IRS memorandum illustrates application of Sec. 704(c) anti-abuse rule

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In Field Attorney Advice (FAA) 20204201F the IRS concluded that the Sec. 704(c) allocation method adopted by a partnership between a U.S. corporation and its domestic and foreign affiliates was unreasonable under the Sec. 704(c) anti-abuse rule in Regs. Sec. 1.704-3(a)(10). The IRS's analysis in the FAA provides insight into the scope and applicability of the Sec. 704(c) anti-abuse rule and hints that the IRS may seek to apply this rule broadly, particularly where related or accommodative partners select a Sec. 704(c) allocation method with an eye toward reducing their aggregate federal income tax liabilities.

Facts

FAA 20204201F describes the following facts: The taxpayer, a U.S. corporation, and its wholly owned domestic subsidiary (together, the domestic partners) owned the worldwide rights to certain intangible assets (the licensed intangibles). The domestic partners transferred the non-U.S. rights to the licensed intangibles (the contributed intangibles) to a foreign entity that was owned by a foreign corporation (the foreign partner) that itself was indirectly wholly owned by the taxpayer. As a result of the property transfers by the domestic partners, the foreign entity converted from an entity disregarded as separate from the foreign partner into a partnership for U.S. federal income tax purposes. For purposes of the FAA, the IRS assumed, without conceding, that the transfers by the domestic partners were transfers of property for purposes of Sec. 721 and that the business reasons for forming the partnership were otherwise valid.

Upon the formation of the partnership, the foreign partner was treated as contributing a mixture of nondepreciable property and depreciable property with a tax basis approximatively equal to its fair market value (FMV) in exchange for its partnership interest. The contributed intangibles transferred by the domestic partners to the partnership had a high FMV and an adjusted basis of $0 and thus constituted "Sec. 704(c) property." Under Regs. Sec. 1.704-3(a)(3), property contributed to a partnership is Sec. 704(c) property if, at the time of contribution, its book value differs from the contributing partner's adjusted tax basis. The contributed intangibles were amortizable for Sec. 704(b) book purposes, but because they had zero tax basis, they would not generate amortization deductions for tax purposes. The value of the contributed intangibles was associated with the remaining on-patent periods for the licensed intangibles; the FMV of each contributed intangible was expected to decline significantly once its respective on-patent period expired.

Sec. 704(c) generally

Under Sec. 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner in a manner that takes into account any built-in gain or loss at the time of the contribution. This allocation must be made using a reasonable method that is consistent with the purpose of Sec. 704(c), which the regulations state is "to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss" in such property (Regs. Sec. 1.704-3(a)(1)). The regulations under Sec. 704(c) describe three methods of making Sec. 704(c) allocations that are generally considered reasonable: the traditional method, the traditional method with curative allocations, and the remedial-allocation method.

Under the traditional method, the partnership must make appropriate allocations to the partners of income, gain, loss, or deduction attributable to Sec. 704(c) property, to avoid shifting the tax consequences of the built-in gain or loss (Regs. Sec. 1.704-3(b)(1)). For instance, if the partnership sells Sec. 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. Tax allocations of cost recovery deductions to the noncontributing partners with respect to Sec. 704(c) property generally must, to the extent possible, equal the Sec. 704(b) book allocations of cost recovery deductions made to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the tax year (referred to as the "ceiling rule").

A partnership using the traditional method with curative allocations may make reasonable curative allocations to correct distortions created by the ceiling rule (Regs. Sec. 1.704-3(c)(1)). A curative allocation is an allocation for tax purposes of income, gain, loss, or deduction that differs from the partnership's allocation of the corresponding Sec. 704(b) book item. To be reasonable, 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. This expectation must exist at the time the Sec. 704(c) property is obligated to be (or is) contributed to the partnership and the allocation with respect to that property becomes part of the partnership agreement. However, the expectation is tested at the time the allocation with respect to that property is actually made if the partnership agreement is not sufficiently specific as to the precise manner in which allocations are to be made with respect to that property (Regs. Sec. 1.704-3(c)(3)(iii)).

