NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 367(d)

October 12, 2010

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Report No. 1222

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 367(d)[1]

PART A: INTRODUCTION

Section 367(d) of the Internal Revenue Code of 1986, as amended (the "Code"), occupies an awkward position within Section 367, serving both as a limitation on the application of the tax-free incorporation and reorganization provisions of Subchapter C in the international context and as a mechanism to impose an exit tax on certain appreciated property leaving the taxing jurisdiction of the United States.[2] In the context of outbound transfers of assets by U.S. taxpayers, Section 367 generally limits the applicability of the tax-free incorporation and reorganization provisions to transactions that are outbound transfers of property to be used in an active foreign trade or business, distinguishing these transactions from transactions structured to avoid U.S. tax on appreciated assets.[3] Assets transferred by a U.S. person to a foreign corporation other than for use in an active foreign trade or business are denied tax-free treatment, and the transferring U.S. person is subject to current tax on realized gains on the transfer of such assets. By contrast, Section 367(d), as interpreted by the temporary U.S. Treasury regulations

[1] The principal draftsperson of this report was David R. Hardy, with substantial assistance from Charles W. Cope, Philip Tretiak, Peter Blessing, Kevin Colan and Paul Seraganian. Contributions and helpful comments were received from Kimberly Blanchard, Diana Wollman, Michael Schler, Andy Braiterman, Tom Zollo, Eric Sloan, William Corcoran, Yaron Reich, Peter Conors, Stephen Land, Charles Kingson and Andrew Needham.

[2] Unless otherwise indicated, all references to Sections are to sections of the Code or the Treasury Regulations thereunder.

[3] Section 367(a)(2) contains an additional exception under which tax-free treatment is extended to certain transfers of stock or securities of a foreign corporation which is party to the exchange or reorganization. This exception is generally not directly relevant to this discussion of Section 367(d) and is not discussed herein.

promulgated thereunder (the "Temporary Section 367(d) Regulations"), makes the outbound transfer of certain enumerated intangible assets taxable effectively as a foreign-source stream of royalty payments paid over the useful life of the asset, adjusted based on the income earned on the assets.[4] Thus, Section 367(d) treatment is potentially worse than the denial of tax-free treatment under Section 367(a), because the Section 367(d) regime subjects the taxpayer to ordinary income treatment without basis offset over an extended period of time based on the income earned on the asset.

A number of factors make it timely to revisit the scope and application of Section 367(d). First, the Internal Revenue Service ("IRS") has indicated that it plans to issue new Section 367(d) guidance.[5] Second, the Temporary Section 367(d) Regulations have outlived the conventional life of temporary regulations and do not reflect significant changes to Section 367(d) that have occurred since their promulgation, including the addition of the "commensurate with income" standard.[6] Third, as more U.S. corporations adopt global business models and as the value of intangible property exported from the United States continues to grow, the rules applicable to outbound transfers of intangible property are rules of increasing significance. Fourth, in recent high-stakes disputes, the IRS and taxpayers have argued about the scope of the "foreign goodwill and going concern value" exception to Section 367(d) currently reflected in the Temporary Section 367(d) Regulations.[7] Finally, the Obama administration's revenue

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[4] The Temporary Section 367(d) Regulations were first promulgated in temporary form by Treasury Decision 8087 (May 15, 1986) and amended by Treasury Decision 8770 (June 18, 1998).

[5] *See, e.g.,* Lee A. Sheppard, "International Projects Coming to an IRS Business Plan Near You," 2009 TNT 119-3 (June 24, 2009) (comments of Michael DiFronzo, IRS deputy associate chief counsel (international)).

[6] Section 7805(e), effective for regulations issued more than ten days after Sept. 10, 1988, provides that temporary regulations expire three years after the date of issuance of such regulations.

[7] It has been suggested that the IRS desires to tighten Section 367(d) so that it is not available to permit taxpayers to avoid the new cost sharing regulations. *See*, e.g., IRS Coordinated Issue Paper on cost-sharing buy-in payments, LMSB -04-0907-62 ("Taxpayers often assert that substantial residual intangible value associated with the right to exploit foreign markets may be made available to the CFC without giving rise to any buy-in obligation to the U.S.

proposals for fiscal years 2010 and 2011 include a proposal to "clarify" the definition of "intangible property" for purposes of Section 367(d) and Section 482 to include workforce-in-place, goodwill and going concern value, as well as certain other changes related to the calculation of the value of such intangibles.[8] The tension surrounding the adequacy of the U.S. rules limiting the outbound migration of U.S.-created intangible assets was highlighted in an extensive report regarding possible income shifting and transfer pricing prepared by the Joint Committee on Taxation, dated July 20, 2010,[9] and the accompanying remarks of Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, at a hearing before the House Ways and Means Committee on July 22, 2010.

This report considers the scope and application of Section 367(d) under current law, including which items are included in "intangible property" as defined in Section 936(h)(3)(B) ("Section 936 Intangibles") and incorporated in Sections 367(a)(3)(B)(iv) and 367(d)(1). This report will also consider the scope of the exception for "foreign goodwill and going concern value" under the Temporary Section 367(d) Regulations and the methods for valuing intangible property subject to Section 367(d). Finally, this report will consider a number of technical issues with the current application of Section 367(d), including basis mechanics, the duration of the Section 367(d) deemed payments, the election to treat certain transfers as lump-sum sales and the relationship between Section 367(d) and certain other Sections of the Code.

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group. Taxpayers may view this claim as consistent with the exclusion of "foreign goodwill or going concern value" in the section 367(d) regulations.").

[8] The Administration proposals are set forth in U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (May 2009) and U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals" (Feb. 2010) (together, the "Administration Proposals").

[9] Staff of the Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 (July 20, 2010) (the "JCT Income Shifting Report").

PART B: SUMMARY OF RECOMMENDATIONS

1. Parity between Sections 482 and 367(d)

In general, we believe that, as suggested by the Section 482 White Paper,[10] there should be reasonable parity in the income tax consequences of a deemed sale of a Section 936 Intangible under Section 367(d) and an actual sale of such intangible under the rules of Section 482 that govern a sale for contingent consideration. Section 367(d), like Section 482, imposes rules governing the taxation of certain transfers of Section 936 Intangibles. Both sections share the concept that income required to be recognized by the transferor must be "commensurate with income," which is designed to help ensure that the gain subject to tax on an outbound transfer of a Section 936 Intangible is based on the fair market value of the intangible at the time of transfer, a value that in theory should reflect the present value of all income that reasonably could be anticipated to be attributable to the intangible in the future as of that date. Treasury Regulation § 1.367(d)-1T(c) currently states that "[t]he appropriate charge shall be determined in accordance with the provisions of section 482 and regulations thereunder," but further clarification would be appropriate. For example, we recommend that the rules of Treasury Regulation § 1.482-4(f), which provide various circumstances in which no periodic adjustment is required to a royalty and safe harbors for arm's length lump-sum payments, be explicitly stated to apply, with such modifications as may be necessary (e.g., to reflect the fact that a royalty is reported for U.S. tax purposes rather than contractually agreed), to transfers described in Section 367(d).

The regulatory framework under Section 367(d) also should balance execution of Section 367(d)'s mechanics, imposing the deemed-sale-for-a-royalty consequences on the outbound

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[10] Notice 88-123, 1988-2 C.B. 458 ("The periodic adjustment of lump sum royalty or sale payments [under the Section 482 "commensurate with income" standard] would merely achieve parity with section 367(d) transfers.").

transfer of Section 936 Intangibles, with policies underlying Section 367(a)(3), which facilitate the tax-deferred transfers of active foreign businesses to foreign corporations. Except to the extent required by the statute, we recommend that the consequences of a deemed sale under Section 367(d) not be more onerous than would govern a sale for contingent consideration that would be governed by Section 482. To the extent that the deemed sale consequences under the Temporary Section 367(d) Regulations are less favorable or clear, taxpayers will be motivated to adopt taxable transfer structures, and to the extent the consequences are not required by the statute, that may frustrate the purpose of Section 367(a)(3).

2. **Scope of Section 367(d)**

(a) Definition of Section 936 Intangibles

We believe that Section 936(h)(3)(B) is the most appropriate definition to use for "intangible property" in the context of Section 367(d). With regard to the scope of that definition, Section 936(h)(3)(B) provides a list of 27 assets sharing certain common traits. We believe that "other similar assets" should be interpreted to describe assets that share common characteristics with the listed assets. We believe the listed items have two prominent common characteristics that should inform whether property is within the "other similar assets" category, that the property may be separately valued and that, at least theoretically, the property may be transferred separately from the business to which it relates. We would recommend that new Treasury regulations under Section 367(d) should also give consideration to court holdings, in cases such as Hospital Corp. of America, as to the scope of Section 367.

(b) Foreign Goodwill and Going Concern Value

A fair reading of the legislative history of Section 367(d) persuades us that Congress intended to permit the tax-free incorporation of foreign branches with associated goodwill and going concern value, except in cases where the branch had accumulated losses subject to recapture. This intention would be frustrated if the undifferentiated goodwill and going concern value of the branch's business were subjected to taxation under Section 367(d). We believe the better reading of section 936(h)(3)(B) is that it excludes goodwill and going concern value. Accordingly, in the absence of legislative intervention to establish otherwise, we recommend that Treasury regulations under Section 367(d) retain the statement in the Temporary Section 367(d) Regulations that "foreign goodwill and going concern value" are excluded from Section 367(d).

(c) Goodwill Limited to Residual Value

Temporary Section 367(d) Regulation § 1.367(a)-1T(d)(5)(iii) limits the scope of the foreign goodwill and going concern value exclusion from Section 367(d) to the residual value of the foreign business after subtraction of the value of all other identifiable tangible and intangible assets. This residual character of goodwill and going concern value permits the potential expansion of intangibles subject to Section 367(d) under the "any similar item" clause of Section 936(h)(3)(B) to the extent that separate and distinct items of intangible property may prove to exist. The status quo may produce a course of litigation that resembles the one that preceded the enactment of Section 197. On the other hand, the ability of the common law to craft outcomes appropriate for unforeseen situations is a strength that is well-suited to address the development of novel forms of intangibles and their manifestations in different contexts. Given the enormous significance of the scope of Section 936 Intangibles to transfer pricing issues in Section 367(d) and Section 482, a prospective legislative or regulatory resolution to this issue, to the extent feasible, while maintaining necessary flexibility, would be appropriate to provide clarity.

(d) Marketing Intangibles

The legislative history to Section 367(d) states that marketing intangibles associated with a foreign trade or business are not within the intended scope of Section 367(d). This conflicts with the Section 936(h)(3)(B) definition, which specifically enumerates certain items that would traditionally be thought of as marketing intangibles, such as trademarks, brand names and campaign and customers lists. We believe the language of the Senate Report and the JCT Report should be read as an invitation to Treasury and the IRS to exercise regulatory authority in a manner that would only apply Section 367(d) to marketing intangibles otherwise covered by Section 367(d) only if they are either not clearly associated solely with a foreign business or that have previously been the source of deductions have reduced U.S. income (*e.g.*, deductible expenses of a global marketing campaign).

(e) Scope of the Lump-Sum Sale Election

The lump-sum sale election provided in Treasury Regulation § 1.367(d)-1T(g)(2) currently applies only to the outbound transfer of operating intangibles, transfers required by foreign law and certain transfers to foreign joint ventures. We recommend that the election should be expanded to be available with respect to all transfers to uncontrolled corporations (including a 50-50 joint venture with an unrelated party) otherwise subject to Section 367(d). In a transaction subject to Section 367(d), where a U.S. person transfers a Section 936 Intangible to a foreign corporation not controlled by the U.S. transferor or related persons, the unrelated owners of the foreign corporation will demand arm's length pricing of the intangible. Further, the economic terms of the venture will likely not entitle the U.S. transferor to a return resembling the deemed Section 367(d) payments. In such situations, the results of applying Section 367(d) bear no relationship to the true income realization of the U.S. transferor on the transfer. An extension of the lump sum election to intangibles that under all reasonable circumstances would provide a low return might also be considered, as a matter of administrative convenience.

A minority of the members also believed that lump-sum sale elective treatment should be extended to transfers to controlled corporations. In the view of this minority, a transfer of Section 936 Intangibles to a controlled foreign corporation would be subject to the "commensurate with income" standard under Section 482, and, more specifically, Treasury Regulation § 1.482-4(f)(6), relating to the treatment of lump sum payments for intangibles under Section 482, and the application of the "commensurate with income" standard should ensure that the pricing of an elective sale transaction captures the value at the date of transfer of the intangible property.

If these proposals to substantially expand the lump-sum sale election under Treasury Regulation § 1.367(d)-1T(g)(2) are not adopted and some version of the current regulations is retained, we suggest that the joint venture election in the Temporary Section 367(d) Regulations be expanded.

(f) Administration Proposals

We believe that describing the Administration Proposal to include workforce-in-place, goodwill, and going concern value in the definition of intangible property for purposes of Section 367(d) as a clarification of existing law is not consistent with the legislative history of Section 367(d). As a result, we believe that if such proposal is enacted, it should be applied prospectively, as described in the Administration Proposals, and not be construed as authority for interpretation of prior law.

Further, we believe that the Administration Proposal to expand the definition of Section 936 Intangibles to apply to goodwill, going concern value and workforce-in-place effectively leaves the value of the entire business open and subject to annual adjustment during the period that the commensurate with income principle may be applied. We are unsure of the appropriateness of taxing post-transfer appreciation of goodwill and going concern value indefinitely, and suggest that the time period during which it can be applied be limited to, for example, five years with a decline in the percentage of appreciation in the residual value of the business that is subject to U.S. tax over that period.

(g) Coordination with Cost Sharing

We believe that platform contribution transactions (PCTs), i.e., the mere making of intangibles available to a cost sharing arrangement but not transferring them to a foreign corporation, are excluded from the scope of Section 367(d). Furthermore, we believe that transactions subject to Section 367(d) are excluded from the temporary cost sharing Treasury regulations, regardless of whether the assets subject to Section 367(d) are subsequently used as elements of a "platform contribution" by the foreign transferee counterparty in a qualifying cost sharing arrangement. Confirmation would be desirable.

3. **Valuation Issues**

(a) Aggregate Valuation

Where the value of a Section 936 Intangible is attributable to or substantially enhanced by that intangible property's relationship to other intangible property, that value could be considered to be attributable to the aggregate value of a group of Section 936 Intangibles, a separately identifiable Section 936 Intangible (*e.g.,* a "pattern," "franchise," "method," "program" or "system") or "goodwill or going concern value." Section 482 valuation methodologies (*e.g.,* Treasury Regulation § 1.482-1(f)(2)) should be applied, under Section 367(d). Aggregate valuation of Section 936 Intangibles is appropriate under Section 367(d) where it leads to a more reliable result, recognizing, however, that the language of Section 936 suggests that each separately identifiable Section 936 Intangible must constitute property and have value independent of the services of any individual. Valuations using an aggregation methodology should also be cognizant of distinguishing between value attributable to one or more Section 936 Intangibles and value more properly attributable to goodwill or going concern value, in order to preserve the exclusion for goodwill or going concern value that is an integral part of the Section 367(a)(3) active foreign business exception, except for periods if any for which the Administrative Proposals come into effect.

(b) <u>Foreign Versus Domestic Goodwill and Going Concern Value</u>

Where property related to domestic and foreign businesses are transferred as part of the same Section 367(d) transaction, it is necessary to identify whether any residual value of the transferred property in excess of the identifiable tangible and intangible assets is foreign goodwill, domestic goodwill or both. We recognize that many factors, which vary by business and by product or service, go into the creation of goodwill. A sourcing of goodwill based on particular facts is one potential method, but formulary methods may be appropriate in addition or in the alternative. A business is conducted at the location of its employees, physical assets and sales and the respective U.S. and foreign elements of a business's goodwill and going concern value could be allocated accordingly. Some portion of goodwill is created by advertising campaigns; therefore, where the advertising deductions are allocable may be an appropriate means to source goodwill in part. The aggregate value of the respective U.S. and foreign goodwill or going concern value transferred in such transaction could be determined based on the relative operating income attributable to the foreign and domestic businesses to which such goodwill or going concern value relates.

We suggest that a formulary approach be adopted (or approaches for specific industries) as a default rule for determining the value of foreign goodwill. We believe a taxpayer should be able to present an alternate valuation method if reasonably acceptable to the Service.

4. **Section 367(d) Mechanics**

(a) Calculation of Section 367(d) Deemed Payments

Treasury Regulations under Section 367(d) should clearly indicate that, for Section 367(d) transfers to controlled transferees, taxpayers are entitled to the same flexibility to prescribe the terms of the deemed annual Section 367(d) payments as taxpayers have with respect to contingent royalty payments under the provisions of Treasury Regulation § 1.482-4. The terminal income inclusion required under Section 367(d) following a disposition of the Section 936 Intangible to an unrelated person should be reduced to the extent the taxpayer can demonstrate that the value of the intangible property is attributable to improvements of the intangible subsequent the original transfer or unanticipated developments occurring after the original transfer.

(b) Basis Recovery

Consistent with treatment of the transfer as a sale, the U.S. transferor of a Section 936 Intangible should be permitted to recover its basis in the transferred intangible over the term of the deemed Section 367(d) payments. Any unrecovered basis remaining at the time of the disposition of the Section 936 Intangible by the foreign transferee should reduce the gain otherwise required to be included by the U.S. transferor on such disposition.

