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February 23, 2016

The Honorable Mark Mazur  
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The Honorable John Koskinen  
Commissioner  
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The Honorable William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
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Re: *Proposed Section 367 Regulations;  
Elimination of the Foreign Goodwill Exception*

Dear Messrs. Mazur, Koskinen and Wilkins:

The Tax Section of the New York Bar Association is submitting this comment letter<sup>1</sup> regarding the proposed regulations (the "Proposed Regulations")<sup>2</sup> under Sections 367(a) and (d) of the Internal Revenue Code of 1986, as amended (the "Code"), published on September 16, 2015, regarding the transfer of intangible property to foreign corporations. Among other things, these Proposed Regulations would eliminate the foreign goodwill exception of Reg. § 1.367(d)-1T(b), which has existed

<sup>1</sup> The principal author of this letter was David Hardy. A significant contribution was made by Charles Cope. Helpful comments were received from Kim Blanchard, Michael Schler, Stephen Shay, Peter Schuur, Peter Connors, Andy Braiterman, Philip Wagman, Yaron Reich, Richard Andersen, and Shu Phua. This letter reflects solely the view of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

<sup>2</sup> 80 Fed. Reg. 55568-83 (Sept. 16, 2015).

## FORMER CHAIRS OF SECTION:

for thirty years, and would subject this goodwill to the gain recognition rules otherwise applicable to assets transferred to a foreign corporation. The Proposed Rules eliminate the foreign goodwill exception out of a concern that the exception has been the subject of significant taxpayer abuse occasioned by the conceptual vagueness of “goodwill” and the administrative difficulties in auditing taxpayers’ valuation of goodwill.<sup>3</sup>

This letter considers the possibility of restricting the definition of foreign goodwill and going concern value to intangibles generated by activities outside the United States. Then consideration is given to how this foreign goodwill would be identified and valued. We suggest that if taxpayers are to become taxable on the incorporation of self-regenerating assets like foreign goodwill and foreign going concern value, Treasury may wish to consider restoring the 20-year useful life limit to any deemed royalty under Section 367(d). Finally, this letter describes potential exceptions to the proposed foreign goodwill recognition rules for some Section 351 transactions that are unlikely to have significant tax abuse potential.

## **1. Background**

The views expressed here are derived in significant part from a prior report,<sup>4</sup> which reached two fundamental conclusions that the Proposed Regulations did not adopt. First, the report concluded that the definition of intangibles contained in Section 936(h)(3)(B) of the Code does not include goodwill or going concern value. The report also concluded that the legislative history to Section 367(d) expressed a clear intention of the Congressional tax writing committees that foreign goodwill and foreign going concern value are not to be taxed on the incorporation of a foreign branch.

The Preamble to the Proposed Regulations notes that taxpayers viewing goodwill and going concern value as outside of the Section 936(h)(3)(B) definition conclude that transfers of these assets to a foreign corporation for use in an active trade or business outside the United States are eligible for nonrecognition under the active trade or business exception set forth in Section 367(a)(3). Other taxpayers have asserted that whether or not goodwill and going concern value are within the definition of Section 936(h)(3)(B) intangible property, the existing regulatory exception in Temp. Reg. § 1.367(d)-1T(b) for foreign goodwill and going concern

<sup>3</sup> See, e.g., T.A.M. 200907024 (Nov. 10, 2008). In this technical advice memorandum, a U.S. corporation incorporated its foreign branch conducting a delivery business utilizing a network of foreign commission agents and processes. The taxpayer claimed that 97% of its foreign branch assets represented foreign goodwill and foreign going concern value.

<sup>4</sup> N.Y. ST. BA. ASS’N, TAX SEC., *Report on Section 367(d)* (Oct. 12, 2010).

value allows these assets to enjoy nonrecognition without application of the gain recognition rule of 367(a) or the deemed royalty provisions of 367(d). The Preamble offers no guidance as to the correct reading of the regulations.

