January 7, 2016

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Notice 2015-54

Dear Commissioner Koskinen:

Enclosed please find comments on Notice 2015-54 regarding the section 482 issues (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs: William Wilkins, Chief Counsel, Internal Revenue Service
    Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
    Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
    Ryan Bowen, Attorney-Advisor, Office of the Associate Chief Counsel (International), Internal Revenue Service
    Kenneth Jeruchim, Attorney-Advisor, Office of the Associate Chief Counsel (International), Internal Revenue Service
    Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
    Robert Stack, Deputy Assistant Secretary (International), Department of the Treasury
    Danielle Rolfe, International Tax Counsel, Department of the Treasury
These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by John M. Breen of the Transfer Pricing Committee (the “Committee”). Substantive contributions were made by Kenneth Christman, George Korenko, Magda Szabo, and Joseph Tobin. The Comments were reviewed by Tracy Gomes, Vice-Chair for the Committee. The Comments were further reviewed by Carol P. Tello, Council Director for the Committee, Sean Foley of the Section’s Committee on Government Submissions, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member of the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 7, 2016
EXECUTIVE SUMMARY

These Comments on behalf of the Transfer Pricing Committee address section 482-related issues with respect to Notice 2015-54 (Notice). The Comments note at the outset that the Notice provides only a general description of the guidance proposed to be issued under section 482; consequently it is not possible to provide detailed point-by-point comments, as it would be with respect to draft regulations (the Notice provides considerably more detail with regard to proposed Subchapter K guidance).¹

The Comments recommend that any section 482 regulations in this area should clearly state whether they primarily address (1) traditional transfer pricing issues, including valuation and allocations of partnership income; or (2) application of section 482 to override non-recognition provisions of the Code. The Comments also recommend that any application of the “commensurate with income” standard with respect to partnership contributions should align with recent statements by the Service, indicating that the standard does not permit the application of hindsight to challenge good-faith determinations by controlled taxpayers. Additional comments are provided concerning practical aspects of applying the commensurate with income standard. The Comments also respond to a specific request for comments in connection with documentation provisions that may be specified in this area. They recommend that any guidance with respect to documentation should await development of specified transfer pricing methods for this specific category of transactions.

The Comments also address certain technical issues that may be presented by guidance in this area, including coordination rules under the section 482 regulations. Finally, the comments propose that a Commissioner-initiated adjustment with respect to the valuation of property contributed to a partnership should not result in a taxpayer’s disqualification from eligibility to use the Gain Deferral method.

¹ Note that separate comments concerning Subchapter K issues are being prepared by the Section’s Committee on Partnerships and LLCs.
DISCUSSION

On August 6, 2015, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued Notice 2015-54 (the "Notice"). These Comments, which address only certain transfer pricing aspects of the Notice, are submitted in response to a request in the Notice for comments. The Section’s Committee on Partnerships and LLCs intends to submit comments on other aspects of the Notice.

I. INTRODUCTION

Notice 2015-54 announces rules, with an immediate effective date as of August 6, 2015, regarding contributions of property by a U.S. person to a partnership if a related foreign person is a direct or indirect partner in the partnership and the U.S. partners and related foreign partners own more than 50 percent of the partnership interests. In general, those rules would result in recognition of gain in respect of certain property contributions to a covered partnership unless a “gain deferral method” is elected and certain other requirements are satisfied.

The Notice was issued pursuant to authority granted by a 1997 amendment to section 721 of the Code. That amendment gave Treasury authority to issue guidance limiting the ability of U.S. partners to shift income to a foreign person. In that same year, Congress enacted new information reporting requirements applicable to most contributions to foreign partnerships and specified that the statute of limitations for such transfers would remain open in the event of failure to comply with the provision. These measures were adopted in conjunction with a repeal of the excise tax that previously applied to certain transfers to partnerships.

The Taxpayer Relief Act of 1997 also added section 367(d)(3) to the Code. That provision gave Treasury authority to issue regulations concerning transfers of intangible property to partnerships and to adopt rules for partnerships similar to those contained in section 367(d)(2) for corporations. In effect, Treasury received regulatory authority to impose deemed-royalty treatment in the event of a transfer of intangible property to a foreign partnership. However,

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3 References to a “section” are to a section of the Internal Revenue Code of 1986 (the “Code”), unless otherwise indicated.


5 See I.R.C. § 6038B.

6 See former I.R.C. § 1491, which imposed a 35% excise tax on the amount of built-in gain in partnership outbound transfers, and the accompanying elective gain recognition provision in I.R.C. § 1057 (Taxpayer Relief Act of 1997, I.R.C. § 1131(a)).

Notice 2015-54 was issued under the authority of section 721(c) and does not directly implicate the authority granted under section 367(d)(3).\(^8\)

The scope of the Notice is limited to transfers to controlled partnerships and does not encompass transfers to other entities.\(^9\) While the Notice focuses on transfers of appreciated property to controlled partnerships, it does not address certain other provisions in Subchapter K that could be relevant.

This letter addresses aspects of the Notice dealing with section 482 and related provisions, including the intersection of section 482 and nonrecognition provisions. We note that there is limited case law or other guidance that addresses the application of section 482 to a partnership with two or more controlled parties as partners. The Service's authority under section 482 to allocate income and deductions to prevent tax evasion and to clearly reflect income applies to controlled transactions involving partnerships and complements the authority under Subchapter K. By implication, the Notice raises the question of how the Service's authority under section 482 will be coordinated with the extensive and more specific rules under Subchapter K. We believe that additional guidance is needed to describe the intended coordination between these two sets of rules, both of which, in the case of a controlled partnership, might apply to the same transfer of appreciated property.

