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New York State Bar Association

Tax Section

Second Report on Notice 2015-54, Transfers of Property to Partnerships with Related Foreign Partners and Controlled Transactions Involving Partnerships – Section 482

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Contents

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I. INTRODUCTION

This report[1] provides a second set of comments on Notice 2015-54 (the "**Notice**"),[2] which announced that the United States Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**IRS**") intend to issue regulations under Sections 482, 721 and 6662 to address certain transfers of appreciated property by United States persons to partnerships that have one or more foreign controlled partners and allocations of income among the controlled partners resulting from such transfers. This report addresses the regulations that the Notice announces will be proposed under Section 482 and Section 6662 (collectively, the "**New Section 482 Regulations**").

As described in Section 5 of the Notice, the New Section 482 Regulations are intended to curb what Treasury and the IRS believe to be potential abuses resulting from the amount of partnership income or gain allocated to U.S. partners being reduced by using incorrect valuations either for contributed property or for the property or services involved in related controlled transactions involving the U.S. partners and the partnership. As provided in the Notice, the New Section 482 Regulations will be effective for controlled transactions occurring on or after the date on which the New Section 482 Regulations are published in final form. The Notice also in-

[1] The principal drafters of this Report were Stuart L. Rosow and Martin T. Hamilton. Significant contributions were made by Michael Schler and Peter Connors. Helpful comments were received from Stephen Land and David Sicular. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 2015-34 I.R.B. 210 (Aug. 6, 2015). Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all "Treasury Regulations Section" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

cludes a request for comments on certain aspects of the New Section 482 Regulations, including whether the regulations should provide specified valuation methods and periodic adjustment rules for controlled transactions involving partnerships based on Treasury Regulations Sections 1.482-7(g) and (i)(6), and the extent to which the regulations should provide that the documentation requirements described in Treasury Regulations Section 1.6662-6(d)(2)(iii) be expanded to include specific requirements for transactions involving partnerships. Our comments in this report are limited to the provisions in the Notice relating to the New Section 482 Regulations. For our comments on the portions of the Notice relating to Section 721, we refer you to our prior report on that topic.[3]

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

1. The New Section 482 Regulations generally should follow the approach of recharacterizing the initial transaction in which contributed property is incorrectly valued as having included a deemed transfer of property among the partners involved. Under this approach, the New Section 482 Regulations should generally provide for adjustments to partnership allocations only to the extent required to make those allocations consistent with this recharacterization.

2. The New Section 482 Regulations should be explicit about their scope, by clearly identifying the particular partnership transactions to which specific aspects of the regulations apply. For example, the New Section 482 Regulations should have a more circumscribed application to transactions not involving intangible property.

3. The New Section 482 Regulations should provide specific guidance on how the principles of the existing cost sharing regulations under Section 482 will apply in determining whether the results of a partnership transactions involving development of intangibles are arm's length.

4. The New Section 482 Regulations should provide that adjustments will generally not be made to the partnership allocations (or additional economic terms imputed) except in those circumstances in which a recharacterization of the transaction as a transfer between the related parties does not achieve an arm's-length result.

5. The New Section 482 Regulations should provide for the adjustment of the partners' respective interests in the partnership (or treatment of any deemed transfer between the partners resulting from the recharacterization of a transfer) either in the case of the contribution of intangibles to the partnership or the development of intangibles by the partnership based upon

[3] N.Y. ST. BA. ASS'N, TAX SEC., *Report Commenting on Notice 2015-54, Transfers of Property to Partnerships with Related Foreign Partners and Controlled Transactions Involving Partnerships* (Rep. No. 1336, Dec. 15, 2015).

actual results of the partnership, to ensure that the resulting partnership allocations are commensurate with the income attributable to the intangible held by or developed by the partnership. We suggest that this portion of the New Section 482 Regulations should be consistent with the principles of Treasury Regulations Sections 1.367(d)-1T and 1.482-4(f).

6. The New Section 482 Regulations should require that the controlled taxpayers under analysis in a partnership subject to the regulations possess and retain documentation sufficient to support their position on examination that the value of both the intangibles contributed to the partnership and the partnership interest received in return satisfy the arm's length standard generally applicable under Section 482.

III. SUMMARY OF NOTICE 2015-54

A. Background

1. Applicable Law

(a) Section 482

Section 482 provides, in part, that where controlled parties are involved, the Secretary of the Treasury may "distribute, apportion or allocate" income and deductions among the controlled parties to prevent evasion of taxes or to reflect clearly the income of the controlled parties. In addition, in the case of a transfer of intangible property, Section 482 requires that the income resulting from the transfer be "commensurate with the income attributable to the intangible."[4] For purpose of Section 482, existing regulations provide that controlled transactions include contributions of property to a partnership.[5] Specifically, existing regulations permit the IRS to make allocations between or among the members of a controlled group and to override nonrecognition treatment otherwise available under one or more sections of the Code if a controlled taxpayer has not reported its true taxable income.[6] In determining the true taxable income of a controlled taxpayer, existing regulations provide that the standard used in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer, where the results of the transaction are consistent with the results that would have been if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[7] Treasury Regulations Section 1.482-1(d)(3)

[4] The commensurate with income standard applies to intangibles described in Section 936(h)(3)(B), which include a broad range of intellectual property encompassing patents and inventions, copyrights and artistic compositions, trademarks and brand names, franchises, methods, customer lists and any similar item.

