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Memorandum

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subject: Application of Treas. Reg. § 1.701-2(e) to Section 367(d) Avoidance Transaction

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ISSUES

1. Section 367(d) and the regulations thereunder provide that a U.S. person that transfers intangible property to a foreign corporation in an exchange described in section 351 or section 361 must recognize income with respect to the property either annually over the property's useful life (general rule) or immediately upon the direct or indirect disposition of the property (disposition rule). Taxpayer's reporting, if allowed, permits a U.S. partnership to recognize income under the general rule and allocate the annual inclusion to partners not subject to U.S. tax. Does the Commissioner have the authority under Treas. Reg. § 1.701-2(e) to treat a domestic partnership, which purports to succeed to the section 367(d) annual inclusion, as an aggregate in order to carry out the purposes of section 367(d)?

2. Section 7701(a)(4) defines a domestic partnership as a partnership created or organized in the United States or under the law of the United States or any state, except as provided in regulations or "where manifestly incompatible with the intent" of the Code. See section 7701(a) (introductory language). A "related U.S. person" may succeed to the annual general rule inclusion in some

circumstances. Is it manifestly incompatible with the intent of Treas. Reg. § 1.367(d)-1T(e) to apply the definition in section 7701(a)(4) to treat a partnership as domestic when the partnership that are not subject to U.S. tax?

CONCLUSIONS

1. Yes, the Commissioner may assert his authority under Treas. Reg. § 1.701-2(e) to treat the partnership as an aggregate of its partners because treating the partnership as an aggregate is appropriate to carry out the purposes of section 367(d). Furthermore, the limitation in Treas. Reg. § 1.701-2(e)(2) does not apply.

2. Yes, treating an partnership as a related U.S. person and thus permitting it to succeed to the section 367(d) annual inclusion is manifestly incompatible with the intent of section 367(d). Accordingly, the definition of a domestic partnership in section 7701(a)(4) is inapplicable. Without an applicable statutory definition, the better view is that a partnership is treated as for purposes of the successor rules in Treas. Reg. § 1.367(d)-1T(e).

FACTS

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LAW AND ANALYSIS

I. Section 367 Background

a. Origin of Section 367

Congress added the predecessor to section 367 to the Code in 1932 as section 112(k) in order to address what it perceived to be a "serious loophole" created by the application of existing nonrecognition provisions to both domestic and foreign corporations.[4]

Section 112(k) closed this loophole by requiring a U.S. transferor to recognize gain with respect to property transferred to a foreign corporation unless the taxpayer obtained a ruling that the exchange was not "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."[5] Congress updated the statute on numerous occasions in the following decades (including redesignating section 112 as section 367), but the basic framework and purpose remained unchanged: Transfers of appreciated assets to a foreign corporation were taxed unless the taxpayer could demonstrate that a principal purpose of the transfer was not the avoidance of tax.

[4] "Property may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for the avoidance of taxes. Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets." H. Rep. No. 708, 72nd Cong., 1st Sess., at 20 (1932).

[5] A letter ruling could be conditioned on the taxpayer agreeing to recognize gain with respect to certain transferred assets, allowing some flexibility for determining whether all or merely a portion of the transfer was principally tax-motivated.

b. The IRS Provides Guidelines for Outbound Transfer Rulings

The IRS and taxpayers relied on this case-by-case approach for each outbound transfer for decades. While acknowledging that whether one of the principal purposes of an outbound transfer was the avoidance of federal income tax requires a facts and circumstances analysis, the IRS issued Rev. Proc. 68-23 in 1968 to provide objective criteria and guidelines for obtaining a favorable ruling. See 1968-1 C.B. 821.[6] Although the statute did not distinguish between tangible property and IP at the time, Rev. Proc. 68-23 explicitly identified outbound transfers of IP to be exploited within the U.S. as a transaction presumed to have a principal purpose of avoiding federal income taxes.