(c) Treatment of Boot and Section 367(d)

Neither the Code nor the Temporary Section 367(d) Regulations address the treatment of boot in outbound reorganizations in which Section 936 Intangibles are transferred. Consistent with the position taken in CCA 200610019 with respect to the transfer of intellectual property not eligible under Section 367(d) in a Section 351 exchange with boot, we recommend that Treasury regulations be promulgated that would reconcile the taxation of boot under the reorganization provisions with the taxation of the deemed Section 367(d) payments. We propose that taxpayers be required to allocate the amount of boot among all the assets transferred in such a reorganization and permit taxpayers to treat amounts so allocated to Section 936 Intangibles as a prepayment of the resulting deemed Section 367(d) payments.

(d) Transferee's Earnings and Profits and Basis in Assets

Consistent with the characterization of the deemed Section 367(d) transaction as a sale, the foreign transferee should not be able to amortize the transferor's basis in the Section 936 Intangible. The only earnings and profits impact of the deemed Section 367(d) transaction on the foreign transferee should be the reduction in earnings and profits by the amount of the Section 367(d) payments provided in Section 367(d)(2)(B).

(e) Useful Life of Intangibles

We suggest that the IRS retain the twenty-year maximum useful life over which deemed Section 367(d) payments must be included. A maximum useful life reduces compliance burdens without significantly decreasing the capture of income intended to be captured by Section 367(d). Further, under Temporary Treasury Regulation § 1.367(d)-1T(e)(2)(iii), on a transfer of the transferee foreign corporation stock by the transferor to a related U.S. person, the related person is deemed to have held a portion of the intangible property and then contributed it to the foreign corporation in a transaction subject to Section 367(d). We believe that it should be clarified that this deemed transfer does not reset the useful life of the intangible property in question.

5. **Indirect Disposition of Intangibles**

The Temporary Section 367(d) Regulations as drafted ensure that, following a U.S. transferor going out of existence pursuant to a transaction that involved a transfer of Section 936 Intangibles subject to Section 367(d) inclusions, the U.S. parent of such transferor would be subject to tax on the unrecognized gains from the transfer of Section 936 Intangibles in the event of either a disposition of such Section 936 intangibles by the foreign transferee or in the event of the U.S. parent's own disposition of its shares of the foreign transferee's shares. This recognition of deferred stock gain would apply to a disposition during the useful life of the applicable transferred Section 936 Intangible. Similarly, we believe that regulations would preserve a wider ambit for the application of Section 367(d) if they extended the continued application of Section 367(d) upon the liquidation of a domestic transferor into a related controlled foreign corporation. We recommend that the final Section 367(d) regulations specify that no indirect transfer of stock subject to Section 367 be subject to a gain recognition agreement where all assets transferred were currently taxed or subject to Section 367(d) at the time of the original transfer.

6. Application of Section 367(d) Principles to Partnerships

We believe that Sections 704(b) and 704(c), together with Section 482, can adequately police the concerns expressed by Congress in enacting Sections 367(d)(3) and 721(c). Existing rules under Subchapter K of the Code, together with Section 482, limit opportunities for income-shifting transactions involving the contribution of intangible property to partnerships. We do recommend that a mandatory remedial allocation be considered for the transfer of Section 936 Intangibles to partnerships to prevent manipulations of the ceiling rule that could be utilized to shift income to a foreign partner.

PART C. STATUTORY DEVELOPMENT

1. Historical Background

(a) Predecessors to Current Section 367

The predecessor of Section 367 was originally enacted as Section 112(k) of the Revenue Act of 1932[11] and included as Section 367 in the Internal Revenue Code of 1954. It stated that, for purposes of an exchange described in the reorganization provisions, Section 351 or Section 332, a foreign corporation would not be considered to be a corporation for U.S. federal income tax purposes unless, before such exchange, it was established to the satisfaction of the Internal Revenue Service ("IRS") that the exchange was "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Since corporate status is required for

[11] Revenue Act of 1932, Pub. L. No. 72-154, 46 Stat. 169 (the "1932 Act").

the application of the reorganization provisions, as well as Section 351 and Section 332, the denial of corporate status meant that gains were recognized and taxed on such exchanges.

The "principal purpose" standard embedded in the prior versions of Section 367 gave rise to an active ruling practice. Ruling guidelines, initially described in Revenue Procedure 68-23, established standards under which the IRS would normally rule favorably on a transaction subject to Section 367.[12] In general, the transfer of assets that were being used in an active foreign trade or business were regarded as not having tax-avoidance as a principal purpose. Revenue Procedure 68-23 applied different standards to particular classes of assets regarded as having higher tax-avoidance potential. Inventory, accounts receivable, installment obligations, stocks, securities and certain intangibles assets were each considered to have higher potential tax-avoidance and were singled out for separate treatment. This ruling practice generally remained in place until the Tax Reform Act of 1984 (the "1984 Act").[13]

The IRS Section 367 ruling practice placed a number of limits on the circumstances in which it would issue a favorable ruling regarding the transfer of intangible property. Under Section 2.02(1)(a)(i) of Revenue Procedure 68-23, tax-free treatment was not applicable to property described in Section 1221(3) (generally, copyrights, compositions and similar property created by the taxpayer). Under Section 2.02(1)(b) of Revenue Procedure 68-23, a favorable ruling under Section 367 would not generally be issued for an exchange where property transferred to the foreign corporation was: (i) property in respect of which the transferor was the lessor or the licensor at the time of transfer; (ii) property transferred where it was reasonable to believe the transferee foreign corporation would license or lease the property after the transfer;

[12] *See* Rev. Proc. 68-23, 1968-1 C.B. 821, *amplified by* Rev. Proc. 75-29, 1975-1 C.B. 754, Rev. Proc. 76-20, 1976-1 C.B. 560, Rev. Proc. 80-14, 1980-1 CB 617, *modified by* Rev. Proc. 77-17, 1977-1 C.B. 577, *obsoleted by* Rev. Rul. 2003-99, 2003-34 I.R.B. 388.

[13] Deficit Reduction Act of 1984 (Division A. Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984).

(iii) U.S. patents, trademarks and similar intangibles to be used in connection with the conduct of a trade or business in the United States or the manufacture of goods for sale or consumption in the United States; or (iv) foreign patents, trademarks and similar intangibles to be used in connection with the sales of goods manufactured in the United States. This list of intangibles for which a favorable ruling could not be obtained suggests that the IRS believed that the transfer of passive-income-generating intangibles or intangibles relating to income from the manufacture or sale of goods in the United States had a presumptive tax-avoidance purpose.

(b) <u>1982 Possession Corporation Changes</u>

Section 367(d) was added to the Code as part of the Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Act") in connection with a change to the taxation of domestic corporations electing the application of Section 936 ("possession corporations").[14] Previously, U.S. drug companies, among others, had utilized the intended benefit of possession corporation status by moving the development, ownership and manufacture of high-profit pharmaceutical intangibles to Puerto Rico and other possessions of the United States.[15] Section 936(h), added by the 1982 Act, required the shareholders of a possession corporation to include in current income, the income from intangible property held by the possession corporation. Congress "was aware that, as a result of [the 1982 Act changes to Section 936], some taxpayers have stated that they would remove investment from Puerto Rico and transfer possession-related intangibles to foreign jurisdictions."[16] Congress believed that such a transfer to a foreign jurisdiction, spurred by the

[14] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (the "1982 Act").

[15] Under the strategy employed by many taxpayers, the research and development giving rise to employment was performed in the United States. Exporting the intangible property at the point of profitability was seen as achieving a reduction in U.S. taxes, through the expensing of research and development costs, without sufficiently improving employment in U.S. possessions, the stated purpose of Section 936.

[16] Conference Committee Report on the 1982 Act, H.R. Rep. 97-760, 97th Cong., 2d Sess. at 512.

change in law under Section 936, would "ordinarily" have as one of its principal purposes the avoidance of Federal income taxes.[17]

To address this concern and to make clear that such a transfer would be treated as having a tax-avoidance purpose under Section 367, the conference agreement to the 1982 Act enacted Section 367(d) to specifically provide that the transfer of intangible property from a possession corporation to a foreign corporation would be treated as being pursuant to a plan having a principal purpose of tax-avoidance and, therefore, under Section 367, not eligible for nonrecognition. Importantly, this first iteration of Section 367(d) applied the normal sanctions of noncompliance with Section 367 requirements (*i.e.,* recognition of realized gain on the transfer of the property), rather than deferred recognition of a royalty stream. Section 367(d)(4), as enacted by the 1982 Act, contained a delegation of authority to restrict the application of Section 367(d) where "the Secretary is satisfied that the transfer will not result in the reduction of current or future Federal income taxes."

(c) Litigation Regarding IRS' Ruling Practice Under Section 367

At roughly the same time, the IRS suffered two significant reversals in its interpretation of the scope of the Section 367 "principal purpose" standard. In Dittler Brothers, Inc. v. Commissioner,[18] the Tax Court considered an IRS determination that a taxpayer's transfer of scratch-off lottery ticket technology to a foreign joint venture was made with a principal purpose of tax avoidance. The Tax Court denied the IRS' assertion that a tax-avoidance purpose was to be inferred based on the government's position that the technology was to be used in essentially passive activities of the foreign joint venture. The Tax Court found that the IRS determination

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[17] *Id.*

[18] 72 T.C. 896 (1979).

that the transaction was primarily motivated by a tax-avoidance purpose was not reasonable because the taxpayer's foreign joint venture partner insisted that the technology be transferred to the foreign joint venture entity. Accordingly, the transfer of this high-profit intangible to a low-tax foreign jurisdiction was eligible for tax-free non-recognition treatment. In another case, Hershey Foods Corp. v. Commissioner,[19] Hershey Foods sought to incorporate the assets of two Canadian branches, one of which was loss-making, at a time when the loss-making branch could be expected to become profitable. The Tax Court found that Section 367 was never intended to recapture past losses when a branch is incorporated in a foreign country. In both Dittler Brothers and Hershey Foods, the IRS' attempts at taxing transactions where valuable assets that were anticipated to generate income were migrated outside the U.S. taxing jurisdiction were frustrated by factual determinations made by courts that the taxpayer had a non-tax motive for the transaction.

(d) The 1984 Act

The 1984 Act replaced the "principal purpose" test and mandatory ruling requirements of prior law with a requirement that gain be recognized on any transfer by a U.S. person to a foreign corporation otherwise qualifying for tax-free treatment, unless an enumerated exception applied. Section 367(d) was concurrently amended to apply more generally to transfers of intangible property by any U.S. persons to foreign corporations. Even though the provision no longer applied solely to possession corporations, Section 367(d) retained its original cross-reference to Section 936(h)(3)(B) for the definition of "intangible property." The 1984 Act also introduced the concept in Section 367(d) that, rather than having current recognition of gain determined definitively at the time of transfer, the U.S. person transferring the intangible property would be treated as having sold the property in exchange for annual payments contingent on the

[19] 76 T.C. 312 (1981).

productivity, use or disposition of the property. This change, while in certain cases beneficial to taxpayers by deferring taxation of the transfer, was intended to better capture the amount of profit attributable to the asset transferred.

The legislative history to the 1984 Act included several references to the treatment of foreign goodwill and going concern under Section 367. The House Ways and Means Committee stated that "the transfer of goodwill or going concern value developed by a foreign branch will be treated under [the active trade or business] exception rather than a separate rule applicable to intangibles."[20] The Senate Finance Committee suggested that "ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business."[21] The Joint Committee on Taxation, in its explanation of the provision, reasoned that "[g]oodwill and going concern value are generated by earning income, not by incurring deductions," and therefore "ordinarily, the transfer of these (or similar) intangibles does not result in the avoidance of Federal income taxes."[22] This legislative history suggests that Congress believed that transfers of foreign goodwill created by an income-generating business were not transfers to which Section 367(d) was intended to apply and were distinguishable, for example, from the incorporation of a foreign-loss branch, along with any associated intangible property, that has previously generated net U.S. deductions.

(e) Temporary Section 367(d) Regulations

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[20] House Ways and Means Committee Report on the Tax Reform Act of 1984, H.R. Rep. No. 98-432, pt. 2 (1984) (the "House Report"), at 1320.

[21] Senate Finance Committee Report on the Deficit Reduction Act of 1984, S. Rep. 98-169 Vol. 1 (1984) (the "Senate Report"), at 365. Elsewhere, the Senate Finance Committee clarified the nature of the goodwill and going concern value in question, stating that the transfer of "goodwill or going concern value (or certain similar intangibles) *developed by a foreign branch*" would not result in abuse of the U.S. tax system. S. Rep. 98-169 Vol. 1, at 362 [emphasis added].

[22] Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong., 2d Sess. P.L. 98-369) (1984) (the "Blue Book"), at 428.

On May 16, 1986, the U.S. Treasury promulgated the Temporary Section 367(d) Regulations setting forth an initial attempt to interpret the new Section 367(d) authority.[23] Along with providing guidance on the mechanics of Section 367(d) and setting forth an elective lump-sum election for certain transfers, Temporary Treasury Regulation § 1.367(d)-1T(b) specifically provided that Section 367(d) "shall not apply to the transfer of foreign goodwill or going concern value," which was defined by cross-reference to Temporary Treasury Regulation § 1.367(a)-1T(d)(5)(iii) to be "the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued."[24]

(f) Tax Reform Act of 1986

On October 22, 1986, under the Tax Reform Act of 1986, Section 482 was amended to cure the government's information disadvantage in determining the value of transfers or licenses of intangible property between related persons.[25] The solution was to provide that income from the transfer or license of such assets would be "commensurate with the income attributable to the intangible," allowing the IRS to determine the arm's length consideration for such a transfer or license based on the actual profits subsequently realized from the intangible. This "commensurate with income" standard was simultaneously added to Section 367(d). The "commensurate with income" language was an attempt to provide the IRS with a tool to properly value and tax assets, which are of a type not normally sold or licensed to third parties, when such assets are transferred between commonly controlled entities.

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[23] T.D. 8087, 51 Fed. Reg. 17936, 5/16/86, 1986-1 C.B. 175.

[24] Unless otherwise indicated, all references to "Treasury Regulation §" or "Treas. Reg. §" are to U.S. Treasury regulations promulgated under the Code.

[25] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (the "1986 Act"), § 1231(e).

In implementing the "commensurate with income" standard in Section 367(d), the House Ways and Means Committee report on the 1986 Act explained:

> "…the committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms….The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The bill is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer."[26]

As stated in the 1988 white paper on Section 482 prepared by Treasury (the "Section 482 White Paper"), "the general goal of the commensurate with income standard is… to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."[27] The legislative history indicates a perceived inability to properly value relevant intangible property at the time of the transfer and hence directs use of hindsight to value it. The Section 482 White Paper goes on to note that "[i]t may also be possible in certain… cases to exclude subsequent profit experience from consideration under the arm's length standard," noting that in such cases the taxpayer would be required to demonstrate that "events had occurred subsequent to the license agreement that caused the unanticipated profitability."[28]

(g) <u>Intervening Goodwill Litigation</u>

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[26] H.R. Rep. No. 426. 99th Cong., 1st Sess. 424 (1985).

[27] Notice 88-123, 1988-2 C.B. 458.

[28] *Id.*

On a parallel track, a development unrelated to Section 367(d) occurred in the context of the domestic taxation of persons acquiring intangible assets. Prior to the enactment of Section 197 in 1993, taxpayers acquiring intangible assets were confronted with the IRS position that basis attributable to goodwill and going concern value could not be recovered by depreciation or amortization because the useful lives of these intangible assets were indefinite.[29] In litigation involving various industries, taxpayers persistently claimed that the purchase price paid in the acquisition of businesses was attributable to identifiable intangible property distinguishable from goodwill and going concern value and that because such assets had determinable useful lives, the basis in such assets should be amortizable over their finite useful lives.[30] For example, insurance policy renewals and customer base were asserted to be assets separate from goodwill and taxpayers claimed that such assets could be shown to turn over entirely within some predictable period, justifying amortization of basis in such assets over that period.[31] As taxpayers won significant victories identifying intangibles with limited useful lives, the tax concept of "goodwill and going concern value," and the portion of purchase price allocable to this asset, began to shrink. A proliferation of judicially identified intangible assets that were found to have determinable lives, like marketing and customer base intangibles, emerged.[32] While these cases

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[29] T.D. 8552, 59 Fed. Reg. 34971, 7/8/94, 1994-2 C.B. 93. Section 197 was enacted as part of Pub. L. No. 103-66, § 13261(g), 107 Stat. 312 (1993). Under Treasury Regulation § 1.167(a)-3(a), the position of the IRS and Treasury as to the amortization of goodwill was as follows: "No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill."

[30] *See, e.g.,* New York State Bar Association Tax Section , "Report on Proposed Legislation on the Amortization of Intangibles (H.R. 3035) (Sept. 30, 1991), reprinted at 91 TNT 214-49 (cataloging 123 cases primarily from the previous thirty years in which taxpayers attempted to separate from goodwill acquired intangible assets with limited useful lives, including insurance expirations, subscription lists, customer files and patient charts).

[31] *See, e.g.,* Richard S. Miller & Sons v. U.S., 537 F.2d 446 (Ct. Cl. 1976) (insurance expirations separable from goodwill; limited useful life established); Charles Schwab Corp. v. Commissioner, 122 T.C. 191 (2004) (allowing amortization of cost of discount broker's "customer base").

