# Using Partnerships to Avoid U.S. Tax on the Expatriation of Intangibles

by Thomas Horst

Thomas Horst

Thomas Horst is the founder and managing director emeritus of Horst Frisch Inc.

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In this article, the author explains why U.S. parent companies can use partnerships with subsidiaries in tax havens to avoid U.S. tax on the expatriation of intangibles.

There is a growing interest in how U.S. multinational enterprises avoid both U.S. and foreign income taxes by transferring their valuable intangible assets to foreign tax haven subsidiaries.[1] In the past, I have always assumed that the relevant federal tax rules were the provisions governing U.S. parent corporations' transfers of intangibles to their tax haven subsidiaries using license agreements, sales of intangible property (IP), or capital contributions. While I knew that Treasury in January issued section 721(c) regulations (T.D. 9891) regarding partnerships between U.S. parents and their foreign subsidiaries, the mind-boggling complexity of the federal tax treatment of partnerships discouraged me — and many others — from understanding why intercompany partnerships were used in sophisticated international tax planning.

Earlier this year, Alex Curatolo and I analyzed data recently published by the IRS Statistics of Income division summarizing how U.S. MNEs' total revenues and pretax income are allocated among their affiliates according to their countries of residence.[2] While the primary focus of our analysis was the large amount of pretax income ($450 billion in fiscal 2017) allocated to tax haven affiliates, I also learned that U.S. MNEs had allocated more than $200 billion of pretax income to stateless entities that were not liable for residence-based income tax in the United States or any other country.

The principal example of a stateless entity is a partnership because federal income tax is imposed not on the partnership per se, but on its partners for their allocated shares of the partnership's income. While there is no way of determining how much of that $200 billion was attributable to partnerships between U.S. parents and their foreign tax haven subsidiaries, the potential magnitude of intercompany partnerships' pretax income convinced me their tax treatment merited consideration.

## I. Summary of Conclusions

Based on my analysis, I conclude that U.S. parent companies obtain two important tax benefits by using a section 721(c) partnership to transfer intangibles to a foreign subsidiary.

The exact nature of the first benefit depends on the method a U.S. parent uses to transfer intangibles to its foreign subsidiary:

- If a U.S. parent sells its intangibles to its foreign subsidiary for a lump sum, it would

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[1] *See, e.g.*, Richard Rubin, "Companies Save Billions in Taxes by Shifting Assets Around Globe," *The Wall Street Journal*, Apr. 8, 2020.

[2] Thomas Horst and Alex Curatolo, "Assessing the Double Count of Pretax Profit in the IRS Summary of CbC Data for Fiscal 2017," *Tax Notes Int'l*, Apr. 27, 2020, p. 427.

have to pay federal tax in the year of the sale on its built-in gain. By contrast, transferring the same intangibles using a section 721(c) partnership allows the U.S. parent to spread the recognition of the built-in gain over the useful life of new intangibles (for example, 15 years for intangibles described in IRC section 197). Given the time value of money, the deferral of taxable gain using a section 721(c) partnership provides a significant economic benefit over a direct lump sum sale.

- Alternatively, if the U.S. parent makes a capital contribution of the intangibles in exchange for stock in its foreign subsidiary, it would be treated as if it had licensed the intangibles in exchange for annual arm's-length royalty payments over their useful life. By contrast, a U.S. parent contributing the same intangibles to a section 721(c) partnership would have additional taxable income in each year limited to the amortization of its initial built-in gain. Assuming the fair market value of the intangibles at the time they are contributed equals the discounted present value of the future stream of royalty income, the annual amortization of the built-in gain under a section 721(c) partnership is a fraction of the annual royalty income the U.S. parent would recognize if it either licensed or made a capital contribution of the same intangibles to its foreign subsidiary.

The second benefit is that the initial valuation of the intangibles contributed to a section 721(c) partnership, unlike lump sum sales or annual royalties, may avoid periodic adjustments in subsequent years under the commensurate with income requirement of section 482.

In effect, there are now two sets of federal tax rules governing transfers of intangibles from a U.S. parent corporation to its foreign subsidiary: the stricter, widely understood set of rules that apply to intangibles that are licensed, sold, or contributed to a foreign subsidiary, and a more generous but not widely understood set of rules that apply to intangibles that a U.S. parent contributes to its partnership with its foreign subsidiary. Given the option of avoiding the stricter rules that apply to direct transfers, it is unsurprising that section 721(c) partnerships are widely used in sophisticated international tax planning.

Treasury could quickly eliminate that significant disparity if it wanted to. Section 367(d) overrides the general rule of section 351 that would allow a U.S. parent to make a tax-free contribution of IP to a foreign subsidiary corporation. In 1997 Congress granted Treasury the authority not only to issue regulations under section 721(c), but also to apply the rules of section 367(d)(2) to IP transfers to a section 721(c) partnership. In 2015 Treasury concluded in Notice 2015-54, 2015-34 IRB 210, that issuing regulations under section 721(c) obviated any need to issue regs under section 367(d)(3). My conclusion is that regulations under section 367(d)(3) are badly needed and should be issued as soon as possible.