[5] Treas. Reg. § 1.482-1(i)(7) and (8).

[6] Treas. Reg. §§ 1.482-1(a)(2), 1.482-1(f)(1)(iii).

[7] Treas. Reg. § 1.482-1(b)(1).

describes factors that must be considered to determine the degree of comparability between controlled and uncontrolled transactions: functional analysis, contractual terms, risks, and economic conditions.[8] Furthermore, depending on the type of arrangements or transactions, existing regulations provide specified and unspecified methods to be used to evaluate whether the arrangements produces results consistent with an arm's-length result.[9] An aggregate analysis may be necessary if the controlled and uncontrolled transactions are interrelated and such an analysis provides the most reliable means of determining the arm's-length results for the controlled transactions.

Section 482 additionally provides that, in the case of any transfer or license of intangible, the consideration charged by the transferor with respect to the transfer or license must be commensurate with the income attributable to the intangible.[10] Existing regulations provide that if the consideration does not meet this statutory requirement, the IRS may make periodic adjustments to the consideration in a subsequent taxable year without regard to whether the statute of limitations for assessment of tax for the taxable year of the original transfer remains open.[11] Similarly, existing regulations permit the IRS to make periodic adjustments to annual royalty payments that are made in exchange for an intangible in a controlled transaction.[12]

(b) Existing Section 482 Regulations Applicable to Matters Described in Section 5 of the Notice

Extensive existing regulations under Section 482 address a number of the issues considered in Section 5 of the Notice. Of particular relevance are Treasury Regulations Section 1.482-7 (generally providing the rules governing cost sharing arrangements) and Treasury Regulations Section 1.482-4(f) (providing the rules for making periodic adjustments to the valuation of transferred intangibles).

Treasury Regulations Section 1.482-7 provides rules governing the arms-length charges between controlled parties to a "cost sharing arrangement" for the development of an intangible. Under these rules, each party's contribution to the cost of the development of the intangible must be made in proportion to such party's share of reasonably anticipated benefits in developing the

[8] Treas. Reg. § 1.482-1(d)(3)(i) (financial analysis); Treas. Reg. § 1.482-1(d)(3)(ii) (contractual terms); Treas. Reg. § 1.482-1(d)(3)(iii) (risks); Treas. Reg. § 1.482-1(d)(3)(iv) (economic terms).

[9] Treas. Reg. § 1.482-7 (provides specific methods for evaluating a cost sharing arrangement); Treas. Reg. §§ 1.482-4 and 1.482-9 (provides specified and unspecified methods for evaluating arrangements, other than cost sharing arrangements covered by Treas. Reg. § 1.482-7, for sharing the costs and risks of developing intangible, which expressly include partnerships).

[10] Section 482, last sentence.

[11] Treas. Reg. §§ 1.482-4(f)(2)(i) and 1.482-7(i)(6)(i).

[12] Treas. Reg. § 1.482-4(f)(2)(i).

intangible. In determining the amount of each party's contribution, if one party to the cost sharing arrangement makes a contribution to be used in the development of the intangible (a "platform contribution transaction," or "**PCT**"),[13] the other parties must either make their own contribution to the PCT or otherwise compensate the contributing party through buy-in payments.

The cost sharing rules provide very detailed guidance on the application of six different possible methods to evaluate the arm's length amount charged in a PCT.[14] The methods contemplated in the cost sharing rules are: (1) the comparable uncontrolled transaction method or the comparable uncontrolled services price method; (2) the income method; (3) the acquisition price method; (4) the market capitalization method; (5) the residual profit split method; and (6) unspecified methods.[15] Under each method the non-contributing party to the PCT (the payor) will have an obligation to compensate the contributing party to the PCT (the payee) equal to the combined pre-tax value of the PCT to all controlled participants, multiplied by the payor's reasonably anticipated benefit share. Regardless of other considerations, the method must be selected and then applied consistently with the general rules for determining the "best method" for purposes of Section 482.[16]

The methods to determine taxable income among the participants in a cost sharing arrangement are based upon an analysis of the economics of a cost sharing arrangement through a focus on the upfront sharing of risks and reasonably anticipated share of benefits over a reasonably anticipated term of activity. The regulation recognizes that the relative reliability of an application of a valuation method depends on the assumption that as of the date of a PCT, the controlled participants' aggregate net investment in the cost sharing arrangement activity is reasonably anticipated to earn a rate of return appropriate to the riskiness of the investment.[17]

The specified methods in Treasury Regulations Section 1.482-7(g) also depend on another critical assumption: that an uncontrolled taxpayer dealing at arm's length would only enter into a cost sharing agreement if there were no preferable alternative. If the projected income as of the date of a PCT is less than the income that could be achieved through a realistically available alternative, it would follow from the assumption that the taxpayer acting at arm's length

[13] A PCT is a transfer of any resource, capability or right to the cost sharing agreement if such resource, capability or right is reasonably anticipated to contribute to the development of the cost shared intangibles. Treas. Reg. § 1.482-7(b)(1)(ii).

[14] Treas. Reg. § 1.482-7(g).

[15] Treas. Reg. § 1.482-7(g)(1)(i)-(vi).

[16] *See* Treas. Reg. § 1.482-1.