[32] *See, e.g.,* Newark Morning Ledger Co. v. U.S., 507 U.S. 546 (1993) (allowing the purchaser of a newspaper to depreciate the portion of the purchase price allocable to "paid subscribers").

did not occur in the context of outbound transfers of intangibles, they arguably had the collateral effect of narrowing the common law concept of goodwill and going concern value and potentially informing the scope of the exclusion for foreign goodwill and going concern value reflected in the Temporary Section 367(d) Regulations. While the provision for the amortization of goodwill and certain other intangibles in Section 197 took the pressure off of the definition of "goodwill and going concern value" with regard to the amortization of basis in acquired intangible assets, the case law which led to the Section 197 compromise has shaped the common meaning of "goodwill and going concern value."

(h) Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 enhanced the information reporting rules that applied to certain transfers of appreciated property by a U.S. person to a foreign entity. Concurrently, the legislation repealed the rule that treated any deemed royalty arising under Section 367(d) as U.S.-source income.[33] The deemed royalty payments under Section 367(d) were instead treated as foreign-source income to the same extent that an actual royalty payment would be considered to be foreign-source income. The legislative history to the 1997 Act suggested that Congress no longer saw the special source rule as necessary to penalize or discourage outbound transfers of intangibles. The Senate Report described the reason for this change as follows:

> "The Committee… understands that the special source rule of present law for deemed royalty payments with respect to a transfer of an appreciated intangible to a foreign corporation was intended to discourage such transfers. The Committee believes that the imposition of enhanced information reporting obligations with respect to both foreign partnerships and foreign corporations would eliminate the need for [this rule]."[34]

(i) American Jobs Creation Act of 2004

[33] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (the "1997 Act").

[34] Senate Finance Committee Report on Revenue Reconciliation Act of 1997, 105th Cong. 1st Sess. 1997, S. Rep. 105-33 (the "1997 Senate Report") at 208-9.

The American Jobs Creation Act of 2004 included a provision that specified that deemed payments under Section 367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit.[35]

(j) Recent Developments Regarding the Breadth and Scope of Section 367(d) and Section 936 Intangibles

In Technical Advice Memorandum ("TAM") 200907024, the taxpayer sought to transfer a network of delivery service contracts with foreign agents in a number of foreign jurisdictions to a newly formed foreign subsidiary.[36] The TAM reported that the taxpayers sought to treat 97% of the value of the assets transferred to the new foreign subsidiary as foreign goodwill and going concern value not subject to Section 367(d). The IRS exam team argued that the network of contracts fell within a number of the categories of Section 936 Intangibles and accordingly were not residual "foreign goodwill and going concern" exempt from Section 367(d) under the Temporary Section 367(d) Regulations. Specifically, the IRS exam team asserted that the taxpayer's network of contracts with a large number of foreign agents in numerous countries fell within the definition of "intangible property" under either the Section 936(h)(3)(B)(iv) category which includes any "franchise, license, or contract"; or the Section 936(h)(3)(B)(v) category which includes any "method, program, system, [or] procedure." The IRS concluded that network of contracts could be characterized as either a collection of contracts which comprise a single asset; a group of franchises that constitute a franchise operation; or as a method, program, or procedure because the network represents a "particular way or plan for accomplishing a goal."

[35] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) (the "2004 Act"), §406.

[36] TAM 200907024 (February 13, 2009).

The facts underlying the TAM are similar to a docketed case in the U.S. Tax Court, First Data Corp. v. Commissioner.[37] In its petition to the court, First Data Corp. takes the position that the IRS erred in characterizing a network of foreign agent relationships as an item of intangible property separate from foreign goodwill or foreign going concern value. The taxpayer argues that its foreign agent relationship network had been aggregated into an ongoing business separate and distinct from the value of the contracts themselves and therefore the value attributable to the network of relationships represents foreign goodwill or foreign going concern value which is not subject to Section 367(d).

Separately, in a recent decision, Veritas Software Corp. et. al. v. Commissioner,[38] the IRS asserted that certain assets transferred by the taxpayer to related foreign parties pursuant to a cost-sharing arrangement (including access to a domestic marketing team and access to a domestic research and development team) were Section 936 Intangibles that should have been taken into account in calculating the requisite buy-in payment due to the taxpayer from the related foreign parties as part of the cost-sharing arrangement. The Tax Court concluded that there was insufficient evidence that the assets in question were transferred to the foreign related parties or had value, but also went on to reject the IRS' determination that the transferred intangibles were Section 936 Intangibles, based on the conclusion that the assets in question lacked the "substantial value independent of the services of any individual" required to qualify as a Section 936 Intangible.

2. **Statutory Context**

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[37] Tax Court Docket No. 007042-09 (T.C. petition filed Mar. 20, 2009).

[38] Veritas Software Corp. et. al. v. Commissioner, 133 T.C. No. 14 (December 10, 2009).

Section 367(a) broadly limits the application of the tax-free incorporation provisions of Section 351 and the tax-free reorganization provisions of Section 354 *et seq*. in the context of outbound transfers of assets.

(a) Section 367(a)

Section 367(a) provides:

(a) TRANSFERS OF PROPERTY FROM THE UNITED STATES.

(1) GENERAL RULE. If in connection with any exchange described in Section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

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(3) EXCEPTION FOR TRANSFERS OF CERTAIN PROPERTY USED IN THE ACTIVE CONDUCT OF A TRADE OR BUSINESS.

(A) IN GENERAL. Except as provided in regulations prescribed by the Secretary, paragraph (1) shall not apply to any property transferred to a foreign corporation for the use by such foreign corporation in the active conduct of a trade or business outside of the United States.

(B) PARAGRAPH NOT TO APPLY TO CERTAIN PROPERTY. Except as provided in regulations prescribed by the secretary, subparagraph (A) shall not apply to any -

(i) property described in paragraph (1) or (3) of Section 1221(a) (relating to inventory and copyrights, etc.),

(ii) installment obligations, accounts receivable, or similar property,

(iii) foreign currency or other property denominated in foreign currency,

(iv) intangible property (within the meaning of section 936(h)(3)(B)), or

(v) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.

(C) TRANSFERS OF FOREIGN BRANCH WITH PREVIOUSLY DEDUCTED LOSSES. Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that – [the branch had accumulated foreign branch losses]. Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside of the United States having the same character as such losses had.

It should be noted that the treatment of a Section 936 Intangible as a tainted asset by virtue of Section 367(a)(3)(B) applies to all transactions subject to Section 367(a), which is somewhat broader than Section 367(d), which only applies to transactions subject to Sections 351 and 361.

(b) <u>Section 367(d)</u>

Section 367(d) creates a special regime for outbound transfers of Section 936 Intangibles in Section 351 and Section 361 transfers. It provides:

(d) SPECIAL RULES RELATING TO THE TRANSFERS OF INTANGIBLES.

(1) IN GENERAL. Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of Section 936(h)(3)(B)) to a foreign corporation in an exchange described in Section 351 or 361-

(A) subsection (a) shall not apply to the transfer of such property, and

(B) the provisions of this subsection shall apply to such transfer.

(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO SALE OF CONTINGENT PAYMENTS.

(A) IN GENERAL. If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as-

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received-

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

(B) EFFECT ON EARNINGS AND PROFITS. For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under subparagraph (A)(ii).

(C) AMOUNTS RECEIVED TREATED AS ORDINARY INCOME. For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income. For purposes of applying Section 904(d), any such amount shall be treated in the same manner as if such amount were a royalty.

> (3) REGULATIONS RELATING TO TRANSFERS OF INTANGIBLES TO PARTNERSHIPS. The Secretary may provide by regulations that the rules of paragraph (2) also apply to the transfer of intangible property by a United States person to a partnership in circumstances consistent with the purposes of this subsection.

(c) Section 936(h)(3)(B)

The third component of the statutory context is Section 936(h)(3)(B), which reads as follows:

> (B) INTANGIBLE PROPERTY. The term "intangible property" means any-
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> (i) patent, invention, formula, process, design, pattern, or knowhow;
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> (ii) copyright, literary, musical, or artistic composition;
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> (iii) trademark, trade name, or brand name;
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> (iv) franchise, license, or contract;
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> (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
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> (vi) any similar item,
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> which has substantial value independent of the services of any individual.

3. **Analytical Categories.**

Section 367 effectively classifies transfers of intangible property into three categories.[39] The first category is outbound transfers of Section 936 Intangibles in transfers described in Section 351 or Section 361. These transfers are ineligible for non-recognition treatment under Section 367(a) and are governed by Section 367(d). Section 367(d) results in a U.S. transferor being treated as having sold the Section 936 Intangible in exchange for payments that are contingent on the productivity, use or disposition of such property, and, receiving amounts that reasonably reflect the amounts which would have been received (i) annually in the form of such payments over the useful life of such property, or (ii), in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.[40] Language added by the 1986 Act specifies that these amounts "shall be commensurate with the income attributable to the intangible." Section 367(d) appears to hypothesize that the transfer of intangibles will be treated as a distinct transaction, severable from the broader transaction of which it is a part, and treated as a "sale" for consideration that is contingent on the productivity, use or disposition of the intangible, subject to the "commensurate with income" standard. This treatment has the twin consequences of (i) deferral and (ii) a contingent amount of gain, taxable as ordinary income (foreign source if used outside the United States).

The second category is outbound transfers of Section 936 Intangibles described in Sections 332, 354 or 356. These transfers are treated as transfers of "tainted assets" pursuant to

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[39] When interpreting the provisions of Section 367, one must keep in mind that the term "property," as used in the Code generally does not include services. For example, Section 351(d) provides "for purposes of this Section, stock issued for services… shall not be considered as issued in return for property." Items or opportunities not representing "property" for tax purposes should not be subject to any part of Section 367, including Section 367(d). *See, e.g.,* Hospital Corporation of America v. Commissioner, 81 T.C. 520 (1983) (holding on the facts before it that the opportunity to negotiate and enter into a contract was not an asset subject to Section 367); E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1218 (Ct.Cl. 1973); Rev. Rul. 79-288, 1979 – 2 C.B. 139. *But see* C. LeBeau and P. Dostart, "Offshore tax planning may be favorably affected by recent Hospital Corp. decision," 60 J. Tax. 294, 300-01 (1984) (court applied flawed property analysis).

[40] The version of Section 367(d) originally proposed by the House Ways and Means Committee characterized the Section 367(d) payments as an exclusive licensing arrangement. The Senate version, ultimately adopted in the final legislation, used the contingent sale approach.

Section 367(a)(3)(B)(iv) that do not qualify for the active foreign trade or business exception, and therefore the transfers are generally subject to current tax.[41] The resulting taxable disposition should be subject to the "commensurate with income" standard under Section 482 where the transferor and the transferee corporation are, directly or indirectly, under common control or ownership. The IRS also has authority under Section 367(d) to provide for exceptions to the application of Section 367(d) for certain transfers of Section 936 Intangibles, which would cause such transfers to be subject to this "tainted asset" rule.[42]

The third class is transfers of intangibles that are not Section 936 Intangibles (e.g., goodwill). Treasury Regulation § 1.367(d)-1T(b) specifically confirms that Section 367(d) does not apply to the "transfer of foreign goodwill or going concern value…" These transfers are subject to the general rule of Section 367(a), not Section 367(d) or the tainted asset rule of Section 367(a)(3)(B)(iv). Thus, an outbound transfer of these intangibles, if used by the transferee foreign corporation in the active conduct of a foreign trade or business, is generally eligible for non-recognition treatment (subject to the application of the Section 367(a)(5) and the branch loss recapture rules of Section 367(a)(3)(C)), and otherwise is currently taxable.

The regulations further treat certain self-created intellectual property in the second class as excluded from the operation of Section 367(d), but currently taxed. Treasury Regulation § 1.367(d)-1T(b) excludes intangible property described in Treasury Regulation § 1.367(a)-5T(b)(2), which in relevant part covers "a copyright, a literary, musical, or intellectual composition, a letter or memorandum or similar property, held by … a taxpayer whose personal

[41] In the case of Section 332 liquidations, the operative provision is Section 367(e), originally added to the Code as part of the 1984 Act, which provides that outbound Section 332 liquidations are treated as taxable transactions.

[42] As will be discussed below, the Temporary Section 367(d) Regulations permit transfers of "operating intangibles" and certain other transfers to be electively taxed as a current sale, but such transactions are not explicitly exempted from Section 367(d).

efforts created such property" and "in the case of a letter, memorandum or similar property, the taxpayer for whom such property was prepared or produced." This language is identical to the exclusion from capital asset treatment for self-created intellectual property in Section 1221(a)(3) which is specifically incorporated in Section 367(a)(3)(B)'s list of assets not eligible for non-recognition. *See* Section 367(a)(3)(B)(i). Transfers of such assets are subject to Section 367(a)(1), which prescribes current recognition rather than the deferred royalty treatment of Section 367(d).

PART D: DISCUSSION

1. General

(a) Parity between Sections 482 and 367(d)

Section 367(d), like Section 482, imposes rules governing the taxation of certain transfers of Section 936 Intangibles. Considerable law has developed and attention has been paid to the treatment of transactions subject to Section 482, in part because Section 482 governs such a wide array of commercial transactions. In general, we recommend that Treasury regulations under Section 367(d) be revised to achieve greater parity between the income tax consequences of a deemed sale of a Section 936 Intangible under Section 367(d) and an actual sale of such intangible under Section 482. We recognize, however, that Section 482 allows a taxpayer to choose between a lump sum sale, a sale for amounts contingent on productivity, use or disposition (installment treatment or open transaction treatment[43]), and a license, whereas Section 367(d) requires that the transaction be structured as a sale contingent on productivity, use

[43] Open transaction treatment would result in (i) recovery of any basis prior to taxable gain and (ii) inapplicability of the installment sale rules, including the Section 453A interest charge.

or disposition and dictates ordinary income consequences.[44] Also relevant is that, in the case of a sale governed by Section 367(d), the gain is not subject to a Section 453A interest charge (and no portion of the proceeds is treated as imputed interest, but the proceeds are treated as wholly ordinary income in any event). Thus, a Section 367(d) deemed sale can produce a deferral benefit.

Another disparity between Sections 367(d) and 482 arises as a result of the different statutory language applied to tax post-transfer appreciation of Section 936 Intangibles. Under Section 482, a sale to a related person, whether structured for a royalty or a lump sum, would be taxed by reference to the value of the asset determined as of the date of transfer but, under the "commensurate with income" standard of Section 482, such value would be subject to a "true-up" to reflect post-transfer performance.

Section 367(d) appears to capture all of the value taxed under Section 482, and potentially more. As noted above, it requires that the consideration deemed received for the transfer of a Section 936 Intangible be treated as royalty-like contingent payments based on actual performance. On the one hand, the deemed royalty under Section 367(d), like a royalty in a transaction structured as a license under Section 482, must be "commensurate with income," and thus post-transfer income again may be used to adjust the royalty rate. Regulation §1.367(d)-1T(c) confirms that the appropriate royalty charge is "determined in accordance with the provisions of Section 482 and the regulations thereunder." We assume, and would seek confirmation, that no adjustment of the royalty rate reported by the taxpayer in respect of a deemed sale under Section 367(d) would be required if none would apply to a similar transaction

[44] This flexibility in structuring will cause many taxpayers to find Section 482 preferable to Section 367(d) in any event.

under Section 482 and Regulation §1.482-4(f)(2) (providing no adjustment where actual profits fall within the 80-120% range of projected profits).

However, because taxation of the built-in gain was deferred under the statutory life-of-the-property royalty construct, Section 367(d)(2)(A)(ii)(II) requires that the transferor of a Section 936 Intangible remain taxable on the appreciated value following the subsequent transfer of the intangible if it disposes directly or indirectly of the property. In taxing the appreciation, no distinction is made between built-in gain and gain attributable to post-transfer appreciation,[45] including appreciation that truly can be shown to be due to a post-transfer event that was not reasonably able to be anticipated at the time of the transfer.[46] The Temporary Section 367(d) Regulations construe an indirect disposition as including a disposition of the shares of the transferor as well as a disposition of the asset by the transferee. For example, the transferor would be taxed on gain in the Section 936 Intangible upon a sale of the foreign transferee's stock, even if no gain is otherwise realized with respect to the stock. Existing regulations permit the transferor's stock gain to be reduced by the asset gain (to avoid double counting) but does not treat the asset gain as a basis adjustment to the transferor's stock in the transferee that might create a capital loss.[47] If a comparable transaction governed by Section 482 had occurred (sale of a Section 936 Intangible to a foreign affiliate), the sale of the affiliate's shares would not result in recognition of gain in respect of the Section 936 Intangible, but the value of the Section

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45 The reason for this is based on the rationale of the commensurate with income concept, which is that drawing such a distinction is too difficult and, in a tax system still relying to a large extent on taxpayer voluntary compliance, would be open to manipulation, as evidence had shown.

46 The built-in gain should in theory reflect value attributable to post-transfer increases in sales, to the extent a range of future sales and expense projections can reasonably be made and an appropriate risk-adjusted discount rate selected.

47 Specifically, Treasury Regulation §1.367(d)-1T(g)(1), which permits the capitalization and stock basis adjustment for unreceived Section 367(d) inclusions, is not applicable to sales of the transferee's stock to an unrelated person.