Notice 2015-54 provides an outline of the guidance that Treasury and the Service intend to issue under section 482. Notwithstanding the relatively general nature of the discussion regarding section 482, we have identified several issues that are appropriate for comment.

First, we make some general comments that address the basic rationale for guidance under section 482. We then turn to several specific technical comments concerning discrete issues that arise under this provision.

II. GENERAL COMMENTS CONCERNING APPROPRIATENESS OF GUIDANCE UNDER SECTION 482

A. The Scope and Nature of Guidance Proposed to be Issued Under Section 482 Is Unclear

The basic concern of Notice 2015-54 relates to transfers of appreciated property by U.S. persons or entities to partnerships that have one or more non-U.S. controlled partners and resulting allocations of income among the controlled partners.\(^10\) At the outset, we note that Subchapter K

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\(^8\) The Notice states that because the relevant transactions may include items other than intangible property, it was more appropriate to proceed under I.R.C. § 721(c).

\(^9\) The Notice does not address transfers of partnership interests to entities other than partnerships, such as complex domestic trusts with foreign beneficiaries. Because such trusts can make discretionary distributions of distributable net income (DNI), beneficial ownership of such trusts by a foreign person could create trigger allocation of domestic “built-in gain” to a foreign person.

\(^10\) The Notice applies to any transfer of appreciated property by a U.S. person to any partnership (domestic or foreign) where a related foreign person is a direct or indirect partner in the partnership and the U.S. partners and (cont’d)
and the implementing regulations in the partnership area (including regulations under section 704(c) and the partnership anti-abuse rules) identify multiple approaches to evaluate (and correct) partnership allocations that evidence a tax avoidance motive or distort taxable income. These provisions apply to all transfers to partnerships, i.e., without regard to whether the partners include controlled parties or the tax jurisdiction in which any controlled parties are located. In addition, the regulations under Subchapter K and the applicable case law affirm the Service’s authority under section 482 to modify partnership allocations, assuming that controlled parties are involved.

The Notice refers to a concern that taxpayers are valuing property contributed to partnerships “in a manner contrary to section 482.” Given existing rules, we believe that the Notice fails to identify specific concerns that warrant development of new regulations.

It appears that Treasury and the Service intend to adopt a modified version of the rules in Regulation section 1.482-7, to replace the existing partnership rules insofar as they relate to contributions of intangible property to partnerships with one or more non-U.S. partners. It is unclear, however, whether the principles of Regulation section 1.482-7(g), which are used to evaluate the arm’s length compensation for platform contribution transactions (PCTs) in the context of cost sharing arrangements (CSAs), would be particularly useful in the partnership area. In our view, substantial modifications would be needed to enable these regulations to apply appropriately in the latter context. Moreover, assuming this approach is taken, it would be necessary to specify to what extent the resulting guidance would supplant, modify, or simply be in addition to existing guidance under Subchapter K. Presumably, existing guidance under Subchapter K would continue to apply to partnership transfers that do not involve a foreign partner that is a controlled party, whereas the new guidance would apply when property is transferred to partnerships that meet a specified minimum common ownership (control) requirement. In any event, the dividing lines would need to be drawn carefully, to prevent the

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11 I.R.C § 704(c) requires allocations to be based on a reasonable method, and the regulations describe three methods (the traditional method, the traditional method with curative allocations and the remedial method) that may be applied, depending on the facts and circumstances.


13 “The Treasury Department and the IRS also are aware that certain taxpayers may be valuing property contributed to partnerships, or the property or services involved in related controlled transactions, in a manner contrary to section 482. As a result, partnership interests or consideration received in related controlled transactions also may be incorrectly valued, thereby reducing the amount of income or gain allocated to U.S. partners. 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.” Notice 2015-54, 2015-34 I.R.B. 210 at 12.
guidance from being duplicative of or inconsistent with the existing guidance under Subchapter K.

B. Guidance Should Specify the Basis on Which Section 482 is Applied

The Notice indicates that Treasury and the Service “intend to issue [regulations] under section 721(c) that will override the general nonrecognition treatment available under section 721(a) unless certain conditions are satisfied.”\(^{14}\) In addition, the Notice describes certain additional guidance that will be developed by analogy to Regulation section 1.482-7. This guidance will presumably address the amount of income to be reported by the partners over the life of the partnership.\(^{15}\) In view of the dual function of the new guidance, Treasury and the Service should state the specific grounds on which section 482 is being applied.

Historically, section 482 was considered to have several branches. One pertains to the Service's authority to evaluate and adjust the prices of controlled transactions as necessary to conform with the arm's length standard, as elucidated by the section 482 regulations. Another aspect of the Service's authority under section 482 is the ability to allocate gross income and to override nonrecognition treatment otherwise available under one or more sections of the Code. The precise limits of this latter authority are difficult to discern, in part because this particular application of section 482 reverses the tax treatment that Congress provided for a specific type of transaction.\(^{16}\)

The section 482 regulations indicate that, “[i]f necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Code (such as section 351 or 1031).”\(^{17}\) The regulations provide a single example illustrating this rule,\(^{18}\) containing facts similar those in *National Securities Corp. v. Commissioner.*\(^{19}\) In that case, a corporate parent contributed stock with a built-in loss to its


\(^{15}\) As developed below, the notion of revisiting the value of a contribution to a partnership based on post-contribution factual developments conflicts with the normal approach under Subchapter K and may lead to inconsistent and conflicting results.


\(^{17}\) Reg. § 1.482-1(f)(1)(iii)(A).

\(^{18}\) Reg. § 1.482-1(f)(1)(iii)(B).