## II. Background of Partnership Tax Rules

Notice 2015-54 provides the background of the relevant federal tax rules. In summary, the Taxpayer Relief Act of 1997 repealed the IRC sections 1491-1494 excise tax of 35 percent on the inherent gain on appreciated property (including IP) transferred to a foreign partnership.[3] The Taxpayer Relief Act mandated enhanced information reporting obligations and granted Treasury authority to issue regulations under section 721(c) to override the general rule of section 721(a) that no gain is recognized on the contribution of appreciated property to a partnership in exchange for an interest in that partnership. The authority to override the general nonrecognition rule was limited to cases when the gain on the appreciated property, when later recognized by the partnership, would be included in the gross income of a person other than a U.S. person.

The Taxpayer Relief Act also enacted section 367(d)(3), which granted Treasury authority to apply the rules of section 367(d)(2) regarding transfers of intangibles to foreign corporations to

[3] That excise tax applied to transfers to foreign, but not domestic, partnerships. The tax benefits described in this article can be obtained using either domestic or foreign partnerships and thus would have been available through a domestic partnership even if the excise tax on transfers to a foreign partnership had not been repealed in 1997.

IP transfers to partnerships.[4] But as of 2015, Treasury had not issued regs authorized by either section 721(c) or 367(d)(3).

Notice 2015-54 explains why Treasury concluded that it should now exercise its authority under section 721(c) to override the general nonrecognition rule for IP contributions to a section 721(c) partnership. In short, Treasury had become aware that "certain taxpayers purport to be able to contribute, consistently with sections 704(b), 704(c), and 482 property to a [section 721(c)] partnership. . . . Many of these taxpayers choose a section 704(c) method other than the remedial method and/or use valuation techniques that are inconsistent with the arm's length standard."

Based on that, Treasury concluded that it was appropriate to exercise its authority to issue regulations under section 721(c). Although Congress had also authorized regs under section 367(d)(3), Treasury found acting under section 721(c) more appropriate because the transactions at issue are not limited to IP transfers. That is, regulations under section 721(c) would apply to all types of property contributed to a section 721(c) partnership, whereas section 367(d)(3) regs would apply only to IP contributions.

In Notice 2015-54, Treasury also expressed concern that some taxpayers may be valuing property contributed to a section 721(c) partnership and other transactions in a manner contrary to section 482:

> For example, a partnership agreement might provide a domestic partner with a fixed preferred interest in exchange for the contribution of an intangible that is assigned a value that is inappropriately low, while specially allocating a greater share of the income from the intangible to a related foreign partner.

[4]As of 2015, the statutory definition of IP under the commensurate with income requirement in section 482 cross-referenced section 936(h)(B)(3). In December 2017 the Tax Cuts and Jobs Act broadened that definition to include goodwill, going-concern value, and workforce in place and expanded the grant of regulatory authority to make clear that the IRS may require aggregate basis valuation and apply the realistic alternative principle in valuing intangibles. *See* Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 387-388 (2018).

Accordingly, Treasury said it intended to augment the section 482 rules as they applied to controlled transactions involving partnerships. To date, it has taken no steps to follow up on that.

## III. High-Level Summary of Section 721(c) Regs

The 2020 final regs and the 2017 proposed (REG-127203-15) and temporary (T.D. 9814) regs under section 721(c) all took the approach that taxable gain would be recognized on the contribution of appreciated property (including intangibles) to a section 721(c) partnership unless the partners agreed to apply the remedial method to allocate a partnership's tax items (for example, depreciation and amortization deductions) between or among its partners.

A simple example explains how the remedial method works. A U.S. parent contributes IP having an FMV of $500 to a partnership. The $500 valuation is based on the present value of the projected cash flow from the IP over the next 15 years. A wholly owned foreign subsidiary (FSC) that is resident in a tax haven contributes $500 in cash to the partnership. The partnership uses that $500 to purchase a highly rated bond paying a floating rate of interest over the next 15 years. The floating interest rate is 4 percent annually when the bond is issued.

Given that both partners' initial contributions have the same value ($500), the partners agree that FSC will receive 80 percent of the gross income from the IP and 20 percent of the interest income from the bond. Parent's shares of those two sources of income are 20 percent and 80 percent, respectively.

If Parent's tax basis in the IP were $500 (the same as the initial market value), the section 721(c) regulations would simply require that 80 percent of the partnership's tax amortization expense be allocated to FSC and the remaining 20 percent be allocated to Parent.[5]

The procedure under the remedial method for allocating income and expenses between the two partners becomes more complex if the U.S. parent's tax basis in its IP is less than its $500 FMV. Assuming the parent had expensed research and development and other intangible development

[5]For details, see the appendix, *infra*.

costs, its tax basis in the IP would be zero. If the partnership agreement provided that the partnership would allocate 80 percent of its total tax deduction for depreciation and amortization costs to its foreign subsidiary and the remaining 20 percent to the U.S. parent, then absent section 721(c) regs or other corrective adjustments, the parent could avoid paying federal tax on 80 percent of its $500 built-in gain by making a tax-free contribution of its intangibles to a partnership with its foreign subsidiary.