936 Intangible would be taken into account in determining the amount realized and recognized on the sale. As a policy matter, we question whether the limited deferral benefit accorded to a transferor under Section 367(d) justifies the harsher treatment of stock dispositions under Section 367(d) than under Section 482.

A strict application of Section 367(d), with respect to, e.g., basis recovery and stock dispositions may have appeal to the Government from the standpoint of ease of administration, and the statute in fact is motivated by a desire to discourage abusive transactions. We have some reservations, however, because taxing transferors on post-transfer values appears to stretch conventional standards and create at least risks of double taxation. [48] Notably, the Section 482 White Paper observes that "[t]he periodic adjustment of lump sum royalty or sale payments [under the Section 482 "commensurate with income" standard] would merely achieve parity with section 367(d) transfers."[49] Further, strict enforcement of "commensurate with income" should capture the full arm's length value of transferred Section 936 Intangibles without additional punitive aspects, which arguably would discourage appropriate uses of the tax-free reorganization provisions.

As developed below with regard to particular mechanical approaches dealt with by regulation, a reduction of asymmetry between the tax consequences applicable under Sections 367(d) and 482, to the extent permissible given the differences in statutory language, should promote greater clarity in the operation of Section 367(d) and mitigate the perceived need or benefit to structure to avoid or come within one or the other. For example, as recommended below, the Temporary Section 367(d) Regulations could be modified to provide that Section

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[48] It has been suggested that the "contingent upon the productivity" language appearing in the original statue in 1982 and 1984 was rendered duplicative or at least unnecessary when the "commensurate with income" standard was added to Sections 367(d) and 482 in 1986.

[49] Notice 88-123, 1988-2 C.B. 458.

367(d) gives rise to basis recovery consequences that are the same as in a comparable sale transaction under Section 482, *i.e.*, installment sale or open transaction treatment, as appropriate.[50]

Further, the current Treasury regulations under Section 482 relating to intangible property should be more specifically referenced or incorporated into Section 367(d). The Temporary Section 367(d) Regulations have a general reference to Section 482,[51] but such regulations have not been updated to reflect the addition of the "commensurate with income" standard to Section 367(d). The relevant Treasury regulations issued under Section 482 for determining an arm's length price for controlled transfers of intangibles were issued subsequent to the Temporary Section 367(d) Regulations and do implement the "commensurate with income" standard. These regulations provide, *inter alia*, in Treasury Regulation § 1.482-4(f)(2)(ii)(C), various circumstances in which no periodic adjustment is required to a royalty (*e.g.*, the 80% to 120% safe harbor for total profits actually earned) and, in Treasury Regulation § 1.482-4(f)(6), for the determination of arm's length lump-sum payments and the application of the safe harbors to such payments. The Temporary Section 367(d) Regulations refer to the Treasury regulations under Section 482 generally, so the later-issued regulations should apply under an ambulatory interpretation of the cross-reference. As suggested above, we believe that explicit clarification that the current rules of Treasury Regulation § 1.482-4(f), with such modification as may be appropriate for their application in a Section 367(d) context, apply under Section 367(d) would be helpful.

(b) Reorganization Policy

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[50] Presumably, if the installment sale method were extended to Section 367(d) transfers, other collateral consequences, such as the deemed interest change under Section 453A, would also be imposed.

[51] *See* Temp. Treas. Reg. § 1.367(d)-1T(c)(1) ("The appropriate charge shall be determined in accordance with the provisions of section 482 and regulations thereunder. See § 1.482-2(d).").

A U.S. taxpayer can transfer intangible assets to a controlled non-U.S. corporation in one of five ways: (i) a taxable sale, (ii) a license arrangement, (iii) as part of a cost sharing arrangement, (iv) through a contribution to capital or (v) as part of a reorganization transaction.[52] In situations (i) through (iii), the transaction would be subject to Section 482. In situations (iv) and (v), the transaction would be potentially subject to Section 367(d). In any case, if the intangible assets constitute Section 936 Intangibles, the income required to be recognized by the transferor must be "commensurate with income."[53] The most salient feature of a transaction subject to Section 367(d) is that the transaction is part of a transaction that is potentially eligible for tax-free treatment as a transaction subject to Section 351 or Section 361, unlike a taxable transaction subject to Section 482. The most significant difference in statutory treatment is the mandatory rather than optional sale for a royalty stream and the other specified consequences under Section 367(d). But both Section 367(d) and Section 482 (as it applies to intangibles) are intended to prevent migration of value of the intangibles from the United States.

As described below, in a number of respects the mechanics of the tax treatment of a Section 367(d) transaction currently diverge from those of a taxable transaction subject to Section 482. To the extent that the deemed sale consequences under the Temporary Section 367(d) Regulations produce income tax results that are more adverse or less clear than the results that accompany an arm's length sale of intangible property under Section 482, the Section 367(d) regime may encourage taxpayers to adopt taxable transfer structures merely to avoid Section

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[52] In addition, a U.S. taxpayer could avoid all of these choices by transferring intangible assets to a foreign entity treated as a partnership for U.S. tax purposes. *See* Section C.5, *infra.*

[53] The commensurate with income standard was concurrently added to both Section 367(d) and Section 482. While the legislative history does not explicitly address the alignment of Section 367(d) and Section 482, this synchronized modification suggests that, as an overarching matter of design, Congress intended that there be some symmetry in the manner that the U.S. tax law applies to the outbound transfer of Section 936 Intangibles whether that outbound transfer is effected by way of a transfer governed by Section 367(d) or Section 482. *See also* Section 482 White Paper, *supra* note 27.

367(d) and its vagaries and "elect" treatment under Section 482. We recognize that, in certain significant respects, the difference is based on the differences in the statutory provisions.

The existing treatment under Section 367(d) may affect implementation of reorganization, incorporation or joint venture transactions that would otherwise qualify for the Section 367(a)(3) "active foreign trade or business" exception.[54] Many practitioners counsel their clients to structure transfers of intangible property as a sale or a license, or elect to treat the transferee as a partnership for U.S. federal income tax purposes, to avoid the regime of Section 367(d), including certain ambiguities.

In many cases, it is not possible to structure a transaction that achieves the economics desired by the parties and that yields a consistent U.S. tax treatment under Section 367(d). For example, if a U.S. transferor desires to enter into a foreign corporate joint venture in which it contributes an active foreign trade or business, including Section 936 Intangibles, for a 30% interest and foreign transferors contribute operating assets for a 70% interest, the simplest approach would be for the U.S. transferor to contribute the business to the joint venture corporation in exchange for 30% of the stock of the foreign corporation. This transaction would be subject to Section 367(d), and the U.S. transferor would be required to include deemed Section 367(d) payments, based on the imputed royalty amount, even though it is not receiving any royalty and, in fact, may not be realizing any accretion to the value of its stock.[55] The transaction cannot be structured as an actual sale or license of intangibles to the joint venture,

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[54] In addition, the Section 367(d) rules might discourage U.S. taxpayers from entering into licenses and cross-licenses with (related or unrelated) foreign persons in which some or all of the consideration paid by the licensee is in the form of stock, because of the potential application of Section 367(d) to such transactions if they would be part of a section 351 or 368 transaction.

[55] Because the imputed amount is not in fact paid, under the Temporary Section 367(d) Regulations, the U.S. transferor would be treated as receiving the imputed amount and contributing it to the capital of the foreign corporation, increasing its basis in the stock. *See* Temp. Treas. Reg. § 1.367(d)-1T(g)(1)(ii).

because such an arrangement would not reflect the commercial arrangement of a 30 percent profit allocation.

The operation of Section 367(d) also may incentivize taxpayers in certain situations to transfer intangibles via taxable transfers subject to Section 482 rather than transfers subject to Section 367(d). There is no indication, following the 1997 changes to Section 367(d), of a Congressional intention to steer taxpayers away from Section 367(d) and toward Section 482. In general, we believe that, to the extent consistent with the statutory differences, the Treasury regulations under Section 367(d) should achieve greater parity between the income tax consequences of a deemed sale of a Section 936 Intangible under Section 367(d) and an actual license or sale of such intangible for contingent consideration under Section 482.

The legislative intent of the 1984 adoption of Section 367(d) was to impose quasi-license consequences on the outbound transfer of Section 936 Intangibles in circumstances that exhibit potential for U.S. tax avoidance, but without regard to a principal purpose of tax avoidance. The House and Senate committee reports stated that the changes to the structure of Section 367 in 1986 were intended to override Tax Court cases, citing <u>Dittler Brothers</u> in particular, that "threatened to weaken" Section 367.[56] Despite the changes in approach, the legislative history still focused on "the types of tax-avoidance transfers that the provisions of [Section 367] were intended to combat."[57] In the case of intangible property, Congress noted that the U.S. tax rules contain tax incentives designed to encourage research, experimentation and development, and expressed concern that transfers to foreign corporations of U.S.-developed know-how, and U.S. patents, trademarks, and other intangibles for use in connection with a U.S. trade or business

[56] House Report, at p. 1315; Senate Report, at 360.

[57] *Id.*

could shift offshore income that arose from these valuable intangibles, the development of which was granted favoured U.S. tax treatment.

The framework of Section 367 as passed by the 1984 Act generally adopted the prior ruling standards of the IRS in its ruling practice under the former Section 367. However, Congress explicitly intended to override the IRS ruling policy with regard to intangibles which exempted the transfer of certain intangibles for use in a active trade or business of a foreign corporation. Congress noted that:

> "By engaging in such a practice, the 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."[58]

Stated differently, the policy of Section 367(d) as expressed in the 1984 legislative history, like the policy of Section 936(h), appears to be to ensure that the value of intangibles, the development of which gave rise to deductions against U.S. taxable income, be subject to U.S. tax without regard to a principal purpose of tax avoidance. In extending the scope of Section 367 with regard to intangibles, Congress overruled the previous IRS ruling practice which had generally looked only to whether the income from the intangible was passive or had a U.S.-nexus.

In addition, the legislative history also appears to contemplate that the notionally severable contingent sale of intangibles under Section 367(d) would not have a deleterious effect on the ability of the remainder of the outbound transaction to qualify as a reorganization transaction. In particular, it does not appear that the deemed sale was intended to be regarded as boot or another form of impermissible consideration that could potentially disqualify the broader

[58] *See* House Report, at 361.

transaction from rollover treatment. More specifically, in the context of describing the operation of Section 367(d), the Senate Report specifies that "this rule applies even if the intangible property is transferred along with tangible personal property eligible for the trade or business exception."[59]

(c) Policy of Section 367(d)

Many difficult issues regarding the determination of the appropriate scope and application of Section 367(d) turn on an interpretation of the policy of this provision as expressed in the legislative record. In certain respects, this legislative history is inconsistent, rendering it difficult to make judgments about what may or may not advance the policy objectives of the provision. A fundamental difficulty with interpreting Section 367(d) is the tension between giving meaning to the exception for foreign goodwill and going concern value from Section 367(d) and the inherent imprecision of concepts of goodwill and going concern value. As a result, many of the interpretive issues addressed in this report reflect our interpretation of the legislative record and best judgment regarding the intended purpose of Section 367(d). We view Congress as desiring to permit tax-free incorporations of foreign branches and other outbound transfers of assets for use in a foreign trade or business, except for

[59] Senate Report, at 368. In addition, in the context of a discussion regarding the operation of "Prior Law" the JCT Report addresses the interplay of the "tainted asset" rules and the tax-free treatment of the outbound transfer of non-tainted assets. Specifically, the JCT Report notes that, under the prior ruling approach to Section 367, "a favorable ruling was issued when assets of a domestic corporation were acquired by a foreign corporation in a corporate reorganization (secs. 354, 355, 356 and 361) provided the transferor agreed to include a toll charge in its gross income with respect to assets whose transfer in a section 351 exchange would have resulted in an unfavorable ruling. For example, if a foreign corporation acquired substantially all of the assets of a domestic corporation solely in exchange for voting stock of the foreign corporation (a type "C" reorganization) and the acquired assets included a tainted asset (e.g., inventory), a favorable ruling was issued (and tax-free reorganization treatment obtained) only if the domestic corporation agreed to include a toll charge in its gross income." Moreover, in the 1984 legislative history, the Senate Report indicates, in the context of a discussion regarding tainted assets generally, that "[w]here tainted assets and other assets are transferred to a foreign corporation for use in an active trade or business, no gain will be recognized on the transfer of assets other than the tainted assets." We have not identified anything in the subsequent statutory amendments to Section 367 or the accompanying legislative history to such amendments that would suggest that payment of a Section 367 toll-charge in connection with the outbound transfer of intangibles (under Sections 367(d), 367(a)(3)(B) or otherwise) was intended to disqualify the remainder of the transaction from rollover or Section 351 treatment.

Section 936 Intangibles, and this interpretation of the legislative intent of Section 367(d) guides our interpretation of the statutory language.

2. Scope of Section 367(d)

(a) Definition of Section 936 Intangibles

As previously described, the scope of Section 367(d) is limited by the definition of intangibles utilized in Section 936(h)(3)(B). This definition, which had been used in the original Section 367(d) enacted in 1982 regarding possession credit intangibles, made perfect sense in that context. Some have questioned whether that Section continues to be the correct definition for the scope of Section 367(d) today. Specifically, in the years since Section 367(d) was first enacted, taxpayers have pursued the ability to describe and identify amortizable intangibles for purposes of increasing amortization deductions attributable to recently purchased assets of a target business. These efforts led to a long and costly series of taxpayer-IRS litigation concerning the amortization of all such assets. The enactment of Section 197 brought this litigation to an end by providing rules for the amortizable life of various purchased intangibles. Might the definition of intangibles found in Section 197(d) be more useful in determining the scope of Section 367(d) in the future?

We would observe that the definition of intangibles in Section 197 was drafted in the context of a compromise regarding the amortizable lives of intangible assets. With respect to such assets, the question which the statute attempts to clarify is the useful life. By contrast, Section 936(h)(3)(B) was utilized to define a specific set of intangible assets which were of a kind typically permitting research and development deductions, which would reduce the U.S. tax base of the transferor. This list of intangibles was regarded to have a high tax-avoidance potential. The clearest example of a difference between the two definitions is the concept of "goodwill" itself. Goodwill is quite simply not an asset which gives rise to the generation of

U.S. deductions prior to an outbound transfer; instead, it is created by revenues generated and customers utilizing a business product or service. Therefore, Congress might well have determined that it was not a high tax-avoidance potential asset of a type which needed to be identified for purposes of Section 367(d). On the other hand, goodwill was exactly an asset the possible amortization of which gave rise to the continuing stream of litigation which ultimately concluded with the enactment of Section 197. While Congress has the power to change the law at any time should that be its determination, the answer to the question of whether Section 197 would make a better definition of intangibles for purposes of Section 367(d) seems to be “no”; based on Congress’s relatively precise consideration and expression of the targeted assets in Section 936(h)(3)(B).

With regard to the scope of Section 936 Intangibles, Section 936(h)(3)(B) provides a list of 27 assets sharing certain common traits. We believe that “other similar assets” should be interpreted to describe assets that share common characteristics with the listed assets. We believe the listed items have two prominent common characteristics that should inform whether property is within the “other similar assets” category, that the property may be separately valued and that, at least theoretically, the property may be transferred separately from the business to which it relates.

In a recent technical advice memorandum, TAM 200907024, the IRS concluded that a group of contracts with foreign agents in numerous countries to provide delivery services to the public or on behalf of a taxpayer were a Section 936 Intangible. We agree that the technical advice memorandum appropriately applied the statutory definition to the taxpayer's facts. We also believe that the reasoning of the TAM is consistent with the decision in DHL Corp. et al. v.

Commissioner.[60] There, the Tax Court found that the infrastructure and operating know-how of affiliates in a package delivery business were intangible assets:

> "The evidence supports a finding that the know-how and system in place that facilitated the ability to make timely and efficient deliveries is at least as important as the name 'DHL'. . . . To a great extent the parties' experts . . . support our factual findings that the infrastructure . . . *is at least as important as the name*.
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> "In reaching that conclusion, we have, to some extent, relied on petitioners' experts, who have opined that the DHL network has value, over and above the stated equity, that should be attributed to intangibles other than the trademark. In particular, we find persuasive the concept that the DHL network enjoyed an intangible benefit from its existing infrastructure and operating know-how that created a 'barrier to entry' of others into the same marketplace. . . Accordingly, we are convinced that intangibles, other than the trademark, account for some portion of the income benefits that have been estimated by the parties' experts."

The technical advice memorandum refers to the collection of contracts as a "network." The term "network" is not listed in Section 936(h)(3)(B), but the IRS appears to have to have used the term as explanatory of its aggregation approach in valuing the underlying contracts.

New regulations under Section 367(d) could include reference to the guidance provided by the courts as to the scope of property for purposes of Section 367(a), which effectively limits the scope of Section 936 Intangibles. For example, a decision of the Tax Court concluded in Hospital Corp. of America v. Commissioner[61] that the opportunity to enter into a contract was not an asset subject to Section 367.[62] If this reasoning were followed, the assignment of a corporate opportunity would be excluded from the scope of Section 367(d). And if there is no transfer of preexisting property, without more, income should not be reallocated: "[a] parent

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[60] TC Memo 1998-461, *aff'd. in part, rev'd. in part on other grounds*, 285 F.3d 1210 (9th Cir. 2001).

[61] 81 T.C. 520 (1983).