\(^{19}\) 137 F.2d 600 (3rd Cir. 1943), *cert. denied*, 320 U.S. 794 (1943). This decision is also cited in the Example in Reg. § 1.482-1(f)(1)(iii)(B).
subsidiary in a non-recognition transfer. The parent was unable to use the loss. Shortly after the transfer, the subsidiary disposed of the stock and took a worthless stock deduction. The U.S. Court of Appeals for the Third Circuit upheld the Commissioner’s allocation of the worthless stock deduction to the parent/contributor -- despite the fact that the taxpayer met the requirements of a Code nonrecognition provision when it made the contribution -- under the theory that the loss with respect to the stock was "economically accrued" by the parent, not the subsidiary. The court reasoned that, under clear reflection of income principles, the parent was entitled to deduct the worthless stock because it, rather than the subsidiary, suffered the actual economic loss with respect to the stock.\(^\text{20}\)

The absence of clear guidance in this area has resulted in further confusion. In \textit{Eli Lilly & Co. v. Commissioner}\(^\text{21}\) and \textit{G.D. Searle & Co. v. Commissioner},\(^\text{22}\) for example, the courts sanctioned overrides of nonrecognition treatment by the Service, although the taxpayers in those cases arguably were squarely within the contemplated scope of the applicable nonrecognition provision.\(^\text{23}\) In \textit{Ruddick Corp. v. United States},\(^\text{24}\) in contrast, the Court of Claims held that the Service should invoke section 482 to override a nonrecognition provision only if the taxpayer applied the provision in a manner contrary to that contemplated by the statute and the legislative intent behind the statute:

> Section 482 cannot be allowed, in the absence of taint, to change or modify (on the ground of income distortion) a transaction which Congress has seen fit to authorize specifically in spite of the fact that the transaction may well embody some sort of income distortion. Having contemplated and authorized that possible distortion, Congress is not to be frustrated by use within the Service of the general provisions of Section 482.\(^\text{25}\)

The \textit{Ruddick} standard would require a finding of some tax avoidance before the nonrecognition override power of section 482 can be invoked. This appears to provide an appropriate threshold to identify cases in which section 482 might be applied to override nonrecognition treatment that would otherwise be available under section 721(a), given the anti-abuse motivation and the

\(^\text{20}\) Id. \textit{See also General Electric Co. v. United States}, 3 Cl. Ct. 289 (U.S. Claims Ct. 1983) (taxpayer subsidiary transferred certain built-in loss assets to parent in a tax-free liquidation and parent sold the assets and recognized a capital loss; court held that the Service properly denied nonrecognition treatment for the transfer in connection with the liquidation).

\(^\text{21}\) 84 T.C. 996 (1985), \textit{aff’d in part, rev’d in part}, 856 F. 2d 855 (7th Cir. 1988).

\(^\text{22}\) 88 T.C. 252 (1987).

\(^\text{23}\) \textit{Lilly} and \textit{Searle} both dealt with transfers of high-value intangibles to related parties located outside the United States. There was no evidence that the transferees had any intent to dispose of the transferred items in a subsequent taxable transaction. These cases were decided before the commensurate with income amendment to I.R.C. § 482 in 1986.


\(^\text{25}\) 643 F.2d at 752 (emphasis added).
broadth of the potential application otherwise. Moreover, given that Treasury and the Service propose to extend relatively complex valuation concepts from the cost sharing area to a distinct category of transactions (partnership contributions), it seems appropriate to apply this standard.

C. Commensurate with Income Standard

1. Existing Standards for Application of Commensurate with Income Authority Should be Applied

Over time, Treasury and the Service have refined the rationale for adjustments under the commensurate with income authority of section 482. The 1988 Treasury White Paper (the “White Paper”) expressed the view that uncontrolled parties that transfer or license intangible property, the valuation of which is uncertain at the time of the transfer or license, would probably include contractual terms that require renegotiation in the event that the property turned out to be substantially more profitable than projected. More recently, the Service has stepped away from this contract renegotiation rationale. Instead, as described below, the Service now views the commensurate with income rule as a quasi-evidentiary principle, which is available to assist the Service in evaluating the arm's length result.

Under this view, the information asymmetry that often exists between taxpayers and the Service justifies the Service in taking into account the actual profit generated by an item of intangible property; in effect, this amount can be used to derive a rebuttable presumption of the arm’s length price. Thus, if the actual profits from the intangible property differ from the projected amounts that were used at the time of the initial transfer or license, the Service may propose an adjustment, and the burden of production shifts to the taxpayer to show that its original projections and valuation were reasonable. The Service apparently rejects the notion that the


27 "Congress determined that the actual profit experience should be used in determining the appropriate compensation for the intangible [property] and that periodic adjustments should be made to the compensation to reflect substantial changes in intangible income as well as changes in the economic activities performed and economic costs and risks borne by the related parties in exploiting the intangibles . . . . [T]his is consistent with what unrelated parties would do.” Notice 1988-123, 1988-2 C.B. 458 at 472 (emphasis added).

28 “[T]he IRS . . . is inherently at a disadvantage in assessing whether the pricing was supported by such upfront reasonable and conscientious evaluation [by the taxpayer] of projected operating profits attributable to the transferred intangible. Therefore, consistent with the legislative history, the regulations allow the IRS, in its discretion, provisionally to treat the income actually resulting from the transferred intangible as evidence of what should have been projected at the time of transfer and to make periodic adjustments to reflect the pricing had such results been projected at such time. The regulations then allow taxpayers the ability to rebut such presumption . . . .” Generic Legal Advice Memorandum, AM 2007-007 (Mar. 15, 2007) at 3 (Issue 3) (emphasis added).

