

US Office of Chief Counsel legal memorandum addresses IP transfer to US partnership

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In a lengthy internal legal memorandum ([ILM 201917007](#)), the United States (US) Office of Chief Counsel addressed the application of Internal Revenue Code¹ Section 367(d) to a particular set of facts. The facts at issue, however, are completely redacted, which makes interpreting the ILM particularly challenging. Nonetheless, the ILM may offer insights regarding the Internal Revenue Service (IRS)'s views on Section 367(d), the definition of "domestic partnership" in Section 7701(a)(4), and the partnership abuse-of-entity rule in Reg. Section 1.701-2(e).

Section 367(d)

Section 367(d) generally treats a US transferor that transfers certain intellectual property (IP) (Section 367(d) property) to a foreign corporation in a Section 351 or 361 exchange as having sold the IP for an amount contingent upon the productivity, use or disposition of the property. In that situation, the transferor must generally include a deemed annual royalty (Section 367(d) deemed royalty) in income over of the IP's useful life (the general rule). If the IP is subsequently transferred to an unrelated person, directly or indirectly, the US transferor is treated as receiving a lump-sum payment equal to the amount it would have received upon disposing of the Section 367(d) property at the time of the subsequent transfer (the disposition rule). For purposes of the disposition

rule, the US transferor's transfer of the stock originally received in exchange for the Section 367(d) property is treated as an indirect transfer of the Section 367(d) property.

The regulations provide different rules that apply to transfers to related persons. If a US person transfers Section 367(d) property to a foreign corporation and "subsequently transfers the stock of the transferee foreign corporation to US persons that are related to the transferor," the related US person must include the Section 367(d) deemed royalty in its income (US related-person-successor rule). On the other hand, if a US person transfers Section 367(d) property to a foreign corporation and later transfers the transferee's stock to one or more related foreign persons, the US transferor continues to include the Section 367(d) deemed royalty in income annually under the general rule as if the subsequent transfer had not occurred (foreign related-person-transfer rule).

ILM 201917007

Facts

As previously noted, the IRS completely redacted the ILM's facts. Thus, any attempt at discerning the transaction at issue involves conjecture.

The circumstances addressed in the ILM, however, may have involved the following series of events: US corporation (USCo) transferred Section 367(d) property to a foreign corporation (FCO1). Subsequently, USCo transferred its stock in FCO1 to a US LLC (Partnership LLC), which was classified as a partnership for US federal income tax purposes. USCo and FCO2, a foreign corporation related to USCo, owned Partnership LLC. We have assumed these are the facts at issue for our discussion of the ILM.

It appears that USCo took the position that the US related-person-successor rule applied because Partnership LLC was (1) related to USCo and (2) a US person as defined in Section 7701(a)(30). To the extent the US related-person-successor rule applied, (1) USCo would cease to include the Section 367(d) royalty in income, (2) Partnership LLC would include the Section 367(d) deemed royalty in its income, and (3) Partnership LLC would allocate the Section 367(d) deemed royalty income to its partners (i.e., both USCo and FCO2). Further, USCo also appears to have taken the position that FCO2's distributive share of Partnership LLC's Section 367(d) deemed royalty income was not treated as subpart F income or otherwise subject to US tax.

Law and analysis

The ILM rejects USCo's position and provides two, seemingly alternate, theories under which the US related-person-successor rule would likely not apply – (1) the partnership abuse-of-entity rule in Reg. Section 1.701-2(e) and (2) the definition of domestic partnership in Section 7701(a)(4). The IRS's application of each theory appears predicated on its view of Section 367(d)'s history and purpose.

Section 367(d)

The ILM contains a lengthy discussion of the history of Section 367(d), noting that its purpose is to prevent the shifting of income attributable to IP created in the United States to foreign persons that are not subject to US tax. The ILM characterizes the disposition rule as "straightforward," stating that the disposition rule is "triggered when the [US] transferor or its domestic successor's connection to the property is severed," and "operates as a backstop to the general rule, ensuring that the [US] transferor reports full compensation for the transferred intangible."

Partnership abuse-of-entity rule

Reg. Section 1.701-2(e)'s abuse-of-entity rule allows the IRS to treat a partnership as an aggregate of its partners in whole or in part to carry out the purpose of any provision in the Code or regulations, unless a provision in the Code or regulations (1) prescribes treating the partnership as an entity in whole or part; and (2) clearly contemplates that entity treatment and the ultimate tax results.

