New Sections 367 and 482 regulations tax foreign goodwill, limit the active trade or business exception, and apply Section 482 to aggregate transactions

September 22, 2015

In brief

On September 14, 2015, Treasury and the IRS issued proposed regulations under Section 367 (REG-139483-13) (the 'Proposed Regulations') and temporary regulations under Section 482 (T.D. 9738) (the 'Temporary Regulations'). This guidance would fundamentally shift the government's application of the law by taxing outbound transfers of foreign goodwill and going concern value under Section 367, restricting the active trade or business (ATB) exception under Section 367(a) from applying to goodwill and going concern value, and providing for aggregate valuation of interrelated transactions that are covered in part by Section 482 and in part by other Code sections (such as Section 367). In doing so, the Proposed Regulations would subject a US transferor to current gain recognition under Section 367(a)(1), or periodic income recognition under Section 367(d), on outbound transfers that previously have not resulted in taxable income under Section 367 or 482.

The Temporary Regulations are effective for taxable years ending on or after September 14, 2015. The Proposed Regulations, once finalized, would apply to transfers occurring on or after September 14, 2015. Treasury and the IRS have requested comments with respect to these regulations by December 15, 2015.

In detail

Highlights of the Proposed Regulations

Under Section 367(a)(1), property transferred by a US person to a foreign corporation in a transaction described in Section 351, 354, 356, or 361 will generally result in the recognition of gain unless an exception applies. A key statutory exception exists with respect to property transferred for use in the active conduct of a trade or business outside of the United States (the ATB exception), an exception that has existed in some fashion for nearly 50 years. The ATB exception does not apply to certain enumerated types of property. Where the transferred property is intangible property described in Section 936(h)(3)(B), Section 367(a)(1) does not apply. Instead, the rules of Section 367(d) apply, which generally require the transferor to recognize annual income inclusions based on the productivity, use, or disposition of the transferred intangible property for the duration of the intangible property's useful life.

The preamble to the Proposed Regulations asserts that taxpayers take different positions regarding whether goodwill and going concern value are within the definition of intangibles under Section 936(h)(3)(B). Rather than take a position on this issue, the Proposed Regulations sidestep it with three fundamental changes to the existing regulations.

Elimination of any exception for foreign goodwill, going concern value, or other intangibles for purposes of Section 367

First, the Proposed Regulations eliminate the sentence addressing foreign goodwill and going concern value in Treas. Reg. sec. 1.367(d)-1T(b), which provides that "Section 367(d) and the rules of [§ 1.367(d)-1T] shall not apply to the transfer of foreign goodwill or going concern value, as defined in § 1.367(a)-1T(d)(5)(iii), or to the transfer of intangible property described in § 1.367(a)-5T(b)(2)." For those who took the position that such intangibles were encompassed by Section 936(h)(3)(B), this sentence was considered to provide an exception from taxation under Section 367(d).

Second, the Proposed Regulations generally limit the scope of property that is eligible for the ATB exception to tangible property, working interests in oil and gas property, and certain financial assets (namely, cash equivalents, certain securities, certain commodities positions, and certain notional principal contracts). Thus, goodwill, going concern value, and other intangible assets cannot qualify for the ATB exception under the Proposed Regulations.

Observations: The legislative history to the 1984 amendments to Section 367 states, in relevant part, that Congress "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system." The Senate Report accompanying the enactment of Section 367(d) further provides: "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." Further, the JCT Report explains that "the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax." Notwithstanding this expression of congressional intent, the Proposed Regulations would tax all transfers of goodwill and going concern value, including all foreign goodwill and going concern value. Treasury and the IRS based this fundamental shift on a determination that transfers of foreign goodwill and going concern value present too much opportunity for abuse of the US tax system and that alternative solutions would be impractical to administer.

If the Proposed Regulations are finalized without change, even the most basic branch incorporation transactions would entail a significant US tax cost. For example, under the Proposed Regulations, the incorporation of a foreign branch of a domestic corporation which has operated abroad for thirty years, with no connection to the United States, would result in full US taxation of the foreign goodwill and going concern value developed by that branch.

The Code provides that, except as provided in regulations, property used in the active conduct of a trade or business outside of the United States generally qualifies for the ATB exception, and then provides a limited list of non-qualifying property (so-called 'hot assets'). The Proposed Regulations reverse the statutory framework by providing only a limited list of property that can qualify for the ATB exception. Notably, what is perhaps the most quintessential component of a business, the value of the going concern, is intentionally omitted from this list of eligible property.