For instance, suppose Partner *A* contributes nondepreciable Property *X* with a built-in gain of $50 to a partnership. Later, the partnership generates a tax gain of $30 when it sells Property *X*. The ceiling rule would limit the amount of tax gain with respect to Property *X* that can be allocated to *A* to the $30 generated by the sale. However, a partnership using the traditional method with curative allocations could make a curative allocation to *A* of $20 of the partnership's other tax gains in the year of sale (if the partnership has other tax gains of the same character as the gain generated by Property *X*) so that *A* effectively recognizes the full $50 of built-in gain in the Property *X* at the time of contribution when the partnership disposes of the property. The regulations also provide that a partnership may make curative allocations in a tax year to offset the effect of the ceiling rule for a prior tax year if those allocations are made over a reasonable period, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution (Regs. Sec. 1.704-3(c)(3)(ii)).

A partnership adopting the remedial-allocation method eliminates distortions caused by the ceiling rule with regard to an item (e.g., depreciation) by creating a notional remedial item equal to the difference between the Sec. 704(b) book allocation and the tax allocation of the item to the noncontributing partner and then creating a notional offsetting remedial item in an identical amount and allocating it to the contributing partner (Regs. Sec. 1.704-3(d)). The application of the remedial-allocation method is not discussed at length in the FAA.

The Sec. 704(c) anti-abuse rule

Regs. Sec. 1.704-3(a)(10) provides the Sec. 704(c) anti-abuse rule, which states that a Sec. 704(c) allocation method 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. Where the Sec. 704(c) anti-abuse rule applies, the IRS is permitted to place the taxpayer on a reasonable Sec. 704(c) method. However, the IRS is not permitted to require a taxpayer to adopt the remedial method (Regs. Sec. 1.704-3(d)(5)(ii)).

The regulations provide examples of Sec. 704(c) methods that run afoul of the Sec. 704(c) anti-abuse rule. For instance, Regs. Sec. 1.704-3(b)(2), Example (2), describes a situation in which a partner, *C*, contributes property to a new 50/50 partnership that has an FMV of $10,000, an adjusted basis of $1,000, and a remaining depreciable life of one year. The other partner, *D*, has a net operating loss (NOL) that will soon expire and contributes $10,000 to the partnership. The partnership selects the traditional method with respect to *C*'s contributed property. During the first year of partnership operations, the partnership generates $10,000 of Sec. 704(b) book depreciation and $1,000 of tax depreciation, eliminating the book/tax difference in the property contributed by *C*. The $10,000 of Sec. 704(b) book depreciation is allocated equally to *C* and *D*, and the full $1,000 of tax depreciation is allocated to *D*. In year 2, the partnership sells the contributed property for $10,000. Because the book-tax difference with respect to the property has already been eliminated, $5,000 of book and tax gain is allocated to each of *C* and *D*, according to the partnership agreement. Through the use of the traditional method, approximately $4,000 of the gain built into *C*'s property is shifted to *D*, who can use the NOLs to offset the income.

The example states, without explanation, that the selection of the traditional method was made with a view of shifting the gain in the contributed property from *C* to *D*. However, the example also states that if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to *C* to offset the effect of the ceiling-rule limitation, the allocation method would not violate the Sec. 704(c) anti-abuse rule (Regs. Sec. 1.704-3(b)(2), Example (2)(ii)(C)).

The partnership's selected Sec. 704(c) method

The partnership in FAA 20204201F selected the traditional method with certain curative allocations for all of its property, including the contributed intangibles. Upon a taxable disposition of one of the contributed intangibles, the partnership would make a curative allocation to the domestic partners. However, the only potential source for a curative allocation to correct a prior ceiling-rule limitation with respect to one of the contributed intangibles was the tax gain recognized when that particular contributed intangible was sold. The taxpayer obtained two tax opinions that covered a variety of U.S. federal income tax issues related to the formation of the partnership. However, neither opinion referred to the existence or application of Sec. 704(c)(1)(A), and, thus, neither opinion discussed the selection of the partnership's Sec. 704(c) method or the Sec. 704(c) anti-abuse rule.