29 Id. It is not entirely clear under this approach which party bears the burden of persuasion. See Coordinated Issue Paper, Section 482 CSA Buy-In Adjustments (Sept. 27, 2007) (§ III.F) (providing similar rationale concerning adjustment of CSA buy-in amount). We note that the Service subsequently withdrew the Coordinated Issue Paper, although it does not appear that the withdrawal had any relationship to the stated rationale for adjustments under the commensurate with income standard.
commensurate with income principle sanctions non-arm’s length results, such as might result from an application of hindsight. We support the view that the Service should avoid examining subsequent developments in isolation, i.e., without regard to whether those developments were reasonably anticipated as of the date of the initial transfer or license.\textsuperscript{30}

We anticipate that the guidance issued in connection with transfers to controlled partnerships will conform to recent statements by the Service, as summarized above. Uncontrolled parties generally evaluate contributions to partnerships based on the information available to them on the date of the contribution (and based on that information alone). In many, if not most, uncontrolled transactions,\textsuperscript{31} even those involving intangible property, the value of property on the date it is contributed is used to determine the contributing partner’s interest in the partnership and the partnership allocations that apply over the life of the partnership. As they have done in other contexts, Treasury and the Service should encourage a principled application of the commensurate with income standard to such transactions; in particular, they should discourage applications of hindsight, provided that the taxpayer made a conscientious valuation based on the information available as of the contribution date.

2. **Guidance Concerning the Commensurate with Income Standard Should be Consistent with the Definition of Intangible Property (Section 936(h)(3)(B))**

As noted, Notice 2015-54 is not limited to transfers to partnerships of intangible property; the concerns identified by Treasury and the Service are broader and potentially relate to transfers of all appreciated property. It bears emphasizing that the commensurate with income principle in the second sentence of section 482 pertains only to controlled transactions that involve intangible property, as defined in section 936(h)(3)(B) of the Code. We acknowledge that temporary regulations have recently been issued that would alter the standard for aggregation of multiple controlled transactions and related contributions.\textsuperscript{32} In our view, these provisions increase the likelihood that commensurate with income adjustments may be made for items that are outside the scope of section 936(h)(3)(B), which would be inconsistent with the statutory scheme. We do not have a specific proposal in this regard, other than to suggest that the regulations clearly limit commensurate with income adjustments in connection with transfers to partnerships to transactions involving intangible property -- the only type of property within the scope of that provision.

\textsuperscript{30} The Service "should exercise its periodic adjustment authority consistent with what would have been a conscientious upfront valuation – had the taxpayer in fact made one . . . . The regulations clearly reflect the intent that the IRS exercise restraint in making periodic adjustments based only on the upfront reasonable expectations and not based on subsequent events that could not be reasonably anticipated." AM 2007-007 at 8 (Issue 1) (emphasis added; footnote omitted).

\textsuperscript{31} “Earn-out” provisions may permit post-contribution changes in value to be taken into account.

\textsuperscript{32} See T.D. 9738. The Committee intends to file separate comments on that Treasury Decision.
3. Royalty Equivalent Amount (Regulation section 1.482-4(f)(6))

Notice 2015-54 states that Treasury and the Service intend to issue periodic adjustment rules that apply to controlled partnerships, applying the principles of Regulation section 1.482-7(i)(6)(v).[33] The Notice also states that the Service intends to apply the "equivalent royalty rule" in Regulation section 1.482-4(f)(6) when section 721(a) is determined not to apply to the initial contribution of intangible property to the partnership.[34] Thus, the regulations contemplate two distinct applications of the commensurate with income authority under section 482. Our comments in this section focus on Regulation section 1.482-4(f)(6).

Among the concerns Congress identified when it added the commensurate with income provision was the possibility that controlled parties might require an unrealistically low payment for a transfer of intangible property, in which case the Service could be prevented from making adjustments in subsequent years, after the statute of limitations for the year of the transfer had expired.[35] The White Paper focused on lump sum payments and considered ways in which the Service might make adjustments if it concluded that the lump sum amount was not commensurate with the income from the intangible property.[36] Although periodic adjustments pose difficult issues, adjustments with respect to lump sum payments present additional challenges, in part because they require the transfer pricing analyst to take into account the time value of money.[37]

In the 1992 proposed and 1993 temporary regulations, Treasury and the Service reserved concerning periodic adjustments of lump sum amounts.[38] The 1994 final regulations addressed this issue for the first time.[39] The regulations provided for calculation of an "equivalent royalty amount," based on the discounted present value of the notional royalty payments, taking into account the projected sales and a discount rate appropriate to the facts and circumstances.[40] The equivalent royalty amount for each year is then compared to the arm's length royalty amount for that year, and a section 482 adjustment may be made for the differential.[41] Exceptions to the

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[33] 2015-34 I.R.B. 210 at § 5.01.

[34] Id. at 5.02.


[37] At the time, it was uncertain whether imputing notional royalty amounts in lieu of a lump sum transfer amount would alter the source and character of the payments, which is generally not permitted under section 482.


[41] Id.
periodic adjustment rule are taken into account in determining whether a section 482 adjustment is warranted.\textsuperscript{42} An example shows a simplified calculation of the equivalent royalty amount.\textsuperscript{43} Other than being renumbered in 2006,\textsuperscript{44} this provision has remained unchanged since its adoption more than 20 years ago.