While the revenue procedure provided additional guidance for a number of years, Congress substantially re-revised the ruling process in the Tax Reform Act of 1976, Pub. L. 94-455. The revisions were intended to provide greater taxpayer certainty and address special cases where the guidelines may not reach the appropriate result, although the legislative history noted general approval of the standards applied by the IRS. H. Rep. No. 658, 94th Cong., 1st Sess., at 240 (1975). To facilitate non-tax motivated business transactions, the Act provided that a favorable ruling could be obtained within 183 days after an outbound transfer; authorized Treasury to issue regulations governing ruling requests; and permitted taxpayers to challenge a denial of a ruling request.

c. Income Shifting Through IP Transfers to Possessions Corporations

Independent of the changes to the ruling process under section 367, Congress considered the unique challenges and potential for tax avoidance in the context of IP transfers to possessions corporations in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97–248. Congress has historically exempted certain corporations with significant possessions operations from U.S. tax, through either exemption or a credit under section 936. Under either section 931 (pre-1976) or section 936, the combination of a possessions exemption with incentives for research and development of IP provided an opportunity for tax planning: create IP in the United States while taking advantage of immediate expensing under then-section 174, and when the IP is ready for profitable exploitation, transfer it to a related possessions corporation where the proceeds can accumulate tax free. Taxpayers took advantage of this incentive, as illustrated by cases such as *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985) and *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987).[7]

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[6] Amplified by Rev. Proc. 75-29, 1975-1 C.B. 754; Rev. Proc. 76-20, 1976-1 C.B. 560; and Rev. Proc. 80-14, 1980-1 C.B. 617; obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388.

[7] In *Eli Lilly* the IRS attempted to use section 482 to reallocate profits attributable to two blockbuster pharmaceutical products, Darvon and Darvon-N, from a possessions subsidiary (Lilly PR) to its parent corporation, Eli Lilly. Both products were developed in the United States. *Eli Lilly* at 1007-108. In December 1966, Eli Lilly transferred to Lilly PR two patents and "manufacturing secrets and processes of

Without making specific reference to the *Eli Lilly* case, which was pending at the time, the Senate Report on TEFRA considered a hypothetical situation with remarkably similar facts:

> For instance, a U.S. pharmaceutical company may spend (and deduct or amortize and take a research and development tax credit for) large sums on research and development of new drugs. When it develops an effective drug, it may transfer the patent on the drug and the know-how to manufacture the drug to a section 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936 company might manufacture the drug and claim the extremely high profits which typically result from the sale of pharmaceutical products. It is the committee's understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all the unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g., patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to their developer (the U.S. parent), a distortion of income results, with the parent obtaining deductions for its efforts while the 936 company realizes tax-free income. S. Rep. No. 494, 97th Cong., 2d Sess., at 158 (1982).

Congress addressed the situation by adding section 936(h) to the Code to mitigate the "unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties." *Id.* at 157. The Senate Report further stated that "no legitimate policy is served by permitting tax-free generation of income related to intangibles created, developed or acquired in the United States or elsewhere outside of the possession." *Id*. at 159. Thus, new section 936(h) provided that income attributable to IP owned or leased by a possessions corporation must be allocated to the U.S. shareholders of the possessions corporation – in effect shifting the income back to the U.S. owner. Section 936(h) did not simply require gain recognition or mere recapture of previous tax benefits, but instead allocated the income attributable to the IP to the U.S. transferor – the developer of the IP. In two years, Congress would take the same approach when enacting modern section 367(d).