The FAA considers whether the partnership's selected Sec. 704(c) method falls within the Sec. 704(c) anti-abuse rule. The IRS identified three requirements for the anti-abuse rule to apply. The contribution of property and allocation of items with respect to it 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.

'With a view'

The IRS noted that the Sec. 704(c) regulations do not describe what is required for a contribution of property and allocation of tax items to be made "with a view" to shift the tax consequences with respect to the property. The examples provided in the regulations simply state, without explanation, that the standard is met under the examples' facts. In the FAA, the IRS indicated that the "with a view" standard has a lower threshold than the general partnership anti-abuse rule in Regs. Sec. 1.701-2(b), 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.

The IRS compared the "with a view" standard in the Sec. 704(c) anti-abuse rule to similar standards under Sec. 246 (rules applying to deductions for dividends received) and the now-repealed Sec. 341 (collapsible corporations). Ultimately, the IRS concluded that, even if a taxpayer has other valid business motives, all that is required to satisfy the "with a view" standard under the Sec. 704(c) anti-abuse rule is that the proscribed shift in tax consequences be "contemplated" or a "recognized possibility."

Unsurprisingly, given the low threshold described in the FAA, the IRS determined that the "with a view" prong of the Sec. 704(c) anti-abuse rule was satisfied. The domestic partners and foreign partner were related, knew the tax attributes of the other partners, and chose a Sec. 704(c) method they understood would maximize the tax benefits to the domestic partners. The IRS indicated that the result would have been the same if the primary motive for the partnership's formation had been a valid business purpose.

Shifting the tax consequences of a built-in gain

The IRS determined that the partnership's selected Sec. 704(c) method would systematically shift the built-in gain in the contributed intangibles from the domestic partners to the foreign partner. Under the partnership agreement, the foreign partner was allocated a share of the partnership's income generated by the contributed intangibles for both Sec. 704(b) book and tax purposes. The foreign partner was also allocated a portion of the Sec. 704(b) book amortization generated by the contributed intangibles. However, because the contributed intangibles had a zero tax basis, the foreign partner did not receive any corresponding items of tax amortization. This mismatch in the Sec. 704(b) book and tax items allocated to the foreign partner, caused by the ceiling rule, effectively resulted in the shift of the built-in gain in the contributed intangibles from the domestic partners to the foreign partners.

The partnership agreement provided that gain from the sale of any one of the contributed intangibles would be allocated to the domestic partners, up to the amount necessary to cure any distortions previously caused by the ceiling rule. Regs. Sec. 1.704-3(b)(2), Example (2), dealing with the application of the traditional method mentioned above, appears to bless a similar back-end allocation to cure a ceiling-rule distortion, notwithstanding that the example also seems to accept the possibility that no tax gain would be recognized upon the disposition of the contributed property (Regs. Sec. 1.704-3(b)(2), Example (2)(ii)(C)).

In the FAA, the IRS noted that the partnership's selected Sec. 704(c) method might have proved effective to reverse the ceiling-rule distortions if the contributed intangibles were likely to retain significant value with the passage of time. However, under the facts of the FAA, the curative allocations provided for by the partnership agreement were unlikely to remedy any ceiling-rule limitations with respect to the contributed intangibles. (Although the FAA cites to Regs. Sec. 1.704-3(b)(2), Example (2), it does not specifically mention the language in Example (2)(ii)(C)). First, the IRS noted that curative allocations would only be made upon a taxable disposition of one of the contributed intangibles. The IRS reasoned that because any such disposition would come with a high tax cost to the taxpayer, who ultimately controlled 100% of the partnership, it was unlikely that any such disposition would occur.

