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Partnership Abuse of Entity Rule Invoked in Section 367(d) Outbound IP Transaction

In CCA 201917007, the IRS asserted its ability to treat a domestic partnership as an aggregate of its partners in a transaction apparently designed to partially avoid the application of Section 367(d) to a foreign transfer of intellectual property (IP).

Outbound IP Transfers and Section 367(d)

Under Section 367(d), a U.S. person that transfers any intangible to a foreign corporation in an exchange governed by Section 351 or 361 is treated as having sold the intangible in exchange for deemed royalty payments recognized annually over the useful life of the intangible (the Section 367(d) "general rule"). However, in the case of a direct or indirect subsequent disposition of the intangible property, the U.S. transferor must recognize an amount based on the value of the intangible at the time of the subsequent disposition (the Section 367(d) "disposition rule"). Amounts included under Section 367(d) are treated as ordinary income.

In general, a direct disposition occurs when the foreign transferee corporation disposes of the intangible property, and an indirect disposition occurs when the U.S. transferor disposes of its stock in the foreign transferee corporation received in the initial transfer. Temporary Treasury regulations provide exceptions for certain direct or indirect transfers to related persons, which generally operate to preserve the general rule's annual inclusions. The first disposition rule exception applies if the U.S. transferor subsequently transfers the stock of the transferee foreign corporation to a *U.S. person* related to the U.S. transferor. Upon such a transfer, the related U.S. person succeeds to a proportionate amount of the original U.S. transferor's annual inclusions. The second disposition rule exception applies if the U.S. transferor subsequently transfers the stock of the transferee foreign corporation to a *foreign person* related to the U.S. transferor. Upon such a transfer, the original U.S. transferor must continue to take into account the annual inclusions.

For purposes of Section 367(d), a "United States person" is defined by reference to the general definition under Section 7701(a)(30), which includes a "domestic partnership." The Section 367(d) regulations do not explicitly define a domestic partnership but rather incorporate the rules of Section 7701 generally. Section 7701(a) separately defines

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"domestic" and "partnership" for all purposes of the Code, except "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof."

Partnership Abuse of Entity Rule

The partnership abuse of entity rule under Treasury Regulations Section 1.701-2(e) permits the IRS to apply an aggregate approach, rather than an entity approach, in circumstances appropriate to carry out the intent of the Code and regulations, subject to a limitation. The limitation restricts the IRS's authority to require aggregate treatment if a two-prong test is satisfied: (1) a provision of the Code or regulations prescribes the treatment of a partnership as an entity (in whole or in part); and (2) that treatment, and the ultimate tax results, taking into account all relevant circumstances, are clearly contemplated by that provision.

IRS Applies Abuse of Entity Rule to a Section 367(d) Subsequent Transfer Transaction

The CCA is heavily redacted but involves a transfer of IP by a U.S. transferor to a foreign corporation in a tax-free exchange under Section 351 or 361 and therefore subject to Section 367(d). After the initial outbound IP transfer, the U.S. transferor subsequently transferred the stock of the foreign corporation to a related domestic partnership. The subsequent transfer was apparently intended to qualify for the successor exception to the disposition rule under Treasury Regulations Section 1.367(d)-1T(e)(1) and thus transfer the general rule annual inclusions to the related domestic partnership. However, the related domestic partnership's income was at least partially allocated to foreign partners who therefore would not be subject to federal income tax on deemed royalty inclusions under Section 367(d). Furthermore, the original U.S. transferor no longer existed and therefore Treasury Regulations Section 1.367(d)-1T(e)(3) (the Section 367(d) disposition rule exception for subsequent transfers to related foreign persons) could not apply because the U.S. transferor was not able to succeed to the annual deemed royalty inclusions.

In the CCA, the IRS examined whether the taxpayer would be permitted to qualify for the successor exception to the disposition rule and recognize income annually over the life of the transferred IP in the hands of the domestic partnership, even though the portion of that income allocable to its foreign partners would not be subject to federal income tax.

First, the IRS invoked the partnership abuse of entity rule under Treasury Regulations Section 1.701-2(e). In applying the first prong of the limitation, Treasury Regulations Section 1.367(d)-1T(h)(1) is not clear in providing entity treatment – the regulation merely states that a partnership can be a related person. Nevertheless, the IRS found the second prong of the limitation could not be satisfied because a review of Section 367(d) and the pertinent regulations do not clearly contemplate the tax treatment the taxpayer purported to achieve – a complete avoidance of federal income tax on an outbound transfer of IP under Section 367(d), in direct contradiction to its apparent purpose. Therefore, the IRS determined that it is permitted to apply aggregate treatment to outbound transfers governed by Section 367(d).

Next, the IRS concluded that applying the definition of a domestic partnership under Section 7701(a)(4) in determining whether a domestic partnership is a "related U.S. person" is "manifestly incompatible" with the purposes of the Section 367(d) successor exception to the disposition rule. The purpose of the successor exception to the disposition rule is to preserve the ability to recognize general rule annual inclusions when a related U.S. person is available to step in the shoes of the original U.S. transferor. If a related domestic partnership with foreign partners that would not be required to pay federal income tax were able to succeed to a U.S. transfer as a "related U.S. person," the IRS views that purpose as inappropriately thwarted.

By concluding that the definition of a domestic partnership in Section 7701(a)(4) is inapplicable and that the IRS could invoke the abuse of entity rule, it was free to treat a domestic partnership as an aggregate of its partners in applying the successor rules, and under the particular facts of the CCA, the IRS determined that the successor exceptions should not apply and that gain should be recognized under the disposition rule.

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