[62] This holding has been criticized. *See* LeBeau and P. Dostart, "Offshore tax planning may be favorably affected by recent Hospital Corp. decision," 60 J. Tax. 294, 300-01 (1984) (court applied flawed property analysis).

corporation may create subsidiaries and determine which among its subsidiaries will earn income. The mere power to determine who in a controlled group will earn income cannot justify a Section 482 allocation from the entity that actually earned the income."[63]

Current Treasury Regulation § 1.367(d)-1T(b), in addition to excluding foreign goodwill and going concern value from the operation of Section 367(d), also excludes "the transfer of intangible property described in §1.367(a)-5T(b)(2)." Temporary Treasury Regulation §1.367(a)-5T includes a list of assets that under Section 367(a)(3)(B) are subject to current recognition under Section 367(a)(1) regardless of whether such assets are transferred for use in an active trade or business. The list includes inventory, installment obligations and foreign currency, among others. Specifically, Treasury Regulation §1.367(a)-5T(b)(2) describes "a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by (i) a taxpayer whose personal efforts created such property; (ii) in the case of a letter, memorandum or similar property, a taxpayer for whom such property was prepared or produced; or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale of exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this paragraph (b)(2)." The introductory language and the first two of the subparagraphs in this cross reference essentially track the language of the capital gains exclusion set forth in Section 1221(a)(3), which in turn is referenced in Section 367(a)(3)(B). While the exclusion generally applies to self-created intellectual property of individuals, if it involves a "letter, memorandum

[63] Merck v. Commissioner, 24 Cl. Ct. 73 (1991).

or similar property," it can apply to such property (e.g., archives) created by employees of a U.S. corporation.[64]

Where applicable, the cross-reference to Treasury Regulation Section 1.367(a)-5T(b)(2) results in current recognition treatment in lieu of the deferred royalty provisions of Section 367(d), not unlike the elective recognition applicable to operating intangibles. Presumably this exception was intended to ease compliance in contexts in which the assets transferred are not of enormous value.

We note that, under the cited authorities, the regulatory cross-reference to self-created intellectual property generally does not include corporate-created Section 936 Intangibles, which we believe is appropriate. However, we question whether the broader range of self-created intellectual property should be excluded from Section 367(d) in the case of individuals in all cases. The covered property includes, *e.g.*, copyrights, which can include, *e.g.*, software and films. These types of property, even if created and owned by individuals, can be of great value. As a matter of policy, allowing the cross-reference to apply the current gain recognition regimes to Section 936 Intangibles would seem to conflict with the intended scope of Section 367(d) and the deemed royalty treatment there prescribed for Section 936 Intangibles.

(b) Foreign Goodwill and Going Concern Value

Section 367(a)(3) makes clear that Congress generally did not wish to tax the gain inherent in the assets used in an active foreign business when those assets were transferred to a foreign company in certain cases. Thus, subject to the provisions of Section 367(a)(5) and the branch loss recapture rule of Section 367(a)(3)(C), the United States cedes current taxing

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[64] *See*, *e.g.* Chronicle Publishing Co. v. Commissioner, 97 T.C. 455 (1991), holding that a corporation is a person subject to Section 1221(a)(3)(B), PLR 200119005 (Nov. 21, 2000) (similar).

jurisdiction to the transferee's country of residence, and defers U.S. tax until the shares received in the exchange are disposed of by the U.S. transferor. Section 367(a)(1) applies to an outbound transfer of "property" in a transaction that would otherwise be eligible for non-recognition treatment. In Revenue Ruling 79-288, the IRS concluded that goodwill was property. By its terms, the transfer of goodwill is governed by the general rule in Section 367(a), unless an exception otherwise applies. Under Section 367(a)(3), the active trade or business exception can apply to property, except for, among other "tainted" items, "intangible property (within the meaning of section 936(h)(3)(B))." A transfer of Section 936 Intangibles is generally subject to the rules of Section 367(d). If goodwill were described in Section 936(h)(3)(B), it would not qualify for the "active foreign trade or business" exception.

A fair reading of the legislative history of Section 367(d) persuades us that Congress intended to permit the tax-free incorporation of foreign branches with associated goodwill and going concern value, except for Section 936 Intangibles and in cases where the branch had accumulated losses subject to recapture. In the context of a discussion regarding the general exception from Section 367(a) for property used in a foreign trade or business, the Senate Report provides that:

> 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. Similarly, it is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names[65]) in appropriate cases.[66]

However, the Senate Report seems to contemplate that, notwithstanding that this excluded class of intangibles is eligible for the active trade or business exception, it may nevertheless be subject

[65] The explicit reference to "trademarks or trade names" is quite remarkable given the fact that trademarks and trade names are also explicitly included in the Section 936(h)(3)(B) definition of intangible property (see 936(h)(3)(B)(iii)).

[66] Senate Report at 365.

to a current toll-charge if the outbound transfer occurs as part of the incorporation of a foreign branch with prior losses. In particular, in the context of a discussion regarding the foreign branch loss recapture rule, the Senate Report observes that "[i]n computing the tax imposed under this rule, gain on transfers of goodwill or going concern value will be taxable."[67]

The Conference Report appears to generally endorse the Senate Report, with certain clarifications. In particular, in the context of a discussion regarding the scope of the active trade or business exception, the Conference Report suggests that marketing intangibles were intended to be within the class of excluded intangibles, subject to exceptions that were developed prior to the 1984 amendments:

> "The conferees wish to clarify that, as under present law, gain will generally be recognized under section 367(a) on transfers of marketing intangibles (such as trademarks or trade names) for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States."[68]

In a subsequent discussion regarding the branch loss recapture rule, the Conference Report identifies two "technical modifications" to the Senate version of the branch loss recapture rule. In the course of this discussion, the report uses potentially confusing language to describe the interplay of the branch loss recapture rule and Section 367(d):

> "The conferees intend that, on incorporation of a loss branch with appreciated intangibles, the transfer of intangibles will generally be subject to the special rule for intangibles, not the loss branch rule."[69]

A literal reading of this passage, and in particular the use of the broad term "intangibles" without specifying a distinction between intangibles meant to be caught by Section 367(d) and

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[67] Senate Report, at 368-69.

[68] House Report, at 209.

[69] Blue Book, at 428.

"excluded" intangibles, may imply that Congress meant to displace the concept of an excluded class of intangibles that was espoused in the Senate Report. In our view, however, this is not an appropriate reading. In an earlier portion of the Conference Report a similar broad reference to "intangible property" is made but, in that case, the reference is immediately followed by a parenthetical qualifier that reads: "as defined for purposes of the special rules relating to intangibles."[70] This suggests that general references to "intangibles" in the Conference Report should be construed as a reference only to that subset of intangible property that is subject to Section 367(d). Accordingly, in our view, the language excerpted above should not be interpreted as overriding the concept, clearly embedded in the Senate Report, that there is a class of intangibles that is not subject to Section 367(d).

The JCT also acknowledged that Congress intended there be an excluded class of intangibles that is not subject to the special rule of Section 367(d). In particular, the JCT stated that:

> "Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes."[71]

Two observations about this passage are in order. First, like the Senate Report, this passage appears to contemplate an excluded class of intangibles that is comprised of goodwill and going concern value, without regard to whether that goodwill or going concern value is "foreign" or "domestic". Perhaps this indicates that goodwill is not within Section 936(h)(3)(B) and therefore

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[70] Also, the excerpted observation was not explicitly identified as one of the two "technical modifications" that the Conference Report wished to make to the Senate Report (and therefore ought not to be construed as displacing any aspect of the Senate Report).

[71] Blue Book, at 434.

is eligible for nonrecognition if the goodwill is used in an active foreign trade or business (*i.e.,* is foreign goodwill). Second, unlike the Senate Report, this passage introduces (parenthetically) the concept that intangibles that are "similar" to goodwill, going concern value and/or marketing intangibles are to be excluded from the special rule of Section 367(d).

However, in the portion of its report entitled "Explanation of Provision," the JCT appears to impose a new concept that was not featured in the Senate or Conference Reports that limits the class of intangibles that are excluded from Section 367(d). In particular, in the context of a discussion regarding the operation of the branch loss recapture rule, the JCT Report indicates that:

> "On incorporation of a loss branch with appreciated intangibles, the transfer of intangibles will be subject to the special rule for intangibles, not the loss branch rule, except that gain on transfers of goodwill, going concern value, or marketing intangibles will be taxable under the loss branch rule <u>to the extent that transfers of such property are excepted in regulations</u> relating to the special rule for intangibles and the rule for tainted assets." [emphasis added]

The JCT Report reiterates this position in a discussion under the heading "Goodwill and certain similar intangibles" by indicating that:

> "The Act contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill, going concern value, or marketing intangibles (such as trademarks or trade names) developed by a foreign branch to a foreign corporation (regardless of whether the foreign corporation is newly organized). <u>Thus, where appropriate, it is expected that regulations relating to tainted assets and the special rule for intangibles will provide exceptions for this type of property</u>. As noted above, however, no such exception will be provided under the loss branch rule. In addition, as under prior law, gain will be recognized on transfers of marketing intangibles for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States". [emphasis added]

These passages suggest that the JCT understood Congress to intend that goodwill, going concern value and marketing intangibles were, in the first instance, Section 936 Intangibles and therefore caught by Section 367(d), but that an exception would be provided in subsequently enacted regulations. This construction does not square comfortably with an earlier passage of the JCT Report which, in the course of describing the scope of the loss branch recapture rule noted that:

> "In computing the tax imposed under this rule, gain on transfers of goodwill, going concern value, and marketing intangibles developed by a foreign branch will be included." [emphasis added]

It appears that the only way to reconcile these statements is to hypothesize that, at least in the view of the JCT, Congress intended "foreign" goodwill, going concern value and marketing intangibles to be exempted from Section 367(d) and the tainted asset rule (and therefore subject to the branch loss recapture rule) but that "domestic" goodwill, going concern value and marketing intangibles would be subject to Section 367(d) unless excluded by regulations.[72] A plain reading of the Conference Report and Senate Report, however, does not appear to explicitly support this distinction between foreign and domestic intangible items.

In addition, we believe the better reading of Section 936(h)(3)(B) is that it excludes goodwill and going concern value.[73] There are several reasons that we believe this to be the case. First, goodwill and going concern value do not share the common traits of the assets listed in section 936(h)(3)(B). They cannot be individually valued. Rather, they are the residual value after all other assets of the business are valued. In addition, goodwill and going concern value may not be transferred separately from the business.

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[72] Although the JCT Report suggested that Section 367(d) is intended to tax the outbound transfer of intangible property the development of which had given rise to deductions against U.S. taxable income, the statute does not limit the property to which it applies to such a type of property. The amount of deductible expenses incurred in developing intangible property, including goodwill and going concern value, bears no necessary correlation to the income to which such property subsequently gives rise.

[73] A number of commentators have also taken this position over the years.

Second, goodwill and going concern value are well-known intangible assets that often appear on the balance sheets of companies. For that reason, the exclusion of such assets appears to be intentional. Moreover, Congress has explicitly included goodwill and going concern value in other definitions of intangible property found in the Code. The limited scope of Section 936(h)(3)(B) is significant because intangible assets that are not described in Section 936(h)(3)(B) and that are part of a foreign active trade or business may be transferred out of the United States in a tax-free transaction, under certain circumstances. The reason for the relatively narrow scope is apparent from the suggestions in the legislative history to Section 367(d) that Congress was principally concerned with the outbound transfer of manufacturing intangibles. Those assets had been developed in the United States and the expenses of development had been deducted against US source income. There is no similar concern for goodwill and going concern value.

In TAM 200907024, the IRS argued that the legislative history to Section 367(d) does not require the goodwill and going concern exclusion. As described above, we do not think that this is the proper reading of the legislative history. In addition, including goodwill and going concern value in the scope of Section 367(d) would significantly limit the scope of the "active foreign trade or business" exception of Section 367(a)(3), because goodwill and going concern value are assets of most active businesses. Congress's intent to permit the tax-free incorporation of foreign branches with associated goodwill and going concern value would be frustrated if the undifferentiated goodwill and going concern value of the branch's business were subjected to taxation under Section 367(d). We believe that the better view is that Congress intended there to be an exception from Section 367(d) for foreign goodwill and going concern value and that, in any case, goodwill and going concern value do not constitute Section 936 Intangibles. Accordingly, in the absence of legislative intervention to establish otherwise, we believe that

Treasury regulations under Section 367(d) should retain the statement that "foreign goodwill and going concern value" are excluded from Section 367(d).

We believe that the JCT Income Shifting Report is not inconsistent with the views expressed herein. That report contains a hypothetical, the Charlie Company hypothetical, in which a U.S. multinational, presumably in the pharmaceutical business, generated 60% of its sales in the U.S. but only 6% of its income tax was attributable to the U.S.[74] It had accomplished this, in part, by transferring its Puerto Rican manufacturing facility to a Cayman disregarded entity owned by a wholly-owned Swiss corporation. The hypothetical notes that the value of the manufacturing division transferred to the Swiss corporation was "almost all…attributed to residual intangible assets of foreign goodwill, going concern value, and workforce in place," even though such assets had been insignificant in the prior acquisitions through which the assets were assembled.[75] Like TAM 200907024, the hypothetical suggests that Section 367(d) was exploited by improperly treating as foreign goodwill value actually attributable to production assets, cost-shared technology and marketing intangibles. Section 367(d) would have imposed a tax on the transfer of such Section 936 Intangibles if properly valued.

(c) Goodwill Limited to Residual Value

Temporary Treasury Regulation § 1.367(a)-1T(d)(5)(iii) limits the scope of the foreign goodwill and going concern value exclusions from the operation of Section 367(d) to the residual value of the foreign business after subtraction of the value of all other identifiable tangible and intangible property. The residual character of goodwill and going concern value permits the potential expansion of intangibles subject to Section 367(d) to the extent that the courts accept

[74] *See* the JCT Income Shifting Report, *supra* note 9, at pp. 73-76.

[75] *See id.* at p.75.

the existence of separate and distinct items of intangible property under the "any similar item" clause of Section 936(h)(3)(B). In this context, the scope of the definition of Section 936 Intangibles is essential to determining, by exclusion, what goodwill and going concern value includes.

As described above, Section 367(d) was added to the Code in connection with the enactment of Section 936(h), which required the shareholders of possessions corporations to include in current income the income produced by intangibles held by a possessions corporation.[76] Not surprisingly in this context, Section 367(d) adopted the definition of "intangible property" set forth in Section 936(h)(3)(B), the definition used for purposes of the possession tax credit. The legislative history to Section 367(d) is clear that Congress intended that there is some subset of intangibles that is intended to be exempted from Section 367(d) (*i.e.,* the residual "similar item" category under Section 936(h)(3)(B) should not be interpreted to include all intangible property). Practitioners have developed elsewhere various arguments based on the legislative history and scope of Section 936 that suggest that there are reasonable arguments that foreign goodwill, going concern value and workforce-in-place are not within the scope of Section 936 Intangibles.[77] With regard to workforce-in-place, we believe that it is not one of the items of intangible property enumerated in section 936(h)(3)(B), and we believe it is

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[76] Compare the scope of the definition of "intangible property" in Section 936(h)(3)(B) with the definition of "intangible" for the special sourcing rule in Section 865(d), which defines "intangible" as meaning "any patent, copyright, secret process or formula, *goodwill*, trademark, trade brand, franchise, or other like property" [emphasis added].

[77] *See, e.g.,* Thomas M. Zollo, "Clarification or Modification? The Tax Treatment of the Outbound Transfer of Goodwill, Going Concern Value, and Workforce in Place to a Foreign Corporation," 39 TM International Journal 71 (Feb. 12, 2010).

not a "similar item" because it cannot be transferred separately from the business that includes the workforce.[78]

One fundamental problem is that Congress did not specify precisely which intangibles are not subject to Section 367(d). It is not clear whether Congress thought goodwill and going concern value were exempted from Section 367(d) because they did not constitute Section 936 Intangibles, or goodwill and going concern value were, in the first instance, Section 936 Intangibles but that they would be exempted from Section 367(d) by way of a regulatory carve-out. As evidenced by the taxpayer positions taken in TAM 200907024, Veritas, and First Data, among others, and the position articulated by the Treasury in the Administration Proposals, it is fair to say that there is genuine uncertainty regarding the scope of Section 936 Intangibles. Given the enormous significance of the issue, the advantage of a legislative or regulatory resolution would be to provide significant clarity, whereas an administrative ruling or judicial solution likely would be less satisfactory given the highly factual nature of these issues and potentially would consume vast amounts of IRS and taxpayer resources in the litigation of the positions taken.[79] In addition, excessive litigation is prone to dissatisfying results similar to those that were produced before 1984 when Section 367 was governed by the "principal purpose" standard. The residual definition of goodwill and going concern and the IRS`s litigating position on what constitutes a Section 936 Intangible may produce a course of litigation that resembles the one that preceded the enactment of Section 197, in which taxpayers

[78] The Veritas court noted that the list of items treated as Section 936 Intangibles is limited to property "which has substantial value independent of the services of any individual," and concluded that workforce-in-place does not have value independent of the services of the individuals constituting the workforce. It would seem that, definitionally, any value attributable to workforce-in-place should only be that resulting from an assembling of the workforce, and thus should be independent of the services performed by the individuals.