[17] Treas. Reg. § 1.482-7(g)(2)(ii)(A).

would not enter into a cost sharing agreement.[18] Thus, the alternatives must be taken into account when determining the arm's-length amount charged in a PCT under the specified valuation methods in Treasury Regulations Section 1.482-7.

The Notice points out that, depending on the facts and circumstances, an unspecified method applied based on these assumptions and adjusted appropriately may provide the most reliable measure of the arm's length results of controlled transactions involving a partnership. Under Treasury Regulations Section 1.482-7(g)(8), an unspecified method should be applied consistently with the general principle that uncontrolled taxpayers only enter into a particular transaction if no preferable alternative is available after evaluating the terms of a transaction by considering the realistic alternatives to that transaction (similar to the rule applicable to the specified methods).

Section 482 requires that the consideration charged by the transferor with respect to any transfer or license of intangible property (within the meaning of Section 936(h)(3)(B)) must be commensurate with the income attributable to the intangible.[19] Currently, as applied to controlled transactions involving partnerships, when intangible property is contributed to a partnership, the IRS may consider making periodic adjustments under Treasury Regulations Section 1.482-4(f) in subsequent years if this consideration does not satisfy the commensurate with income requirement, regardless of whether the taxable year of the original transfer remains open for statute of limitations purposes.[20]

For purposes of making periodic adjustments in open years, Treasury Regulations Section 1.482-4(f) permits the IRS to consider the consequences of what would have been appropriate adjustments to the commonly controlled participants' interests in light of their respective contributions and the associated controlled transactions, even when those occurred in closed years. Furthermore, if the usual nonrecognition treatment of the contribution to the partnership is disallowed, the IRS may consider the application of the equivalent royalty rule under Treasury Regulations Section 1.482-4(f)(6) to determine periodic adjustments to the recognition of gain on the contribution of the intangible property to the partnership. If an intangible is transferred in a controlled transaction in exchange for annual royalty payments, the IRS may make periodic adjustments to those payments as necessary to ensure an arm's-length royalty amount is paid in each taxable year.[21]

[18] Treas. Reg. § 1.482-7(g)(2)(iii)(A).

[19] Section 482, last sentence.

[20] Treas. Reg. § 1.482-4(f)(2). Five exceptions to this rule are provided in Treas. Reg. § 1.482-4(f)(2)(ii).

[21] Treas. Reg. § 1.482-4(f)(2)(i).

(c) Section 6662

Section 6662 generally imposes an accuracy-related penalty on underpayments, subject to the limitation under Section 6664(c) providing that in general a penalty may not be asserted under Section 6662 for a portion of an underpayment if reasonable cause and good faith can be shown with respect to that portion. Under Section 6662(e)(3), the taxpayer is not treated as having reasonable cause for a portion of an underpayment attributable to a net Section 482 adjustment unless the taxpayer meets the requirement of Section 6662(e)(3)(B)(i), (ii), or (iii) with respect to that portion, which includes a requirement to maintain sufficient contemporaneous documentation to establish the taxpayer's reasonable conclusion. The specified or unspecified method that was used in the controlled transaction must also be one that the taxpayer could reasonable conclude met the relevant measure of reliability set forth in Treasury Regulations Section 1.6662-6(d).

2. Reasons for Exercising Regulatory Authority

(a) Section 482

The Notice states that Treasury and the IRS are aware that certain taxpayers are valuing property contributed to partnerships, or the property or services involved in related controlled transaction, in a manner contrary to Section 482. According to the Notice, partnership interests or consideration received in related controlled transactions may be incorrectly valued as a result, thereby reducing the amount of income or gain allocated to United States persons. The Notice points out that although IRS has a broad authority under Section 482 to make allocations, the IRS may still face the disadvantages and challenges in evaluating the transaction stemming from lack of information or passage of time. Accordingly, the Treasury and the IRS determined that it is appropriate to augment the Section 482 rules as they apply to controlled transactions involving partnerships.

(b) Section 721

The Notice also provides that it intend to issue regulations under Section 721(c) to address certain transactions in which a United States person transfers appreciated property to a partnership that has foreign partners related to the transferor. As noted above, we addressed the issues presented under this provision in our previous report.

B. Regulations under Section 482 and Section 6662

1. Regulations to Be Issued Regarding Controlled Transactions Involving Partnerships

The Notice announces that Treasury and the IRS intend to issue the New Section 482 Regulations, and that these regulations will apply certain provisions of the cost sharing regulations to partnership transactions involving controlled taxpayers. In particular, the New Section 482 Regulations will provide specified methods for valuing controlled transactions involving partnerships. These valuation methods will presumably apply to the valuation of assets, particularly intangibles, contributed to the partnership, as well as, in appropriate cases, the valuation of the partnership interest received. Certain of these determinations will be based on the specified valuation methods that are currently applicable to cost sharing arrangements. The specified methods will be appropriately adjusted given the differences in the facts and circumstances between partnerships and cost sharing arrangements. Moreover, the New Section 482 Regulations will provide periodic adjustment rules that would permit the IRS to make periodic adjustment and corresponding adjustments to allocations under Section 704 in the event of a significant divergence of actual returns from projected returns for controlled transaction involving a partnership. The Notice further states that Treasury and the IRS are also contemplating issuance of regulations pursuant to Section 6662 to require additional documentation for certain controlled transactions involving partnerships.