Elective application of Section 367(a) or (d)

The third fundamental change is a new rule that allows a US transferor to choose to apply either Section 367(a) or Section 367(d) to a transfer of property (except as described below) that would otherwise be subject to Section 367(a). Such electivity is not permitted for so-called 'eligible property' (*i.e.*, tangible property, working interests in oil and gas properties, and certain financial assets, as described above). Under proposed conforming amendments to the Section 6038B regulations, a taxpayer must disclose whether it is applying Section 367(a) or (d) to a transfer of such property.

Thus, under the Proposed Regulations, the same result is achieved regardless of the taxpayer's view of whether such intangible property is a Section 936(h)(3)(B) intangible. If the taxpayer takes the position that the intangible property is a Section 936(h)(3)(B) intangible, the taxpayer must subject itself to Section 367(d) with respect to the property, without exception. Accordingly, the taxpayer must recognize annual contingent income inclusions for the useful life of the property, or, in the case of 'operating intangibles,' one-time gain recognition based on the difference between fair market value and adjusted basis under a deemed sale election.

If, on the other hand, the taxpayer takes the position that the intangible property is not a Section 936(h)(3)(B) intangible, the taxpayer has effectively the same choice: it can either subject itself to tax under Section 367(a)(1) without exception (*i.e.*, one-time gain recognition) or it can subject itself to tax under Section 367(d) without exception (*i.e.*, annual income inclusions). If the election is made, it must be consistently applied by the US transferor and all related persons to all property that is transferred to one or more foreign corporations pursuant to a plan.

Observations: Over the years, commentators have expressed differing views with regard to whether goodwill and going concern value are within the definition of intangibles under Section 936(h)(3)(B) (specifically, whether they fall within the 'any similar item' category of Section 936(h)(3)(B)(vi)). Beginning in 2009, Treasury proposed to 'clarify' the definition of intangible property for purposes of Sections 367(d) and 482 to include workforce in place, goodwill, and going concern value. Beginning in 2014, the proposal morphed to instead 'provide' that the definition of intangible property under Section 936(h)(3)(B) (and therefore for purposes of Sections 367 and 492) also includes workforce in place, goodwill, going concern value, and any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual. With the appearance of these proposed regulations, it seems that Treasury and the IRS are no longer willing to wait for legislative action, instead creating a new scope to Section 367 by regulation (with no delay in effective date and therefore no ability for stakeholders to adjust to and comment on the significant change in the taxation of outbound property transfers).

The election described above is not limited to foreign goodwill or going concern value. Rather, it applies to any intangible (such as workforce in place) that is not specifically enumerated in Section 936(h)(3)(B).

Elimination of 20-year limit on useful life

Under the current regulations, where Section 367(d) applies, periodic income must be recognized by the US transferor for the lesser of the useful life of the transferred intellectual property or 20 years. With respect to transfers made on or after September 14, 2015, the Proposed Regulations eliminate this rule and instead provide that the useful life of intangible property is the entire period during which the exploitation of the intangible property is reasonably anticipated to occur, as of the time of the transfer. For this purpose, the Proposed Regulations include the use of the intangible property in research and development as 'exploitation' of the intangible property.

Observation: With this proposed amendment, Treasury and the IRS are incorporating into the Section 367(d) regime the expansive concept of 'platform' contributions that is reflected in the cost sharing regulations (Treas. Reg. sec. 1.482-7(g)(2)(ii)). The cost sharing regulations generally require that valuation methods for platform contributions take into account the entire period over which not only the current generation of intangibles is expected to be exploited, but also the expected period of exploitation of future developments to which the existing intangibles might contribute (*i.e.*, as a 'platform' for future developed intangibles). Given that almost every business must develop continual improvements to its base of intangible assets to stay competitive, this 'platform' concept could lead the IRS to posit that a perpetual useful life is required in many cases. In connection with the cost sharing regulations, Treasury and the IRS have acknowledged that this platform notion may not correspond to conventional concepts of useful life. Because Section 367(d) was enacted in 1984, well before the IRS and Treasury developed the admittedly non-conventional 'platform' notion of useful life, one might question whether this new useful life rule is consistent with the statutory term 'useful life' in Section 367(d) as originally enacted. Taxpayers may be required to consider the impact of this change on intangible property that is expected to reach the end of its commercial life at some point but which is also leveraged for additional research and development. For example, software that has been obsoleted through later versions might be viewed as continuing to be 'exploited' under this new rule and therefore result in periodic income to the US transferor of the original (now obsolete) software with respect to income earned from later versions of the software.