Broadly speaking, the remedial method prevents a U.S. parent from avoiding tax on the built-in gain on appreciated property contributed to a section 721(c) partnership. That is achieved by shifting part or all of the partnership's total tax deduction for depreciation and amortization from the U.S. parent to the foreign subsidiary and making a remedial allocation that creates an artificial tax deduction for the foreign subsidiary and an offsetting increase in the U.S. parent's taxable income.

The most important general conclusions about the remedial method are that the U.S. parent can defer federal tax on built-in gains in the year it contributes appreciated property to a section 721(c) partnership, and that after the initial contribution, the parent's taxable income will be increased in subsequent years using any cost recovery method that is available to the partnership for the same type of new property that is placed in service at the time of the contribution.[6] For example, if a U.S. parent had built-in gain on contributed intangibles of the type described in section 197, it will be allocated taxable income equal to 1/15th of the built-in gain for each of the next 15 years. In sum, the remedial method allows a U.S. parent to defer for a multiyear period the federal tax on the built-in gain on contributed intangibles.

## IV. Direct Transfers of Intangibles

This article compares the transfer of an interest in intangibles by a U.S. parent to its foreign subsidiary by creating and using a section 721(c) partnership with a direct transfer of the same interest to the foreign subsidiary. Generally speaking, a U.S. parent can make a direct transfer by using an intangible license agreement with its foreign subsidiary, selling the interest in the intangibles in exchange for a single lump sum cash payment, or contributing the interest in the intangibles in exchange for an equity interest in its foreign subsidiary.

### A. Sale of Interest for a Lump Sum Payment

Consider first the U.S. parent's option of selling an interest in the intangibles to its foreign subsidiary in exchange for a single lump sum cash payment. Using the simple example from the preceding section, assume Parent sells to FSC an 80 percent interest in its IP for a lump sum cash payment of $400 — that is, 80 percent of the intangible's FMV of $500. Parent uses the $400 cash proceeds to buy a highly rated bond with a 15-year maturity and a floating interest rate that is 4 percent annually when the bond is purchased.

Over the next 15 years, Parent would have two sources of gross income: 20 percent of the total gross income from the IP and interest income at the initial floating rate of 4 percent on its $400 bond investment. At the end of the 15th year, Parent would also receive $400 from the redemption of its bond.

That sale of the intangible for a lump sum cash payment has a projected pretax cash flow for Parent identical to the projected pretax cash flow from its interest in a section 721(c) partnership.[7] However, there are two important differences in Parent's federal tax payments under those alternatives. First, the direct sale of an 80 percent interest for a lump sum cash payment of $400 would result in Parent's incurring federal tax on its $400 built-in gain in the year the interest is sold.[8] By contrast, under the remedial method applied to a section 721(c) partnership, the federal tax on that built-in gain would be spread over future years based on the amortization method applied to the same type of new intangibles.

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[6] Reg. section 1.704-3(d)(2).

[7] I have focused on Parent's pretax cash flow because Parent pays federal tax at 21 percent, whereas FSC pays no income tax. FSC could also obtain the same projected pretax cash flow as it obtained from the partnership by supplementing its $400 purchase of an 80 percent interest in Parent's intangibles with a $100 purchase of the same bond Parent purchased.

[8] The valuation of gains from the transfer of intangibles for a lump sum is described in reg. section 1.482-4(f)(6).

Given the time value of money, a multiyear deferral of federal taxes allowed by section 721(c) yields a significant economic benefit.

The second important difference is that all three types of direct transfers (licenses, lump sum sales, and contributions to capital) are subject to periodic adjustments under the commensurate with income requirement of section 482. That is, if a U.S. parent makes a direct transfer of intangibles to a foreign subsidiary, the IRS can make section 482 transfer pricing adjustments in later years for intangibles transferred in an earlier year even though the statute of limitations may preclude a transfer pricing adjustment for the earlier year in which the intangibles were transferred.

### B. Capital Contribution of Intangibles

A second method of transferring intangibles directly to a foreign subsidiary is by contributing intangibles to the sub in exchange for its capital stock. Under section 367(d), the U.S. parent's contribution does not result in an immediate tax on the parent's built-in gain. Rather, the parent is deemed to receive over the IP's subsequent life arm's-length royalties that are commensurate with the foreign subsidiary's income from the contributed intangible.[9]

In our simple example, if Parent contributed an 80 percent interest in the intangibles to FSC, its projected total cash flow from its intangibles would equal 100 percent of the gross income from those intangibles — 20 percent of the total gross income because of its retained interest plus 80 percent of the total gross income received as a commensurate with income royalty.

Because Parent's tax basis is assumed to be zero, its projected taxable income would equal its projected gross income. Thus, in each and every year, the arm's-length royalty amount resulting from the contribution of the IP to FSC exceeds the amortization of the initial built-in gain on the contribution of the IP to a section 721(c) partnership.

Under either a 721(c) partnership or a direct capital contribution, Parent's tax liability is spread out over the future life of the intangible. However, while the time profiles are similar, Parent's taxable gain in every year resulting from a direct contribution exceeds its taxable gain resulting from a comparable contribution to a 721(c) partnership. And, as noted, the commensurate with income royalties resulting from a capital contribution to a foreign subsidiary are subject to periodic adjustments in future years, whereas the amortization of the built-in gain under the remedial method does not appear to be subject to those adjustments.