Eli Lilly relating to the manufacturing and formulation of its Darvon® product line within the United States and Puerto Rico." *Id.* at 1031-32. At the time of the transfer, it was clear "that the Darvon product line was an extraordinarily successful product line" and "had a substantial intangible value." *Id.* at 1059. Following the transfer, the Darvon and Darvon-N products were manufactured exclusively by Lilly PR, which sold products to Eli Lilly for marketing and distribution in the United States. *Id.* at 1108. The IRS challenged the pricing of the sales to allocate additional income to Eli Lilly. Even after the section 482 adjustment, however, a relatively small portion of the income attributable to the transferred intangibles' value would be subject to U.S. tax.

d. Congress Repeals the Section 367 Ruling Requirement and Enacts Modern Section 367(d)

Congress once again addressed outbound transfers of property in the Deficit Reduction Act of 1984 (DEFRA), Pub. L. 98-369. In the years following the dramatic changes to the ruling requirements brought by the Tax Reform Act of 1976, numerous taxpayers challenged ruling denials through the declaratory judgment procedures Congress provided. Instead of providing the intended certainty to the ruling process, the *ad hoc* ruling process and declaratory judgment procedures resulted in protracted controversy. See, e.g., *Dittler Brothers v. Commissioner*, 72 T.C. 869 (1979), aff'd, 642 F.2d 1211 (5th Cir. 1981); *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325 (1981).

While retaining the policy of taxing certain outbound transfers of appreciated assets, DEFRA dramatically changed the structure of section 367. The requirement to obtain a favorable ruling was removed entirely and the purpose-based test replaced with a general rule imposing tax with specified exceptions. For example, section 367(a)(3) provided that certain property used in the active conduct of a trade or business conducted outside the United States may be transferred to a foreign corporation tax-free (ATB exception). However, Congress also identified certain tainted assets which could never be transferred tax-free under the ATB exception: inventory, receivables, foreign currency, lessor property, and IP. See section 367(a)(3)(B).

Congress was concerned that "specific and unique problems exist" with respect to outbound transfers of intangible property. S. Rep. No. 169, 98th Cong., 2d Sess., at 360 (1984); H. Rep. No. 432, 98th Cong., 2d Sess., at 1315 (1984). Congress identified problems as arising when "transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible." *Id*. After considering a similar issue in the possessions context only two years earlier and in light of ongoing litigation, Congress was concerned with the potential for tax avoidance through transfers of intangibles – often developed with the benefit of special U.S. tax preferences – to a related party not subject to current U.S. tax. In addition to treating IP as a tainted asset ineligible for the ATB exception, Congress added modern section 367(d) to the Code to provide a regime similar to section 936(h) for transfers of IP to foreign corporations.

e. Section 367(d) Mechanics

Section 367(d) provides the general framework for the taxation of certain outbound transfers of IP. Section 367(d)(1) provides that, except as provided in regulations, if a U.S. transferor transfers IP to a foreign corporation in an exchange described in section 351 or 361, section 367(d) applies rather than section 367(a).

Section 367(d)(2)(A) provides that a U.S. transferor that transfers IP subject to section 367(d) is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of the property. Specifically, the U.S. transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of the IP (general rule), or in the case of a disposition of the IP following such transfer (whether direct or indirect), at the time of the disposition (disposition rule). The amounts taken into account under either rule must be commensurate with the income attributable to the IP. Section 367(d)(2)(A) (flush language).

Section 367(d)(2)(A) can be viewed as containing, in effect, two operative provisions. The first provision, provided in section 367(d)(2)(A)(i), characterizes the transaction. It provides that despite nonrecognition treatment accorded under section 351 or 361, the U.S. transferor is treated as having sold the IP in exchange for contingent payments.

The second provision, provided in section 367(d)(2)(A)(ii), sets forth what amounts are required to be reported under the statute. It provides that the contingent payments that the U.S. transferor is treated as receiving pursuant to the first provision must be taken into account in one of two ways. The general rule of section 367(d)(2)(A)(ii)(I) provides that the U.S. transferor is treated as receiving amounts which reasonably reflect the amounts which would have been received annually over the useful life of the intangible property. The disposition rule of section 367(d)(2)(A)(ii)(II) then provides that, in the case of a direct or indirect disposition of the intangible property, the U.S. transferor is treated as receiving the amount that would have been received upon a disposition of such property. Thus, the disposition rule requires the U.S. transferor to recognize an amount based on the value of the intangible at the time of the disposition.