The IRS declined to reach a conclusion as to whether entity treatment is prescribed in the Section 367(d) context, stating: "It is not clear if the treatment of a partnership as a related person in [Reg. Section] 1.367(d)-1T(h)(1) [which references IRC Sections 267 and 707] is equivalent to prescribing entity treatment."

The IRS concluded that the second prong of this test was not satisfied: "There is no reasonable argument that [IRC] [S]ection 367(d) or [Reg. Section] 1.367(d)-1T(h) clearly contemplated the permanent, complete avoidance of [US] tax with respect to an outbound transfer of IP under [IRC] [S]ection 367(d)."

The ILM concludes that the IRS may apply the abuse-of-entity rule to Partnership LLC because USCo's position "purports to obtain tax results that are directly contrary to [congressional] intent and the overarching purposes of the implementing regulations." If the abuse-of-entity rule applied

in full, Partnership LLC would be treated as an aggregate of USCo and FCO2. It appears that FCO1's stock would be treated as partially transferred to FCO2 and partially retained by USCo. If such treatment applied, USCo would appear to continue to include the Section 367(d) deemed royalty in its income (under the general rule and foreign related-person-transfer rule).

Definition of domestic partnership

As described previously, the US related-person-successor rule applies when a US transferor "subsequently transfers the stock of the transferee foreign corporation to US persons that are related to the transferor." Because the Section 367 regulations do not explicitly define what constitutes a domestic partnership, the ILM notes, the meaning of the term as used in the Section 367 regulations "is determined by reference to [IRC] [S]ection 7701 generally." IRC Section 7701 provides definitions for all purposes of the Code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Section 7701(a)(30) lists a "domestic partnership" as a US person. The ILM notes that "domestic," as defined in IRC Section 7701(a)(4), generally means a partnership that is "created or organized in the United States or under the law of the United States or of any State."

For purposes of the successor rules, the ILM states that Section 7701(a)(4)'s definition of domestic partnership is "manifestly incompatible with the purposes of Treas. Reg. Section 1.367(d)-1T(e)(1)," which preserves "the [general rule] if an appropriate related [US] person is able to step into the shoes of the original transferor and recognize the income attributable to the IP." The ILM concludes that the Section 7701(a)(4) definition does not apply, so Partnership LLC is not treated as a "domestic partnership" (or related US person), despite being organized under the laws of a US state. As a result, USCo would continue, under the foreign related-person-transfer rule, to include the Section 367(d) deemed royalty in its income.

Implications

The ILM appears to adopt a broad view of the abuse-of-entity rule's scope, which, as noted, may not apply when entity treatment is prescribed and the Code or a regulatory provision clearly contemplate entity treatment and the ultimate tax results. The ILM may suggest that references to rules designating a partnership as a "person" separate from its partners may, in certain instances, be insufficient to show that entity treatment is prescribed. The ILM is surprising in that it does not specifically address Reg. Section 1.701-2(f), Example 3. In that example, a foreign corporation and a domestic corporation formed a domestic general partnership. As a "United States person" under Section 7701(a)(30) and a "domestic partnership" under Section 7701(a)(30)(B), the domestic partnership was respected as a US shareholder for purposes of determining the CFC status of the partnership's wholly owned foreign corporation. The example concludes that the Commissioner may not treat the domestic partnership as an aggregate of its partners for Section 904 purposes.

The IRS asserts that the Section 7701(a)(4) definition of domestic partnership does not apply because it is "manifestly incompatible with the purposes of Treas. Reg. Section 1.367(d)-1T(e)(1)." This approach to challenging a transaction, though not entirely new (e.g., see Notice 2010-41, 2010-1 C.B. 715), appears to represent a rare assertion by the IRS that a Section 7701 definition does not apply because the definition contravenes the purposes of another Code provision.

While the IRS's views on the scope of the abuse-of-entity rule and the definition of domestic partnership are unexpected, the specific facts at issue in ILM 201917007 were likely determinative. Because the facts are completely redacted, it is hard to draw broad conclusions from the ILM. Nonetheless, taxpayers should be aware of the views expressed in the ILM.

Endnote

1. All "Section" references are to the Internal Revenue Code (IRC) of 1986, and the regulations promulgated thereunder.

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