Consolidation of active trade or business rules

The Proposed Regulations consolidate the provisions currently applicable to the ATB exception and make conforming changes to the depreciation recapture and branch loss recapture rules. The Section 367 proposed regulations also modify the scope of the term 'U.S. depreciated property' to include Section 126 property (as defined in Section 1255(a)(2)) for purposes of the depreciation recapture rule. Proposed Treas. Reg. sec. 1.367(a)-2(a)(1) retains a coordination rule under which a transfer of stock or securities in an exchange subject to Treas. Reg. sec. 1.367(a)-3 is not subject to proposed Treas. Reg. sec. 1.367(a)-2. The preamble to the Proposed Regulations note that, although it has changed the wording of several provisions relating to the ATB exception, these changes do not represent substantive changes in law.

Elimination of exception for certain foreign currency denominated property

The Proposed Regulations eliminate the current exception under Treas. Reg. sec. 1.367(a)-5T(d)(2) that allows for certain property denominated in the foreign currency of the country in which the foreign corporation is organized to qualify under the ATB exception. Treasury and the IRS determined that this exception was inconsistent with the general policy of Section 367(a)(3)(B)(iii), which generally requires gain to be recognized on the outbound transfer of foreign currency denominated property. According to Treasury and the IRS, "[r]emoving the exception will preserve the character, source, and amount of gain attributable to Section 988 transactions that otherwise could be lost or changed if such gain were not immediately recognized but instead were reflected only in the U.S. transferor's basis in the stock of the foreign corporation."

Subsequent transfers of transferred stock

The Proposed Regulations do not retain the portion of existing Treas. Reg. sec. 1.367(a)-4T(d) that treat stock or securities as not qualifying for a GRA or other exception (e.g., the exceptions potentially applicable for less than five percent shareholders) to Section 367(a)(1) if it is reasonable to believe that, in the reasonably foreseeable future, the transferee would sell or otherwise dispose of any material portion of the transferred stock, securities, or other property, other than in the ordinary course of business. Treasury and the IRS have determined that Treas. Reg. secs. 1.367(a)-3 and 1.367(a)-8 adequately carry out the policy of Section 367(a) with respect to such stock.

Reporting requirements under Section 6038B

The Proposed Regulations make conforming changes to the requirements under Treas. Reg. sec. 1.6038B-1(c) and (d) to account for changes to the Section 367 regulations. The Proposed Regulations move the rule providing relief for certain failures to comply with the reporting requirements of Section 6038B to proposed Treas. Reg. sec. 1.367(a)-2(j).

Conforming changes

The Proposed Regulations revise the definition of 'intangible property' for purposes of Section 367(a) and (d). As revised under proposed Treas. Reg. sec. 1.367(a)-1(d)(5), the term means "either property described in Section 936(h)(3)(B) or property to which a U.S. person applies Section 367(d) pursuant to paragraph (b)(5) of this Section, but does not include property described in Section 1221(a)(3) or a working interest in oil and gas property." The Section 367 Proposed Regulations make conforming changes for purposes of the provisions under Treas. Reg. sec. 1.367(a)-7, which concern outbound transfers of property subject to Section 367(a) in certain asset reorganizations. Additionally, Treasury and the IRS noted that conforming changes will be made in guidance issued under Notice 2012-39, which announced regulations to be issued addressing outbound transfers of intangible property subject to Section 367(d) in certain asset reorganizations.

Effective dates

The Proposed Regulations are generally intended to apply to transfers occurring on or after September 14, 2015, and to transfers occurring before September 14, 2015, resulting from entity classification elections made under Treas. Reg. sec. 301.7701-3 that are filed on or after September 14, 2015. The proposed elimination of the current exception under Treas. Reg. sec. 1.367(a)-5T(d)(2) that allows for certain property denominated in the foreign currency of the country in which the foreign corporation is organized to qualify under the ATB exception will apply to transfers occurring on or after the date that those rules are finalized (or to transfers occurring before that date resulting from entity classification elections made under Treas. Reg. sec. 301.7701-3 that are filed on or after that date).