2. Application of Current Law to Transactions Described in the Notice

The Notice notes that currently, Section 482 and related penalties apply to controlled transactions involving partnerships, including partnership allocations under Section 704(c) and the relative magnitudes of the partners' interests in the partnership in light of their respective contributions and the related controlled transactions. Additionally, existing authority permits the IRS to impute terms for purposes of an adjustment if it deems that the substance of the transaction is not reflected in, or is inconsistent with, the terms of the partnership agreement or any related agreements of the controlled taxpayers.[22] Because the principles, methods, comparability, and reliability considerations set forth in Treasury Regulations Section 1.482-7 for cost sharing arrangements are relevant to controlled transactions involving partnerships, the Notice notes the possibility that an "unspecified method," as described in Treasury Regulations Section 1.482-7(g)(8), may provide the most reliable measure of the arm's-length results of controlled transactions involving partnerships. The Notice further points out that an aggregate analysis of the combined effects of controlled transaction is necessary under Treasury Regulations Section

[22] Treas. Reg. § 1.482-1(d)(3)(ii)(B).

1.482-7(f)(2)(i) if it provides the most reliable means of determining the arm's-length results for the controlled transactions.

The Notice also indicates that the IRS may consider making periodic adjustments in years subsequent to the contribution of an intangible property to a partnership without regard to statute of limitations of the original transfer.[23] In a situation where Section 721(a) is inapplicable, the IRS may consider the application of the equivalent royalty rule under Treasury Regulations Section 1.482-4(f)(6) to determine periodic adjustments to the recognition of gain on the contribution of the intangible property to the partnership.

In regard to Section 6662, penalties could potentially apply under Section 6662(e) or (h) in the absence of a basis, including the appropriate documentation, for establishing that the taxpayer reasonably concluded that its valuation methods used for controlled transactions involving a partnership met the relevant measure of reliability.

C. Approaches to Recharacterization

Although under existing law Section 482 and the related penalty provisions apply to partnership transactions among controlled taxpayers, including transactions that are the subject of the Notice, there is little guidance as to the manner in which those provisions should apply. In particular, there are questions as to whether partnership transactions should be recharacterized as transactions directly among or between the controlled entities or whether the terms of the partnership arrangement should be modified. The authority granted the Secretary under Section 482 is likely broad enough to permit either approach. The issue, which should be at the core of the proposed regulations, is to provide guidelines for which approach may be more appropriate in certain circumstances.

The issue can be illustrated by the following example. U.S. Parent ("**USP**") contributes property to a partnership with its wholly owned foreign subsidiary ("**FS**"). The partners agree that the contributed property has a value of $100. FS makes no contribution but agrees to manage the property. The partnership agreement provides generally that each partner is entitled to 50% of all income and loss, except that USP will be entitled to a priority distribution of $100, the agreed-upon value of the property. If the actual value of the property is $200, there are at least two different approaches under section 482 to rectifying the error in valuation. First, the transaction may be viewed as a transfer of a $50 interest in the property from USP to FS, followed by a contribution of the property by both FS and USP to the partnership. That transfer would presumably be governed by Section 367. Alternatively, Section 482 could be applied to reallocate partnership items so that USP would be allocated two-thirds of all income and loss and FS only one-third. In either case, the greater value would be used in determining the remedial allocation

[23] Treas. Reg. § 1.482-7(f)(2).

under Section 704(c) if the partnership elected the deferred gain method under Section 721 under the Notice.

Each approach has certain benefits and potential issues. Under the first approach, the transaction is generally recharacterized as a transfer of property by the contributing partner to the other partner or partners, together with the contribution of the transferred property to the partnership by that other partner. This approach is consistent with the economics of the transaction. By receiving a partnership interest that represents an entitlement to value less than the value of the property contributed, the contributing partner has effectively transferred an interest in the partnership's property to the other partner.[24]

Although the first recharacterization is straightforward, the Notice does not necessarily adopt that approach. Rather the Notice specifically contemplates that adjustments can be made to the terms of the partnership arrangement. Specifically, the Notice states that "…[a]lso subject to adjustment are partnership allocations, including allocations under section 704(c), and the relative magnitudes of the partners' partnership interests in light of their respective contributions and the related controlled transactions." Moreover, the Notice also asserts that the IRS may "impute terms in the partnership…that are consistent with the substance of the transaction." Thus, in the Notice, the IRS claims a very broad authority to revamp related party partnership transactions in order to satisfy the arm's-length standard.

The choice of how this authority is exercised will have different tax consequences even among the acceptable modifications. To illustrate, in the example above, the first recharacterization is likely to result in immediate gain recognition, although the gain may be capital gain or Section 1231 gain. In the future, however, less income will be allocated to USP. In contrast, changing the partnership interest will result in less immediate income but an increased amount subject to Section 704(c). Therefore, there will be a larger amount of ordinary income (rather than Section 1231 or capital gain) allocated to USP, although that income may be delayed. Use of the modification of partnership allocations also may seem to be more consistent with the taxpayer's election to use the gain deferral method.