## V. Conclusion

U.S. MNEs use section 721(c) partnerships to transfer intangibles to foreign subsidiaries because the present value of their projected federal taxes is lower than the present values of projected taxes resulting from direct transfers of the same intangibles, and the remedial allocations required by section 721(c) do not appear to be subject to periodic adjustments in subsequent years.

I doubt Congress intended that disparity when it repealed the excise tax on appreciated property contributed to a foreign partnership but authorized Treasury to issue regulations under sections 721(c) and 367(d)(3). In my view, Treasury erred in 2015 when it concluded that the proposed section 721(c) regs obviated any need for new section 367(d)(3) regs to address contributions of intangibles to section 721(c) partnerships. With the Tax Cuts and Jobs Act's inclusion of goodwill, going concern value, and workforce in place in the definition of intangibles,[10] new section 367(d)(3) regulations are badly needed and should be issued as soon as possible.

## VI. Appendix

This appendix provides a numerical example of partnership tax allocations under IRC section 721(c) regulations and a comparison of results to transfers of intangibles to a foreign subsidiary.

The easiest way to understand the tax consequences of using a partnership to transfer an IP interest to a foreign subsidiary corporation is with a simple hypothetical example.

[9] Because section 367(d) treats capital contributions of intangibles to foreign subsidiaries as if the parents had licensed those intangibles, no separate analysis of the licensing alternative is required.

[10] IRC section 367(d)(4)(F).

### A. Contributing Intangibles to the Partnership

The amounts described in this section are summarized in tables 1 and 2. For simplicity, the example assumes that various items of income and expenses are fixed annual amounts that continue for 15 years and are zero thereafter. Accordingly, the columns for the fourth through the 13th year have been hidden, but the amounts for all years are included in the total value shown in the last column.

#### 1. Key Assumptions

Parent and FSC form Partnership. Parent contributes IP, which is expected to generate a fixed cash benefit of $58.40 a year for 15 years, and no cash benefit thereafter, to Partnership. The IP's FMV at the time of its contribution ($500) equals the present value of the projected annual cash benefits discounted at a rate of 8 percent a year, which is the assumed risk-adjusted cost of capital for IP valuation purposes.[11]

FSC contributes $500 to Partnership, which in turn invests in a publicly traded 15-year bond that has a floating interest rate of 4 percent annually, based on the bond's $500 par value. Partnership's annual interest income is thus projected to be $20 a year. At maturity, the bond will be redeemed at its par value ($500).

Although Parent contributed IP and FSC contributed cash, both initial contributions have the same initial value ($500). Given that initial equality of capital contributions, the partnership agreement provides that Parent will be allocated 20 percent of the gross income from the IP and FSC will be allocated the remaining 80 percent. Further, Parent will be allocated 80 percent of the interest income from the 15-year bond and 80 percent of the proceeds from its redemption, and FSC will be allocated the remaining 20 percent.

#### 2. Partnership's Book Capital Accounts

Partnership maintains book capital accounts as required by IRC section 704(b) to reflect the partners' economic interests in it. In each year, the initial value of Partnership's equity capital ($1,000) is split equally between Parent and FSC; 20 percent of Partnership's annual gross income from the IP ($58.40) is allocated to Parent ($11.70), and the remaining 80 percent is allocated to FSC ($46.70); and 80 percent of the annual interest income ($20) is allocated to Parent ($16), and the remaining 20 percent is allocated to FSC ($4). For book accounting purposes, Partnership annually amortizes the IP's $500 initial value based on the straight-line method and a 15-year useful life, so Partnership's annual amortization expense is $33.30.[12] The total annual amortization ($33.30 a year) is allocated 80 percent to FSC ($26.70 a year) and 20 percent to Parent ($6.70 a year).[13]

At the end of each year, Partnership distributes to its two partners the total cash it receives during the year, which is the sum of the total gross income ($58.40) from the IP plus the interest income ($20), or $78.40 a year.[14] For Parent, that amount equals 20 percent of the $58.40 IP total plus 80 percent of the $20 of interest income, for a total cash distribution of $27.70 a year. For FSC, that amount equals $50.70 (Partnership's total distribution or $78.40 minus the $27.70 distributed to Parent). The cash distributed at the end of the 15th year also includes proceeds from the redemption of the $500 bond, 80 percent of which ($400) goes to Parent, with the remaining 20 percent ($100) to FSC.

The balances in the partners' and Partnership's capital accounts at the end of each year equal:

- the balance in the capital account at the beginning of the year plus the total gross income for the current year (the sum of the gross income from the IP plus the interest income); minus
- the amortization of the IP for the year, the cash distributions for the year, and the proceeds from the bond redemption at the end of the 15th year.

[11]That result was achieved by using the Excel annuity-payment formula based on an 8 percent interest rate, 15-year repayment period, and $500 initial value to calculate the $58.40 payment amount shown on line 4.

[12]Unlike other book accounting amounts, the book method of amortizing the initial value of contributed property is governed by reg. section 1.704(d)(2) if the partnership elects to apply the remedial method.

