Office of Chief Counsel
Internal Revenue Service
memorandum

CC:LB:1:   :1:JECornwell
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to: David Shuart
Senior Revenue Agent – Cross Border Activities

from: Jonathan Cornwell
Attorney (   )
(Large Business & International)

subject: **Taxpayer**:
Tax Year:
UIL: 704.00-00, 704.01-04

INTRODUCTION

The Large Business and International ("**LB&I**") operating division of the Internal Revenue Service (the "**Service**") is currently examining the U.S. federal income tax returns of   (the "**Taxpayer**"), a   corporation, for its taxable year ended   (“**Year 1**”). This memorandum responds to your request about contributions by the Taxpayer and its wholly owned U.S. subsidiary,   ("**Taxpayer's U.S. Affiliate**"), a   limited liability company, treated as a corporation for U.S. federal income tax purposes, and a member of the Taxpayer's U.S. consolidated tax group, of high-value, low-basis intangible property to a foreign unlimited liability company that owned high-value, high-basis property. This foreign entity had converted from an entity disregarded from its owner (a foreign corporation indirectly owned by the Taxpayer) to a partnership for U.S. federal income tax purposes (the "**Partnership**") as a result of such contributions. It elected the traditional method with a limited back-end curative gain-on-sale allocation for purposes of applying § 704(c).[1] You inquired whether these contributions and choice of § 704(c) method were made with a view to shifting the tax consequences of the pre-contribution gain in the intangible property contributed by the Taxpayer and its U.S. corporate affiliate to the Taxpayer's indirectly owned foreign affiliate in a manner that substantially reduced the present value of the partners' aggregate federal tax liability, as described in the anti-abuse rule of § 1.704-3(a)(10)(i). This memorandum also discusses the applicable remedy if this anti-abuse rule applies.

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[1] Unless otherwise stated, references to "**§**" or "**Section**" in this memorandum are to sections of the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

This memorandum assumes, without conceding, that the transfers described herein as made by the Taxpayer, its U.S. corporate affiliate, and its foreign corporate affiliate were transfers of property for purposes of § 721, and that the business reasons for forming the Partnership (as discussed below) are otherwise valid. No inference is intended as to the U.S. federal income tax characterization of such transfers or other aspects of the Tax Opinion Letter (defined below) or the Second Tax Opinion Letter (defined below).

The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. If the facts are different from the facts set forth below, you should immediately advise us.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client and attorney work product privileges. Accordingly, this memorandum is not to be distributed to the Taxpayer or anyone else. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. Does the anti-abuse rule of § 1.704-3(a)(10)(i) apply to contributions by the Taxpayer and Taxpayer's U.S. Affiliate of high value, low-basis property to the Partnership and the Partnership's use of the traditional method (with a limited curative gain-on-sale allocation provision) to account for the built-in gain under § 704(c)?

2. What is the applicable remedy if the anti-abuse rule of § 1.704-3(a)(10)(i) applies?

FACTS

Background

The Taxpayer is engaged in

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Prior to the reorganization discussed below, the Taxpayer and Taxpayer's U.S. Affiliate held the worldwide intellectual property rights to

(the "**Licensed Intangible Assets**"). Specifically, the Taxpayer held the worldwide rights to

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Using a series of licensing agreements, the Taxpayer and Taxpayer's U.S. Affiliate granted the exclusive rights to manufacture and sell the Licensed Intangible Assets to (“**Holdings**”), a company domiciled in , and treated as a corporation for U.S. federal tax purposes. Holdings was, indirectly, wholly owned by the Taxpayer.

Under the terms of the licensing agreements, in return for granting the exclusive rights noted above, the Taxpayer and Taxpayer's U.S. Affiliate were entitled to receive from Holdings a percent royalty payment on all third-party net sales of the Licensed Intangible Assets for the duration of patent period. Upon expiration of the patent period, the Taxpayer's internal transfer pricing policies dictated that the royalty rate would decrease from to percent. The patent periods for extend until .

The Partnership Formation

In Year 1, the Taxpayer reorganized its operations (the “**Reorganization**”). According to the tax opinion letter issued by (the “**Outside Advisor**”) relating to the Reorganization, dated (the “**Tax Opinion Letter**”), the stated purpose of the Reorganization was to better align the geographical and operational focus of the Taxpayer.

As part of the Reorganization, the Taxpayer's foreign affiliate, which owned % of the equity interest in Holdings, contributed the entirety of its interest in Holdings to (“**ForeignCo**”), an entity domiciled in . ForeignCo was, indirectly, wholly owned by the Taxpayer. Holdings then elected to be treated as an entity disregarded from ForeignCo for U.S. federal income tax purposes, which caused ForeignCo to be treated as directly owning Holdings's assets. Subsequent to this election, using a series of assignments and licenses, each of the Taxpayer and Taxpayer's U.S. Affiliate transferred its non-U.S. rights (i.e., rest of the world rights, or “**Non-U.S. Rights**”) in the Licensed Intangible Assets to Holdings (these Non-U.S. Rights are referred to hereinafter as the “**Contributed Intangible Assets**”). Under the terms of the relevant agreements, in return for transferring the Non-U.S. Rights noted above, the Taxpayer and Taxpayer's U.S. Affiliate received newly issued Class B shares with a total fair market value of $ and Class C shares with a total fair market value of $, respectively, in Holdings.