As illustrated above, the proposed regulations will be issued in a field in which there is currently little guidance, and Treasury and the IRS claim far reaching authority to recast related

[24] This result is also consistent with an analysis of the capital accounts under section 704(b). In the above example, USP would be credited with a capital account of $100 upon contribution. If the property is actually worth $200, then upon a sale of the property immediately after its contribution, each of USP and FS would be credited with $50 of gain. In substance, FS has received a transfer of $50 of value.

A similar analysis would apply in other situations, such as those in which services to be contributed by the foreign partner are being overvalued. In that event, the foreign partner should still be considered to have received a transfer of value by the other partners.

party partnership transactions and impose tax consequences other than may be anticipated. In light of this issue, we urge Treasury and the IRS to act with caution. Overall, because of the paucity of material in the area, Treasury and the IRS should strive to issue regulations whose application is clear and give taxpayers that attempt to comply a measure of comfort that generally the basic tax consequences of the transaction will be preserved.

Our recommendations are focused with these goals in mind. We believe that it is appropriate for Treasury and the IRS to address in regulations the issues involved in either understating or overstating the value of property (or services) contributed to a partnership. These rules should clearly specify their scope, and our recommendations suggest certain ways in which this can be achieved. We also consider the manner in which adjustments to the transaction should be made. Finally, our recommendations will also address the manner in which certain Section 482 rules, including rules under Treasury Regulations Section 1.482-7, should be applied.

IV. RECOMMENDATIONS

Recommendation 1: Approach to Recharacterization

The proposed regulations should follow the approach of recharacterizing the transaction in which contributed property is incorrectly valued as a transfer of property among the controlled parties involved. Under this approach, the regulations should provide for adjustments to partnership allocations only to the extent necessary to make the allocation consistent with that recharacterization.

On balance, we believe that this approach is preferable to attempting to adjust the terms of the partnership arrangement, including but not limited to shares of income or loss, to match an arm's-length transaction. First, as noted above, the recharacterization of the transaction as a transfer of property coincident with the contribution to the partnership reflects the essence of the economic transaction, a current transfer of value between the controlled parties. Second, this approach should provide greater certainty to taxpayers as to their exposure than the approach of adjusting partnership allocations. The myriad different ways that the terms of the partnership agreement may be adjusted offers too much uncertainty and potential complexity.

Consider the following example. USP contributes property with an agreed value of $200 and FS contributes $200 in cash, with each partner being entitled to a 50% interest in all partnership items. If the contributed property is actually worth $500, there are a number of adjustments to the partnership allocations that could be made to reflect the value differential. These include changing the overall share of partnership items. Alternatively, the additional contribution could be viewed as a preferred interest, to be returned to the contributing partners with a market preferred return. Ascertaining which adjustment is closer to an arm's-length arrangement is an extraordinarily difficult task, particularly because comparable situations may be exceedingly

hard to find. In addition, the approach of changing the partnership allocations would also require imputation of additional transactions to account for the deemed transfer of distributions to the other partner.

The characterization of the transactions as a transfer of property among the partners is compatible with the rules concerning the transfers of intangibles and the Notice's concern that periodic adjustments be made to reflect actual results. As explained in greater detail below, the recharacterization of the contribution as a transfer to the other partner will treat the excess value as a transfer of an interest in the underlying property, subject to section 367. If the contributed property is an intangible, the rules of section 367(d) and the commensurate with income standard will be applicable and provision can be made to take into account.[25]

Recommendation 2: Scope

The proposed regulations should be explicit about their scope. This involves identifying the partnership transactions to which specific aspects of the regulations apply. For example, the regulations should generally have a more circumscribed application to transactions not involving intangible property.[26]

The Notice states that the proposed regulations are intended to apply to partnerships "certain provisions" of the cost sharing regulations in Treasury Regulations Section 1.482-7. Although the Notice specifically references the valuation rules in Treasury Regulations Section 1.482-7(g), the implication in the Notice is that other rules will also apply. The other provisions in Treasury Regulations Section 1.482-7 focus on arrangements designed to develop intangible assets, the benefits of which are to be shared among the controlled taxpayer participants. It is unclear the extent to which these rules are appropriate for many partnership arrangements.[27] While certain of the valuation rules in Treasury Regulations Section 1.482-7(g) may have general applicability to assets other than intangibles, these rules are focused on determining the value of intangible property, and certain of the approaches have limited applicability to many partnership arrangements, particularly these in ruling only property other than intangibles. Accordingly, we believe that the proposed regulations should specify that these valuation rules apply generally

[25] This approach can be applied in other circumstances involving incorrect valuations. For example, if the contribution of services by a related party is overvalued, the transaction would be recast as a transfer of an interest in partnership property to the service provider.

[26] A principal concern of the Notice appears to involve the use of incorrect or uncertain valuations of intangible property to shift income to foreign partners in those situations in which application of the cost sharing rules would have a different result. We believe those concerns are not applicable to transactions which do not involve the transfer or development of intangibles.

[27] We believe that the regulations should adopt a limited use of the valuation rules in Treas. Reg. § 1.482-7(g).

only to certain partnerships. Moreover, for partnerships concerning involving activities other than the development of intangible property, we believe that the rules of Treasury Regulations Section 1.482-7 should not apply, but that the general rules governing Section 482 should apply instead.[28]

(a) The proposed regulations should have limited application to partnerships with unrelated parties.