The Preamble to the 1994 final regulations described this provision as follows:

\begin{quote}
The final regulations provide that lump sum payments are potentially subject to periodic adjustments to the same extent as license agreements providing for periodic royalty payments. For purposes of determining if the lump sum payment satisfies the arm's length standard . . . the lump sum must be treated as an advance payment of a stream of royalty over the life of the agreement. This "equivalent royalty amount" serves as the basis for determining if the consideration is arm's length. If a periodic adjustment is made . . . the royalty that was deemed to have been prepaid for the taxable year will be set off against the arm's length royalty for each year, and the difference will be treated as an additional payment in the year of the allocation that is of the same character as the initial lump-sum payment.\textsuperscript{45}
\end{quote}

The final regulations considered and rejected more complex ways of calculating adjustments in this context, some of which had been outlined in the White Paper.\textsuperscript{46}

The regulation reflects the notion that the arm's length consideration for a controlled transfer or license of intangible property is independent of the form selected for the payment. A controlled party, if offered a choice between a royalty stream or a lump-sum amount for an item of intangible property, should be indifferent, assuming that adjustments are made for the relative riskiness of the payment forms and for the time value of money. We do not believe this same equivalency concept necessarily applies to a partnership contribution. Among other things, partnership interests may incorporate both preferred and residual interests, and the partnership structure by its nature allows for highly refined allocations of risk on a going forward basis.

To take a simple example, assume that Controlled Partner 1 contributes to the partnership a valuable item of intangible property that is projected to generate total operating income of $400

\textsuperscript{42} Reg. § 1.482-4(f)(5)(ii) (2005). For example, no adjustment is appropriate if the equivalent royalty amount is within 80-120\% of the arm's length royalty amount, if a reasonably unanticipated event occurred that resulted in an increase in the value of the intangible property.

\textsuperscript{43} Reg. § 1.482-4(f)(5)(iii) (2005). In the Example, the license subject to the lump-sum payment has a fixed 5-year term. Calculating the equivalent royalty amount would be more complex if the license covered a longer term of years or an open-ended period.

\textsuperscript{44} See T.D. 9278, 2006-34 I.R.B. 277. The provision was renumbered as Reg. § 1.482-4(f)(6).

\textsuperscript{45} T.D. 8552, 1994-2 C.B. 93.

\textsuperscript{46} Among the approaches considered at the time was one that accounted for the time value of money by means of a notional investment of the lump sum amount in an interest-bearing certificate of deposit.
million over its useful life of ten years. Assume that Controlled Partner 2 contributes a manufacturing facility with a value of $30 million, which the partnership will use for a ten year term. The partners may agree to various partnership deals, any of which might be consistent with arm’s length compensation for their respective contributions. For example, Controlled Partner 1 might receive a preferred interest of $20 million per year, and a 30% share of residual profits, which are reasonably projected to be $10 million per year. Arguably, the preferred interest could be evaluated using a discounted cash flow approach and – if necessary – the resulting amount might be restated as a royalty equivalent amount. The residual interest, on the other hand, is not so readily analyzed, given that it reflects the overall risk of the partnership. Further, this simple example does not address many factors that would likely be present in a real-world transactions. For example, some partnership agreements include earn-out provisions that permit adjustment of partnership interests if the value of contributed property turns out to be greater or less than anticipated. It seems clear that Regulation section 1.482-4(f)(6) was not designed to address these or other issues that may arise when a partnership interest is received in exchange for a contribution of intangible property to the partnership.

Issuing comprehensive guidance to address commensurate with income adjustments in the context of partnership contributions would be a complex undertaking. Assuming that Treasury and the Service decide to issue more prescriptive guidance in this area, we believe that such guidance might be better patterned on the prescriptive provisions in the cost sharing regulations, such as in Regulation section 1.482-7(g)(2)(vi) (discount rate), 1.482-7(g)(2)(iii) (financial projections), and 1.482-7(i)(6) (commensurate with income). These provisions address issues associated with conversion between different forms of payment, but they are of more recent vintage than Regulation section 1.482-4(f)(6), which, as noted, dates to 1994.

4. Reliability of Ex Post Adjustments to Valuations of Partnership Contributions

Section 1.04 of the Notice provides an overview of the rules under section 482. The inference that we draw from this discussion is that Treasury and the Service intend to analyze partnership contributions under section 482 by reference to events that take place subsequent to the date of contribution of the intangible property to the partnership. Likewise, in other respects, the Notice suggests that the “total value” of the property contributed to the partnership is relevant, i.e., the Commissioner may aggregate related transfers as appropriate under the temporary section 482 regulations.

47 The provisions in Reg. § 1.482-7(i)(6) rank among the most complex provisions in the cost sharing regulations (see Note 62, infra). In our view, these provisions would need substantial modification before they could be used to evaluate contributions in the partnership context.

48 Several weeks after Notice 2015-54 was issued, Treasury and the Service issued T.D. 9738, containing Temp. Reg. § 1.482-1T(f)(2)(i), which modifies the standard for aggregation of transactions and permits aggregation of transactions for purposes of Code provisions other than section 482. T.D. 9738 repeatedly refers to the need to determine the total value of the transaction.
This approach contrasts with the approach under Subchapter K, which is based on the difference between fair market value and the basis of contributed property as of the date of contribution. The focus on pre-contribution gain is consistent in section 721, the disguised sale rules of section 707, the so-called “mixing bowl” rules of section 737, and section 704(c). Each of these provisions contemplates that the amount of pre-contribution gain will be evaluated by reference to the facts known at the date of contribution, without regard to subsequent events.

For example, section 704(c)(1)(A) states:

income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. (emphasis added)

Likewise, Regulation section 1.704-3 considers the variance between basis and the value of the property in the hands of the contributing partner at the time of contribution. Under section 704(c), pre-contribution gain is allocated using one of the three methods specified in Regulation section 1.704-3. No additional analysis is contemplated concerning the potential use or exploitation of the property after the date on which it was contributed to the partnership.

The approach described in Notice 2015-54 could result in two separate and distinct sets of rules applying to partnerships – i.e., the traditional rules under Subchapter K, applicable to all partnerships, and a modified version of those rules, incorporating section 482 principles, that applies to all partnerships with controlled partners that include non-U.S. partners. This proposed architecture will call for extensive coordination rules to indicate exactly when the section 482 modified rules apply and under what circumstances they will lead to different determinations of value than the Subchapter K rules.