Upon the transfer of the Contributed Intangible Assets by the Taxpayer and Taxpayer's U.S. Affiliate to Holdings, Holdings was treated as a partnership for U.S.

federal income tax purposes;[2] the Partnership's partners included the Taxpayer and Taxpayer's U.S. Affiliate (collectively, the "**U.S. Partners**") and ForeignCo, hereinafter referred to as the "**Foreign Partner**".

The Taxpayer engaged the Outside Advisor to value the contributions of the partners, which the Outside Advisor provided in a report dated (the "**Valuation Report**"). The Outside Advisor determined the value of the Contributed Intangible Assets using a discounted cash flow basis and valued the Contributed Intangible Assets at approximately $.[3]

With the exception of , the fair market value for each Contributed Intangible Asset was predominantly, and in one case, entirely, attributable to the transferred property's remaining patent period (i.e., the "**on-patent period**"). The Valuation Report observes that future sales with respect to were expected to significantly decline upon the expiration of their respective patents. In each case, the Valuation Report assumed a complete withdrawal from the relevant market within to years of patent expiration (again, excluding). The forecast for is a blended average of two different earnings projections, one reflecting and one not reflecting . Each scenario was given a % probability of occurring by the Taxpayer.

The Outside Advisor valued the contribution by the Foreign Partner to the Partnership as being approximately $, or % of the total value of the Partnership. Thus, the Foreign Partner was treated as owning %, the Taxpayer as owning %, and Taxpayer's U.S. Affiliate as owning % of the Partnership's capital immediately after the Partnership's formation.

Tax Opinions Issued in Connection with the Reorganization

The Taxpayer received two tax opinions in connection with the reorganization: the Tax Opinion Letter and a tax opinion from (the "**Second Tax Opinion Letter**"). The Tax Opinion Letter is 138 pages long and the Second Tax Opinion Letter is 144 pages long. Both opinions are limited in scope and, as such, do not address all potential tax issues that could arise in connection with the Reorganization. The Tax Opinion Letter specifically provides that it does not address the economic substance of the Reorganization but does not otherwise identify any other

[2] ForeignCo, as the sole owner of Holdings, was deemed to contribute the assets held at the time by Holdings to the Partnership. See Rev. Rul. 99-5, Situation 2, 1999-1 C.B. 434.
[3] According to the Valuation Report, this value was equal to the present value of the forecasted royalties that would have otherwise been received from Holdings (and other of the Taxpayer's subsidiaries), less any royalties that would have had to have been paid to third parties. Valuation Report at 72.

issues that are out of the opinion's scope. The Second Tax Opinion states that it only addresses certain aspects of the Reorganization and does not identify any of the issues that are not addressed.

The Tax Opinion Letter addresses the following issues in connection with the contribution of the Contributed Intangible Assets to the Partnership and in connection with the Partnership's formation and operations: whether the allocations under the Partnership's agreement had substantial economic effect under § 704(b); the Partnership's tax year end under § 706; whether § 7701, the abuse-of-subchapter K rule under § 1.701-2 and the abuse-of-entity rule under § 1.701-2(e), the substance-over-form doctrine, or the sham transaction doctrine applied to the formation and operations of the Partnership; and whether the contribution of the Contributed Intangible Assets qualified as tax-free under § 721(a). In connection with determining whether the contribution of the Contributed Intangible Assets qualified as tax-free under § 721(a), the Tax Opinion Letter considered whether the Contributed Intangible Assets qualified as "property" for purposes of § 721; whether the Partnership would be respected as a partnership; whether §§ 721(b), (c), or (d) applied to the contribution; whether § 367 applied to the contribution; whether § 337(d) applied to the contribution; whether the Taxpayer or Taxpayer's U.S. Affiliate would recognize gain under § 731(a) because of the effect of a deemed distribution under § 752(b); whether § 704(c)(1)(B) or § 737 applied to the contribution; and whether the contribution and potential distributions could result in a disguised sale under § 707(a)(2)(B).

The Second Tax Opinion Letter addresses the following issues in connection with the contribution of the Contributed Intangible Assets to the Partnership and in connection with the Partnership's formation and operations: whether the Contributed Intangible Assets qualified as "property" for purposes of § 721; whether the Partnership would be respected as a partnership; whether the contribution and potential distributions could result in a disguised sale under § 707(a)(2)(B); whether § 367 applied to the contribution; whether the economic substance doctrine applied to the Reorganization; and whether § 482 applied to the Reorganization.