[79] Compare the litigation that arose with regard to the characterization of intangible assets prior to the enactment of Section 197, which nonetheless required subsequent legislative action to bring clarity and stability to the area of the law.

successfully identified new and separate items of intangible property that were differentiated from goodwill. On the other hand, the flexibility to construe statutes in contemporary factual contexts, such as dealing with novel forms of intangibles that may develop and their manifestations in various contexts, is an advantage of the common law and, relatively speaking, can operate best in a milieu that requires a nimble rather than rigid approach.

In the absence of legislative or regulatory guidance, we recommend that the IRS position regarding various classes of intangibles be made specific and explicit in published rulings, expanding on the position taken in the Coordinated Issue Paper on cost-sharing buy-in payments, LMSB -04-0907-62. We recommend that the positions stated by the IRS give consideration to existing judicial guidance.[80] It should be noted that a new interpretation or change to the scope of Section 936 Intangibles reflecting such judicial guidance would reduce the scope of application for the commensurate with income provisions of Section 482, as well.

(d) Marketing Intangibles

Marketing intangibles would appear to be both inextricably interwoven into "goodwill" and simultaneously identified with the Section 936(h)(3)(B) list of covered intangibles. The 1984 legislative history to Section 367(d) states that marketing intangibles associated with a foreign trade or business were not within the intended scope of Section 367(d). This conflicts with the Section 936(h)(3)(B) definition which specifically enumerates certain items that would traditionally be thought of as marketing intangibles, such as trademarks, brand names, campaign, and customers lists. We believe the language of the Senate Report and the JCT Report should be read as an invitation to Treasury and the IRS to exercise regulatory authority in a manner that

[80] Note, for example, the language in Veritas in which the Tax Court concludes that the access to marketing and research and development teams that was at issue in the decision (i.e., "workforce-in-place") did not have "substantial value independent of the services of any individual" and thus did not constitute Section 936(h)(3)(B) intangibles. The Veritas decision also noted the inapplicability of judicial authority discussing the definition of "intangible" outside the Section 482 context.

would exclude from Section 367(d) marketing intangibles that are clearly associated solely with a foreign business and that have not previously been the source of deductions which have reduced United States income (*e.g.*, deductible expenses of a global marketing campaign). The IRS accepted this invitation by adopting a temporary window for the tax-free transfer of marketing intangibles in Temporary Regulation § 1.367(a)– 1T(d)(5)(iv) for periods up to May 16, 1986. We recommend new and continuing regulatory safe harbors or elective procedures to permit appropriate marketing intangibles to be excluded from Section 367(d).

A marketing intangible of particular note is the asset companies often show on their balance sheet described as "customer relationships." This asset is amortizable for financial accounting purposes, which distinguishes it from goodwill and going concern value, which is not amortizable. In connection with an acquisition, customer relationships are valued after all of the other tangible and intangible assets of the company are valued in the following manner. The difference between the purchase price of the company and the individual assets previously valued, *i.e.*, the residual value of the company, is split between the customer relationship asset and goodwill and going concern value. The customer relationships asset is given a life based on some measure of customer turnover and assumed to decline on a straight-line basis for that period, *e.g.*, 10 years.

To the extent the customer relationships are not attributable to actual contracts, then, notwithstanding the approach taken for financial accounting purposes, we believe they are similar to goodwill and could be treated in the same manner as goodwill, *i.e.*, they could be taxed under Section 367(a) and not Section 367(d). Because economists typically are able to value trademarks and trade names as separate assets, the regulations could exclude customer relationships from the scope of Section 367(d), without also excluding trademarks and trade names.

(e) Scope of the Lump-Sum Sale Election

In the case of certain outbound transfers of Section 936 Intangibles within the scope of Section 367(d), the regulations permit the U.S. transferor to recognize gain immediately, rather than take into account deemed annual payments over the useful life of the intangible.[81] For purposes of determining the gain required to be recognized as a result of the election, the Temporary Section 367(d) Regulations provide that the fair market value of the Section 936 Intangible is the single payment arm's length price that would be paid for the property by an unrelated purchaser, as determined in accordance with the principles of Section 482 and the regulations thereunder.[82] This special treatment is extended to three types of transfers of Section 936 Intangibles: transfers of "operating intangibles," transfers compelled by a foreign government, and certain transfers to foreign joint ventures.[83] "Operating intangibles" are defined by reference to Treasury Regulation § 1.367(a)-1T(d)(5)(ii) to mean "any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of the property." The regulation includes as examples "long-term purchase or supply contracts, surveys, studies, and customer lists." Transfers compelled by a foreign government are those transfers that are either legally required as a condition of doing business by the foreign country where the transferee is

[81] A U.S. transferor electing to treat a transfer of Section 936 Intangibles as a taxable event must notify the IRS in accordance with the information reporting requirements of Code Sec. 6038B and include the appropriate amounts in gross income in the year of the transfer. *See* Treas. Reg. § 1.367(d)-1T(g)(2), Treas. Reg. § 1.6038B-1T(d)(1)(vii).

[82] It should be clarified that a transfer otherwise subject to Section 367(d) for which a lump-sum sale election is made should be subject to Treasury Regulation § 1.482-4(f)(6), relating to the treatment of lump sum payments for intangibles under Section 482.

[83] *See* Treas. Reg. § 1.367(d)-1T(g)(2).

organized or compelled by a genuine threat of immediate expropriation by the foreign country.[84] The transfers to joint ventures eligible for the deemed sale election ("JV Sale Election") are transfers (i) within three months of the organization of the transferee foreign corporation in connection with its original plan of capitalization, after which (ii) the U.S. transferor owns 40 to 60% of the voting power of the transferee and (iii) foreign persons unrelated to the U.S. transferor own 40 to 60% of the voting power of the transferee, but only if (iv) at least 50% of the fair market value of property transferred by the U.S. transferor constitutes intangible property and (v) the intangible property transferred is used by the transferee in the active conduct of a trade or business outside the U.S. (as defined in Temporary Treasury Regulation § 1.367(a)-2T) and not in connection with the manufacture or sale of products in or for use or consumption in the United States.

We believe that elective lump-sum sale treatment under Section 367(d) should be generally available with respect to transfers to uncontrolled corporations (including a 50-50 joint venture with an unrelated party). In a transaction subject to Section 367(d), where a U.S. person transfers a Section 936 Intangible to a foreign corporation not controlled by the U.S. transferor or related persons, the unrelated owners of the foreign corporation will demand arm's length pricing of the intangible.[85] Further, the economic terms of the venture will likely not entitle the U.S. transferor to a return resembling the deemed Section 367(d) payments. In such situations, applying Section 367(d) hopelessly obscures the true income realization to the U.S. transferor on

[84] Temporary Treasury Regulation § 1.367(a)-4T(f) presumes that tangible property is transferred for use in the active conduct of a trade or business outside the United States if it was previously used in the country in which the transferee is organized and the transfer is compelled or legally required by the foreign government.

[85] We acknowledge that, in order to facilitate the avoidance of U.S. tax by a U.S. transferor, a foreign participant in the foreign corporate joint venture subject to Section 367(d) could proportionately undervalue the property it contributes to the foreign corporation, to maintain the economic deal but depress the value of the Section 936 Intangible. The IRS may wish to promulgate an anti-abuse rule to police such mutual pricing agreements.

the transfer.[86] An extension of the lump sum election to intangibles that under all reasonable circumstances would provide a low return might also be considered, as a matter of administrative convenience.

If these proposals to substantially expand the lump-sum sale election under Treasury Regulation § 1.367(d)-1T(g)(2) are not adopted and some version of the current regulations is retained, we suggest that the requirements for using the JV Sale Election should be relaxed. The JV Sale Election includes a number of strict requirements. It is unclear why the particular numbers are used (*e.g.,* 40 to 60 percent ownership, transfer within three months, 50% of value transferred is intangible property). For example, the requirement that the transferor own no more than 60 percent of the joint venture might be based on a concern as to whether the amount of equity received in the venture represents fair market value, but, if so, the qualification for the exception might more rationally turn on whether the transferor and the joint venture are "owned or controlled directly or indirectly by the same interests" as the phrase is used in Section 482 and rely on the law developed under that provision. The purposes of the 40 percent lower bound, the requirement that at least 50% of the property transferred constitutes intangible property and the requirement that the transfer occur within three months from the organization of the joint venture are less clear. These requirements seemingly arbitrarily restrict the number of transactions to which the JV Sale Election applies. Because the alternatives to a contribution (*e.g.,* an actual sale or license of the technology) may not be able to deliver the economics desired by the parties,

[86] Some members of our Executive Committee considered, but the majority did not agree, that the lump-sum sale election should also be extended to transfers to controlled corporations. In the view of the minority of members, in the case of transfers of Section 936 Intangibles to controlled foreign corporations otherwise subject to Section 367(d), as long as such transfers would otherwise fall within the scope of Section 482 and be subject to the "commensurate with income" standard, it was felt that elective lump-sum sale treatment is appropriate. Expansion of the sale election to transfers to controlled corporations would allow more taxpayers to elect to be taxed under the clearer Section 482 regime, at the cost of up-front U.S. tax. Further, the application of the "commensurate with income" standard should ensure that the pricing of the deemed lump-sum sale transaction captures the value of the intangible property at the time of transfer

a U.S. transferor in a foreign corporate joint venture needs access to a sale election alternative to avoid deemed Section 367(d) payments with respect to income that may not be earned. The unavailability of a lump-sum sale election limits the ability of U.S. taxpayers to enter into corporate joint ventures with foreign persons without an uneconomic tax cost. In most cases, a "check the box" election will be available, though at the cost of no deferral of income. If the joint venture entity is a *per se* corporation, however, even that is not an alternative. Relaxation of the requirements under the JV Sale Election would go some way to mitigate the disruption caused by Section 367(d) with regard to foreign corporate joint ventures.

(f) Administration's 2011 Budget Proposals

As discussed above, under current law, an outbound transfer of a U.S. business (including its goodwill and going concern value) is taxable under Section 367(a). Accordingly, the Administration Proposal to expand the definition of "intangible property" in section 936(h)(3)(B) to include workforce-in-place, goodwill and going concern value would apply to transfers of active foreign businesses. The proposal also would cause transfers of U.S. goodwill, going concern value and workforce-in-place to be valued and taxed under Section 367(d) and Section 482 in accordance with the "commensurate with income" standard.

We believe that the policy and practical implications of such an approach need to be fully considered. In the context of a particular intangible asset (*e.g.*, a patent or a software copyright) that is difficult to value and has a long life, an open transaction approach is most practical. However, to apply the "commensurate with income" approach to goodwill, going concern value and workforce-in-place effectively leaves the value of the entire business open and subject to annual adjustment during the period that the "commensurate with income" standard may be applied. Such "earn-out" provisions are common in the sale of a business between unrelated parties, but have a limited life. We assume that the "commensurate with income" standard is intended to be applied to more accurately set the value of the transferred assets closer to an arm's length. Therefore, the time period during which it can be applied should be limited. We suggest a limitation of five years and that the percentage of appreciation in the residual value of the business that is subject to U.S. tax decline over that period. Without a limitation on application of the "commensurate with income" standard to these assets, not just built-in gain and anticipatable appreciation but also true post-transfer appreciation of the business carried on by a foreign corporation would be subject to current U.S. taxation, regardless of whether resulting from factors and influences occurring after the date of the transfer.[87]

In addition, as described, above, we believe that describing this change as a clarification of existing law is not consistent with the legislative history to Section 367(d). As a result, we believe this proposal, if adopted, should be applied prospectively (as described in the Administration Proposals) and not be construed as authority for the interpretation of law prior to the adoption of the proposal.

(g) Coordination with Cost Sharing

The JCT Report provides that "the special rule for intangibles [in Section 367(d)] will have no application to bona fide cost sharing arrangements (under which research and development expenditures are shared by affiliates as or before they are incurred, instead of being recouped by licensing or selling intangible after successful development)." The temporary cost sharing regulations require a "PCT Payment" for any "platform contribution" that one of the controlled parties makes to a cost sharing arrangement ("CSA"). The definition of "platform

[87]As also for Section 936 Intangibles, current taxation of post-transfer appreciation of goodwill and going concern value would be contrary to both the realization principle in U.S. income tax law as well is the deferral principle generally applicable to foreign corporations.

contribution" in Temporary Treasury Regulation § 1.482-7T(c)(1) is broader than the definition of "intangible property" in Section 936(h)(3)(B). A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost-shared intangibles.

Temporary Treasury Regulation § 1.367(a)-1T(d)(3) provides that "a person's entering into a cost sharing arrangement under § 1.482-7 or acquiring rights to intangible property under such an arrangement shall not be considered a transfer of property described in section 367(a)(1)" (*i.e.*, not described in Section 332, Section 351, or the reorganization provisions of Subchapter C of the Code). This statement serves as a coordination rule that excludes platform contribution transactions ("PCTs") from Section 367(d). That is, the rules and valuation methods of the temporary cost sharing regulations (Temporary Treasury Regulation § 1.482-7T) should apply to PCTs. Furthermore, Temporary Treasury Regulation § 1.482-7T(h)(2) provides that the consideration for a platform contribution may take the form of a fixed payment or a contingent payment. However, a payment may not be made in shares of the stock of the PCT payor or its affiliate (presumably because such form of payment would be consistent with transfer to an affiliate). We view this as confirmation that transactions that fall within the purview of Section 367(d) are excluded from the temporary cost sharing regulations and vice versa. For example, US multinational groups are permitted to transfer assets in a transaction described in Section 367(a) or Section 367(d), even where those assets may in turn be included as elements of a "platform contribution" by the foreign transferee in a CSA. Such a transfer might facilitate the subsequent creation of a CSA in a manner that avoids the valuation principles applicable under the investor model to parties that contribute only cash under the CSA.

Whether such a transfer would be taxable would depend upon the nature of the transaction. For example, the transfer of a foreign research and development branch to a foreign corporation may qualify for tax-free treatment under Section 367(a)(3), subject to Section 367(d) in respect of patents, knowhow, etc. Also, a U.S. company could transfer its U.S. research and development facility to a foreign corporation, which would generally be a taxable event under Section 367(a) and Section 367(d). The valuation methods of Section 482, including, when appropriate, the methods provided in the temporary cost sharing Treasury regulations, could be applied to value the assets transferred.

3. **Valuation Issues**

(a) Aggregate Valuation

Where the value of a Section 936 Intangible is attributable to or substantially enhanced by that intangible property's relationship to other intangible property, that value could be considered to be attributable to either the aggregate value of a group of Section 936 Intangibles, a separately identifiable Section 936 Intangible (*e.g.,* a "pattern," "franchise," "method," "program" or "system") or "goodwill or going concern value." We recognize that valuing each Section 936 Intangible independently may undervalue the value attributable to the aggregation of such intangibles. Section 482 valuation methodologies (*e.g.,* Treasury Regulation § 1.482-1(f)(2)) should be applied, under Section 367(d). Aggregate valuation of Section 936 Intangibles is appropriate under Section 367(d) where it leads to a more reliable result,[88] recognizing, however, that the language of Section 936 suggests that each separately identifiable Section 936 Intangible must constitute property and have value independent of the services of any individual. Valuations using an aggregation methodology should also be cognizant of distinguishing between value attributable to one or more Section 936 Intangibles and value more properly

[88] Compare Treas. Reg. § 1.482-1(f)(2)(i).

attributable to goodwill or going concern value, in order to preserve the exclusion for goodwill or going concern value that is an integral part of the Section 367(a)(3) active foreign business exception. An unrestrained application of an aggregate valuation methodology for Section 936 Intangibles in the context of Section 367(d) could give rise to the risk of marginalizing the value of goodwill or going concern value. In many cases, this would effectively eliminate the exclusion for goodwill or going concern value which is an integral part of the Section 367(a) active foreign business exception.

(b) Foreign Versus Domestic Goodwill and Going Concern Value

The Temporary Section 367(d) Regulations define "foreign goodwill or going concern value" as "the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued."[89] As an initial matter, therefore, the amount of foreign goodwill transferred in connection with the transfer of assets to a foreign corporation can be calculated as the excess of the fair market value of the foreign business transferred over the value of the identifiable tangible and intangible assets associated with the business transferred. Where domestic business assets are transferred as part of the same transaction, it may be difficult to identify whether the excess of the value of the combined enterprises transferred over the value of the identifiable tangible and intangible assets transferred constitutes foreign or domestic goodwill.

If goodwill is used in its traditional sense to refer to the expectation of continued public patronage, the source or location of that expectation may be more difficult to determine, and the factors considered to determine that location may vary depending on the particular business and type of goodwill. For example, the goodwill attributable to a multinational that produces an

[89] Treas. Reg. §1.367(a)-1T(d)(5)(iii).

internationally recognized branded product may retain its patronage as a result of the qualities of the product, the trade name, the quality or dependability of the production method, where the product is sold, reliability of delivery, or the location of consumer-directed advertising, to name a few potential factors. Goodwill attributable to manufacturing intangibles presumably should be sourced at the place of manufacture. Goodwill created where such factors are not relevant or identifiable could be sourced based on the location of the business's employees, physical assets and/or sales.

Because of the range of types and origins of goodwill and going concern value, an approach based on the facts of each case may be unavoidable. Treasury regulations could provide illustrative examples or a method for determining whether goodwill is foreign or domestic based on a list of factors, possibly dependent on the nature of the goodwill.