In the Preamble, some of that legislative history is set forth in detail, including language such as, “the Committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business.”<sup>5</sup> Further, each of the Senate Finance Committee and the House Ways and Means Committee “does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of U.S. tax system.”<sup>6</sup> Nonetheless, the Preamble states:

The Treasury and the IRS have concluded that the taxpayer positions and interpretations described in this section of the Preamble raise significant policy concerns and are inconsistent with the expectation, expressed in legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system ... The Treasury Department and the IRS ultimately determined, however, that such an approach [that might preserve the favorable treatment for foreign goodwill and going concern value] would be impracticable to administer. ... Given the amounts at stake, as long as foreign goodwill and going concern value are afforded favorable treatment, taxpayers will continue to have strong incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value however defined, and thereby erode the U.S. tax base.<sup>7</sup>

The Proposed Regulations implement this policy decision by eliminating the existing foreign goodwill exception in Temp. Reg. §1.367(d)-1T and restricting the active trade or business exception to tangible personal property and financial assets. Taxpayers are permitted under Prop. Reg. § 1.367(a)-1(b)(5) to apply either the current gain recognition rules under Section 367(a) or the deemed royalty rules under Section 367(d) to intangible assets the taxpayer considers not to be within the Section 936(h)(3)(B) definition (*i.e.*, goodwill or going concern value). The Proposed Regulations also eliminate the 20-year useful life limitation in Reg. § 1.367(d)-1T(c)(3) so that the Section 367(d) deemed royalty may continue indefinitely.<sup>8</sup>

<sup>5</sup> S. Pt. No. 98-169 Vol. I, at 364 (1984); H.R. Rep. No. 98-432, at 1319 (1984).

<sup>6</sup> S. Pt. No. 98-169 Vol. I, at 362 (1984); H.R. Rep. No. 98-432, at 1317 (1984).

<sup>7</sup> 80 Fed. Reg. 55568, 55571 (Sept. 16, 2015).

<sup>8</sup> Prop. Reg. § 1.367(d)-1(c)(3).

In the Preamble, the Treasury and the IRS declined to state whether goodwill and going concern value are within the definition of Section 936(h)(3)(B) intangible property. The Section 936(h)(3)(B) definition of intangible property, following “... invention, formula, process ... knowhow ... copyright, trademark, tradename ... franchise ... contract ... method, program ... campaign ... [or] customer list ...” adds “or any similar item.” The current Section 367 regulations state that “foreign goodwill and going concern value is the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued.” The Preamble suggests that the distinction between goodwill and other enumerated Section 936(h)(3)(B) intangibles can be difficult to conceptualize and even more difficult to value. However, the silence of the Treasury on whether it considers goodwill to be a Section 936 intangible and the electivity to treat goodwill as either subject to Section 367(a) or 367(d), will not make the issue disappear. Under the Proposed Regulations, many taxpayers may prefer to treat goodwill as a non-936 intangible in order to tax their foreign goodwill and going concern value under Section 367(a) (which lacks the “commensurate with income” language) and avoid the uncertainty of possible future adjustments to the contingent payments under the “commensurate with income” standard used in Section 367(d)<sup>9</sup> and 482.

Many tax practitioners may remain unconvinced that “any similar item” in Section 936(h)(3)(B) could embrace goodwill and going concern value. Tax practitioners do understand that a broad scope of foreign goodwill and foreign going concern value could become an avenue taxpayers would exploit to move profitable intangibles out of the U.S. taxing jurisdiction. All must acknowledge the correctness of the government’s position that significant differences in the tax treatment between goodwill and going concern value on the one hand, and other customer based intangibles on the other hand, seems a prescription for disagreement and potential litigation much like that which preceded the enactment of Section 197 of the Code. Nonetheless, we feel that the acceptance of the elimination of the foreign goodwill exception by taxpayers and by courts would be strengthened by the introduction of some limited exceptions designed to preserve nonrecognition of foreign goodwill in demonstrably non-abusive contexts.<sup>10</sup>

<sup>9</sup> Perhaps taxpayers affirmatively electing to have foreign goodwill taxed under Section 367(d) may assert that “commensurate with income” does not apply to these assets if the assets are electing treatment under Section 367(d) but are otherwise not Section 936 intangibles.

<sup>10</sup> See *Altera Corp. v. Comm’r*, 145 T.C. No. 3 (July 27, 2015). The decision invalidating regulations requiring the sharing of stock option expense in cost sharing transactions is very different from foreign goodwill. However, some might assert that the Altera reasoning might question a regulation justified by targeting abuse in situations where abuse is unlikely.

## 2. Foreign Goodwill Limitation

The difficulty in crafting a precise definition of goodwill and going concern value that isolates those assets from other identifiable Section 936(h)(3)(B) intangibles is clear. However, goodwill, as created by prior customer patronage,<sup>11</sup> is an asset created by prior income (not expense) and thus less likely to be an item susceptible to abuse. We believe that Congress generally intended for U.S. corporations to be able to incorporate their foreign branch activities without tax on their goodwill and going concern value, subject to the rules for foreign branch loss recapture under Section 367(a)(3)(C).