D. It is Unclear Whether the Cost Sharing Paradigm Provides a Useful Construct for Analyzing Controlled Contributions of Appreciated Property to Partnerships

The Notice states that Treasury and the Service intend to issue guidance applicable to controlled partnerships based on the transfer pricing methods and valuation principles developed with regard to CSAs in Regulation section 1.482-7. In a CSA, two or more controlled participants share the costs of developing intangible property in proportion to their reasonably anticipated

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49 Officials of the Service have repeatedly stated the accounting and business valuation techniques applied to determine fair value (or fair market value) “may be a useful starting point,” but do not necessarily comport with transfer pricing valuation.

50 See also Reg. § 1.704-3(a)(3) (book value equals fair market value on the date of contribution).

51 These allocation methods are: traditional allocation per Reg. § 1.704-3(b); curative allocation per Reg. § 1.704-3(c); and remedial allocation per Reg. § 1.704-3(d).

52 It is not apparent how guidance derived from the CSA regulations would apply to assets other than intangible property, except perhaps as part of an aggregate analysis.
benefit ("RAB") shares. Each participant bears its share of intangible development costs ("IDC") in proportion to its RAB share. If the RAB shares change over time, expense allocations may be modified accordingly. Under Regulation section 1.482-7(i), the Commissioner may also adjust RAB shares under certain circumstances.

Each controlled participant in a CSA commits to pay, and must in fact pay, arm's length consideration for PCTs made by other controlled participants. If a controlled participant makes a platform contribution (viz., any resource, capability or right relevant to the intangible development activity), all other controlled participants must make arm’s length PCT payments.\(^{53}\) As a result of bearing intangible development costs in accordance with its RAB share, and making arm’s length PCT payments for contributions by other participants, each participant receives a proportionate interest in the intangible property covered by the CSA. We recognize that activities similar to those under a CSA may take place in a controlled partnership – indeed, the potential that taxpayers may engage in such transactions is in part the impetus for T.D. 9738. However, except in the case of contributions of less-than-fully-developed intangible property, or property that is subject to modification or enhancement after contribution, it is not apparent that the basic CSA paradigm can be reliably applied to the range of fact patterns that may be encountered.

In addition, we reiterate our concern that the CSA/PCT approach appears to be fundamentally inconsistent with the traditional concept of built-in gain in Subchapter K and Subchapter S.\(^{54}\) Although it is not possible to comment in detail until more specific section 482 guidance is issued in this regard, we foresee a likelihood of conflict between the two sets of rules, assuming that Treasury and the Service seek to extend the principles applicable to CSAs to controlled transfers of property to partnerships with non-U.S. partners.

E. Documentation Provisions for Contributions to Controlled Partnerships

Notice 2015-54 requested comments on whether the documentation provisions in Regulation section 1.6662-6(d)(2)(iii) should incorporate requirements for transactions involving partnerships.\(^{55}\) On the whole, the Notice accurately describes the existing provisions regarding documentation, although in our view the reference to documentation "requirements" is potentially confusing.\(^{56}\) A taxpayer that meets the documentation "requirements" is in compliance with section 6662(e), which permits the taxpayer to avoid penalties in the event that a section 482 allocation is made and additional tax is assessed in excess of certain threshold amounts. In other respects, however, a taxpayer is generally not "required" to prepare any documentation. In other words, a taxpayer that declines to prepare documentation is potentially

\(^{53}\) See Reg. § 1.482-7(e).

\(^{54}\) See also I.R.C. § 1374.


\(^{56}\) It is not clear that I.R.C. § 6662(e) would apply to an application of section 482 that is based on override of nonrecognition treatment. To the extent that an adjustment rests on that aspect of section 482, documentation is likely irrelevant.
subject to penalties in the event of an adjustment by the Service, but faces no other consequences.

In contrast, the situation with regard to cost sharing is different. In cases involving CSAs, the taxpayer is in effect directed to prepare and maintain certain documentation items, lest the underlying agreement fail to qualify as a CSA. In that specific context, if a taxpayer fails to prepare the listed documentation items and provide them to the Service on a timely basis, it faces the risk that, in addition to penalties, the CSA will be ineligible for treatment under Regulation section 1.482-7.

In our view, an enhanced documentation provision of the type in Regulation section 1.482-7(k)(2)(ii) should not apply to contributions to partnerships, because it would not be appropriate to require immediate gain recognition in connection with a partnership contribution due to a failure to comply with documentation provisions alone. Rather, any regulations adopted in this area should align with general documentation concepts in the transfer pricing area.

In addition, any new documentation provisions in this area should be adopted in a phased manner. A taxpayer complies with section 6662(e) and the regulations by showing that it reasonably selected and applied a specified or unspecified transfer pricing method to determine the arm's length result. As evident in Notice 2015-54, no specified or unspecified transfer pricing methods exist at present with respect to contributions to controlled partnerships. We believe that it would be advisable to flesh out the transfer pricing methods and additional guidance concerning their application before attempting to develop additional or specific documentation rules for this category of transactions.

III. TECHNICAL COMMENTS ON NOTICE 2015-54

A. Coordination with Code Provisions and Other Guidance

The possibility that a controlled partnership will be subject to both the substantive rules of Subchapter K and new, specialized rules to be issued under section 482 creates a likelihood of conflict and confusion. At a minimum, a strong coordination rule is needed to indicate when and how the new section 482 guidance will apply.

We note the provision in the section 482 regulations that addresses arm's-length interest charges as possibly instructive regarding coordination. Under those rules, an amount charged by controlled parties as "interest" is first analyzed by applying judicial principles, such as debt vs. equity, as well as applicable Code-based rules other than section 482. The coordination rule in these regulations clearly delimits the role of section 482 with respect to interest charges between

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57 See Reg. § 1.482-7(k)(2)(ii). The only exceptions are: (1) description of the taxpayer's overall structure; and (2) general index of principal and background documents. Reg. § 1.6662-6(d)(2)(iii)(C).