Neither the Tax Opinion Letter nor the Second Tax Opinion Letter refers to the existence or application of § 704(c)(1)(A). Accordingly, neither the Tax Opinion Letter nor the Second Tax Opinion letter addresses the Partnership's selection of a § 704(c) method or the anti-abuse rule under § 1.704-3(a)(10).

Tax Attributes of Contributed Property and the Terms of the Partnership Agreement

For each asset (or groups of assets) contributed to the Partnership, the Taxpayer provided the fair market value, tax basis, and useful (depreciable) life for tax and § 704(b) book purposes. Each Contributed Intangible Asset had a § 704(b) book basis

consistent with its determined fair market value and zero tax basis; each of such assets was treated as amortizable over either or years for § 704(b) book purposes. By contrast, the contribution by the Foreign Partner consisted of assets that were either (1) non-depreciable or (2) were depreciable or amortizable, but had a tax basis that was equal to, or a significant percentage of, its fair market value and, thus, its § 704(b) book basis. Accordingly, it was expected that the Contributed Intangible Assets would not produce any tax depreciation or amortization but that the Foreign Partner's contributed assets, to the extent depreciable or amortizable, would produce significant tax depreciation or amortization.

As noted previously, with the exception of , the Valuation Report forecasts significantly diminished values for each of the Contributed Intangible Assets after the expiration of their on-patent periods. Specifically, Representation 50 in the Tax Opinion Letter provides that the economic life of each Contributed Intangible Asset is not significantly different from its remaining cost recovery period for U.S. federal income tax and § 704(b) purposes. Additionally, Representation 61 of the Tax Opinion Letter states that, except with respect to , the remaining economic life of each Contributed Intangible Asset does not exceed such property's remaining tax depreciable life.

The U.S. Partners and the Foreign Partner entered into a Shareholder's Agreement, dated (the "**Agreement**") delineating the terms and conditions of the Partnership, as well as the rights and responsibilities of its partners. Section 5.02 of the Agreement describes the manner in which the partners agreed to account for the § 704(c) built-in gain and loss related to property contributed to the Partnership, including the Contributed Intangible Assets. Section 5.02 of the Agreement provides that the Partnership adopted the "traditional method" under § 704(c) for all of its contributed property, with a curative gain-on-sale allocation described in section 5.02(b)(ii) of the Agreement. Under section 5.02(b)(ii) of the Agreement, any curative gain-on-sale allocation is limited in several respects. Specifically, any such curative allocation would (i) apply only to the Contributed Intangible Assets, (ii) be applicable only upon a taxable disposition of a Contributed Intangible Asset, (iii) be limited to the amount of tax gain recognized on the sale of a Contributed Intangible Asset, and (iv) further be limited to the cumulative amount of book depreciation allocated to the Foreign Partner from the disposed of asset for all prior years that was unmatched by tax deprecation.

Under section 5.01 of the Agreement, the Partnership's partners agreed to share § 704(b) "book" income and loss from Partnership operations *pro rata* according to the partners' capital percentages (the "**Sharing Percentages**"), i.e., % to the Foreign Partner and % to the U.S. Partners. The Agreement contains provisions intended to comply with the regulatory § 704(b) safe harbor for partnership allocations. Thus, the

Agreement (i) provides for the maintenance of partner § 704(b) book capital accounts, (ii) provides that liquidating distributions will be based on the positive § 704(b) book capital account balances of the partners, and (iii) contains a qualified income offset provision, as described in § 1.704-1(b)(2)(ii)(d).

Partnership Operations and Tax Reporting for Year 1

The Partnership was formed on of Year 1 and uses a year for U.S. federal income tax reporting purposes. Thus, Year 1 was a short tax year. The Partnership nevertheless generated significant revenue and net income for the month period in Year 1. The Partnership's total § 704(b) book (economic) income for the year was $. This amount was allocated under the Agreement according to the Sharing Percentages of the partners; the Foreign Partner was allocated %, or $, the Taxpayer was allocated %, or $, and Taxpayer's U.S. Affiliate was allocated %, or $. The Partnership's taxable income (i.e., the partners' distributive shares of tax items) was significantly higher than the Partnership's § 704(b) book income.

Of particular relevance is the manner in which the Partnership accounted for, and amortized, the Contributed Intangible Assets for tax and § 704(b) book purposes. As noted previously, the Partnership amortized each Contributed Intangible Asset over its useful life of either or years for § 704(b) purposes. The amounts of § 704(b) book and tax amortization for Year 1 for each Contributed Intangible Asset (and the allocations of those amounts among the partners) as provided by the Taxpayer are summarized below (rounded, in millions).

