US Outbound Tax Newsalert

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Notice 2012-39: New rules for outbound reorganizations

Government issues Notice 2012-39:

- **Section 367(d) trumps section 361(b) in outbound reorganizations**
- **Commensurate with Income standard set aside if boot received in an outbound reorganization**

Overview

Today the IRS and Treasury issued Notice 2012-39, providing that in an outbound reorganization, boot received by the US transferor will be treated as a prepayment of the section 367(d) royalty, and thus currently includible in income, to the extent the boot is attributable to section 936(h)(3)(B) intangible property.

Background

Section 361(a) provides that no gain or loss is recognized when a corporation exchanges property pursuant to a reorganization described in section 368, solely for stock or securities in another corporation that is a party to the reorganization. Further, section 361(b) generally provides that if the corporation exchanging property also receives other property or money in addition to the stock or securities permitted to be received by section 361(a), the corporation is not required to recognize gain on the exchange if the corporation distributes such other property or money pursuant to the plan of reorganization.

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Subject to certain exceptions, section 367(a) generally applies to the transfer of property by a US person to a foreign corporation in an exchange described in sections 332, 351, 354, 356, or 361. However, section 367(d) generally provides that if a US person transfers intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or section 361, section 367(d) (and not section 367(a)) applies to such transfer.

When section 367(d) applies, the US transferor is treated as having sold the intangible property in exchange for payments that are contingent upon the productivity, use, or disposition of such property. Under the statute, the US transferor is required to recognize ordinary income each year over the useful life of the property in an amount that is commensurate with the income attributable to the intangible, and such amount is treated in the same manner as if it were a royalty.

Previously, the government issued three nonbinding documents (a 1990 Non-Docketed Service Review,[1] CCA 200610019, and PLR 200845044) stating that in an outbound section 351 contribution of intangible property where boot was received by the US transferor, section 367(d) trumps section 351(b) with respect to boot received by the transferor. The consequence in the section 351 context was to (a) ensure that there would not be a double tax (i.e., that only section 367(d), and not both section 367(d) and section 351(b), apply) and (b) to tax the boot as ordinary income under section 367(d), rather than capital gain under section 351(b), a reasoned conclusion in the absence of any authority.

Until Notice 2012-39, there was no written viewpoint from the government on the issue of whether section 367(d) trumps section 361(b) with respect to the treatment of boot received for intangible property in an outbound reorganization. However, in public comments, a high ranking government official stated his view that boot in an outbound reorganization should be treated in a similar manner to boot in an outbound section 351 transfer, i.e., that section 367(d) should trump section 361(b). To read the US Outbound Newsalert dated March 31, 2011, please click here.

PricewaterhouseCoopers comment letter

On April 29, 2011, PricewaterhouseCoopers issued a comment letter to the government recommending that boot in an outbound reorganization should not be treated as a prepayment of the section 367(d) inclusion. In making this recommendation, the comment letter looked to the differences between section 351 contributions and reorganizations and to section 361(b), which Congress added to the Code to provide conduit treatment for consideration passed from the acquiring corporation to the target shareholders through the target corporation. The comment letter discusses the fundamental differences between sections 351(b) and 361(b). Section 361(b) is a nonrecognition provision, while section 351(b) is a taxing provision: there was a need for a tiebreaker between sections 351(b) and section 367(d), while there is not a need for a tiebreaker between section 367(d) and section 361(b). To read the comment letter, please click here.

Boot as a prepayment of the section 367(d) inclusion: Qualified successors of US target

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[1] 1990 IRS NSAR 8126.

Under the Notice, to the extent boot is received by the US target corporation in exchange for intangible property in an outbound reorganization, section 367(d) will trump section 361(b) and the boot will be treated as a prepayment of the section 367(d) inclusion, and thus will be currently taxable to the US target corporation. Notwithstanding the statutory language that the US transferor should recognize amounts that are commensurate with the income attributable to the intangible, the Notice provides that the inclusion under section 367(d) is without regard to the productivity of the section 367(d) property in the year of the transfer or in subsequent years. In subsequent years, any qualified successor to the US target corporation will receive a credit, on a first in, first out basis, against future section 367(d) inclusions. Any amounts excluded from the qualified successor's gross income because of this credit will not qualify for the tax-free accounts receivable repayment mechanism available under Treas. Reg. § 1.367(d)-1T(g)(1) (applicable to amounts included in gross income pursuant to section 367(d)).

Boot, for purposes of the Notice, includes all liabilities assumed, other than liabilities which (a) were incurred in the ordinary course of business; (b) did not arise in connection to the reorganization; and, (c) are owed to persons who were not related, within the meaning of section 267(b) or section 707(b), immediately before the reorganization. In addition, the amount of non-qualifying liabilities is further increased (but not in excess of the total liabilities of the US transferor) by the sum of the distributions (i) made by the US transferor to its shareholders pursuant to the plan of reorganization (but only to the extent such money or other property was not received from the transferee foreign corporation pursuant to the reorganization exchange) and (ii) made by such US transferor (or any predecessor) with respect to its stock (including in redemption of its stock) during the two-year period preceding the reorganization.