But we think that the goodwill and going concern component(s) of such branch assets should embrace only items “developed by” and resulting from the activities and assets of the foreign branch. Thus, customer loyalty to retail sites and personnel of a branch located in a foreign country represents foreign goodwill and ought to be permitted to be incorporated without tax. Customer loyalty emanating from international marketing campaigns and favorable product recognition leading to international acceptance of a particular product are not foreign branch goodwill even if a portion of the customer base is located in the branch’s foreign country. This type of international customer and product loyalty is not an attribute of the branch and should not emerge as foreign goodwill under the residual value method of identification discussed below.

Similarly, the local supply chain and logistics relationships of a branch, represent branch going concern value and should be able to be incorporated without tax. On the other hand, production processes, international supply chains, or logistics contracts that service a multi-national parent of the branch across borders, would not represent branch going concern value simply because the branch also employs those processes. This sort of international going concern value should not be eligible for the foreign going concern exception.<sup>12</sup>

The definition of foreign goodwill and going concern value in the existing regulations simply requires that the business operations be conducted outside the United States, and thereafter any associated goodwill and going concern value would be foreign goodwill and going concern value.<sup>13</sup> We think this definition could be modified to insert the word “generated by the assets, risk and functions managed by employees of the branch” in order to assure that

<sup>11</sup> See *Newark Morning Ledger v. United States*, 507 U.S. 546 (1993).

<sup>12</sup> See, e.g., T.A.M. 200907024. (Nov. 10, 2008). An international network of delivery contracts were Section 936 intangibles ineligible for the foreign going concern value exception. Perhaps the analysis would further suggest that if the network were going concern value, it was not unique the foreign branch being incorporated.

<sup>13</sup> See *Treas. Reg. § 1.367(a)-1T(d)(5)(iii)*.

international goodwill and international product loyalty and international going concern value owned by the U.S. parent cannot be attributed to the branch in connection with its corporation. The connection to activities of the branch could be fashioned from the existing definition of a foreign trade or business in Prop. Reg. §1.367(a)-2(d)(2).<sup>14</sup>

### **3. Valuation of Foreign Goodwill**

After separating goodwill and going concern value from other intangible assets, it is then necessary to separate the foreign component of those assets from their U.S. component. In many cases, we think that the foreign goodwill of the foreign branch can be evaluated with relative confidence by extrapolating from the branch profits and asset values being reported to the foreign country and to the United States. In the case of a foreign branch operating in a country with which the United States has a comprehensive tax treaty, the profits attributable to the branch would probably be determined after claiming deductions for international intangibles like products, trademarks and going concern value not unique to the local branch. And where such a branch has been filing income tax returns in the local jurisdictions for three or more years, the branch profits and branch transfer pricing would have been subject to audit by the foreign jurisdiction and by the Internal Revenue Service.

Under existing regulations, foreign goodwill has always been evaluated under a residual method.<sup>15</sup> Thus, the enterprise value of the foreign branch is determined based upon conventional multiples of cash flow (earnings before interest, tax, depreciation, and amortization or “EBITDA”), plus or minus net tangible and financial assets. The residual component of the net enterprise value is the amount remaining after all other tangible and intangible assets have been identified, evaluated and subtracted from the aggregate enterprise value. This enterprise value represents the total value of the assets being transferred on a branch incorporation, and the residual of the branch’s net enterprise value is the foreign branch’s goodwill and going concern value.

In the case of foreign branches operating in jurisdictions with whom United States enjoys a comprehensive income tax treaty, taxpayers will have been preparing income tax return subject to audit by two jurisdictions with opposing interests that will include the EBITDA information from which to calculate enterprise value, to identify other tangible and intangible assets, and to

<sup>14</sup> In the case of branches in the financial service industry, perhaps the standards contained in the active finance exception to Subpart F income contained in Section 954(h) might be helpful.

<sup>15</sup> Treas. Reg. § 1.367(a)-1T(d)(5)(iii).

identify and value the residual amount representing foreign goodwill. The Authorized OECD Approach (“AOA”) utilized by the Treasury in attributing profits to permanent establishment in recent U.S. tax treaties,<sup>16</sup> which would generate this EBITDA information, has received multilateral acceptance.<sup>17</sup> For U.S. taxpayers operating through a branch in a foreign jurisdiction and filing income tax returns in the branch jurisdiction for three or more years, the residual value of foreign goodwill would be ascertainable from the filed income tax returns. Taxpayers using this residual method to identify and calculate value of foreign goodwill would be able to substantiate a claim non-recognition for the incorporation of foreign goodwill and going concern value for which they have normal substantiation. For purposes of administrability, however, we suggest that goodwill and going concern value eligible for nonrecognition under Section 367(a)(3) be limited to an amount that does not exceed 25% of net enterprise value, unless a ruling is obtained as discussed below. The number 25% is used simply as a modest proportion of branch asset value being transferred upon incorporation, which we believe is likely to be attributable to branch goodwill or going concern value.