58 Reg. § 1.482-2(a).
controlled parties.\textsuperscript{59} Thus, section 482 applies only to \textit{bona fide} debt, as determined under case law and Code provisions. Thereafter, substantive provisions of the Code that directly concern interest payments, including section 467, 483, 1274 and 7872 are applied. Then and only then is section 482 applied to evaluate whether the interest charge between the controlled parties is consistent with the arm's length standard.

We believe that a similar coordination or sequencing rule would be appropriate here. As Notice 2015-54 points out, section 482 already plays a role regarding partnership allocations – a role that Treasury and the Service intend to expand materially.\textsuperscript{60} Taxpayers and Service examiners will need clear guidance concerning which of these complex rules they should apply first, and which rules take precedence over the others in the event of conflicts.

\section*{B. Statute of Limitations Considerations and Triggering Events}

Section 5.02 of the Notice states:

\begin{quote}
When intangible property within the meaning of section 936(h)(3)(B) is contributed to a partnership, the IRS may consider making periodic adjustments under \S 1.482-4(f)(2) in years subsequent to the contribution, without regard to whether the taxable year of the original transfer remains open for statute of limitations purposes.\textsuperscript{61}
\end{quote}

In our view, the notion that the statute of limitations can remain open supposedly indefinitely is troubling. On its face, this statement directly conflicts with the approach under Subchapter K, which evaluates the fair market value of property as of the date of contribution. Any subsequent developments that may increase (or reduce) the value of the intangible property are irrelevant under Subchapter K.

An “acceleration event” is defined in the Notice as:

\begin{quote}
any transaction that either would reduce the amount of remaining Built-in Gain that a U.S. transferor would recognize under the Gain Deferral Method if the transaction had not occurred or could defer the recognition of the Built-in-Gain.\textsuperscript{62}
\end{quote}

\textsuperscript{59} See \textit{Reg}. \S 1.482-2(a)(3).

\textsuperscript{60} See 2015-34 I.R.B. 210 at \S 2.02, citing \textit{Reg}. \S 1.704-1(b)(1)(iii), which references section 482.

\textsuperscript{61} This provision is in addition to a separate requirement that the taxpayer keep the statute of limitations open for eight years after the year of the initial transfer, in order to qualify for the Gain Deferral Method. The Notice indicates that if the original contribution was subject to nonrecognition treatment under I.R.C. \S 721(a), a subsequent change in foreign ownership that brings the partnership within the scope of I.R.C. \S 721(c) would keep the statute of limitations open. This implies that, in some cases, an adjustment could be made even after the statute of limitations for assessment has expired.

\textsuperscript{62} 2015-34 I.R.B. 210 at \S 4.05(1).
As a result, gain recognition could be triggered by relatively routine events, such as a change in the foreign jurisdiction in which the partnership is located, or a technical termination of the partnership. For items like intangible property that have a 15-year amortization period, gain recognition under the remedial allocation rules would be spread over a 15-year period. Most businesses would face one or more acceleration events over such a long period. To subject the contributing partner to immediate gain recognition due to an event such as a technical termination seems inconsistent with the purpose of the Notice. The underlying goal of the Notice, after all, is to prevent built-in gain from being allocated to a foreign partner when the contributing partner or other partners remain active in the partnership.

For present purposes, we assume that the regulations will specify certain triggering events that allow the Service to make an adjustment under section 482. Conversely, taxpayers should be given an opportunity to show that they qualify for the Gain Deferral Method, notwithstanding the occurrence of a routine event, such as a technical termination. In short, the regulations should make provision for events that are likely to occur in the ordinary course of business, but pose minimal risk that built-in gain will be shifted from the contributing partner.

C. A Section 482 Allocation with Regard to the Initial Contribution Should not Disqualify the Taxpayer from Using the Gain Deferral Method

Section 4.02 of Notice 2015-54 states that Treasury and the Service intend to issue regulations that eliminate non-recognition treatment under section 721(a) in any case where the Gain Deferral Method is not used to determine the recognition and allocation of built-in gain attributable to section 721(c) property. The Notice defines “built-in gain” as the excess of the section 704(b) book value of the property over its adjusted tax basis. Furthermore, the regulations will apply certain provisions of the section 482 regulations to determine partnership interests, including, by implication, the section 704(b) book value. This suggests that a section 482 allocation may be made that alters the value of the original partnership contribution.

Because section 4.05(1) defines an acceleration event as any event that reduces the amount of built-in gain in the United States, a section 482 allocation that increases the amount of built-in gain attributable to a U.S. Transferor might be interpreted as resulting in a failure to apply the Gain Deferral Method to all built-in gain, potentially disqualifying the transfer. In our view, such a result is unduly harsh and apparently not intended. Disputes regarding the arm's length consideration for transfers of intangible property have become increasingly common. Under the circumstances, one cannot discount the possibility that the Service might make a section 482 allocation with regard to valuation of a partnership contribution. The mere fact that such an allocation is made should not disqualify the partnership from nonrecognition treatment.

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63 Id. at §4.01(2).