Under the disposition rule, the property is disposed of directly when, for example, the transferee foreign corporation disposes of the intangible property it received in the transaction. An indirect disposition occurs, for example, when the U.S. transferor disposes of the stock of the transferee foreign corporation. This is made clear in the legislative history:

> The conferees intend that disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor's interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor. The amount of U.S.-source ordinary income will depend on the value of the intangible at the time of the second transfer.[8]

[8] H. Rep. No. 98-861, 98th Cong., 2d Sess., at 955 (1984). Note that the special U.S. source rule was subsequently repealed in 1997. See footnote 4, *supra*.

Thus, under the disposition rule, if the U.S. transferor disposes of the stock of the transferee foreign corporation, the U.S. transferor must recognize an amount that reasonably reflects a lump-sum amount that would have been received at the time of the disposition.

The policy underlying the disposition rule is straightforward. It operates as a backstop to the general rule, ensuring that the U.S. transferor reports full compensation for the transferred intangible. The U.S. transferor can take into account the general rule amounts only so long as it continues to indirectly hold the intangible property by retaining its interest in the transferee foreign corporation. But if the intangible property is directly or indirectly disposed of, the U.S. transferor can no longer take into account the amounts required to be reported by the statute under the general rule. Thus, the disposition rule ensures that full compensation for the intangible is properly taken into account by the U.S. transferor.

As the example below illustrates, in some circumstances, it is possible to preserve the general rule amount even though the U.S. transferor can no longer take into account the amounts required to be reported by the statute .

In general, an indirect disposition occurs when the U.S. transferor subsequently disposes of the stock of the transferee. The exceptions in the regulations can be thought of as preserving the general rule inclusion when the U.S. transferor both retains nexus to the property and can take into account the annual inclusion for U.S. tax purposes. The regulations further provide that even if the U.S. transferor cannot take into account the inclusion, if the U.S. transferor transferred the transferee stock to a related person that can take into account the inclusion, such person may become a

successor to the inclusion.[9] In short, the disposition rule is triggered when the U.S. transferor or its domestic successor's connection to the property is severed.

II. The Partnership Anti-Abuse Rule

a. Background

Treasury and the IRS proposed the partnership anti-abuse rule in 1994 to clarify "the authority of the Commissioner of Internal Revenue to recast those transactions that exploit and misuse the provisions of subchapter K in an attempt to avoid tax." 59 FR 25,581, at 25,582. The proposed regulation included a single facts and circumstances test that permitted the Commissioner to recast a transaction as appropriate for federal tax purposes. *Id.* The final regulation divided the partnership anti-abuse rule into two distinct anti-abuse rules: the abuse of subchapter K rule in Treas. Reg. § 1.701-2(b) and the abuse of entity rule in Treas. Reg. § 1.701-2(e). The preamble explained that this change was intended to clarify whether the partnership anti-abuse rule is meant to prevent abuse of subchapter K provisions, or to prevent the use of subchapter K to circumvent the purpose of other Code provisions:

> The final regulation clarifies this aspect of the regulation by removing the clause from paragraph (a) and adding a new paragraph (e) to address inappropriate treatment of a partnership as an entity. Paragraph (e) confirms the Commissioner's authority to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the regulations thereunder. As stated in some comments, as well as under current law, the Commissioner's authority to treat a partnership as an aggregate of its partners is not dependent on the taxpayer's intent in structuring the transaction. However, the Commissioner may not treat the partnership as an aggregate of its partners under paragraph (e) to the extent that a provision of the Code or the regulations thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Underlying the promulgation of paragraph (e) is the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships.[10]

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[9] Some taxpayers may take the position that a related U.S. person that is not the subsequent transferee of the stock may succeed to the inclusions under the general rule (that is, the annual inclusion can "jump" across tiers or chains of related entities in order to find a U.S. person to recognize the charge and thus avoid the disposition rule). The Treasury Department and IRS have announced that regulations will be issued addressing the successor rules. Notice 2012-39, 2012-31 I.R.B. 95. Section 5 of the Notice provides that "[n]o inference is intended as to the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines."