We recommend that the proposed regulations limit their application to partnerships in which an unrelated party has a substantial participation. The thrust of the rules under Section 482 is to ensure that transactions are conducted on the same basis as those with unrelated parties. Therefore, the presence of an unrelated party that negotiated the economic terms of the agreement would seem to warrant restricting how the regulations may impact the partnership. In that case, the rules should still apply to the portion of the transaction between the related parties. However, the application of the rules should have no effect upon the unrelated party. Therefore, any recharacterization of the transaction or reallocation of items of income, gain or loss or other partnership items should leave the distributive share and tax consequences of the unrelated party unchanged.

This restriction in the regulations would apply only in those circumstances in which the unrelated party has a sufficiently large interest or investment to provide assurance that the terms of the arrangement reflect arm's-length bargaining. This determination would be based upon all of the relevant facts and circumstances, including the amount and terms of the investment by the unrelated party, the extent of its interest in the partnership and its role, if any, in management. Thus, an unrelated party that may make a small investment, but will manage the operation and have a significant interest in profits attributable to its management should ordinarily be considered to have a substantial participation. However, an unrelated party that provides preferred equity with a preferred return and small share of residual profits may not, absent more, be considered to have a substantial participation.[29]

This exclusion would not prevent the IRS from addressing the relationship and transactions between the common controlled entities. For example, assume USP and FS collectively are required to contribute 50% of the capital of the partnership and an unrelated party is also re-

[28] These regulations define "controlled transaction" very broadly to include any "transaction or transfer between two or more members of the same group of controlled taxpayers." While the regulations do not explicitly so state, the contribution of property to a partnership which includes two or more controlled parties would certainly seem within the scope of this definition, even if the partnership is not itself a controlled party.

[29] Even in such a situation, we would expect that the rules would apply only to recharacterize or adjust the interests of the related parties.

quired to contribute 50% of the capital, with each of USP and FS collectively and the unrelated party having a 50% interest in the partnership. In that case, the IRS could analyze the capital contributions made by each of USP and FS to recharacterize the contribution as a transfer among the controlled parties, or adjust the allocations to allocate the aggregate 50% interest between them. Such an analysis, however, would need to be consistent with the arm's-length agreement with the unrelated party that the aggregate contribution represented 50% of the total. In contrast, if each of the unrelated party and USP contributed property that they agreed had equal value for 45% interests in the partnership and FS made no contribution but received a 10% interest for its services in managing the partnership, no IRS reallocation of interests between USP and FS should be permitted. In this latter example, any recharacterization would implicitly have an impact on the unrelated party.[30]

(b) The general section 482 valuation rules should apply to partnerships not engaged in developing intangibles.

The focus of the rules under Treasury Regulations Section 1.482-7 are arrangements in which the activity consists of the development of intangibles. As set forth in those regulations, the activities at issue may be subject to a large degree of risk and present special concerns about valuation. These issues are generally not present in those situations in which the partnership is not engaged in developing intangibles. Moreover, the rule in Treasury Regulations Section 1.482-7(g) that valuation is determined by examining other alternative transactions is inappropriate in the partnership context in cases where the activity does not involve the development of the intangible. In those cases, we believe that proposed regulations should make clear that the best method rule of Treasury Regulations Section 1.482-1(c) applies to determine both the value of the property transferred to the partnership and the value of the partnership interest received.

For example, consider a transaction in which USP transfers marketable securities to a hedge fund partnership with FS which is engaged in the business of providing investment advice. The terms of the arrangement are comparable to the terms FS offers to third parties in other hedge funds. In this case, the usual rules under Section 482 would support the conclusion that the arrangement is arm's length. There would appear to be no need to determine the valuation of the partnership interest received by USP, as currently provided by Treasury Regulations Section 1.482-7(g)(1), by an estimate of the future income to be generated. Nor should it be relevant in this case that the USP might have had an alternative investment strategy that would have involved less cost.

[30] We anticipate that this limitation would apply only in circumstances in which the relative values of the separate interests of the related parties can be established through the arm's-length bargain with the third party.

Similarly, consider the situation in which USP provides 80% of the equity funding and FS provides 20% of the equity funding to a partnership to construct a plant in the country in which FS is organized. Under the term of the partnership agreement USP is entitled to a preferred equity position: a market rate preferred return on its invested capital and return of its capital before distributions are made to FS. In addition, USP is entitled to 5% of profits while FS, which, as the managing partner, will oversee operation of the plant, will be entitled to 95% of the profits. A financial instrument with comparable terms to the preferred equity held by USP would trade at par. In this circumstance, there has been no transfer of an intangible and the regulations under Treasury Regulations Section 1.482-7 would appear to be irrelevant. To be sure, the partnership interest would need to be valued using the best method. In this case, however, the fact that USP could possibly have earned more by owning equity should not determine the valuation of its interest in the partnership.

(c) The proposed regulations applying the principles of the cost sharing regulations should apply only to the extent that the partnership is engaged in development of an intangible.