Taxpayer - and Taxpayer's U.S. Affiliate - Contributed Property	**Total Year 1 Book Amortization**	**Total Year 1 Tax Amortization**	**Foreign Partner Book Amortization (%)**	**Foreign Partner Tax Amortization**	**U.S. Partners Book Amortization (%)**	**U.S. Partners Tax Amortization**
Total						

The Foreign Partner's contributed property produced the following cumulative amounts of § 704(b) book and tax depreciation and allocations of such amounts to the partners (rounded, in millions):

Foreign Partner Contributed Property	**Total Year 1 Book Depreciation**	**Total Year 1 Tax Depreciation**	**Foreign Partner Book Depreciation (%)**	**Foreign Partner Tax Depreciation**	**U.S. Partners Book Depreciation (%)**	**U.S. Partners Tax Depreciation**
Foreign Partner Property						

As with the Contributed Intangible Assets' § 704(b) book amortization, the § 704(b) book depreciation from the Foreign Partner's contributed property was allocated according to the partners' Sharing Percentages. Unlike for the Contributed Intangible Assets, however, there were also significant amounts of tax depreciation to allocate among the partners. Thus, the Partnership allocated to the U.S. Partners an amount of tax depreciation, i.e., $, equal to the amount of § 704(b) book depreciation that was also allocated to the U.S. Partners, i.e., $. The Foreign Partner was allocated the remaining tax depreciation ($). These allocations of tax depreciation were due to the operation of the "traditional method" under § 704(c) specified in section 5.02 of the Agreement, discussed below.

According to the Taxpayer's representations made in the Tax Opinion Letter, at the time of its formation, the Partnership had no intention of transferring or assigning any of the Contributed Intangible Assets to any third party. Nor did the U.S. Partners have any intention of selling any portion of their interests in the Partnership or of eventually liquidating the Partnership. To date, none of the Contributed Intangible Assets have been sold (in part or in whole), and the Partnership remains a going concern. No curative allocations have been made pursuant to section 5.02(b)(ii) of the Agreement.

LAW AND ANALYSIS

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. That is, § 704(c)(1)(A) governs allocations made with respect to contributed property, not the tax consequences of the contribution itself.

Section 1.704-3(a)(1) provides that the purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss in such property. Under § 704(c), a partnership must allocate income, gain, loss, and deduction with respect to 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. This allocation must be made using a reasonable method that is consistent with the purpose of § 704(c).

Sections 1.704-3(b), (c), and (d) describe three methods of making § 704(c) allocations that are generally considered reasonable: the traditional method, the traditional method with curative allocations, and the remedial allocation method, respectively.

Section 1.704-3(b)(1) describes the traditional method. For property subject to depreciation, amortization, or other cost recovery, the allocation of tax deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to § 704(c) property generally must, to the extent possible, equal the § 704(b) book allocations of depreciation, amortization, or other cost recovery, made to those partners. In applying the traditional method, however, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. This limitation is generally referred to as the "ceiling rule," because the partnership's tax items from the contributed property for the year are the maximum amount that the partnership can allocate to noncontributing partners with respect to such § 704(c) property.

Section 1.704-3(c) describes the traditional method with curative allocations (the "**curative method**"). To correct distortions created by the ceiling rule, a partnership using the traditional method may make reasonable curative allocations to reduce or eliminate disparities between § 704(b) book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding § 704(b) book item. Under § 1.704-3(c)(3)(iii), a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. For example, if a noncontributing partner is allocated less tax depreciation than § 704(b) book depreciation with respect to an item of § 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding § 704(b) book depreciation is allocated to the contributing partner.

Finally, § 1.704-3(d) describes the remedial method. The remedial method is also designed to eliminate distortions caused by the ceiling rule. Under the remedial method, the partnership allocates tax items recognized by the partnership, if any, using the traditional method. If the ceiling rule causes the § 704(b) book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to that partner, the partnership creates a notional remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates a notional offsetting remedial item in an identical amount and allocates it to the contributing partner.

The three methods described above generally apply on a property-by-property basis. Thus, a partnership is permitted to use one method for one or more pieces of property and a different method for other property as long as the partnership and partners consistently apply a single reasonable method to each item of contributed property. Section 1.704-3(b)(1) provides that if a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

An anti-abuse provision was added to the § 704(c) regulations in 1993. Specifically, § 1.704-3(a)(10) provides that an allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) 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 in exercising its authority under the anti-abuse rule to make adjustments if a partnership's allocation method is not reasonable, the Service will not require a partnership to use the remedial allocation method or any other method involving the creation of notional tax items. See § 1.704-3(d)(5)(ii). Thus, the Service's authority is generally limited to placing a partnership on the traditional method or the curative method.

The regulations illustrate the application of the anti-abuse rule with two examples, one in the context of the traditional method and one in the context of the curative method (collectively, the "**Examples**"). See §§ 1.704-3(b)(2) (Example 2) and 1.704-3(c)(4) (Example 3). In both examples, an equal partnership is formed with one partner contributing property with a value of $10,000 and an adjusted basis of $1,000 and the other partner contributing $10,000 cash. The property has only one year left in its recovery period, but has a substantially longer economic life, which the partners attempt to exploit.