[10] T.D. 8588, 1995-1 C.B. 111; 60 FR 23, at 25.

b. Application of Abuse of Entity Rule

As adopted in final regulations, the abuse of entity rule provides that, "The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder." Treas. Reg. § 1.701-2(e)(1). Here, the Commissioner is asserting the rule to carry out the purpose of section 367(d) by ensuring that the outbound transfer of IP is subject to U.S. tax.

However, the Commissioner cannot assert the abuse of entity rule if the limitation in Treas. Reg. § 1.701-2(e)(2) applies. This limitation on the application of the abuse of entity rule restricts the Commissioner's authority to apply aggregate treatment established through a two-prong test:

1. A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and
2. That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

i. Limitation Prong 1: Prescribed Entity Treatment

The first prong of the abuse of entity limitation requires that the Code or regulations prescribe the treatment of the partnership as an entity, in whole or in part. Treas. Reg. § 1.701-2(e)(2)(i). It is not clear if the treatment of a partnership as a related person in Treas. Reg. § 1.367(d)-1T(h)(1) is equivalent to prescribing entity treatment.[11] However, because the second prong of the limitation (discussed *infra*) is clearly not satisfied, it is unnecessary to resolve the question of whether "person" and "entity" are equivalent terms in the context of the partnership anti-abuse rule.

ii. Limitation Prong 2: Ultimate Tax Results

The second prong of the limitation is satisfied if, taking into account all the relevant facts and circumstances, the tax results of treating the partnership as an entity rather than an aggregate are clearly contemplated. There is no reasonable argument that section 367(d) or Treas. Reg. § 1.367(d)-1T(h) clearly contemplated the permanent, complete avoidance of U.S. tax with respect to an outbound transfer of IP under section 367(d). A review of the statutory language and related legislative history establishes that the statute and regulations do not contemplate the treatment and tax results that Taxpayer

[11] The standard in Treas. Reg. § 1.367(d)-1T(h)(1) provides a formulation for determining relatedness by reference to sections 267 and 707 that is utilized for a myriad of purposes. The regulations under section 367(d) do not contain substantive rules addressing partnerships as either an aggregate or entity, in contrast to regulations under section 367(a). See Treas. Reg. § 1.367(a)-1T(c)(3).

seeks to achieve. As discussed in Part I, there is a clear and indisputable policy driving the development of section 367 over almost a century: ensuring U.S. taxation of certain assets leaving U.S. taxing jurisdiction in a nonrecognition transaction.

Furthermore, with respect to an outbound transfer of an intangible asset, Congress was concerned with the "deferral of U.S. tax on the profits generated by the intangible." S. Rep. No. 169, 98th Cong., 2d Sess., at 360 (1984); H. Rep. No. 432, 98th Cong., 2d Sess., at 1315 (1984).

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Taxpayer's position purports to obtain tax results that are directly contrary to Congressional intent and the overarching purpose of the implementing regulations. Accordingly, the second prong of the limitation is not satisfied, and the Commissioner is not prevented from asserting the abuse of entity rule in Treas. Reg. § 1.701-2(e).

c. Application of Section 367(d)

Treasury Regulation § 1.367(d)-1T(e)(1) provides that if a U.S. person transfers IP in a transaction subject to section 367(d) and "within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor" then the related U.S. persons may succeed to the general rule inclusion.

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Treasury Regulation § 1.367(d)-1T(e)(3) provides that if a U.S. person transfers intangible property to a foreign corporation and the U.S. transferor later transfers stock of the transferee to one or more related foreign persons, then the U.S. transferor shall continue to include in income annually the general rule inclusions as if the subsequent transfer had not occurred.