Unlike cost sharing arrangements, partnerships may engage in a variety of different activities, only some of which may consist of the development of intangibles. In that case, we believe that the regulations should be applied by looking to each separate activity conducted by the partnership. Moreover, the regulations should consider a *de minimis* rule, but only if the activity developing the intangible is incidental to the other activities of the partnership and is not expected to contribute substantially to the partnership's revenue. For example, assume that USP and FS are members of partnership XYZ, which is engaged in manufacturing widgets. XYZ occasionally develops small improvements to its manufacturing processes. No person spends a substantial amount of time developing the improvements, and the improvements generally result from suggestions made by factory workers. These processes generally do not contribute substantially to sales of the product, but simply enable the partnership to produce the product at a slightly lower cost. For purposes of the regulations, activities which are incidental to another activity should not be considered development of intangibles, even if the result of those activities is the production of an item of intellectual property.[31]

Recommendation 3: Cost Sharing Principles

The proposed regulations should provide specific guidance on how the principles of the cost sharing regulations will apply to partnership transactions involving development of intangibles in order to determine whether the results are arm's-length.

[31] Such a *de minimis* rule should be limited to those situations in which the intellectual property that has been developed lacks a substantial value independent of the activity in which it is exploited.

A significant task for the proposed regulations will be to develop rules analogous to the requirements of the cost sharing regulations in situations involving development of intangibles. We agree with Treasury and the IRS that taxpayers should not be able to exploit partnership structures in which the activity is essentially the same as the intangible development activity addressed in cost sharing arrangements, and yet achieve materially different tax results. In order to accomplish this task, the regulations will need to identify the manner in which capital contributions to partnerships equate to platform contributions and in which the allocations of income or loss within the partnership can be viewed as the anticipated benefits to be obtained by the partners from the development activity. Similarly, rules will need to be developed to provide guidance for how allocations of income or loss can also be viewed as analogous to platform contribution transactions. We recognize that this is not easy.

A partnership transaction differs fundamentally from a cost sharing arrangement in several ways. Although there is a ready analogy between capital contributions to the partnership and platform contributions, they are not identical. In particular, contributions can be used not just for the development of the intangible but its exploitation as well. In addition, partners can effectively provide their services to the partnership thereby contributing both to the development as well as the exploitation of the intangible. Similarly, unlike a cost sharing arrangement in which each participant is expected to receive a direct interest in the intangible created, the partners in the partnership will receive their expected benefit through their entire interest in the partnership, which may include their interests not only in the development but also the exploitation of the intangible.

Consider the following example. USP contributes the foreign rights to an intangible to a partnership, and FS contributes cash equal to the value of the foreign rights. The funds will be used not to develop the intangible but rather to build a sales network for the products to be sold using the intangible. Under Treasury Regulations Section 1.482-7, if the arrangement were structured as a cost sharing agreement, FS's contribution would be considered a payment and income to USP. In a partnership arrangement, that treatment may not be appropriate, as described below.[32]

[32] We note that in the partnership arrangement USP will be required to recognize gain either upon the contribution of the intangible or under the gain deferral method under section 721(c) and the regulations to be issued under the Notice.

(a) The proposed regulations should measure the arm's-length standard by combining the activity of the development of the intangible with exploitation of the intangible.

As explained above, because the expected return from the partnership consists of the partners' shares of income from the partnership and those shares of income include returns from the exploitation of the intangible, whether the transaction is arm's length should be measured by examining the entire activity. The Notice contemplates this approach when it provides that if controlled transactions involve contributions of services, and tangible as well as intangible property, an aggregate analysis of their combined effects may provide the most reliable means of determining the arm's-length results. For example, assume that USP contributes a patent along with cash to a partnership with FS, which agrees to supervise research and development of new products based upon the patent. The partnership, under FS's direction, will engage third party manufacturers to produce the new products which will then be sold by the partnership to consumers. Whether this arrangement is arm's-length will depend upon an analysis of the entire interest in the partnership of each partner.

(b) The value of each partner's contribution and each partner's interest in the partnership should be determined in a manner consistent with the provisions of Treasury Regulations Section 1.482-7(g).

Determinations of the value of a contribution to the partnership (other than with respect to assets that are readily marketable) as well as the value of the partnership interest received are dependent upon an analysis of the risk associated with the development of the intangible as well as the likely potential economic return. In this regard, the partnership interest received may be equated with the potential benefit from the cost sharing arrangement. We believe it would be appropriate to make the determination of the value of both the contribution and the partnership interest using the methods set forth in Treasury Regulations Section 1.482-7(g).

Implicit in this approach is the recognition that the use of a partnership contemplates an exchange in the way that the cost sharing arrangement may not. In the cost sharing arrangement, each partner's contributions to the development of the intangible are shared. To the extent that a participant has not contributed its share to the development, then payments are required to the other participants. Those payments will have tax consequences to both participants. In the case of a partnership, a partner may in substance make that payment by providing contributions not just to the development, but also to the exploitation of the intangible. In addition, the partner may in substance make the payment by accepting a lower share of profits. These structures are inherent in the flexibility of partnerships. We believe the regulations should permit these arrangements without recharacterization or adjustment, provided that in the aggregate the partnership transaction can be shown to produce arm's-length results.

Recommendation 4: Limitation on Adjustments

The regulations should provide that adjustments will generally not be made to the partnership allocations (or additional economic terms imputed) except in those circumstances in which a recharacterization of the transaction as a transfer between the related parties does not achieve an arm's-length result.