In Example 2, which illustrates an unreasonable use of the traditional method, the property is sold during the second year for $10,000 (having been fully depreciated for tax and book purposes in Year 1), resulting in $10,000 of tax and book gain on the

sale, which is allocated $5,000 to each partner. The sale results in a shift of $4,000 of the property's built-in gain to the noncontributing partner, which has expiring net operating loss carryforwards.[4] The analysis concludes that the anti-abuse rule is applicable because "the contribution is made, and the traditional method is used, with a view to shifting a significant amount of taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate." § 1.704-3(b)(2) (Example 2).

In Example 3, which illustrates an unreasonable use of the curative method, it is the *contributing* partner whose net operating loss carryforwards are about to expire. In the example, the $10,000 of cash (from the "noncontributing" partner) is invested in inventory which is sold at the end of Year 1 for an $8,000 profit (for both book and tax purposes). For tax purposes, a curative allocation of $4,000 of taxable income from the sale of the inventory is made to the contributing partner (which is absorbed by his net operating losses) to offset the noncontributing partner's $4,000 depreciation shortfall with respect to the property. The example concludes that the curative allocation is not reasonable because the curative allocation is made with a view to shifting income from a high bracket taxpayer to a low bracket taxpayer "within a period of time significantly shorter than the economic life of the property." The analysis concludes that if the partnership agreement had provided for curative allocations over a reasonable period of time, such as over the property's actual economic life, and not its remaining cost recovery period, the allocations would have been reasonable. § 1.704-3(c)(4) (Example 3).

Section 721 governs whether a partner recognizes gain or loss upon the contribution of property to a partnership. Recently, the Service and Treasury issued temporary regulations under § 721(c) addressing the contribution of property by U.S. transferors to a controlled partnership with a foreign related partner. See T.D. 9814, 82 F.R. 7582 (Jan. 19, 2017). Those regulations followed Notice 2015-54, which previewed the § 721(c) temporary regulations. The temporary regulations generally provide that, unless such partnerships adopt the remedial allocation method for all U.S.-contributed property, the non-recognition rule under § 721 will not apply, and the related U.S. transferors will recognize all existing § 704(c) gain immediately upon contribution to the partnership. See Temp. § 1.721-1T(c). Notice 2015-54 applied to transactions executed on or after August 6, 2015. The temporary regulations were effective for transfers that occurred on or after January 18, 2017, and were finalized on January 23, 2020. The Reorganization predates Notice 2015-54.

[4] The $4,000 of the built-in gain shifted to the noncontributing partner is equal to his $5,000 share of gain from the sale, offset by the $1,000 of depreciation allocated to him in Year 1. The contributing partner recognizes only $5,000 of the $9,000 total built-in gain from the property.

Application of the § 704(c) Anti-Abuse Rule to the Taxpayer

In this case, the Contributed Intangible Assets were contributed to the Partnership by the U.S. Partners with a significant § 704(b) book-tax disparity and are accordingly subject to § 704(c). The Contributed Intangible Assets were amortizable property in the hands of the Partnership and were in fact amortized on a straight-line basis for § 704(b) book purposes. Pursuant to § 1.704-3(a)(1), the Partnership was required to adopt a § 704(c) method to account for the built-in gain in the Contributed Intangible Assets over their useful life that was reasonable.

If the requirements of the anti-abuse rule are met, the Service may exercise its authority to require the Partnership to use a different § 704(c) method (other than the remedial method), pursuant to §§ 1.704-3(a)(10) and 1.704-3(d)(5)(ii). By its terms, the § 704(c) anti-abuse rule contains three separate requirements. 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 consequence of the property's built-in gain (3) in a manner that substantially reduces the present value of the partners' aggregate tax liability. As discussed below, all three requirements are clearly met in the case of the U.S. Partners' contribution of the Contributed Intangible Assets to the Partnership.

"*Shifting the tax consequence of built-in gain"*

The contribution by the U.S. Partners of the Contributed Intangible Assets and the Partnership's use of the traditional method (with a limited curative gain-on-sale allocation provision) to account for the built-in gain under § 704(c) was certain to shift the pre-contribution gain in the property from the U.S. Partners to the Foreign Partner for as long as the Partnership held the property. The Contributed Intangible Assets were amortizable property (over either or years) and were contributed with a zero tax basis and a fair market value of approximately $. As noted in the Facts, in the short period Year 1, the Contributed Intangible Assets generated a total of $ in § 704(b) book amortization. Of that amount, $ was allocated to the Foreign Partner, consistent with its % interest in the Partnership. However, 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 § 704(b) book amortization. Therefore, absent adopting either the § 704(c) curative or the remedial method to remedy this mismatch of tax and § 704(b) book amortization, the built-in tax gain would shift inexorably from the contributing U.S. Partners to the Foreign Partner. The shift each year is equal to the Foreign Partner's allocable share of book amortization from the Contributed Intangible Assets, which in Year 1 was $. After years, approximately $ of the built-in tax gain will have been shifted to the Foreign Partner. By Year , when all of the Contributed Intangible Assets are fully amortized for § 704(b) book purposes, the total shift will be approximately $.