[13]All amounts reported in the text and displayed in the attached tables are rounded values of the underlying precise values. Consequently, in this and some other cases, the sum of two rounded values may differ by $0.10 from the rounded value of the sum of the two precise amounts.

[14]The total gross income amounts are shown on Table 1, line 7, and the cash distribution of those amounts is shown on Table 1, line 16.

**Table 1. Book Capital Accounts for Partnership Between Parent and FSC (in dollars)**

| | | | Year | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 1 | 2 | 3 | 14 | 15 | Total |
| | **Capital Account — Beginning of Year** | | | | | | | |
| 1 | Partnership | | 1,000 | 966.7 | 933.3 | 566.7 | 533.3 | |
| 2 | FSC | | 500 | 473.3 | 446.7 | 153.3 | 126.7 | |
| 3 | Parent | | 500 | 493.3 | 486.7 | 413.3 | 406.7 | |
| | **Gross Profit From IP** | | | | | | | |
| 4 | Partnership | | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 876.2 |
| 5 | FSC | 80% | 46.7 | 46.7 | 46.7 | 46.7 | 46.7 | 701 |
| 6 | Parent | 20% | 11.7 | 11.7 | 11.7 | 11.7 | 11.7 | 175.2 |
| | **Gross Interest Income** | | | | | | | |
| 7 | Partnership | | 20 | 20 | 20 | 20 | 20 | 300 |
| 8 | FSC | 20% | 4 | 4 | 4 | 4 | 4 | 60 |
| 9 | Parent | 80% | 16 | 16 | 16 | 16 | 16 | 240 |
| | **Total Gross Income** | | | | | | | |
| 10 | Partnership | | 78.4 | 78.4 | 78.4 | 78.4 | 78.4 | 1,176.2 |
| 11 | FSC | | 50.7 | 50.7 | 50.7 | 50.7 | 50.7 | 761 |
| 12 | Parent | | 27.7 | 27.7 | 27.7 | 27.7 | 27.7 | 415.2 |
| | **Book Amortization of IP** | | | | | | | |
| 13 | Partnership | | 33.3 | 33.3 | 33.3 | 33.3 | 33.3 | 500 |
| 14 | FSC | 80% | 26.7 | 26.7 | 26.7 | 26.7 | 26.7 | 400 |
| 15 | Parent | 20% | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 | 100 |
| | **Cash Distribution at Year-End** | | | | | | | |
| 16 | Partnership | | 78.4 | 78.4 | 78.4 | 78.4 | 78.4 | 1,176.2 |
| 17 | FSC | | 50.7 | 50.7 | 50.7 | 50.7 | 50.7 | 761 |
| 18 | Parent | | 27.7 | 27.7 | 27.7 | 27.7 | 27.7 | 415.2 |
| | **Distribution of Proceeds From Bond Redemption** | | | | | | | |
| 19 | Partnership | | | | | | 500 | 500 |
| 20 | FSC | 20% | | | | | 100 | 100 |
| 21 | Parent | 80% | | | | | 400 | 400 |
| | **Capital Account — End of Year** | | | | | | | |
| 22 | Partnership | | 966.7 | 933.3 | 900 | 533.3 | 0 | |
| 23 | FSC | | 473.3 | 446.7 | 420 | 126.7 | (0) | |
| 24 | Parent | | 493.3 | 486.7 | 480 | 406.7 | 0 | |

Because the cash distribution at the end of the year equals the gross income for that year, the capital balance at the end of that year also equals the cash balance at the beginning of the year minus the amortization deduction for the year.

## 3. Allocation Under the Remedial Method

This section describes the allocation of partnership tax items as required by the regulations under IRC sections 704(c) and 721(c). The allocations as applied to our hypothetical example are summarized in Table 2.