Observation: Although the proposed regulations are only proposed and therefore do not carry the force of law, if finalized the final regulations would apply retroactively. In this sense, the proposed regulations are the equivalent of a Notice (which the IRS and Treasury have frequently used under Section 367 in recent years – see Notices 2012-15, 2012-39, 2014-32, and 2014-52). Consequently, taxpayers entering into outbound Section 351 transfers or reorganizations on or after September 14, 2015, should consider the potential impact of the proposed regulations to those transfers.

Highlights of the Temporary Regulations

Section 482 authorizes the IRS to distribute, apportion, or allocate gross income or deductions between related parties if necessary to prevent evasion of taxes or clearly to reflect the income of any of such parties. The regulations under Section 482 implement this goal by requiring that transactions between related parties reflect arm's length pricing. Although the pricing methods set forth in the existing regulations generally address individual transactions, they also recognize that, in certain circumstances, it may be appropriate to analyze transactions on an aggregate basis (*e.g.*, for related products or services) to provide the most reliable measure of arm's length pricing.

Aggregate transactions

The Temporary Regulations purport to 'clarify' Treas. Reg. sec. 1.482-1(f)(2)(i)(A), which provides that the combined effect of two or more separate transactions may be considered if they are so interrelated that an aggregate analysis provides the most reliable measure of an arm's length result. First, the Temporary Regulations provide that arm's length compensation must be consistent with, and must account for all of, the value provided between the parties in a controlled transaction, without regard to the form or character of the transaction. Second, the Temporary Regulations note that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any synergies among items and services provided. Finally, the Temporary Regulations also remove the requirement that transactions be aggregated only when they involved related products or services.

Observations: The Temporary Regulations reflect the IRS's continuing concern that separate evaluation of discrete economic inputs in a transfer pricing analysis may fail to capture the 'synergies' that exist among the inputs and create a perceived opportunity to shift value between related parties without full compensation. The primary example is the transfer to a related party of intangible property rights together with a commitment from the transferor's management team and research team to assist the transferee to continue to refine, improve, and further develop the intangible property, a combination that entails synergies in the IRS's view. This concern was a specific target of the cost sharing regulations, which generally seek to capture the perceived impact of synergies by requiring that all the economic inputs provided by a party in connection with a cost sharing arrangement be evaluated in the aggregate. The temporary regulations reflect an expansion of this approach to groups of transactions outside of cost sharing.

The Temporary Regulations' requirement that arm's length compensation be consistent with the 'value' provided in a transaction between related parties risks creating confusion and uncertainty where, as is typically the case, the definition of 'value' may be different from the price charged in an arm's length transaction. Similarly, the 'clarification' of when an aggregate analysis is appropriate depends on subjective tests which may be susceptible to differing interpretations, like determining whether transactions are 'interrelated' or 'economically interrelated,' and whether 'synergies' are present. In practice, it may lead to increased assertions that one-sided transfer pricing methods are less reliable than a method (such as the income method) based on a discounted cash flow analysis. In this respect, the use of subjective terminology and greater use of aggregation echoes the proposals set forth in the work of the OECD to revise the guidance on use of the profit split method as part of its project on Base Erosion and Profit Shifting.

Example 7 in the Temporary Regulations purports to illustrate these refined aggregation principles. The example concludes that, where a transferor transfers intangible property to a transferee for future research and development, and exploitation, but continues to perform development functions with respect to the transferred intangible property, the value associated with the transferor's contributions must be compensated under Section 482, even if it is determined that no property has been transferred with respect to the transferor's continuing activities. Presumably this example is intended to illustrate that a transaction must be valued in the aggregate and components of the transaction cannot be ignored in applying Section 482, but read broadly, the example may suggest that, whenever a party to a transaction becomes enriched, a compensable value transfer is deemed to occur for purposes of Section 482 irrespective of whether a cognizable property right has been transferred.

Example 10 posits a situation where a parent corporation, P, has successfully performed R&D to create Product X, and then provides R&D services to its foreign subsidiary, which will build on the Product X platform. The example states that P's use of intangible property (and any other valuable resources) means that the arm's length charge for the R&D services is not limited to reimbursement of P's costs. Instead, even though P did not transfer the platform or the R&D team, the arm's length charge for the R&D services must be consistent with the 'value' provided, and may be most reliably determined on an aggregate basis, reflecting the 'interrelated value' of the services and the embedded value of the platform and knowhow. The boundaries of the rule for pricing of services on such an aggregate basis are unclear, as it is likely that any service provider relies on knowhow and synergies based upon prior experience.