None of the Foreign Partner-contributed property was likely to result in a similar shift of § 704(c) built-in gain to the U.S. Partners. The Foreign Partner's contributed property was either non-depreciable or was contributed with a tax basis sufficient to ensure that the U.S. Partners would be allocated an amount of tax depreciation or amortization equal to their corresponding allocations of § 704(b) book depreciation or amortization. In Year 1, for example, the U.S. Partners were allocated $ of § 704(b) book depreciation and $ of tax depreciation from the Foreign Partner's contributed property, indicating that there was no ceiling rule limitation and consequently no shift of built-in gain from the Foreign Partner to the U.S. Partners.

Section 5.02(b)(ii) of the Agreement, which provides for curative gain-on-sale allocations to the U.S. Partners under certain circumstances, does not change this conclusion. Although any allocation of tax gain made pursuant to that section would reverse prior year ceiling rule impacts on a dollar-for-dollar basis, the provision's practical impact was always likely to be limited (or nonexistent). First, the curative-gain-on-sale provision is activated only by a "taxable disposition" (e.g., sale) of a Contributed Intangible Asset, which, given the tax benefits at stake, was clearly an unattractive economic option to the Taxpayer. As long as the Partnership continued to own the Contributed Intangible Assets – a decision that the Taxpayer itself controlled – the shift of § 704(c) built-in gain to the Foreign Partner would continue over the useful life of the property. A sale would end this shifting of taxable income to the Foreign Partner, accelerate the remaining built-in gain to the U.S. Partners, and potentially trigger a curative allocation of income. The tax cost in present value terms to the Taxpayer's consolidated group from a sale would be significant.[5] Indeed, the Taxpayer has represented that, at the time that the Partnership was formed, there was no intention of selling any of the Contributed Intangible Assets.[6] To date, more than years since the Partnership's formation, none have in fact been sold. Assuming the fair market value of a Contributed Intangible Asset declines in a manner approximating its amortization schedule, at this point (more than years since the Partnership's formation), a sale at even its remaining fair market value would result in a *de minimis* allocation, at most.

Second, section 5.02(b)(ii) of the Agreement contains an additional limitation that greatly restricts its potential applicability. The Agreement could have permitted *any* appropriate Partnership tax item to "participate" in the curative allocation upon a sale of a Contributed Intangible Asset, which would have significantly increased the odds of reversing prior year ceiling rule impacts, even in the unlikely event of a taxable

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[5] Quantifying the present value benefit of retaining the Contributed Intangible Assets within the Partnership and shifting the built-in gain to the Foreign Partner over time depends upon several considerations and assumptions, but under almost any plausible scenario, use of the traditional method was worth .

[6] See Tax Opinion Letter, Representation 53 (providing there was no plan or intention to assign or transfer the assets contributed by the U.S. Partners).

disposition.[7] Instead, section 5.02(b)(ii) of the Agreement shows that the Taxpayer intentionally limited the available curative allocation to the tax gain recognized on a sale. Limiting curative allocations to the taxable gain generated by the disposed-of property – whose value was expected to decrease steeply over time generally in proportion to its loss of § 704(b) value – all but ensures that any such sale would fail to generate sufficient (or even any) tax items to cure prior ceiling rule distortions. Even if retained its value (or even increased in value), a curative allocation of gain from the sale of that property would be limited to the cumulative amount of book depreciation allocated to the Foreign Partner from the disposed-of asset that was unmatched by tax depreciation, and would therefore not remedy any of the shift in built-in gain from the other Contributed Intangible Assets.

The analysis above in part depends on the expectation that the § 704(b) book amortization schedule for the Contributed Intangible Assets is likely to approximate the actual economic decline of the properties over time, and in part that the Taxpayer evinced an intent not to dispose of the Contributed Intangible Assets. If, contrary to those assumptions, the Contributed Intangible Assets were likely to retain significant value with the passage of time, section 5.02(b)(ii) of the Agreement might prove effective to reverse the distortion caused by the ceiling rule (because the Contributed Intangible Assets would generate tax gain upon sale in excess of their depreciated § 704(b) book values). In this case, however, the Contributed Intangible Assets are quintessential wasting assets, as even the Taxpayer represented. Once the Contributed Intangible Assets are no longer on patent, . As the Valuation Report notes, future sales with respect to these assets were expected to significantly decline upon the expiration of their respective patents. Indeed, the Taxpayer's internal earnings projections show a rapid fall-off in annual revenue for in the initial post-patent period followed by a complete withdrawal from the relevant market to years thereafter (with the exception of).