64 Id. at § 5.01. See also id. at § 4.07, Example 1.
D. To the Extent Possible, Rulemaking in this Area Should Take into Account the Behavior Observed Among Uncontrolled Parties

The Notice indicates that “the regulations will provide periodic adjustment rules that are based on the principles of §1.482-7(i)(6) for controlled transactions involving partnerships.”65 In developing guidance in this area, the behavior of uncontrolled parties that engage in similar contributions to partnerships may be instructive. After all, uncontrolled parties that enter into a partnership arrangement often value their partnership interests and establish initial capital accounts by reference to valuations that, in many cases, are uncertain. These valuations and the resulting allocations of partnership interests govern the allocation of income and deductions to each partner over the life of the partnership. Unless a specific “earn-out” provision is in place, an uncontrolled partner would not intend that the initial valuation of intangible property be revisited because the actual income produced by that property in subsequent years departed from the initial projections.

The CSA regulations provide a relatively complex set of calculations to evaluate whether the results reported by the CSA participants are consistent with the commensurate with income provision.66 If these calculations show that the ex post returns generated by the CSA participants deviate materially from the ex ante projections, the Commissioner may require that income be reported based on the actual results, assuming that none of the enumerated commensurate with income exceptions apply.

We question whether, as an empirical matter, an uncontrolled seller can force an uncontrolled buyer to pay more for an intangible asset if the returns that such buyer obtains from the intangible asset are more than 150% of its investment. In our view, the evidence strongly suggests that uncontrolled buyers sometimes obtain more than 150% percent of their investment and are not forced to pay more than their original ex ante price.67

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65 Id. at 26.

66 Reg. § 1.482-7(i)(6). If the PCT Payor’s Actually Experienced Return Ratio (AERR) with respect to its profits from exploitation of cost shared intangibles is outside the Periodic Return Ratio Range with respect to such profits (that is, if its AERR is less than 66.7% or more than 150% of the PCT Payor’s Present Value of Total Profits (PVTP) divided by the Present Value of Investment (PVI)), the Service can make periodic adjustments to the PCT Payments (with respect to the platform contribution made by the PCT Payee for development of such cost shared intangibles) to conform with the actually experienced profits of the PCT Payor.

67 For example, in 2009, Cisco paid $590 million in stock for Pure Digital, the maker of the super popular Flip Cam. http://www.cnet.com/news/cisco-buys-flip-video-maker-for-590-million/. Venture capital investors had originally put $95 million into Pure Digital when it was a start-up company; thus, making the reasonable assumption that the venture capitalists controlled somewhere between 50% to 80% of Pure Digital (a typical amount of control for a venture capital investor) this means that these investors made somewhere between a 400% to 500% return on their original investment. http://avc.com/2009/03/what-is-a-good-venture-return/. They of course were not forced to give everything over 150% of their investment to the original owners of the start-up (the people from whom they bought the shares in the start-up). This kind of “5x return” is considered routine for venture capital investors. In fact, many venture capital investors would consider a return of 3x or less “a dud.” Id. As another example, in 2008, Emergence Capital Partners made a $4 million investment in Veeva Systems Inc., a startup-company that developed cloud software to help pharmaceutical companies manage their sales operations. http://www.bloomberg.com/news/articles/2013-10-16/veeva-ipo-generates-300-fold-return-for-emergence-capital-1. After Veeva’s initial public offering (IPO), the company was valued at

(cont’d)
Conversely, there are many examples of venture capital investors losing millions of dollars on risky ventures.\textsuperscript{68} Each year buyers write-down/write-off hundreds of millions of dollars in impairment of assets (typically goodwill) previously acquired\textsuperscript{69}, and except where an “earn-out” provision applies, sellers are not obligated to refund (and do not in fact refund) any of the purchase price, even where fraud is alleged.\textsuperscript{70}

It is questionable whether any empirical evidence directly supports the rule in Regulation section 1.482-7(i)(6).\textsuperscript{71} It is not clear that whether this rule in its present form, if required to be tested against arrangements involving unrelated parties, would survive scrutiny under the \textit{State Farm}\textsuperscript{72} standard. Accordingly, Treasury and the Service should decline to extend this rule (and potentially other rules lacking empirical support)\textsuperscript{73} to the partnership context.

E. Rules Should Distinguish Between Controlled and Noncontrolled Partnerships

The Notice does not clearly state how Treasury and the Service propose to treat a partnership that has both controlled and uncontrolled parties as partners. In our view, if an uncontrolled partner holds a more than \textit{de minimis} partnership interest, that constitutes strong evidence that the partnership allocations adopted by the parties are consistent with the arm's length standard and should not be subject to further analysis under section 482. The section 482 regulations give the Service authority to disregard certain uncontrolled transactions that are artificial or self-serving, in the sense that they are intended to establish an arm's length result for the transaction.\textsuperscript{74} Subject to this authority to disregard artificial transactions, the regulations should consider excluding from the scope of the new guidance any partnership in which an uncontrolled party has more than a 20% interest in the non-U.S. partnership.

\begin{itemize}
\item \textit{(cont’d from previous page)}
\item $4.4$ billion. \textit{Id.} Thus, after the IPO, Emergence Capital owned a stake that was worth more than $1.2$ billion, a 300-fold return on its original investment. \textit{Id.}
\item Most recent and most notable is the case of Solendrya, in which investors, including the Federal Government, lost more than one billion dollars, and received no subsequent compensation or refund based on \textit{ex ante} projections or contractual company promises.
\item \textit{See generally} Duff and Phelps, Financial Executives Research Foundation, U.S. Goodwill Impairment Study.
\item \textit{Id.}
\item For example, it is unclear whether the requirement in Reg. § 1.482-7(g)(2)(x) (i.e., all PCT payments must be grossed up to pre-tax value) is consistent with the behavior of uncontrolled parties that engage in similar transactions.
\item \textit{Id.}
\end{itemize}
IV. CONCLUSION

On behalf of the Transfer Pricing Committee of the ABA Tax Section, we appreciate the opportunity to submit these comments concerning section 482 issues in connection with Notice 2015-54. We would be glad to discuss any of these Comments in more detail at your convenience.