However, determining what portion of aggregate goodwill is attributable to each source or origin may be impractical. Therefore, alternatively or additionally, a formulary approach could be adopted based on traditional indicia of the location of a business, such as the location of employees, physical assets and sales,[90] or its employees and physical assets,[91] or based on the relative operating income considered derived by the foreign and domestic businesses to which goodwill or going concern value relates.[92]

4. **Section 367(d) Mechanics**

[90] *See, e.g.,* Treas. Reg. § 1.863-3AT(b)(2) Ex. 2 (using a property and sales apportionment method); Treas. Reg. § 1.863-3(c)(1)(ii) (using production assets to apportion manufacturing income).

[91] *See, e.g.,* Piedras Negras Broadcasting Co., 43 BTA 297 (1941), *nonacq.* 1941-1 CB 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942) (foreign corporation's income from Mexican broadcast station facilities treated as foreign-source income, even though its programs were broadcast over airwaves into United States). In practice, a business may have some employees that often travel away from their home office to conduct sales and marketing activities; in those cases, an allocation may be appropriate.

[92] *See, e.g.,* Treas. Reg. § 1.861-9T(h)(2) (apportioning the fair market value of intangibles among related persons by relative net income exclusive of interest and dividends and before interest expense and taxes).

(a) Calculation of Section 367(d) Deemed Payments

Section 367(d) does not specify how deemed Section 367(d) payments are to be calculated. Section 367(d)(2)(A) merely indicates that the payments will be "contingent upon the productivity, use, or disposition of" the Section 936 Intangibles and that the amount of such payments should "reasonably reflect the amounts which would have been received annually in the form of such payments over the useful life of such property, or in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition." Section 367(d)(2)(A) further provides that the annual amounts be "commensurate with the income attributable to the intangible." The Temporary Section 367(d) Regulations provide little additional guidance, referring only generally to the Treasury Regulations under Section 482 for purposes of determining the "appropriate arms-length charge" for the annual Section 367(d) payments.[93]

The tax consequences of deemed annual payments under Section 367(d) should yield a result similar to the result that would apply under Section 482 to a sale of intangible property for payments contingent upon the productivity, use or disposition of the property. While implied by the existing cross-reference to the Section 482 Treasury Regulations, we recommend that Treasury Regulations under Section 367(d) clearly indicate that, for Section 367(d) transfers to controlled transferees, taxpayers are allowed to prescribe the terms of the deemed annual Section 367(d) payments, in accordance with the provisions of Treasury Regulation § 1.482-4(f)(1). Thus, minimum royalties, tiered rates, anticipated or targeted uses, to the extent justifiable for a contingent royalty payment under Section 482, should be permitted for the calculation of the Section 367(d) annual inclusions. Where the treatment of such a transfer under the Section

[93] Temporary Treasury Regulation § 1.367(d)-1T(c)(1) refers to "the provisions of section 482 and regulations thereunder." The regulation also refers to former Treasury Regulation § 1.482-2(d), which is now Treasury Regulation § 1.482A-2(d). Presumably this latter reference should be treated as obsolete.

367(d) regulations differs from the treatment of a comparable transaction under Section 482, this difference should be clearly stated and prescribed in the Treasury Regulations.

The legislative history to Section 367(d) also unambiguously indicates that Congress intended that the U.S. transferor of an intangible in a transfer that is subject to Section 367(d) would recognize gain upon a subsequent (i) disposition of the foreign transferee stock, or (ii) disposition of the transferred intangible by the foreign transferee corporation. The Senate Report makes clear that it was anticipated that the U.S. transferor would be treated as receiving a payment with a U.S. source on a disposition of the intangible by the foreign transferee corporation.[94] The Conference Report (and JCT Report) further specifies. "The amount of U.S. source ordinary income [recognized on a subsequent disposition described above] will depend on the value of the intangible at the time of the second transfer."[95] While this language clearly contemplates some sort of relationship or correlation between the amount of income recognized on the second transfer and the value of the intangible at the time of such transfer, the precise nature of this relationship is not prescribed.

The Temporary Regulations implement this directive by providing that, on the disposition to an unrelated person by the foreign transferee corporation of a Section 936 Intangible transferred to such corporation in a transaction subject to Section 367(d), the U.S. transferor is required to recognize gain from U.S. sources (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of such subsequent disposition and the U.S. transferor's former adjusted basis in that property

[94] Senate Report, at 368.

[95] Conference Committee Report on the Tax Reform Act of 1984, H.R. Rep. 98–861, 1984 U.S.C.C.A.N. 1445, 1643 (the "Conference Report").

(determined as of the original transfer date).[96] If an amount of income is recognized because of such transfer of the intangible by the foreign transferee corporation, the foreign corporation's earnings and profits are reduced accordingly and the U.S. transferor may establish an account receivable from the transferee foreign corporation, in accordance with the general rules related to the establishment of such an account for deemed Section 367(d) payments.[97]

This approach captures all of the gain on the subsequent disposition of the intangible, without regard to whether any of the value realized on the disposition of the intangible was created by actions of the foreign transferee or was not anticipated at the time of the original transfer. Further, the inclusion of the excess of the amount realized by the foreign transferee over the U.S. transferor's original basis potentially could be duplicative of the value previously included by the U.S. transferor as Section 367(d) payments. Consistent with the valuation methodology used in and policy of Section 367(d), the amount of income included by the U.S. transferor should be reduced by the portion of the amount realized on the subsequent disposition that the taxpayer can prove was attributable to improvement or enhancement of the intangible property by the foreign transferee. Note that to the extent the proposal described below, relating to the recovery of the U.S. transferor's basis over the term of the deemed annual Section 367(d) payments, is adopted, only residual basis not previously recovered under that basis recovery method would be used to calculate gain to the U.S. transferor from the disposition of the intangible property by the foreign transferee corporation.

(b) Basis Recovery

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[96] *See* Treas. Reg. § 1.367(d)-1T(e)(1).

[97] *See* Treas. Reg. § 1.367(d)-1T(e)(2).

When Section 367(d) applies to the transfer of intangible property to a foreign corporation, Section 367(d)(2)(A) provides that the U.S. person transferring the property is treated as "having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property."[98] However, under Treasury Regulation § 1.367(d)-1T(c), the transferor deemed to have received payments under Section 367(d) is required to include the full amount of such payments in gross income. The transferor does not treat the payments as the amount realized on the disposition of the property and calculate its income inclusion by subtracting its basis in the transferred property, as would generally apply to sale treatment under Section 1001(a), subject to the application of the installment sale rules of Section 453.[99] For those taxpayers who have basis in their intangible assets, Section 367(d) thus provides a result that is worse than the result that would apply to a transaction structured as a contingent sale subject to Section 482. Nothing in the legislative history to Section 367(d) indicates that the provision is intended to yield a worse result than a taxable transaction subject to Section 482. As a result of the current interpretation of Section 367(d) in the Temporary Section 367(d) Regulations, many practitioners structure transactions with the intent of avoiding Section 367(d). However, it may not be possible to structure a sale or license of intangibles that comports with the business deal.[100]

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[98] Treasury Regulation § 1.367(d)-1T(a) and Treasury Decision 8087 (May 16, 1986) refer to the payments as "license payments" seemingly in direct contradiction to the deemed treatment required by the statute. The statute does provide for ordinary income treatment of Section 367(d) payments, but as discussed above, ordinary income treatment was required to prevent taxpayers from taking ordinary deductions against U.S. income on the development of the intangible and capital gain on the disposition of the intangible, not to displace the "deemed sale" framework of the statute.

[99] In the context of Section 367(d), where the amount taken into account is to be commensurate with the income attributable to the intangible, the IRS may have a significant administrative interest in restricting the ability of taxpayers to elect out of installment sale treatment, if it were to bring the treatment of Section 367(d) amounts more in line with sale treatment.

[100] For example, in the case of a joint venture, a royalty to the U.S. partner will generally be inconsistent with a straight 50:50 profit split between the venture partners unless the foreign partner is compensated by receiving an amount equivalent to the royalties paid to the U.S. partner.

Further, because the transferor is deemed to have transferred the intangible property "in exchange for" the annual payments under the Temporary Regulations, it does not appear that the transferor's basis in the stock received in the exchange described in Section 351 or Section 361 includes the transferor's basis in the intangible property. The only circumstances in which the transferor recovers its original basis in the intangible property is in the calculation of the transferor's gain if the transferor disposes of its stock in the transferee corporation or the transferee corporation disposes of the transferred intangible property. In either such case, the transferor's gain on the deemed disposition of the transferred intangible is calculated by reference to the transferor's original basis in such property.[101] We suggest that Treasury provide guidance for the recovery of the transferor's basis over the useful life of the intangible to make Section 367(d) treatment more consistent with the treatment of a comparable transaction subject to Section 482.

If Section 367(d) treatment is treated consistently with deemed sale treatment, the transferor's basis in the foreign transferee stock should not include any amount determined by reference to the transferor's basis in the intangible subject to Section 367(d). The foreign transferee's basis in the transferred intangible should be determined by reference to the amount paid. Because no amount of consideration should generally be deemed to have been paid for the intangible at the time of the transfer subject to Section 367(d) (subject to the treatment of any boot in the Section 351 or Section 361 transaction), the transferee would generally have a zero basis in the transferred intangible. The amounts deemed paid annually over the useful life of the property would increase the foreign transferee's basis in the intangible, but, if such payments were deemed to be equal to the amortizable amount of the intangible's basis in such year, the transferee would generally continue to have a zero basis in the transferred intangible.

[101] *See* Treas. Reg. §§ 1.367(d)-1T(d)(1) and (f)(1)(i).

(c) Treatment of Boot and Section 367(d)

Neither the Code nor the Temporary Section 367(d) Regulations coordinate the taxation of boot in an outbound reorganization transaction in which Section 936 Intangibles are transferred with the resulting deemed royalty payments required to be included in income under Section 367(d) after the transfer. If boot attributable to the value of a transferred Section 936 Intangible is required to be taxed on the transfer under the reorganization provisions of the Code, and if that value were required to be included in income as a stream of deemed royalty payments under Section 367(d), gain with respect to the transferred Section 936 Intangible would effectively be taxed twice. The IRS Chief Counsel, in Chief Counsel Advice ("CCA") 200610019 (Mar. 10, 2006), confirmed the IRS' understanding that Congress did not intend to impose double taxation on transfers of Section 936 Intangibles. Accordingly, Treasury regulations reconciling these regimes so as to tax the transferred intangibles only once should be promulgated.

In CCA 200610019, a domestic corporation transferred a Section 936 Intangible to a related foreign corporation in exchange for common stock and Section 351(g) nonqualified preferred stock ("boot"), in a transaction otherwise qualifying under Section 351. Based on the legislative history under Section 367(d) coupled with the fact that Section 367(d) and Section 351(b) provide conflicting tax characterizations for the same exchange, the Chief Counsel concluded that Congress intended Section 367(d) to override Section 351(b). The Chief Counsel determined that the boot received in the Section 351 transfer was properly treated as a payment of the Section 367(d) amount for such year (rather than such property being "other property" under Section 351(b)), with the excess being treated as an advance payment of future Section 367(d) annual payments. We find the Chief Counsel's reasoning persuasive and approach reasonable and suggest that Treasury regulations explicitly adopt this approach and expand it to apply to all reorganization transactions with boot in which Section 936 Intangibles are transferred.

We recommend that such regulations should also address how boot should be allocated in cases where both Section 936 Intangibles and other assets not subject to Section 367(d) are transferred. We suggest that the taxpayer should be required to allocate the boot among all the assets transferred in accordance with, e.g., their fair market values, and then to treat only the boot allocated to Section 936 Intangibles as a royalty prepayment.

(d) Transferee's Earnings and Profits and Basis in Assets

In addition to the lack of guidance regarding whether the basis of the transferor in the transferred intangible is included in the transferor's basis in its stock of the foreign transferee (as discussed above), the Temporary Regulations provide no guidance as to the basis of the transferee foreign corporation in the intangible property transferred in a transaction subject to Section 367(d). Amortization of any basis would be relevant for purposes of calculating the foreign corporation's Subpart F income and earnings and profits for U.S. federal income tax purposes. If, notwithstanding Section 367(d), the transferee were treated as having received the intangible property in a transaction subject to Section 351 or Section 361, the transferee would take a basis in the property equal to the U.S. transferor's basis in such property under Section 362(a). This amortization would be in addition to the reductions of earnings and profits of the foreign corporation and Subpart F income allowed with respect to deemed Section 367(d) payments.[102]

[102] *See* Section 367(d)(2)(B); Treasury Regulation § 1.367(d)-1T(c)(2)(i) (reduction of earnings and profits by amount of Section 367(d) deemed payments); Treasury Regulation § 1.367(d)-1T(c)(2)(ii) (treatment of Section 367(d) deemed payments as an expense for purposes of calculating Subpart F income). The flush language of Treasury Regulation § 1.367(d)-1T(c)(2) does provide that, other than the adjustments cited in this footnote "[n]o other special adjustments to earnings and profits, basis, or gross income shall be permitted by reason of the recognition of a [deemed Section 367(d) payment]." This prohibition should not be applicable to the amortization of

Consistent with the characterization of the deemed Section 367(d) transaction as a sale, the foreign transferee should not be able to amortize the transferor's basis in the intangible asset. The only earnings and profits impact of the deemed Section 367(d) transaction on the foreign transferee should be the reduction in earnings and profits by the amount of the Section 367(d) payments provided in Section 367(d)(2)(B). If the transferee foreign corporation were instead treated as having received the property in exchange for the deemed Section 367(d) payments, the transferee would take a basis in such property equal to the Section 367(d) payments made. While, on the one hand, the reduction in earnings and profits of the foreign transferee provided in Section 367(d)(2)(B) could be read as being consistent with the deemed Section 367(d) payments being treated as royalty payments, it alternatively could be read as being consistent with the transferee being treated as having acquired the intangible and amortized its basis in the intangible in an amount equal to the contingent purchase price paid in such year.[103] In either case the net basis would be zero.

Basis attributable to other assets, which may be permitted to be transferred tax-free in the transaction, would normally carry over and be eligible for amortization.

(e) Useful Life of Intangibles

Section 367(d)(2) requires that Section 367(d) payments be deemed to be made "over the useful life of the property."[104] "Useful life" is defined in the Temporary Regulations as "the entire period during which the property has value," but in no event longer than twenty years.[105]

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basis in intangible property determined under Section 362, because such amortization would not be "by reason of the recognition of" a deemed Section 367 payment.

[103] *See* Associated Patentees, Inc., 4 T.C. 979 (1945).

[104] *See also* Treas. Reg. § 1.367(d)-1T(c)(1).

[105] *See* Treas. Reg. § 1.367(d)-1T(c)(3).

The regulation does not specify whether the twenty-year outer limit applies as of the date of the transfer or as of the date the useful life of the intangible property commences.

As intangible property is altered and improved, not all of the income generated by the intangible is attributable to the intangible as originally transferred. To the extent that the value of the intangible that is not attributable to the intangible as originally transferred must be separately tracked, a maximum twenty-year tracking period places a reasonable time limit on taxpayer's burden to maintain these records and calculations. Such a maximum life reduces compliance burdens without significantly preventing the capture of most of the income intended to be captured by Section 367(d).

Further, under Treasury Regulation § 1.367(d)-1T(e)(2)(iii), on a transfer of the transferee foreign corporation stock by the transferor to a related U.S. person, the related person is deemed to have held a portion of the intangible property and then contributed it to the foreign corporation in a transaction subject to Section 367(d). We recommend that it be clarified that this deemed transfer does not reset the useful life of the intangible property in question.

5. **Indirect Disposition Rules**

If a U.S. transferor of a Section 936 Intangible subject to Section 367(d) inclusions subsequently disposes of the stock of the transferee foreign corporation during the term that such U.S. transferor is required to include Section 367(d) deemed amounts, the treatment of such a disposition depends on whether it is to an unrelated person, as defined in Treasury Regulation §1.367(d)-1T(h). If the disposition is to an unrelated person, the U.S. transferor is required to recognize gain with respect to the intangible property that was previously transferred to the transferee foreign corporation, based on the fair market value of the property on the date of disposition and the U.S. transferor's basis in the intangible property on the date of the initial

Section 367(d) transfer (reduced by any gain that the U.S. transferor recognizes with respect to the deemed sale of intangible property under Section 367(d)). If the disposition is to a related person, the treatment of the disposition depends on whether it is to a U.S. person. If the related person that acquires the stock is a U.S. person, the related U.S. person succeeds to a proportionate share (determined by reference to fair market value) of the initial U.S. transferor's obligation to include annual deemed payments under Section 367(d). If the related person that acquires the stock is a foreign person, the U.S. transferor continues to include in income the annual deemed payments under Section 367(d), as though the subsequent transfer to the related foreign person had not occurred. These provisions imply a preference for continuing the regime of Section 367(d) inclusions while there is a U.S. taxpayer to include the amounts, with at least one purpose being so that transfers to related persons cannot be used as a means to elect current recognition in a manner inconsistent with Section 367(d).

The Temporary Section 367(d) Regulations do not specifically address what happens if the U.S. transferor goes out of existence, either in connection with the Section 367(d) transfer or after the transfer. This issue was specifically recognized in the preamble to the 1998 amendments to the Section 367(a) Treasury regulations (the "1998 Regulations").[106] Such regulations, in considering indirect stock transfers regulated by Treasury Regulation § 1.367(a)-3(d) sought practitioner comments as to how Section 367(d) and such indirect stock transfer rules would work together.