#### **4. Useful Life**

Proposed Regulation §1.367(d)–1(c)(3) would eliminate the 20-year maximum period for the deemed royalty under Section 367(d). We observe that goodwill and going concern value are continually self-regenerating assets. This may suggest a reason why Congress in 1984 might not have considered those assets to be susceptible to the deemed royalty over useful life imposed under Section 367(d).

However, if under the Proposed Regulations, the Section 367(d) royalty continues indefinitely, then taxpayers would potentially have deemed royalties from foreign goodwill and going concern value forever. This result would seem to impose a U.S. tax on assets not transferred in the original Section 351 incorporation transaction but generated subsequently. Because the asset is self-regenerating, the taxpayer would struggle to prove that the useful life of the transferred foreign goodwill or going concern value had been exhausted. For this reason, we strongly urge the Treasury to consider reinstating the 20-year maximum life. While this provision may not be tied to the actual life of a particular asset, it introduces an administrative finality that captures all of the asset’s present value for most assets. This limitation helps to

<sup>16</sup> See Tax Treaties and Protocols with Belgium, German and Poland (to be ratified).

<sup>17</sup> Other methods currently used by the IRS to apportion intangible assets are also available to segregate foreign goodwill from U.S. goodwill. See, e.g., Reg. § 1.861–9T(h) (apportioning intangibles by net operating income before interest expense).

justify the elimination of the foreign goodwill exception. Although this rationale is applicable to foreign goodwill and going concern value and not to other intangibles, it may be advisable not to introduce a special rule for goodwill that might provoke taxpayer planning and abuse.

## 5. Exceptions

Assuming that the foreign goodwill and going concern value definition is modified as recommended above, we believe that a series of common factual situations involving foreign branch goodwill and going concern value could be excepted from the new provisions of the Proposed Regulations taxing the transfer of foreign goodwill. These exceptions would be limited to Section 351 transactions and not include other more complex Section 361 transactions.<sup>18</sup> Because the exceptions relate to transactions subject to Section 351, the exceptions would include transitions from disregarded entity status to corporation status pursuant to a U.S. check-the-box election under Regulation § 301.7701-3. All exceptions would require the taxpayer to have auditable proof of its goodwill, the value of the goodwill, and its foreign status. Some of these common exceptions are set forth below.

(a) *Professional Service Goodwill.* Among the simplest examples of branch incorporation where U.S. income tax abuse is not evident would be the incorporation of a foreign professional practice by a U.S. citizen. For example, some practitioners have suggested that many U.S. citizens may conduct professional practices in Canada or another country as a sole practitioner or in partnership with other practitioners. These persons may decide for liability reasons to incorporate their own individual practice or potentially to join in the incorporation of a professional practice. In either case, the U.S. citizen would be considered to have participated in a Section 351 transaction with a foreign corporation. As a result, the goodwill value of the professional's foreign patient or client loyalty, would be subjected to tax either under Section 367(a) or Section 367(d). For such a professional practising in a foreign country under licensing required by that country, all customer goodwill is foreign (patients or clients will be resident in the jurisdiction of licensing). In these instances, there is no question that the foreign patient or client loyalty and foreign goodwill relates exclusively to professional services performed in the foreign country through the branch.

<sup>18</sup> Section 361 applies to mergers and asset reorganizations, among other things, that involve multiple parties. Such transactions will have complexities that make the identification and valuation of foreign goodwill more difficult. For this reason, we suggest the foreign goodwill exception be limited to Section 351 transactions.



We therefore suggest that an exception be provided for the incorporation of foreign professional practices. The professional service exception should not be limited to 25% of enterprise value, since professional practice goodwill is likely to constitute substantially the entire value of the practice. This same exception could be applied to lawyers, architects, engineers and actuaries. If local licensing existed it might also apply to investment managers and other financial consultants.

(b) *Regulatory Incorporation.* Similarly, certain businesses have historically operated in other countries in branch form for regulatory reasons. As the regulatory environment evolves, these foreign branches may be newly permitted or required to incorporate. In circumstances where taxpayers are able to certify that their branch incorporation is the result of foreign regulatory changes permitting or requiring incorporation, we see the probability of U.S. tax abuse to have been greatly reduced.