As we recommended, we believe the preferable approach is for the adjustments in which contributed property or the corresponding partnership interest is incorrectly valued to be treated as a transaction between the related parties at the time the contribution is made. We believe that there may be rare instances, however, in which it would nevertheless be necessary to adjust partnership allocations. For example, assume USP contributes money to a partnership in exchange for a preferred interest entitling it to a return of its investment and a below market preferred return. In that situation it would be appropriate to change the preferred return to a market rate sufficient so that the value of the partnership interest received in exchange for the contribution is equal to the amount contributed. The alternative recharacterization—a transfer of money to FS and considering FS to have made the additional contribution—would not necessarily achieve an arm's-length result. Under this example, the entire additional return to USP (and therefore taxable income) would be deferred until the partnership repaid the entire principal amount.

We believe these types of adjustments should be limited to situations in which the treatment of the transaction as a transfer of property between the related parties would not further the purposes of section 482. Cases in which the contribution may be readily valued, such as contributions of money, are an example as illustrated above. Other situations may include circumstances in which the contributions of the foreign related party are overvalued. In that case, it would be appropriate to adjust the partners' respective shares of income or loss.

Consider the following example. USP contributes cash to the partnership and FS agrees to contribute certain patents it owns and to supervise the research and development of a new medical device based upon the patents. The partnership will sell the medical device to customers when developed. The parties agree that all income and loss will be shared 75% by FS and 25% by USP. Also assume that an unrelated party making the contribution of money would have required a 40% interest in profits and losses from the sale of the medical device. In that circumstance, the purposes of section 482 would not be furthered by treating recharacterizing the transaction as a transfer of money to FS in exchange for a purchase of an interest in FS's property. Rather, in this case, the regulations should reallocate the items of partnership income or loss to reflect the arm's-length terms.

Recommendation 5: Commensurate with Income Standard

The proposed regulations should provide for the adjustment of the partners' respective interests in the partnership (or treatment of any recharacterized transfer), either in the case of the contribution of intangibles or the development of intangibles, based upon actual results to ensure that the allocations are commensurate with the income attributable to the intangible. This portion of the regulations should be consistent with the principles of Treas. Reg. 1.367(d)-1T and Treas. Reg. 1.482-4(f).

Treasury Regulations Section 1.482-4(f) provides certain special rules governing the transfer of intangible property that we believe are applicable in analyzing partnership transactions in which either the intangible is transferred to the partnership by one of the related parties or the partnership itself develops and exploits the intangible. In particular, the regulation provides methods for determining the arm's-length compensation to be paid for use of the intangible. In any of these situations, a principal factor in determining the value of the partnership interests of each party received in exchange for their respective contributions is the anticipated profits to be realized. For example, assume USP contributes the intangible to the partnership with FS in which FS agrees to supervise manufacturing and sale of the products produced using the intangible. The value of each party's interest in the partnership will depend upon the future income to be earned and any projection of that income may be inaccurate.

The regulations to be issued should provide for adjustments based on actual results that are comparable to the adjustments that would be made under Treasury Regulations Section 1.482-(f)(2). Specifically, the regulations should address the situation in which the contribution to the partnership is recast as a transfer of an interest in the intangible property to the related party and a contribution of that interest to the partnership. If, in a subsequent year, the actual results from the exploitation of the intangible are not commensurate with the income developed, then adjustments should be made. In such a situation, the regulations could treat the allocation to the related party as resulting in an additional payment to the original contributing party in accordance with the provisions of section 367(d).[33] The proposed regulations should make clear that the adjustments under section 367(d) would be made taking into account the results in prior years, even if assessment of tax for those years is barred by the statute of limitations. In such a case, however, the regulations could also provide an alternative of adjusting the partners' respective shares of income to correct for the initial incorrect valuation of the intangible.

Similar rules may apply in circumstances in which the partnership is developing the intangible. Consider the situation in which USP contributes cash and FS agrees to oversee

[33] Such an approach would also be consistent with the intent of Treas. Reg. § 1.482-4(f)(1), which provides that transfers of an intangible for nominal or no consideration will be in the form of a royalty.

development and exploitation of the intangible, which development will involve manufacturing and sale of the products. In that case, USP would expect a certain return on its investment, based upon projected sales and profits of the products after taking into account the development and manufacturing costs. To the extent that the actual results differ materially from the projected results, the regulations should provide for periodic adjustments to the allocations of income or loss of the parties.[34]

Recommendation 6: Documentation

The regulations should require that controlled taxpayers provide documentation sufficient to justify their position that the valuations of the contributions to the partnership and the partnership interest received are arm's length. Failure to provide this documentation would subject the taxpayers to penalties under Section 6662.

The proposed regulations should generally make the requirements of Treasury Regulations Section 1.6662(d) applicable to the valuation of transfers of property to a partnership. The proposed regulations should make clear that the controlled parties are required to meet both the method requirement and the documentation requirement. In particular, the controlled party should be required to establish that the method selected for valuation provided the most reliable method.[35] In making this selection, the controlled party should explicitly be able to support unspecified methods.

In addition, the controlled party should be required to meet a modified version of the documentation requirement in Treasury Regulations Section 1.6662-6(d)(2)(3). The proposed regulations should include a description of the documentation required, including, for example, appraisals or valuations obtained from third parties, projections of future income which were used to determine value, and any evaluation or computation of risk or applicable discount rates.

[34] The determination of material variation could be made on the same basis as provided in Treas. Reg. § 1.482-4(f).

[35] *See* Treas. Reg. § 1.6662-6(d)(2)(ii).