"In a Manner that Substantially Reduces the Present Value of the Partners' Aggregate Tax Liability"

The shift in the built-in gain from the Contributed Intangible Assets described above was highly likely to result in a substantial reduction in the present value of the partners' aggregate federal tax liability. The Partnership's predominant partner (Foreign Partner) was a foreign domiciled corporation that was not subject to U.S. federal income tax. Moreover, the income generated by the Partnership was not U.S. source income

[7] See § 1.704-3(c)(3)(i) (curative allocations are reasonable to make up for prior year ceiling rule limitations "upon disposition of the property").

and therefore was not otherwise subject to U.S. taxing jurisdiction (for non-U.S. resident taxpayers). Effectively, the Foreign Partner was a zero percent marginal rate U.S. taxpayer. On the other hand, the Taxpayer's U.S. consolidated group – of which the Taxpayer and Taxpayer's U.S. Affiliate were members – was subject to a tax rate of up to 35%, the highest marginal rate for a corporate taxpayer.[8] Therefore, every (taxable) dollar shifted from the U.S. Partners to the Foreign Partner would be expected to save the partners in the aggregate up to 35 cents of U.S. federal income tax.

The reduction in the partners' aggregate tax liabilities was expected to be "substantial" for the simple reason that the amount of income shifted from the U.S. Partners (the high-rate taxpayers) to the Foreign Partner (the zero-rate taxpayer) was expected to be substantial. As noted, by Year , the Contributed Intangible Assets will be fully amortized, meaning that % of the entire $ of built-in gain ($) will have been shifted to the Foreign Partner, saving the U.S. Partners approximately up to $ in U.S. tax.[9] As discussed, there is no offsetting phantom income from the Foreign Partner-contributed property that is expected to be allocated to the U.S Partners.[10] If the Contributed Intangible Assets lose their value in the manner approximating their amortization schedule, the shift in built-in gain may never fully be corrected.

"*With a view to*"

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 discussed above. The anti-abuse rule does not expound on what the "with a view" standard entails, and the Examples simply assume in the various fact patterns that the requisite view exists without further analysis. As an initial matter, however, the standard is clearly a lower threshold than that established by other anti-abuse provisions, most notably the general partnership anti-abuse rule, which requires a showing that a partnership was formed or availed of in connection with a transaction "a principal purpose of which" is to reduce the partners' aggregate tax liability. See § 1.701-2(b).

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[8] The anti-abuse rule provides that "all references to the partners shall include both direct and indirect partners," and clarifies that "[a]n indirect partner is…any consolidated group of which the partner in the partnership is a member (within the meaning of section 1.1502-1(h))." § 1.704-3(a)(10)(i) and (ii). Thus, the tax effect to be considered is the effect on the Taxpayer's U.S. consolidated tax group as a whole and not the separate returns of the U.S. Partners.

[9] $ x .35 = $.

[10] Although the Foreign Partner would recognize a loss upon liquidation of its interest, this loss would not be taken into account for U.S. tax purposes.

Analogous provisions provide additional insight. Although repealed in 2003, § 341, which policed "collapsible corporations", included the same "with a view" language and provided in regulations additional detail on the intent requirement.[11] The regulations explained that "the [with a view] requirement is satisfied whether such action [the premature sale or exchange of stock] was contemplated, unconditionally, conditionally, or as a recognized possibility. . ." § 1.341-2(a)(2). 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]." (Emphasis added.)[12] The same analysis also concluded that "such a motivation need not be a 'primary' or 'principal' determinant."[13] Generally speaking, if taxpayers are sophisticated and organize their affairs so that the prohibited action or benefit could happen – and the action occurs or the benefit accrues – the Service and courts have determined that taxpayers presumptively had the requisite view, even if the taxpayers may have had other valid business motives.[14] Requiring merely that the proscribed actions be "contemplated" by the taxpayer or a "recognized possibility" is consistent with the overall concern that, absent a robust anti-abuse rule, taxpayers could manipulate corporate distributions (in the case of § 341), deductions for corporate dividends (in the case of § 246) or § 704(c) methods (in the current case), to produce unwarranted tax benefits.

The partners in this case are all related, know the tax attributes of the other partners, and therefore were in a position to understand and exploit the tax saving effects of the various § 704(c) methods. Indeed, the method chosen was the one that maximized the shift of built-in gain in the Contributed Intangible Assets to the Foreign Partner, a tax-indifferent party. The present value of these tax savings is expected to be considerable. The partners control the timing of any sale (and therefore whether any curative allocations will even *potentially* be made), and in any case were aware that the relatively predictable rate of amortization over time meant that any sale of a Contributed Intangible Asset was unlikely to generate material amounts of curative items, much less enough to fully offset the full amount of prior year shifts occasioned by the ceiling rule. The Taxpayer, a company with sophisticated outside advisors who were

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[11] Section 341 applied to prevent abuses stemming from the General Utilities doctrine, which had provided that distributions of appreciated property from a corporation to a shareholder on liquidation of the corporation were generally not taxable to the corporation, leading to numerous types of abusive transactions. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). Section 341(b)(1) provided that if certain types of corporations were "formed or availed of" to conduct certain businesses (e.g., construction) "with a view" to the later sale or exchange of the stock by its shareholders (in liquidation or otherwise) before certain threshold amounts of income related to corporate property accrued within the corporation, then the gain to the shareholder was characterized as ordinary income.