**Table 2. Partnership Tax Allocations Under the Remedial Method (in dollars)**

| | | | | Year | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | 1 | 2 | 3 | 14 | 15 | Total |
| | **Total Gross Income** | | | | | | | | |
| 1 | Partnership | | | 78.4 | 78.4 | 78.4 | 78.4 | 78.4 | 1,176.2 |
| 2 | FSC | | | 50.7 | 50.7 | 50.7 | 50.7 | 50.7 | 761 |
| 3 | Parent | | | 27.7 | 27.7 | 27.7 | 27.7 | 27.7 | 415.2 |
| | **Tax Amortization and Remedial Allocations** | | | | | | | | |
| | *Partnership* | | | | | | | | |
| 4 | Tax amortization of IP | | | 0 | 0 | 0 | 0 | 0 | 0 |
| | *FSC* | | | | | | | | |
| 5 | Book amortization of IP | | | 26.7 | 26.7 | 26.7 | 26.7 | 26.7 | 400 |
| 6 | Tax amortization of IP | | | 0 | 0 | 0 | 0 | 0 | 0 |
| 7 | Remedial allocation of expense to FSC | | | 26.7 | 26.7 | 26.7 | 26.7 | 26.7 | 400 |
| 8 | Total tax deduction for FSC | | | 26.7 | 26.7 | 26.7 | 26.7 | 26.7 | 400 |
| | *Parent* | | | | | | | | |
| 9 | Tax amortization of IP | | | 0 | 0 | 0 | 0 | 0 | 0 |
| 10 | Remedial allocation of income to Parent | | | (26.7) | (26.7) | (26.7) | (26.7) | (26.7) | (400) |
| 11 | Net tax deduction (income) of Parent | | | (26.7) | (26.7) | (26.7) | (26.7) | (26.7) | (400) |
| | **Taxable Income** | | | | | | | | |
| 12 | Partnership | | | 78.4 | 78.4 | 78.4 | 78.4 | 78.4 | 1,176.2 |
| 13 | FSC | | | 24.1 | 24.1 | 24.1 | 24.1 | 24.1 | 361 |
| 14 | Parent | | | 54.3 | 54.3 | 54.3 | 54.3 | 54.3 | 815.2 |
| | **Pretax Cash Flow** | | | | | | | | |
| 15 | Partnership | | (1,000) | 78.4 | 78.4 | 78.4 | 78.4 | 578.4 | 676.2 |
| 16 | FSC | | (500) | 50.7 | 50.7 | 50.7 | 50.7 | 150.7 | 361 |
| 17 | Parent | | (500) | 27.7 | 27.7 | 27.7 | 27.7 | 427.7 | 315.2 |
| | **Income Tax** | | | | | | | | |
| 18 | Partnership | | | 11.4 | 11.4 | 11.4 | 11.4 | 11.4 | 171.2 |
| 19 | FSC | 0% | | 0 | 0 | 0 | 0 | 0 | 0 |
| 20 | Parent | 21% | | 11.4 | 11.4 | 11.4 | 11.4 | 11.4 | 171.2 |
| | **Post-Tax Cash Flow** | | | | | | | | |
| 21 | Partnership | | (1,000) | 67 | 67 | 67 | 67 | 567 | 505 |
| 22 | FSC | | (500) | 50.7 | 50.7 | 50.7 | 50.7 | 150.7 | 361 |
| 23 | Parent | | (500) | 16.3 | 16.3 | 16.3 | 16.3 | 416.3 | 144 |

Assume Parent's tax basis in the contributed IP is zero because before Partnership was formed, Parent had expensed the R&D and other costs of developing the IP transferred to Partnership. To avoid recognition of the $500 built-in gain on the transfer of appreciated property to a section 721(c) partnership, Partnership is required (as of August 6, 2015) to apply the remedial method of allocating partnership tax items.

In the first step, Partnership's taxable gross income and its allocation between Parent and FSC are assumed to equal the comparable gross income amounts for book purposes.[15]

Next is the allocation of Partnership's total tax amortization expense between Parent (the contributing partner) and FSC (the non-contributing partner). Because Partnership applies the remedial method to avoid Parent's recognition of gain on its IP contribution to Partnership, Partnership inherits Parent's carryover tax basis ($0). Accordingly, Partnership has no tax amortization expense in subsequent years to allocate between its partners.

If Partnership had any tax amortization expense to amortize, the next step would have been to allocate the partnership's tax amortization expense to the non-contributing partner (FSC) in an amount up to a ceiling equal to the non-contributing partner's book amortization expense.[16] But because Partnership has no amortization expense to allocate, the amount allocated to the non-contributing partner (FSC) in this step is zero.

To remedy the insufficiency of Partnership's total tax amortization expense, Partnership must make a remedial allocation of the shortfall of $26.60 as an additional tax expense for FSC and an offsetting allocation of $26.60 additional taxable income to Parent. Because the tax amortization expense amounts are all zero, the taxable incomes of Partnership, FSC, and Parent equal their respective taxable gross incomes adjusted for the remedial allocation amounts.[17]

The cumulative remedial allocation to FSC over the entire 15 years ($400) equals FSC's 80 percent share of Parent's $500 built-in gain on its tax-free contribution of intangibles to Partnership. Broadly speaking, the remedial method prevents Parent from using Partnership to shift part or all of its $500 built-in gain to FSC, a non-contributing affiliate that is not a U.S. person.

#### 4. Pre- and Post-Tax Cash Flows

Table 2 also calculates the pre- and post-tax cash flows for Partnership and its partners. Those calculations will be useful in comparing the tax treatment of intangibles contributed to a partnership to the tax treatment of intangibles contributed directly to a foreign subsidiary corporation.

The pretax cash flows are derived from amounts in Table 1. In general, the net cash inflow for a year equals:

- the cash distribution for that year[18] plus the distribution of the proceeds from the bond redemption at the end of the 15th year;[19] minus
- the initial contributions to Partnership.[20]

The income tax payments assume that Parent's taxable income is taxed at a 21 percent rate and that FSC is incorporated in a tax haven that imposes no income tax.[21]

The projected post-tax cash flows are simply the projected pretax cash flows minus the projected income tax payments.[22]

### B. Contributions vs. Direct Transfers

#### 1. Lump Sum Sale

Table 3 describes the treatment of a direct transfer of intangibles to a foreign subsidiary that produces the same pretax cash flow for Parent as the contribution of intangibles to Partnership described in tables 1 and 2 above.

Parent is assumed to own IP having an FMV of $500 and a tax basis of zero. Parent sells an 80 percent interest in the income from those intangibles to FSC for a lump sum cash payment of $400. Because Parent's tax basis is zero, the $400 sale proceeds are taxable to Parent in the year of the sale.

