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## Tax Treatment of Certain Outbound Transfers

The IRS has recently issued proposed regulations with respect to transfers of “foreign goodwill and going concern value” by U.S. persons to foreign corporations in a non-recognition transaction under Internal Revenue Code (Code) section 367. The IRS cited significant policy concerns involving certain taxpayers’ attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367.

The proposed regulations would eliminate the foreign goodwill exception under Treas. Reg. § 1.367(d)-1T and would limit the scope of the active trade or business (ATB) exception under section 367(a)(3) and the regulations thereunder. Additionally, the IRS issued temporary regulations under section 482 to clarify coordination of transfer pricing rules with other Code provisions. The text of the temporary regulations under section 482 serves as the text of a portion of these proposed regulations.

### **Current Law:**

#### *General Outbound Transfers under Section 367(a):*

Under section 367(a)(1), if a U.S. person (U.S. transferor) transfers property to a related foreign corporation in connection with any tax free exchange described in sections 332, 351, 354, 356, or 361, the transferee foreign corporation generally is not considered to be a corporation for purposes of determining whether gain is recognized on such transfer. In other words, under section 367(a)(1), the U.S. transferor recognizes gain (but not loss) on the outbound transfer of the property, unless certain exceptions apply. One exception is under section 367(a)(3)(A) for transfers of certain property to a foreign corporation that will be used in the active conduct of a trade or business by such foreign corporation outside of the United States (ATB exception). However, certain categories of property are not eligible for the ATB exception, including (i) property relating to inventory, copyrights, musical, artistic, or similar property; (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) (as discussed below); and (v) property with respect to

which the U.S. transferor is a lessor at the time of the transfer, unless the transferee corporation was the lessee. Additionally, the branch loss recapture rule under section 367(a)(3)(C) prohibits the application of ATB exception to gain realized on an outbound transfer of the assets of a foreign branch to the extent that previously deducted losses of the branch exceed the taxable income earned by the branch after the losses were incurred.

For the purposes of the application of the ATB exception, treasury regulations under section 367(a) provide general rules for determining the following:

- i. Whether property is transferred for use by a transferee foreign corporation in the active conduct of trade or business outside the U.S. (Treas. Reg. §§ 1.367(a)-2 and -2T).
- ii. Whether certain property satisfies the ATB exception and whether depreciation recapture is required upon an outbound transfer of U.S. depreciated property. (Treas. Reg. §§ 1.367(a)-4 and -4T).
- iii. The five categories of property (discussed above) ineligible for the ATB exception, and whether certain exceptions to those categories apply. (Treas. Reg. §§ 1.367(a)-5 and -5T).
- iv. Whether certain property denominated in the foreign currency of a country in which a transferee foreign corporation is organized qualifies under the ATB exception if such property was acquired in the ordinary course of the business of the U.S. transferor that will be carried on by such transferee foreign corporation. (Treas. Reg. §§ 1.367(a)-5T(d)).
- v. Application of branch loss recapture rules. (Treas. Reg. §§ 1.367(a)-6 and -6T).

#### Outbound Transfer of Intangible Property under Section 367(d)

Section 367(d) provides specific rules with respect to outbound transfers of intangible property (within the meaning of section 936(h)(3)(B)) to a transferee foreign corporation in certain tax free exchanges described in section 351 or 361. Section 936(h)(3)(B) generally defines intangible property to include a patent, invention, copyright, trademark, franchise, method, or any similar item, which has substantial value independent of the services of any individual. Pursuant to section 367(d), the U.S. transferor of the intangible property described above is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of the property. Such U.S. transferor is treated as receiving the amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life (not to exceed 20 years) of such property, or in the case of a disposition of the intangible property following such transfer, at the time of such disposition. These amounts must be commensurate with the income attributable to the transferred intangible.

However, pursuant to Treas. Reg. § 1.367(d)-1T(b), section 367(d) historically has not applied to the transfer of foreign goodwill or going concern value (foreign goodwill exception). Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines “foreign goodwill or going concern value” as the residual value of a business operation (including right to use a corporate name) conducted outside of the United States after all other tangible and intangible assets have been and valued.

The legislative history of section 367 provides logic for foreign goodwill exception that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation would not result in abuse of the U.S. tax system. Further the Congress believed that no gain should be recognized on the transfer of goodwill or going concern value for the use in an active trade or business. S. REP. NO. 169, 98th Cong., 2d Sess., at 360 (1984); H.R. REP. NO. 432, 98th Cong., 2d Sess., at 1315 (1984).

#### **Proposed Changes:**

The proposed regulations would eliminate the foreign goodwill exception and limit the scope of property that is eligible for the ATB exception to certain tangible property and financial assets. Such a change would subject a U.S. transferor of foreign goodwill or going concern value to either current gain recognition under section 367(a)(1) or the tax treatment of intangibles under section 367(d) discussed above.

Prop. Reg. §1.367(d)-1(b) would apply section 367(d) to outbound transfers of intangible property without providing any exception for foreign goodwill or going concern value. The definition of intangible property for purposes of sections 367(a) and 367(d) also would be modified to facilitate the elimination of goodwill exception. The proposed regulations would further give taxpayers an option to apply section 367(d) with respect to certain outbound transfers of property that

otherwise would be subject to section 367(a) under the new rules. A U.S. transferor who takes a position that goodwill and going concern are not section 936(h)(3)(B) intangible property may nonetheless apply section 367(d) to goodwill and going concern value. To implement this rule along with the removal of the foreign goodwill exception, the proposed regulations revise the definition of intangible property to mean either property described in section 936(h)(3)(B) or property to which a U.S. transferor elects to apply section 367(d) (in lieu of section 367(a)).

In addition, the proposed regulations would eliminate the rule that limits the useful life of intangible property to 20 years. Instead, the proposed regulations would 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.

Further, under the existing regulations, all property is eligible for the ATB exception unless the property is specifically excluded. The IRS believes that the taxpayers have an incentive to take the position that certain intangible property that is not described in section 936(h)(3)(B) is not subject to section 367(d) and is instead subject to section 367(a) and eligible for the ATB exception because the intangible property is not specifically excluded from the ATB Exception. The IRS believes this result is giving taxpayers an incentive to undervalue intangible property subject to section 367(d). To avoid this issue, the proposed regulations provide that only certain types of property are eligible for the ATB exception (eligible property) when such property is transferred for use by the foreign corporation in the active conduct of trade or business outside of the United States. The eligible property for the exception is tangible property, working interests in oil and gas property, and certain financial assets unless the property falls within one of the four categories specifically excluded from the ATB exception. These categories are (i) inventory or similar property; (ii) installment obligation; (iii) foreign currency or certain other property denominated in foreign currency; and (iv) certain leased property. The regulations deleted the category for the intangible property because it is not an eligible property under the general rule and hence this specific exclusion is not relevant. Additionally, certain reporting requirements under section 6038B must also be satisfied.

The proposed regulations would also modify Treas. Reg. § 1.367(a)-1T(b)(3) with a new rule for better coordination of the application of the arm's length standard and the best method rule under section 482 regulations. Accordingly, the proposed regulations provide that in cases where an outbound transfer of property subject to section 367(a) constitutes a controlled transaction as per transfer pricing regulations, the value of the property transferred would be determined in accordance with section 482 and the regulations thereunder.

**Effective/Applicability Dates:**

The proposed regulations are proposed to apply to transfers occurring on or after Sept. 14, 2015, and to transfers occurring before this date resulting from entity classification elections made under Treas. Reg. § 301.7701-3 that are filed on or after this date.

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