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Paragraph (e)(3) only applies when each of the following steps occurs: (i) a U.S. person transfers intangible property to a foreign corporation in an exchange under sections 351 or 361; (ii) the U.S. transferor subsequently transfers the stock of the foreign corporation to one or more foreign persons related to the transferor; and (iii) the U.S. transferor continues to include in income the deemed royalty payments as if the stock transfer had not occurred. The steps in paragraph (e)(3) are simply a mechanical analysis,

III. LLC Is Not a Related U.S. Person

The disposition rule exception in Treas. Reg. § 1.367(d)-1T(e)(1) only applies if a U.S. transferor "subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor." For purposes of applying this rule, it is thus necessary to determine who is considered a U.S. person.[12] The regulations define the term "United States person" by reference to section 7701(a)(30), which lists a "domestic partnership" among other enumerated United States persons. Treas. Reg. § 1.367(a)-1(d)(1). The regulations provide a general cross-reference to section 7701 for definitions of the enumerated terms, but do not explicitly incorporate the definition of a "domestic partnership" in section 7701(a)(4). *Id.* So although the regulations define a U.S. person to include a domestic partnership, the regulations do not explicitly define what constitutes a domestic partnership. This stands in contrast to the regulations' approach to corporations, as Treas. Reg. § 1.367(a)-1(d)(2) defines a "foreign corporation" to have the same meaning as provided in section 7701(a)(3) and (5). Accordingly, the term "domestic partnership" as used in the regulations under section 367 is determined by reference to section 7701 generally.

[12] In order for the exception to apply, it must also be determined whether the U.S. person is related to the transferor. That analysis is omitted because in this case it is not disputed that
are related.

Section 7701 provides definitions for all purposes of the Code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." To the extent not manifestly incompatible with the Code, the term "domestic" is defined to mean "created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations." Section 7701(a)(4).

. Therefore, it must be determined if the definition is "manifestly incompatible" with the application of Treas. Reg. § 1.367(d)-1T(e)(1). *Pierre v. Commissioner*, 133 T.C. 24, 38 (2009) (Cohen, J., concurring) ("The language of the regulation requires a determination of which 'federal tax purposes' are implicated and whether a given purpose might be manifestly incompatible with the Internal Revenue Code.").

Taxpayer may argue that section 7701(a)(4) defines the term domestic with respect to a partnership "unless, in the case of a partnership, the Secretary provides otherwise by regulations." Here, no regulations have been issued treating although the Secretary has taken that approach in other contexts. See Notice 2010-41, 2010-1 C.B. 715 (announcing regulations to treat a partnership as foreign in certain circumstances inconsistent with the purposes of subpart F). Thus, under this interpretation of the limiting language in section 7701(a)(4), LLC is treated as because there are no regulations prescribing that it be treated as .

This argument implies that even if the section 7701(a)(4) definition of "domestic" is manifestly incompatible with the intent of the Code , it still applies unless and until the Secretary issues regulations otherwise. Such a construction contradicts the plain language of section 7701 and should be rejected. *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'") (internal citations omitted). The construction of section 7701 is clear — the enumerated definitions do not apply if they are "manifestly incompatible" with the intent of the Code. The statute presents a clear order to interpreting its provisions: First, determine whether the enumerated definition is manifestly incompatible with the intent of the Code. Only if the definition is not manifestly incompatible does it apply, including any incorporated limitations or exceptions. Thus, if the definition in section 7701(a)(4) is manifestly incompatible with the purposes of Treas. Reg. § 1.367(d)-1T(e)(1), then it simply does not apply in its entirety. The language authorizing regulations to treat
does not modify this result because it is rendered inapplicable by the introductory clause of section 7701.