Where the foreign branch would have been operating in the foreign jurisdiction for three or more years and filing income tax returns in the foreign jurisdiction, and if the foreign jurisdiction has substantial income tax rates and is a jurisdiction with which the United States has a comprehensive tax treaty, reliable audited tax data exists to identify and quantify foreign goodwill and going concern value. As discussed above, the prior income tax returns are all required to have been prepared as if the branch had dealt with its related parties and head office on an arm's-length basis. These prior tax returns could be expected to have segregated the international intangibles from the truly local branch goodwill and going concern value. The branch would normally claim deductions for the use of all tangible and intangible assets of the head office or affiliates.

Where a taxpayer is able to certify that the foreign branch incorporation is a result of regulatory change, and can show that the foreign branch goodwill and going concern value has a value of 25% of the branch enterprise value or less, the taxpayer should be permitted non-recognition treatment with respect to the incorporation of identified foreign goodwill and going concern value that it can substantiate.

(c) *Joint Venture Companies.* Many U.S. taxpayers operate in other jurisdictions through unincorporated joint ventures with unrelated foreign participants. Where the U.S. taxpayer's percentages of profit and capital are less than or equal to 50%, and the foreign venturers own an equal or larger share, the U.S. taxpayer would have a self-interested motivation and a fiduciary obligation to exercise care to segregate those intangible property rights of the U.S. taxpayer that it was permitting the foreign joint venture to utilize. For this purpose, we

suggest that the taxpayer be able to certify that the joint venture has substantial foreign ownership, that the joint venture conducts business outside the United States under a tradename different from that of the U.S. venturer, and that the organizational documents reserve the venturers' tradenames and goodwill to themselves. Such U.S. taxpayers participating in an incorporation of a foreign joint venture should be permitted to obtain nonrecognition for the joint venture's substantiated goodwill and going concern value, up to 25% of the U.S. taxpayer's interest in the enterprise value, where the joint venture has been filing income tax returns in the foreign jurisdiction for three or more years, where the foreign jurisdiction has a substantial tax rate and where the foreign jurisdiction has comprehensive income tax treaty with the United States.

*(d) Ruling Practice.* In the 1984 legislative history, Congress stated that notwithstanding the repeal of the prior mandatory Section 367 rulings, "Taxpayers ... who seek the certainty of tax treatment that a ruling provides may continue to request a ruling regarding the tax treatment of the transfer."<sup>19</sup> In this case of taxpayers desiring to establish these transfers of foreign goodwill and going concern value upon the incorporation of a foreign branch in amounts exceeding the limitations provided in the other available exceptions, they could apply for an Internal Revenue Service ruling as had occurred under pre-1984 Section 367 regulatory regime. The quoted statement regarding ruling certainty conveys the sensitivity Congress had to allowing taxpayers to achieve higher levels certainty, but only upon the presentation of the full factual record to the Internal Revenue Service.

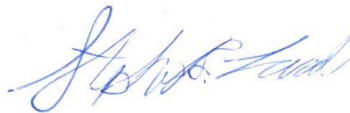
At the current time, the resource constraints imposed the Internal Revenue Service National Office have substantially diminished the ruling practice generally. However, the practice of advance pricing agreements offered to taxpayers prepared to pay the \$50,000 filing fees has grown as an increasingly well accepted approach to prospective certainty. We believe that this ruling (or pre-filing agreement) prospective certainty could be offered to taxpayers wishing to avoid recognition of foreign goodwill and going concern value, who were not otherwise eligible for the safe harbors described above. Like an advance pricing agreement, the IRS would entertain a ruling request as a matter of discretion but would not be mandated to deliver rulings in all situations.

<sup>19</sup> S. Prt. No. 98-169, Vol. I, at 369 (1984).

**6. Conclusion**

We recognize that the growing incentives of U.S. taxpayers to transfer intangible assets out of the U.S. taxing jurisdiction are emerging in many contexts. We understand that difficulties are imposed upon the IRS in administering the existing foreign goodwill and going concern value exceptions in the current regulations. We are concerned, however, that the complete elimination of the foreign goodwill exception by regulatory action alone may lead to disputes and litigation that could make the work of the IRS even more difficult. For these reasons we submit the suggestions for certain limited exceptions set forth above. We would be pleased to assist in the development of these suggestions, if appropriate.

Yours very truly,



Stephen Land, Chair

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