered whether this rule would have a significant economic impact on a substantial number of small entities. The term ''small entities'' comprises small businesses, not-for-profit organizations that are independently owned and operated and are not dominant in their fields, and governmental jurisdictions with populations of less than 50,000.

The Coast Guard certifies under 5 U.S.C. 605(b) that this rule would not have a significant economic impact on a substantial number of small entities.

This rule will affect the following entities, some of which might be small entities: The owners of operators of vessels intending to transit or anchor in the areas designated as safety zones in subparagraphs (1) through (26) during the dates and times the safety zones are being enforced.

These safety zones will not have a significant economic impact on a substantial number of small entities for the following reasons: This rule will be in effect for short periods of time, and only once per year, per zone. The safety zones have been designed to allow traffic to pass safely around the zone whenever possible and vessels will be allowed to pass through the zones with the permission of the Captain of the Port.

Assistance for Small Entities

Under section 213(a) of the Small Business Regulatory Enforcement