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Global Tax Alert

US IRS concludes anti-abuse rule under Section 704(c) triggered in asset contribution to foreign partnership

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In a United States (US) Internal Revenue Service (IRS) Office of Chief Counsel Memorandum (FAA 20204201F), the IRS has advised that the Internal Revenue Code[1] Section 704(c) anti-abuse rule applies to contributions that a US corporate taxpayer made of high-value, low-basis assets to a partnership formed with a related foreign entity. The partnership used the "traditional method," with curative allocations limited to gain on the disposition of the contributed property, for making allocations with respect to the built-in gain for purposes of Section 704(c). The IRS determined that it may exercise its authority to apply a "curative method" that would cure the distortion.

Facts

Taxpayer (a corporation), along with a wholly owned US affiliate, held the worldwide intellectual property rights to certain intangible assets (Licensed Intangible Assets). Using licensing agreements, Taxpayer granted exclusive rights to manufacture and sell the Licensed Intangible Assets to Holdings, a foreign entity indirectly owned by Taxpayer. Under the terms of the licensing agreements, Taxpayer was entitled to receive from Holdings royalty payments on all third-party net sales of the Licensed Intangible Assets for the duration of the patent period (with a reduced royalty rate applying after the patent period).

Building a better working world

As part of a reorganization of Taxpayer's organization, a foreign affiliate of Taxpayer transferred the entirety of its interest in Holdings to ForeignCo, a foreign entity indirectly owned by Taxpayer. Holdings then elected to be treated as an entity disregarded from ForeignCo for US federal income tax purposes. Following this election, Taxpayer and its US affiliate transferred their non-US rights in the Licensed Intangible Assets to Holdings (the Contributed Intangible Assets) in exchange for shares in Holdings. Upon this transfer, Holdings converted to a partnership (the Partnership) for US federal income tax purposes, with Taxpayer and its US affiliate as US partners and ForeignCo as the foreign partner.

Taxpayer hired an outside advisor to value the partners' contributions in Holdings. The US partners' Contributed Intangible Assets had a Section 704(b) book basis consistent with their determined fair market value and zero tax basis — and such assets were treated as amortizable for tax purposes. It appears that most or all of the Contributed Intangible Assets had an expected economic life consistent with their income tax and Section 704(b) recovery period, indicating that the assets were wasting assets.

ForeignCo's contributed assets (some, but not all, of which were depreciable/amortizable) had tax bases that were equal to, or a significant percentage of, their fair market value and Section 704(b) book basis. Accordingly, the foreign partner's contributed assets (to the extent depreciable or amortizable) would produce significant tax depreciation or amortization, while the US partners' Contributed Intangible Assets would not.

The US partners and foreign partner entered into a shareholder's agreement setting forth certain terms and conditions of the Partnership. The agreement specified that the partners agreed to share Section 704(b) "book" income and loss from Partnership operations pro rata according to the partners' capital percentages (Sharing Percentages). The agreement also specified that, for purposes of applying Section 704(c), the Partnership elected the "traditional method" with a limited back-end curative gain-on-sale allocation. The curative allocation could apply only to gain from a taxable disposition of a Contributed Intangible Asset, among other limitations.

In its first tax year, Partnership generated significant revenue and net income. The Section 704(b) book depreciation or amortization for the partners' contributed assets was allocated according to the partners' Sharing Percentages. However, only the foreign partner's contributed assets generated significant amounts of tax depreciation to allocate among the partners.

It appears that these contributions occurred before the effective date of the Section 721(c) regulations, discussed later.

Law

Under Section 704(c), a partnership must allocate income, gain, loss and deduction for property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of the contribution. Treas. Reg. Section 1.704-3(b), (c) and (d) describe three methods of making Section 704(c) allocations that are generally considered reasonable: the traditional method, the traditional method with curative allocations (the curative method) and the remedial allocation method.

In applying the traditional method (Treas. Reg. Section 1.704-3(b)), the allocation of tax deductions attributable to property subject to depreciation or amortization takes into account built-in gain or loss on the property. However, the traditional method includes a limitation referred to as the "ceiling rule," under which the total income, gain, loss or deduction allocated to the partners for a tax year for a property cannot exceed the total partnership income, gain, loss or deduction for that property for the tax year.

To correct distortions created by the ceiling rule, the curative method (Treas. Reg. Section 1.704-3(c)) allows a partnership using the traditional method to make reasonable curative allocations to reduce or eliminate disparities between 704(b) book and tax items of noncontributing partners. The regulations generally permit a partnership to limit its curative allocations to allocations of one or more particular items. If depreciation or amortization allocations have been limited by the ceiling rule, the regulations generally allow a partnership to make curative allocations from gain on the disposition of the contributed property that was subject to the ceiling rule (but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation). The remedial allocation method (Treas. Reg. Section 1.704-3(d)) is similarly designed to eliminate distortions caused by the ceiling rule.

An anti-abuse provision in Treas. Reg. Section 1.704-3(a)(10) stipulates that an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The regulations clarify that the IRS's authority in making adjustments under the anti-abuse rule is generally limited to placing a partnership on the traditional method or the curative method (i.e., not the remedial allocation method). The regulations include two examples illustrating application of the anti-abuse rule.

Analysis

The IRS explained that the Section 704(c) anti-abuse rule has three separate requirements. Specifically, the contribution of property and the allocation of tax items with respect thereto must be "[1] made with a view [2] to shifting the tax consequences of built-in gain or loss among the partners [3] in a manner that substantially reduces the present value of the partners' aggregate tax liability."