Parent uses the $400 lump sum cash proceeds from the sale to purchase a 15-year bond having a

[15] That is, the amounts shown in Table 2, lines 1-3, are identical to the amounts shown in Table 1, lines 10-12.

[16] FSC's book amortization expense is shown in Table 1, line 16; that amount is carried over to Table 2, line 5.

[17] The remedial allocations for FSC and Parent are shown on Table 2, lines 7 and 10. Because FSC additional tax expense is offset by Parent's additional taxable income, the remedial allocation has no net effect on Partnership's taxable income.

[18] Table 1, lines 16-18.

[19] Table 1, lines 19-21.

[20] Table 1, lines 1-3, first column only. To calculate rates of return on cash flows, the initial capital contributions are shown in Table 2 as having been made at the end of "year 0" — that is, the year preceding Partnership's first year of operation.

[21] Table 2, lines 19-20.

[22] Table 2, lines 21-23, 15-17, and 18-20, respectively.

**Table 3. Lump-Sum Sale of Interest in Intangibles (in dollars)**

| | | | Year | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 0 | 1 | 2 | 3 | 14 | 15 | Total |
| | *Parent IP* | | | | | | | | |
| 1 | FMV of IP - EoY | | 500 | | | | | | |
| 2 | Tax basis of IP - EoY | | 0 | | | | | | |
| | *Sale of Interest by Parent to FSC* | | | | | | | | |
| 3 | FMV of IP - EoY | 80% | 400 | | | | | | |
| 4 | Tax basis of IP - EoY | 80% | 0 | | | | | | |
| 5 | Taxable gain on lump-sum sale | | 400 | | | | | | 400 |
| | *Investment in 15-Year Bond* | | | | | | | | |
| 6 | Value of bond - BoY | | 0 | 400 | 400 | 400 | 400 | 400 | |
| 7 | Interest income | 4% | | 16 | 16 | 16 | 16 | 16 | 240 |
| 8 | Investment in 15-year bond | | 400 | 0 | 0 | 0 | 0 | (400) | |
| 9 | Value of bond - EoY | | 400 | 400 | 400 | 400 | 400 | 0 | |
| | *Parent Taxable Income* | | | | | | | | |
| 10 | Gross income from IP | | | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 876.2 |
| 11 | Share of gross income from IP | 20% | | 11.7 | 11.7 | 11.7 | 11.7 | 11.7 | 175.2 |
| 12 | Interest income | | | 16 | 16 | 16 | 16 | 16 | 240 |
| 13 | Total taxable income | | 400 | 27.7 | 27.7 | 27.7 | 27.7 | 27.7 | 815.2 |
| | *Parent Pre- and Post-Tax Cash Flow* | | | | | | | | |
| 14 | Pretax cash flow | | (500) | 27.7 | 27.7 | 27.7 | 27.7 | 427.7 | 315.2 |
| 15 | Income tax | 21% | 84 | 5.8 | 5.8 | 5.8 | 5.8 | 5.8 | 171.2 |
| 16 | Post-tax cash flow | | (584) | 21.9 | 21.9 | 21.9 | 21.9 | 421.9 | 144 |

floating rate of interest of 4 percent annually. Its projected interest income is $16 a year for 15 years. At the end of 15 years, the bond is redeemed for its $400 par value. Based on the same economic assumptions as above, the intangible assets are projected to yield a fixed cash flow of $58.40 a year for 15 years. Parent retains 20 percent of that gross income ($11.70 a year) and pays the remaining 80 percent to FSC.

Parent's taxable gross income equals the $400 received from FSC in year 0 for the sale of the 80 percent interest in Parent's IP plus the $27.70 per year of taxable gross income, which is the sum of the gross income from its 20 percent retained interest in the intangibles ($11.70 a year) plus its interest income ($16 a year).

Because Parent has a tax basis of zero in its intangibles, it has no tax-deductible expenses, so its taxable income equals its taxable gross income.

Parent's projected pretax cash flow consists of an imputed cash outlay of $500 in year 0 based on the IP's FMV, projected cash inflows equal to its total gross income of $27 a year for years 1-15, and the $400 proceeds from the redemption of its bond at the end of year 15. Parent's pretax cash flows shown on line 14 of Table 3 are identical to the pretax cash flows from its interest in Partnership shown on line 17 of Table 2.

Parent's projected income tax expense equals 21 percent of its projected taxable income. That expense over the IP's 15-year life ($171.20) is