[12] CCA 201827011; cf. NSAR 20131902F.

[13] Id.

[14] See, e.g., Braunstein v. Commissioner, 305 F.2d 949 (2d Cir. 1962), aff'd, 374 U.S. 65 (1963).

involved in, and opined upon, the Taxpayer's structuring in connection with the Partnership formation, is considered to have contemplated the consequences of the use of the chosen § 704(c) method and to have recognized the potential of a shift of the built-in gain in the Contributed Intangible Assets due to the short-lived patent period of such properties. As noted, the fact that the Taxpayer appears to have organized its affairs to shift the built-in gain in the Contributed Intangible Assets, and the shift occurred, suggests and supports the conclusion that the Taxpayer acted with a view to shifting the gain.[15] Moreover, the Taxpayer's financial statements evidence that the Taxpayer had the view that the built-in gain from the Contributed Intangible Assets would never be subject to U.S. tax because it appears that no U.S. tax provision was reported and the Taxpayer asserted for GAAP purposes, pursuant to APB 23, that such gain would be permanently reinvested outside of the U.S. Notably, the Taxpayer reported in its GAAP financial statement for an effective tax rate of % in the year in which the transaction was consummated, as compared to an effective tax rate of % in the prior year.

The fact that the Reorganization *may* also have been motivated in part by a non-tax business purpose is irrelevant to the § 704(c) anti-abuse rule analysis. In fact, even if the purported cost and resource allocation efficiencies (among other reasons) cited in the Tax Opinion Letter were the *primary* motive for the Reorganization, that would not be inconsistent with the further finding that the Taxpayer "contemplated" or "recognized [as a] possibility" that the contribution of the Contributed Intangible Assets and choice of § 704(c) method would result in a shift of built-in gain to the Foreign Partner, with attendant U.S. federal income tax savings.

Remedy

Having concluded that the elements of the § 704(c) anti-abuse rule are met, the § 704(c) regulations permit the Service to place the Partnership on a § 704(c) method that is reasonable. In exercising this authority, however, the Service is not permitted to place the Partnership on the remedial method or otherwise require the Partnership to create notional items. § 1.704-3(d)(5)(ii). In this case, the Service has concluded that the Partnership's use of the traditional method to shift built-in gain in the Contributed Intangible Assets to a tax-indifferent party was abusive. Therefore, the Service may exercise its authority under § 1.704-3(a)(10) to place the Partnership on the curative method, which cures the above distortion.

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[15] Even with respect to , the Taxpayer explicitly contemplated the scenario in which its value dropped in the off-patent period, similar to the projected drop in value of the other Contributed Intangible Assets.

The curative method requires appropriate Partnership items to allocate to the Foreign Partner (or the U.S. Partners) to cure the distortion caused by the ceiling rule. In Year 1, this distortion was $, the amount of § 704(b) book depreciation allocated to the Foreign Partner from the Contributed Intangible Assets that was not matched by corresponding items of tax depreciation. A review of the Partnership return indicates that there are sufficient items within the Partnership with which to make the full curative allocation. The Foreign Partner was allocated in taxable gross income from Partnership operations, including from products related to the Contributed Intangible Assets. A curative allocation of a portion of that taxable income from the Foreign Partner to the U.S. Partners to fully offset the effect of the ceiling rule is therefore possible. Moreover, the income is generally of the same type, and will have substantially the same tax effect on the partners as income from the Contributed Intangible Assets, consistent with the requirements of the regulations. See § 1.704-3(c)(3)(iii)(A).

CONCLUSION

The contribution by the U.S. Partners of the Contributed Intangible Assets to the Partnership – and the use of the traditional method with only limited back-end curative allocations to account for the built-in gain under § 704(c) – was made with a view to shifting the tax consequences of the pre-contribution gain in the Contributed Intangible Assets from the U.S. Partners to the Foreign Partner in a manner that substantially reduced the present value of the partners' aggregate federal tax liability. The elements of the § 704(c) anti-abuse rule are met. Accordingly, the Service may exercise its authority to place the Partnership on the curative method with respect to the Contributed Intangible Assets and allocate sufficient tax items to eliminate the effect of the ceiling rule distortion for Year 1.

HAZARDS OF LITIGATION

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Please call the undersigned at (646) 259-8014 if you have further questions.

PETER GRAZIANO
Area Counsel
Financial Services

By:_/s/ Jonathan Cornwell____
Jonathan Cornwell
Attorney ( )
LB&I