"Shifting the tax consequences of built-in gain"

The IRS noted that the Contributed Intangible Assets were amortizable property and were contributed with a zero tax basis and a significant fair market value. Because the Contributed Intangible Assets had a zero tax basis, the ceiling rule prevented the foreign partner from receiving any tax amortization to match its allocations of Section 704(b) book amortization. The property contributed by the foreign partner was unlikely to result in a similar shift of Section 704(c) built-in gain to the US partners, because it was either non-depreciable or had a significant tax basis.

The IRS determined that the limited curative gain-on-sale allocations in the partnership agreement were insufficient to change this result. Due to restrictions on the curative provision's applicability, the IRS stated, the "provision's impact was always likely to be limited (or nonexistent)." It appears that the IRS was particularly troubled by the fact that the curative allocation was available only from a sale of the Contributed Intangible Assets and the Contributed Intangible Assets were truly wasting assets, suggesting that they would generate neither Section 704(b) gain nor tax gain that would cure the prior ceiling rule limitations.

"In a manner that substantially reduces the present value of the partners' aggregate tax liability"

The IRS concluded that the shift in built-in gain from the Contributed Intangible Assets was "highly likely to result in a substantial reduction in the present value of the partners' aggregate federal tax liability." The IRS noted that the foreign partner was not subject to US federal income tax and the Partnership's income was not US-source income, leaving the foreign partner with an effective US tax rate of 0%. Shifting income away from the US partners, which were subject to a 35% corporate rate, would significantly reduce tax liability. The reduction in tax liability was expected to be "substantial," the IRS explained, because the amount of income to be shifted was expected to be substantial.

"With a view to"

The IRS explained that the regulations under the Section 704(c) anti-abuse rule do not expound on the "with a view to" standard, and the examples included tend to simply assume that the requisite view existed. However, the IRS stated that the standard is "clearly a lower threshold" than for other anti-abuse provisions such as the general partnership anti-abuse rule (which generally ties the formation of the partnership to the tax avoidance purpose). Rather, the IRS reasoned that the Section 704(c) anti-abuse rule applies, generally speaking, if the taxpayers intentionally organized their affairs to effect the prohibited action (and the prohibited action occurred), even if the taxpayers' primary motive for the contributions was done for valid non-tax business motives. The IRS also cited regulations under repealed Section 341, which provided that the "with a view to" requirement is satisfied if the ultimate tax benefit was "contemplated, unconditionally, conditionally, or as a recognized possibility" by the taxpayer. However, relying on guidance under Section 246, the IRS also indicated that "the taxpayer must be motivated to some degree [by an IRC Section 704(c) benefit] to structure a transaction or series of transactions in a particular manner" in order for the Section 704(c) anti-abuse rule to apply.[2] The IRS also stated that "[t]he fact that the Reorganization may also have been motivated in part by a non-tax business purpose is irrelevant to the [IRC Section 704(c)] anti-abuse rule analysis."

In the current instance, the IRS concluded that the contribution of the Contributed Intangible Assets and the use of the traditional method with a curative allocation that was "intended to be so limited that it would never be used or effective" were made with a view to the income shifting and tax savings. The IRS noted that the partners are all related and understood the tax effects of their actions and that the tax savings were likely to be considerable. The IRS added that the fact that the reorganization may also have been motivated in part by a non-tax business purpose is irrelevant to the Section 704(c) anti-abuse rule analysis.

Remedy

Having concluded the requirements of the Section 704(c) anti-abuse rule are met, the IRS stated that it may exercise its authority to place the Partnership on a curative method that would cure the distortion.

Implications

The FAA is significant for a few reasons. First, it provides insight on the IRS's view of the application of the Section 704(c) anti-abuse rule. Second, the FAA raises questions concerning the IRS's interpretation of the "with a view to" requirement in the Section 704(c) anti-abuse rule; more specifically, the FAA suggests that the IRS may seek to apply the Section 704(c) anti-abuse rule even to partnership contributions that were partially motivated by valid non-tax business purposes. Third, it confirms that the IRS cannot apply the remedial allocation method to remedy an adoption of a Section 704(c) method that violates the Section 704(c) anti-abuse rule.

Although the Section 721(c) regulations did not apply to the contributions in the FAA, those regulations impose certain requirements that are relevant to taxpayers considering a similar transaction. The regulations under Section 721(c) deny nonrecognition treatment to certain contributions of appreciated property by US persons to partnerships with related foreign partners unless the partnership satisfies specific requirements. To avoid gain recognition, the partnership must, among other things, adopt the remedial allocation method under Section 704(c) and the consistent allocation method in the Section 721(c) regulations, in each case with respect to the transferred property. Under the remedial allocation method, a ceiling rule limitation is "cured" each year by having the partnership allocate (i) notional items to the non-contributing partner to ensure its allocation of tax items matches its allocation of Section 704(b) items (tax amortization deductions, for example) and (ii) offsetting notional items to the contributing partner (taxable income, for example).

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Specifically, the IRS stated: "In another context, the Service has read the 'plain language' of the 'with a view' standard under the § 246 regulations to mean that 'the taxpayer must be motivated to some degree to structure a transaction or series of transactions in a particular manner so as to avoid disallowance of the [dividends received deduction]'" (quoted language taken from CCA 201827011).

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