For example, consider an outbound reorganization under Section 368(a)(1)(C), where the U.S. parent owns a U.S. target whose assets are transferred to an unrelated foreign corporation in exchange for its stock (a "C" reorganization) or for stock of its foreign parent (a "triangular C"

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[106] T.D. 8770 (June 18, 1998), 1998-2 C.B.3 (the "1998 Regulations").

reorganization).[107] In this case, the U.S. target must generally liquidate as a part of the transaction under Section 368(a)(2)(G). Under the 1998 Regulations, where tangible assets are transferred and some gain is recognized, the U.S. target would recognize gain and take a higher stock basis in the foreign parent shares received. Such foreign parent shares with increased basis would then be distributed to the U.S. parent in liquidation of the U.S. target. Where the U.S. parent's stock basis in the foreign shares received is below their fair market value, the indirect stock transfer rules would implicate gain recognition agreement and other consequences.

The preamble to the 1998 Regulations states that, if the U.S. target's outbound transfer of tangible assets is fully taxable, then the U.S. parent would have a fair market value basis in its shares of U.S. target, making a gain recognition agreement (if available) irrelevant. The preamble to the 1998 Regulations then notes that where the outbound asset transfer consists of Section 936 Intangibles subject to Section 367(d), "the regulations under Section 367(d) do not address the tax consequences when the U.S. transferor goes out of existence pursuant to the transaction." In such event, it should be clear that the U.S. parent should be required to continue to include deemed Section 367(d) income as a result of the outbound transfer of Section 936 Intangibles over the life of such Intangibles. What remains unclear is whether the indirect stock transfer is also subject to potential future gain recognition. Because the U.S. parent would be subject to tax on its unrecognized gains under Section 367(d)(2)(A)(ii) from the transfer of Section 936 Intangibles in the event of either a disposition of such Section 936 intangibles by the foreign transferee or in the event of its own disposition of its shares of the foreign transferee's shares, we do not believe any indirect transfer rule with a potential gain recognition agreement needs to apply. This recognition of deferred stock gain would apply to a disposition during the

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[107] A similar issue may arise in an outbound reorganization described in Section 368(a)(1)(D) or 368(a)(1)(F) (assuming the transferee is not treated as a domestic corporation under Section 7874).

useful life of the applicable transferred Section 936 Intangible. As a result, the gain inherent in the foreign transferee's shares attributable to the transfer of the Section 936 Intangibles remains subject to U.S. tax for periods exceeding the five-year limitation under the gain recognition agreement provisions. Accordingly, we recommend that the final Section 367(d) regulations specify that no indirect transfer of stock subject to Section 367 be subject to a gain recognition agreement where all assets transferred are currently taxed or subject to Section 367(d) at the time of the original transfer.

Somewhat more complicated is the situation where a U.S. target owned by a foreign corporation effects an outbound C reorganization of Section 936 Intangibles. In the easier case, assume U.S. Target is owned by a controlled foreign corporation ("CFC") subject to Subpart F. As a statutory construction matter, we would think that Section 367(d) displaces Section 367(a) only for U.S. Target's transfer of a Section 936 Intangible to the foreign transferee. U.S. Target's subsequent distribution to its parent of the transferee's stock in liquidation should be eligible for non-recognition under Section 361(c) and Section 367(a)(2). Accordingly, a tax free distribution of the transferee's shares should be available to the U.S. target's CFC/parent. The CFC/parent as successor to U.S. Target's attributes under Section 381(c) would succeed to and recognize subsequent Section 367(d) inclusions over the useful life of the transferred Section 936 Intangibles or until it ceased to be a CFC. In the case of a CFC, this analysis preserves the widest ambit for Section 367(d) to operate and avoids allowing taxpayers to elect current recognition and elect out of Section 367(d) by such related person transfers.[108]

However, in the case of a foreign parent corporation that is not a CFC (or to the extent the foreign parent corporation's shareholders are not U.S. Shareholders within the meaning of

[108] Of course, such approach would permit a taxpayer that wanted to avoid current recognition of all gain to enjoy deferral.

Section 951(b)), continuation of the Section 367(d) regime would ensure that Section 367(d) income would be taxable. For example, existing Regulation §1.367(d)-1T(e)(3) provides that, in the case of subsequent transfers of shares bearing a Section 367(d) obligation to a related CFC, only the continuing U.S. transferor continues absorbing the Section 367(d) inclusions. Accordingly, new regulations could provide, with respect to an outbound C or D reorganization in which the transferor of Section 936 Intangibles goes out of existence in connection with the transaction, that the transferor is taxed currently on its gain as in the case of a terminating disposition under Section 367(d)(2)(A)(ii) unless the distributee is domestic or, if foreign, is, e.g., a CFC more than 80% of whose shares are held by U.S. shareholders, in which case the distributee would continue recognition of Section 367(d) inclusions.

6. Application of Section 367(d) Principles to Partnerships

(a) Overview

A transfer of Section 936 Intangibles to partnerships, including controlled foreign partnerships, which generally is not currently taxable but also does not permit deferral of allocable income from the transferee entity, is often an alternative to transfers governed by Section 482 or especially Section 367(d). So consideration of Sections 367(d) would be incomplete without coordination with Subchapter K.

Unlike a corporation, a partnership is a pass-through entity. That fact, together with the functions performed by Sections 704(b) and 704(c), arguably make a regime like that of Section 367(d) unnecessary in the partnership context. Section 704(b) requires that income allocations by a partnership have substantial economic effect and Section 704(c) requires that "built-in" gains (and losses) recognized by a partnership on contributed assets back to the contributing partner. And under Section 482, the arrangements among the partners must be at arm's length.

Section 704(c) does not apply a "commensurate with income" standard or a deemed royalty structure. Since the U.S. contributing partner remains fully and currently taxable on properly allocable income and gain from the partnership, as well as built-in gain from the contributed assets, we believe that overriding nonrecognition treatment under Section 721 or imposing the other mechanics of Section 367(d) is unnecessary in the partnership context.

(b) Section 704(c)

Section 367(d)(3), which is cross-referenced in Section 721(d),[109] was added to the Code in the 1997 Act at the same time that the excise tax provisions of Sections 1491 through 1494 were repealed. Prior to repeal, Sections 1491 through 1494 imposed a 35% excise tax on certain transfers of appreciated property by U.S. persons to foreign entities.[110] The Senate Committee report to the 1997 Act states that:

> "Instead of the excise tax that applies under present law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner."

The 1997 Act also added Section 721(c), which provides that:

> "The Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person."

Treasury has not issued regulations under Sections 721(c) or 367(d)(3) regarding the taxation of intangible property transfers to partnerships.

Under Sections 721 and 722, property contributions to partnerships are generally tax-deferred transactions pursuant to which the adjusted tax basis of the contributed property in the

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[109] Section 721(d) provides "for regulatory authority to treat intangibles transferred to a partnership as sold, see Section 367(d)(3)."

[110] Note that, unlike Sections 1491 through 1494, Section 367(d)(3) is not limited to transfers of intangible property to foreign entities; it could also potentially be applied to transfers to domestic partnerships.

hands of the partnership reflects the contributing partner's basis in the property. Accordingly, built-in gain or loss is deferred and is not recognized until the contributed property is sold in a taxable transaction by the partnership. However, when the property is sold, the deferred gain or loss is not allocated to the partners under the general substantial economic effect rules of Section 704(b), but is instead generally allocated to the contributing partner under Section 704(c)(1)(A). Under Section 704(c)(1)(A), partners are required to share partnership tax items in a manner that takes into account variations between the tax basis and the fair market value of property contributed to partnership. In addition, if contributed property is distributed by a partnership within seven years to non-contributing partners, the gain or loss built-in at the time of original contribution is generally recognized by the contributing partner as if the property had been sold for its fair market value on the date of contribution, under Section 704(c)(1)(B)(i). If property other than the contributed property is distributed by a partnership to the contributing partner within that seven-year period, a similar recognition rule applies under Section 737. Finally, Sections 707(a)(2)(A) and 707(a)(2)(B) recharacterize certain allocations, distributions and transfers of property by a partnership to partners as "disguised sales," triggering recognition of realized gain to a partner who contributes property to a partnership and receives a related allocation, distribution or transfer.

These partnership recognition rules, and Section 704(c) in particular, preserve the taxation of built-in gain to a partner contributing property to a partnership, provided that the partner remains a partner at the time that the partnership disposes of the property, and serve as a significant impediment to income-shifting among partners with respect to contributed property. Treasury regulations under Section 704(c) provide allocation rules requiring that pre-contribution gain is allocated to the contributing partner. Although these allocation rules are limited in certain cases (for example, by the so-called "ceiling rule"), the rules provide safeguards against transactions intended to shift value in intangible property to non-U.S. persons. The ceiling rule generally provides that, for a taxable year, the total income, gain, loss or deduction allocated to a partner with respect to an asset cannot exceed the total partnership income, gain, loss or deduction with respect to that asset for that year.[111] However, the Section 704(c) regulations provide that the partnership may allocate tax items to reduce ceiling rule distortions. In addition, the anti-abuse rule of Treasury Regulation § 1.704-3(a)(10) provides that, if the contribution of property and an allocation of income, gain, loss, deduction "are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability," then the allocation of such tax items is not an acceptable method of allocation.

As a general matter, we do not believe that transfers of intangible property to partnerships pose the same issues as transfers to foreign corporations subject to Section 367(d). While contributors of Section 936 Intangibles to a corporation in a tax-free transfer receive stock in the exchange and the income of the corporation is not taxed immediately to the transferor (other than in limited circumstances, *e.g.,* to the extent Subpart F applies), a contributor of Section 936 Intangibles to a partnership is subject to current taxation on its allocable share of income from the partnership and is subject to Section 704(c). In this context, we fail to see the rationale that justifies overruling the general rules of non-recognition applicable under Section 721.

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[111] *See* Treas. Reg. § 1.704-3(b). The application of the ceiling rule can be illustrated as follows:

> In year one, A, a U.S. person, and B, a non-U.S. person, form the AB partnership. A contributes a non-amortizable Section 936 Intangible with an adjusted tax basis of $50 and a fair market value of $150 to AB. B contributes cash of $150 to AB. Accordingly, the pre-contribution built-in gain on the contributed Section 936 Intangible is $100. In year two, AB sells the Section 936 Intangible for $125. AB recognizes a $25 loss for capital accounting purposes, which is allocated equally to A and B under the partnership agreement ($12.50 each), and a $75 gain for tax purposes. Under section 704(c)(1)(A), this tax gain must be allocated to A. If AB employs the traditional method for making section 704(c) allocations, the "ceiling rule" would limit AB's section 704(c) allocations to AB's total recognized tax gain. Thus, AB would be unable to allocate to B a tax loss equal to B's $12.50 economic loss.

Moreover, Subchapter K has significant protective mechanisms to prevent uneconomic shifting of future income away from the contributing partner. In cases of partnerships between U.S. persons and unrelated U.S. or foreign persons, Section 704(c) generally is sufficient to keep the U.S. transferor's built-in gain within the U.S tax net and to tax the U.S. transferor on the appropriate share of post-contribution appreciation in the transferred intangibles. However, we do believe that Section 704(c) would operate more effectively in this context if the remedial method described in Treasury Regulation § 1.704-3(d) were mandatory.[112] Under current law, where the U.S. and foreign partners both contribute appreciated property to a partnership that will not have income effectively connected with the conduct of a U.S. trade or business, the U.S. partner can take advantage of the tax indifference of the foreign partner (subject to possible application of the anti-abuse rule of Treasury Regulation § 1.704-3) by electing the traditional method for property contributed by the U.S. partner so as to defer recognition of built-in gain while electing the remedial method for property contributed by the foreign partner so as to permit the U.S. partner to claim enhanced amortization deductions.[113] If the remedial method

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[112] Our recommendation to mandate the application of the remedial allocation method should be limited to the situation referred to in the text. An alternative to mandating the application of the remedial allocation method would be to provide an example under the anti-abuse rule of Treasury Regulation § 1.704-3(a)(10). Treasury may also determine to consider whether the remedial allocation method is appropriate for intangible assets described in Treasury Regulation § 1.197-2(h)(12)(vii)(B) in situations involving related parties.

[113] This selective application of the remedial method could be illustrated as follows:

> A, a U.S. person, contributes a Section 936 Intangible -- "Property A" -- to partnership AB. Property A has a tax basis of $30 and a fair market value of $150 on the date of contribution, is an amortizable asset in A's hands, and has 5 years remaining useful life. B, a non-U.S. person, contributes a Section 936 Intangible -- "Property B" -- to AB. Property B also has a tax basis of $30 and a fair market value of $150 on the date of contribution, is an amortizable asset in B's hands, and has 5 years remaining useful life. AB elects the traditional method with respect to Property A and the remedial method with respect to Property B.
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> With respect to Property A, AB will have a $30 section 704(b) book amortization deduction in years 1-5 ($150 fair market value/5 years remaining useful life). Tax amortization, however, will only be $6 each year ($30 tax basis/5 years). The section 704(b) book amortization will be allocated equally to A and B ($15 each) under the partnership agreement. The $6 of tax amortization will be allocated entirely to B, leaving B with an annual $9 "shortfall" of tax amortization as a result of the ceiling limitation.
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> As to Property B, however, the results are different. The remedial method requires AB to "create" tax amortization and offsetting amounts of taxable income. To do this, AB initially treats Property B as two assets,

were mandatory, this would no longer be possible. Moreover, the U.S. party generally would not be in a position to benefit from the parties agreeing to over-value or under-value the contributed property -- for example, any benefit derived in the form of reduced remedial income allocations as a result of an undervaluation of property contributed by the U.S. partner generally would be offset by diminished allocations of amortization to the U.S. partner with respect to the property contributed by the foreign partner.

On the other hand, Section 704(c), even if the remedial method were mandatory, it would not be a complete solution where the U.S. and foreign partners are related and thus not dealing at arm's length. For example, where the U.S. partner contributes low basis intangible property and the foreign partner contributes cash, if the percentage interest in the partnership received by the foreign partner is overstated as a result of an undervaluation of the intangible property, there would be abuses similar to those that Section 367(d) is intended to address. Such abuses could be overturned on audit by applying existing partnership rules, and, in a controlled setting, the IRS has indicated that Section 482 may apply to determine the value of the contributed intangible in connection with transfers to partnerships.[114] Rather than directly importing Section

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one with a fair market value and tax basis of $30, and a second with a fair market value of $120 and a zero tax basis. The "first" asset will be amortized for capital accounting purposes over the remaining useful life of Property B; the "second" asset will be amortized over a new useful life (in this case, 15 years). Accordingly, the "first" asset will generate $6 of section 704(b) book amortization for 5 years and zero thereafter. The "second" asset will generate $8 of section 704(b) book amortization for 15 years ($120 fair market value/15 years). The amounts of section 704(b) book amortization will then be combined and allocated under the partnership agreement. Thus, in years 1-5, the section 704(b) book amortization with respect to Property B will be $14 ($6 + $8); in years 6-15, the section 704(b) book amortization will be $8. In each year, the section 704(b) book amortization with respect to Property B will be allocated equally to A and B under the AB partnership agreement. Thus, in each of years 1-5, each of A and B will be allocated $7 of section 704(b) book amortization. A will be allocated $6 of tax amortization, and B will be allocated no tax amortization. In addition, in each of those years, AB will be required to create and allocate to A $1 of "notional" amortization deductions and simultaneously create and allocate to B $1 of "notional" income to "remediate" what would otherwise be a shortfall in tax amortization to A as a result of the ceiling rule. In years 6-15, AB will allocate $4 of section 704(b) book amortization to each of A and B. AB will not have any tax amortization to allocate, because Property B will have been fully amortized for tax purposes. Thus, in each of those years, AB will be required to create and allocate to A $4 of "notional" amortization deductions and simultaneously create and allocate to B $4 of "notional" income.

[114] *See* Field Service Advice 200149019

367(d) concepts into subchapter K, existing rules applicable to this type of abusive transaction could be strengthened by applying the "commensurate with income" standard to a deemed transfer from the U.S. partner to the related foreign partner in order to ensure that the U.S. partner's share of partnership income is not understated. Thus, where subsequent review of operating results establishes that the partnership interest issued to the U.S. partner contributing the Section 936 Intangible was inadequate, the excess value identified by a commensurate with income analysis could be used to reallocate partnership interests from the related foreign partner to the contributing U.S. partner.

If Treasury believes that it is appropriate to exercise its authority to promulgate regulations under Section 367(d)(3), the regulations should address whether Section 367(d)(3) applies to contributions of intangible property to domestic partnerships[115] and whether contributions of intangible property to partnerships that do not have foreign partners should be exempted. If Treasury applies the imputed royalty provisions of Section 367(d)(2) to contributions of intangible property to partnerships, the transaction should generally be treated as a sale for all purposes of the Code, consistent with the principles of Section 707(a)(2).[116] Finally, in cases where the contributing partner is allocated income from the contributed intangible reflecting the payment deemed to be received and taxed under Section 367(d)(2), the contributing partner should not be taxed on such allocated income as well.

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[115] The legislative history to the 1997 Act suggests that Section 367(d)(3) was intended to apply only to contributions to foreign partnerships. *See* H.R. Rep. No. 220, 105th Cong., 1st Sess. 629 (1997).

[116] *See* Treas. Reg. § 1.707-3(a)(2).