Coordination with other Code Sections

The Temporary Regulations also provide that, for one or more controlled transactions governed by more than one provision of the Code and regulations, a coordinated best method analysis and evaluation of the transactions may be necessary to ensure that the overall value provided (including any synergies) is properly taken into account. The Temporary Regulations further provide that a coordinated best method analysis and evaluation may be necessary with respect to (1) two or more interrelated transactions when either all such transactions are governed by one regulation under Section 482 or all such transactions are governed by one subsection of Section 367, (2) two or more interrelated transactions that are governed by two or more regulations under Section 482, (3) a transfer of property is subject to Section 367(a) and an interrelated transfer of property that is subject to Section 367(d), (4) two or more interrelated transactions where Section 367 applies to one transaction and the general recognition rules of the Code apply to another interrelated transaction, and (5) other circumstances in which controlled transactions require analysis under multiple Code and regulatory provisions.

Observation: The new rule providing for a coordinated best method analysis and evaluation of two or more controlled transactions to which one or more provisions of the Code or regulations apply adds to a similar provision in the regulations governing cost sharing arrangements (CSAs). In particular, in a transfer of intangibles in a transaction governed by Section 367(d) in connection with contributions related to those same intangibles in connection with a CSA, the pricing of the intangibles under Section 367(d) may need to be evaluated on an aggregate basis with the pricing of all contributions in connection with a CSA, where doing so provides the most reliable measure of an arm’s length result even if the two transactions take place in different years. However, the fact that the commensurate with income rules in the regulations governing CSAs are not consistent with those governing a Section 367(d) transaction makes the coordinated best method analysis even more challenging to apply.

Effective dates

The Temporary Regulations apply to taxable years ending on or after September 14, 2015. Consequently, the Temporary Regulations apply to transactions entered into before September 14, 2015, that fall within a taxable year ending on or after September 14, 2015.

The takeaway

Although the Proposed Regulations would not apply until finalized, they are intended to apply to transfers made on or after September 14, 2015. Consequently, once finalized, the Proposed Regulations would have retroactive effect. Among other significant changes, transfers of foreign goodwill would now be subject to taxation under Section 367(a) or Section 367(d)—a fundamental change to the taxation of even the most basic foreign branch incorporations. Taxpayers engaging in outbound transfers on or after September 14, 2015, should review carefully the Proposed Regulations to determine their potential applicability.

Furthermore, the Temporary Regulations are effective for taxable years ending on or after September 14, 2015, even with respect to transactions entered into before September 14, 2015. Consequently, taxpayers with transactions involving multiple controlled transactions or subject to multiple Code provisions should consider the potential applicability of the Temporary Regulations to those transactions.

Let's talk

For a deeper discussion, please contact:

International Tax Services

Tim Anson, *Washington, DC*
+1 202 414 1664
tim.anson@us.pwc.com

Michael DiFronzo, *Washington, DC*
+1 202 312 7613
michael.a.difronzo@us.pwc.com

Marty Collins, *Washington, DC*
+1 202 414 1571
marty.collins@us.pwc.com

Carl Dubert, *Washington, DC*
+1 202 414 1873
carl.dubert@us.pwc.com

David Sotos, *San Jose*
+1 408 808 2966
david.sotos@us.pwc.com

Charles Markham, *Washington, DC*
+1 202 312 7696
charles.s.markham@us.pwc.com

Matthew Chen, *Washington, DC*
+1 202 414 1415
matthew.m.chen@us.pwc.com

Sean Mullaney, *Washington, DC*
+1 202 346 5098
sean.w.mullaney@us.pwc.com

Transfer Pricing

Horacio Peña, *New York*
+1 646 471 1957
horacio.pena@us.pwc.com

Richard F. Barrett, *Washington, DC*
+1 202 414 1480
richard.f.barrett@us.pwc.com

Ward Connolly, *San Jose*
+1 408 817 8234
ward.connolly@us.pwc.com

Gregory J. Ossi, *Washington, DC*
+1 202 414 1409
greg.ossi@us.pwc.com

David Ernick, *Washington, DC*
+1 202 414 1491
david.ernick@us.pwc.com

Lili Kazemi, *Washington, DC*
+1 202 346 5252
golaleh.kazemi@us.pwc.com