**Table 4. Capital Contribution of Interest in Intangibles (in dollars)**

| | | | Year | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 0 | 1 | 2 | 3 | 14 | 15 | Total |
| | *Parent IP* | | | | | | | | |
| 1 | FMV of IP - EoY | | 500 | | | | | | |
| 2 | Tax basis of IP - EoY | | 0 | | | | | | |
| | *Gross Income From IP* | | | | | | | | |
| 3 | Gross income from IP — total | | | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 876.2 |
| 4 | Parent gross income from retained interest | 20% | | 11.7 | 11.7 | 11.7 | 11.7 | 11.7 | 175.2 |
| 5 | Parent's commensurate-with-income royalty from FSC | 80% | | 46.7 | 46.7 | 46.7 | 46.7 | 46.7 | 701 |
| | *Parent Taxable Income* | | | | | | | | |
| 6 | Taxable gross income | | | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 876.2 |
| 7 | Amortization of tax basis | | | 0 | 0 | 0 | 0 | 0 | 0 |
| 8 | Taxable income | | | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 876.2 |
| | *Parent Pre- and Post-Tax Cash Flow* | | | | | | | | |
| 9 | Pretax cash flow | | (500) | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 376.2 |
| 10 | Income tax | 21% | | 12.3 | 12.3 | 12.3 | 12.3 | 12.3 | 184 |
| 11 | Post-tax cash flow | | (500) | 46.1 | 46.1 | 46.1 | 46.1 | 46.1 | 192.2 |

identical to that expense over its 15-year investment in Partnership.[23]

When Parent sells an 80 percent interest in the intangibles directly to FSC, it pays tax on $400 of its built-in gain in year 0. By contrast, when Parent contributes 100 percent in its intangibles, the remedial allocations resulting from the allocation of an 80 percent interest in those intangibles to FSC are spread ratably over the 15-year useful life of those intangibles.

### 2. Contributing an 80 Percent IP Interest

Table 4 evaluates the tax and cash flow consequences if Parent contributes an 80 percent interest in its intangibles to FSC's capital stock. Under section 367(d), that contribution would be treated as if Parent had licensed the intangibles to FSC in exchange for royalty payments over the useful life of the intangibles that in each year were commensurate with the income from the intangibles. Unlike the sale of the interest in the intangibles for a lump sum, this situation does not produce the same pretax cash flows for Parent and FSC as the section 721(c) partnership did.

What this case has in common with the section 721(c) partnership is that Parent's pretax cash flow and its income tax payments are uniform over the useful life of the intangibles. Thus, the difference in Parent's federal tax between this case and the section 721(c) partnership will also be uniform over that useful life. Parent's taxable gross income equals 100 percent of the total gross income from the intangibles,[24] and consists of Parent's retained 20 percent interest in the intangible plus its commensurate with income royalty equal to FSC's gross income from the 80 percent interest that it contributed to FSC's capital.

[23] Table 2, line 20, last column.

[24] In Table 4, line 6 equals line 3.

**Table 5. Comparison of Parent's Results Under Alternative Scenarios (in dollars)**

| | | | Year | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 0 | 1 | 2 | 3 | 14 | 15 | Total |
| | **Contribution of Intangibles to Partnership** | | | | | | | | |
| 1 | Pretax cash flow | | (500) | 27.7 | 27.7 | 27.7 | 27.7 | 427.7 | 315.2 |
| 2 | Income tax | 21% | 0 | 11.4 | 11.4 | 11.4 | 11.4 | 11.4 | 171.2 |
| 3 | Post-tax cash flow | | (500) | 16.3 | 16.3 | 16.3 | 16.3 | 416.3 | 144 |
| | **Lump-Sum Sale of Interest in Intangibles** | | | | | | | | |
| 4 | Pretax cash flow | | (500) | 27.7 | 27.7 | 27.7 | 27.7 | 427.7 | 315.2 |
| 5 | Income tax | 21% | 84 | 5.8 | 5.8 | 5.8 | 5.8 | 5.8 | 171.2 |
| 6 | Post-tax cash flow | | (584) | 21.9 | 21.9 | 21.9 | 21.9 | 421.9 | 144 |
| | **Capital Contribution of Interest in Intangibles** | | | | | | | | |
| 7 | Pretax cash flow | | (500) | 58.4 | 58.4 | 58.4 | 58.4 | 58.4 | 376.2 |
| 8 | Income tax | 21% | 0 | 12.3 | 12.3 | 12.3 | 12.3 | 12.3 | 184 |
| 9 | Post-tax cash flow | | (500) | 46.1 | 46.1 | 46.1 | 46.1 | 46.1 | 192.2 |

### 3. Summary of Results

Table 5 summarizes Parent's results under the three alternative methods of transferring the same interest in its intangibles to FSC.[25]

The cumulative tax shown in the last column of line 5 is the same as the cumulative tax shown in the last column of line 2, but approximately half of the cumulative taxes shown on line 5 are payable in year 0 (the year of the initial transfer), whereas the total taxes shown on line 2 are spread uniformly over years 1-15.[26]

The cumulative taxes shown on line 8 are now spread uniformly over years 1-15, but the fixed annual tax amount shown on line 8 is higher than the fixed annual tax amount shown on line 2.[27] ■

[25] Lines 1-3 of Table 5 are the same as lines 17, 20, and 23 of Table 2, respectively. Parent's cash flows and taxes paid also reflect its 80 percent share of the interest and principal amount of the bond.

[26] Lines 4-6 of Table 5 are the same as lines 14-16 of Table 3, respectively. Parent's cash flows and taxes paid also reflect the interest and principal amounts of its bond purchase and redemption.

[27] Lines 7-9 of Table 5 are the same as lines 9-11 of Table 3, respectively. Parent's cash flows and taxes paid also reflect the interest and principal amounts of its bond purchase and redemption.