Furthermore, it is well-established that two statutory provisions in a statute must be read in harmony. *Hibbs v. Winn*, 542 U.S. 88, 101 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant . . . ."). Here, the clear interpretation is that the Secretary may promulgate regulations adopting an alternative definition of in appropriate circumstances, including situations where treating as domestic is not manifestly incompatible with the purposes of the Code. The authorizing language in section 7701(a)(4) merely acknowledges that such situations are possible and provides authority to the Secretary to issue regulations as needed.

It thus must be determined if the definition in section 7701(a)(4) applies, which in turn requires an analysis of the federal tax purposes implicated and whether such a purpose is improperly undermined by the application of the section 7701 definition. As discussed in Part I, *supra*, the unequivocal purpose of section 367(d) is to address the specific and unique problems with respect to outbound transfers of IP by requiring the U.S. transferor to recognize income attributable to the IP, either over time or immediately in a lump sum (in the case of a disposition of the IP). The specific purpose implicated by Treas. Reg. § 1.367(d)-1T(e)(1) is to preserve the general rule inclusions if an appropriate related U.S. person is able to step into the shoes of the original transferor and recognize the income attributable to the IP. The rule merely acknowledges that a transfer to a related person does not change the ultimate economic ownership of the IP, and accordingly permits that related person to continue paying tax on the income. In effect, the successor rule preserves the inclusion when the substance of ownership is unaffected but the form is altered.

The substance of ownership, however, is affected when . The IP is no longer owned by taxpayers subject to U.S. tax. Section 701 (“A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in the separate or individual capacities.”[13]). Treating such a partnership as a successor to the general rule inclusion undermines Congressional intent and is manifestly incompatible with the purpose of preserving the general rule inclusion when a related U.S. person remains subject to tax on the income attributable to the IP. Because the definition in section 7701(a)(4) is manifestly incompatible and thus inapplicable, the better view is that

[13] As noted *infra*, . This analysis simply points out that even if , the transaction still fails to meet any of the disposition rule exceptions Treas. Reg. § 1.367(d)-1T(e).

, the disposition rule exception in Treas. Reg. § 1.367(d)-1T(e)(1) is inapplicable.

Treasury Regulation § 1.367(d)-1T(e)(3) provides that if a U.S. person transfers intangible property to a foreign corporation and the U.S. transferor later transfers stock of the transferee to one or more related foreign persons, then the U.S. transferor shall continue to include in income annually the general rule inclusions as if the subsequent transfer had not occurred. However, paragraph (e)(3) cannot apply to the present case because the U.S. transferor no longer exists:
. Therefore, the transferor cannot include a deemed royalty in income each year. The analysis is identical to that in Part II.e, *supra.*

As the regulations do not provide an exception to the disposition rule with respect to is required to recognize gain attributable to the transferred IP.

V. Summary

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First, the Commissioner has asserted his authority to treat in order to effectuate the purposes of section 367(d). The limitation restricting the Commissioner's authority does not apply because it only applies if, taking into account all relevant facts and circumstances, the ultimate tax results were clearly contemplated by the Code and regulations. There is no reasonable argument that the permanent avoidance of U.S. tax with respect to an outbound transfer of IP is contemplated by section 367(d) and the regulations thereunder. Over eighty years of legislative and administrative development make it clear that the exact opposite result was intended by Congress. Taxpayer's position plainly contradicts the clear purpose of section 367(d). Because are treated as owning the stock of USS directly.

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Second, the disposition rule exception taxpayer relies on in Treas. Reg. § 1.367(d)-1T(e)(1) only applies to the extent a related U.S. person is available to succeed to the general rule inclusion. Taxpayer relies on the definition of

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However, the definitions of section 7701 only apply to the extent they are not manifestly incompatible with the intent of the Code.
for purposes of the successor rules is manifestly incompatible with the intent of section 367(d) and the underlying regulations, and thus the definition in

section 7701 is not applicable.

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CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Rob Williams at (202) 317-6937 if you have any further questions.