Any amount included in the income of the US target under the Notice is treated as a royalty for section 904(d) purposes.

A qualified successor generally is a domestic corporation which either received stock of the foreign acquiring corporation pursuant to the reorganization or otherwise owned stock of the foreign acquiring corporation (transferee foreign corporation) immediately after the reorganization. A non-qualified successor is any other person.

PwC observations: The most perplexing aspect of the Notice is its failure to reconcile the statutory mandate that income recognized under section 367(d) must be commensurate with the income attributable to the intangibles, over the useful life of the intangibles. The statutory language is unambiguous and does not suggest any circumstances where the income recognition should be accelerated. Notwithstanding the clear mandate of the statute, the Notice requires a US transferor to recognize income with respect to an exchange, regardless of the productivity of the section 367(d) property in the year of the transfer or in subsequent years. Further, the Notice fails to address or reconcile its approach with section 356 and section 361(b). As a general matter, the breadth of the Notice is troubling and, arguably, raises more questions under section 367(d) than it answers. In this regard, the Notice fails to address two important questions.

(1) What happens if the contingent, commensurate with income section 367(d) inclusion is less than the amount of the prepayment (i.e., what happens if the intangible property performs worse than projected at the time of the outbound reorganization?).

(2) What are the section 356 consequences of the current taxation, to the US target, of the section 367(d) inclusion?
While not made explicitly clear in the Notice, it appears the amount of the

section 367(d) inclusion at the time of the reorganization would, in the case of a consolidated US target, increase the qualified successor's basis in the stock of the US target for section 356 purposes.

We anticipate finalized regulations issued under the Notice will clarify these issues.

Gain on transferred intangible property: Non-qualified successors

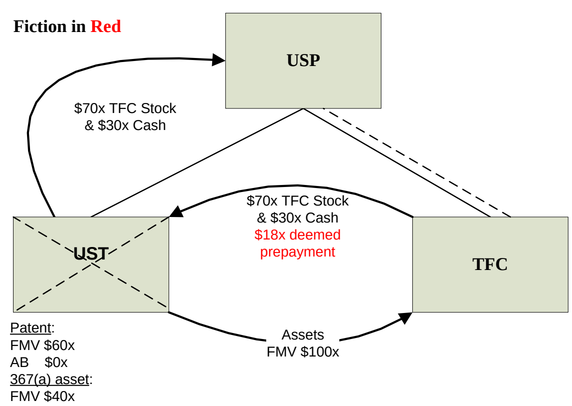
Under the Notice, to the extent any section 367(d) property is attributable to non-qualified successors (based on their ownership of the value of the US target immediately before the reorganization), the US target will recognize gain on the intangible property under section 367(d)(2)(A)(ii)(II). See Section 4.03 of the Notice. This new rule applies regardless of whether the consideration in the section 361 is stock or boot.

PwC observations: The Notice provides a new rule to an area which has lacked clarity since the passage of the current version of section 367(d) in 1984. Unless there is a qualified successor, any gain in section 936(h)(3)(B) intangible property at the time of the outbound reorganization will be taxed to the US target. While this rule provides clarity, it does not easily reconcile with the statute, which does not provide for immediate gain recognition based on the identity of the shareholder.

Partnerships

The Notice applies an aggregate theory to partnerships. Thus, if a partnership is a shareholder of the US transferor, the partners of such partnership are the potential qualified successors and are treated as receiving qualified stock in the foreign acquiring corporation.

Example



Section 4.07 of the Notice includes an example of the new application of section 367(d) to outbound reorganizations. In the example, USP, a domestic corporation, wholly owns UST, a domestic corporation, and TFC, a foreign corporation. UST owns two assets: a patent with a value of $60x and no basis, and section 367(a) property with a value of $40x. In a reorganization described in section 368(a)(1)(D), UST transfers the two assets to TFC for $70x of TFC stock and $30x of cash, and then UST liquidates. The result is that $18x of the $30x of cash is treated as a prepayment of the section 367(d) inclusion, and thus currently includible in UST's income. This

amount is determined by multiplying the boot received ($30x) by the "section 367(d) percentage" which is determined by dividing the value of the section 367(d) property ($60x) by the value of all the property UST transferred in the section 361 exchange ($100x).

Under the Notice, the first $18x of section 367(d) inclusions USP would be required to include in its gross income will be excluded because UST included that amount in its gross income in the year of the reorganization.

Effective Date

The Notice is effective for transfers occurring on or after July 13, 2012. Notably, there is no binding commitment or similar exception to this effective date. The Notice provides that no inference is intended as to the treatment of the transactions described in the Notice under current law, and that the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

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