The IRS also pointed to representations in the tax opinions the taxpayer had received stating that, at the time of the formation of the partnership, there was no intention of selling any of the contributed intangibles. In fact, more than seven years after the partnership's formation, none of the contributed intangibles had been sold. The IRS also noted that because the value of the contributed intangibles at contribution was associated with their remaining on-patent periods, any asset sales after the on-patent periods ended would be unlikely to generate sufficient tax gain to cure prior ceiling-rule limitations.

Substantial reduction in the present value of the partners' aggregate tax liability

The facts of the FAA suggest that a substantial amount of income generated by the contributed intangibles over their remaining useful life would be allocated to the foreign partner. Because the foreign partner would not be subject to U.S. federal income tax on the foreign-source income generated by contributed intangibles, the IRS suggested that this income shift would reduce the domestic partners' U.S. federal income tax liabilities by up to $1.38 billion (based on a 35% corporate income tax rate for the domestic partners). The IRS concluded this represented a substantial reduction in the partners' aggregate federal tax liability.

Remedy

Ultimately, the FAA concludes that the partnership's selected Sec. 704(c) method was unreasonable under the Sec. 704(c) anti-abuse rule because it was made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduced the present value of the partners' aggregate tax liability. The FAA further concludes that the IRS may exercise its authority to place the partnership on the curative method with respect to the contributed intangibles and allocate sufficient tax items to eliminate the effect of the ceiling-rule distortion for the year in issue. Ultimately, the FAA suggests making a curative allocation of the taxable income from the foreign partner to the U.S. partner to fully offset the effect of the ceiling rule. (The FAA explains that a review of the partnership return indicated that there were sufficient items within the partnership with which to make the full curative allocation. The FAA refers to the fact that the foreign partner was allocated taxable gross income from partnership operations, including from products related to the contributed intangible assets.) Citing Regs. Sec. 1.704-3(d)(5)(ii), the FAA confirms that the IRS is not permitted to place the partnership on the remedial method or otherwise require the partnership to create notional items. If applied, the IRS's suggested method would likely cause the domestic partners to recognize the full amount of the built-in gain in the contributed intangibles over their remaining Sec. 704(b) book amortization period.

Takeaways

The FAA notes that the transaction in issue predated Notice 2015-54, in which Treasury and the IRS announced that they intended to issue regulations under Sec. 721(c) to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor. Regulations under Sec. 721(c) have since been finalized and generally require a U.S. transferor to immediately recognize gain on the transfer of property to certain partnerships with related foreign partners where the U.S. transferor and related persons collectively own 80% or more of the interests in the partnership, unless the partnership adopts the remedial method with respect to the contributed property and meets certain other requirements (T.D. 9891, 85 *Fed. Reg*. 3833 (Jan. 23, 2020), corrected, 85 *Fed. Reg*. 8725 (Feb. 18, 2020)). A transaction similar to the one described in the FAA, if undertaken today, likely would not present the same opportunity for tax planning through the selection of Sec. 704(c) methods. Nevertheless, the FAA still presents several relevant issues regarding the Sec. 704(c) anti-abuse rule.

First, the "with a view" standard, in the view of the IRS, has a low threshold. According to the Service, the Sec. 704(c) anti-abuse rule can apply to transactions undertaken primarily for valid business purposes. Any Sec. 704(c) method selected by related or accommodative partners is apparently subject to challenge by the IRS as abusive if it is likely or anticipated to result in a substantial reduction of the partners' U.S. federal income tax liabilities. However, the FAA leaves open the amount of tax savings necessary to constitute a substantial reduction in the present value of the partners' aggregate tax liability.

Finally, the FAA also indicates that the IRS may respect a back-end gain curative allocation only where there is a reasonable possibility that the relevant Sec. 704(c) property will actually be sold and, at the time of sale, the property will retain sufficient value to generate enough tax gain to effectively cure prior ceiling-rule limitations. Query whether the concepts discussed in the FAA might extend to situations involving other types of assets.

In any case, FAA 20204201F provides helpful guidance to taxpayers and practitioners, considering the scope and potential application of the Sec. 704(c) anti-abuse rule.

EditorNotes

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