A Note From the Editor-in-Chief

Disputed Issues with the Application of Code Sec. 367 to Intangibles

The transfer of intangible property by a U.S. person to a foreign corporation in an otherwise tax-free contribution or outbound reorganization generally is subject to U.S. taxation under Code Sec. 367. An exception is provided for foreign goodwill and going concern value. There is current debate concerning certain important issues regarding the application of Code Sec. 367 to intangibles.

As background, Code Sec. 367(a)(1) provides generally that gain on the transfer of property by a U.S. person to a foreign corporation is subject to immediate taxation. An exception applies to the transfer of property used in the active conduct of a trade or business outside the United States. In addition, taxation of gain on the transfer of stock in a foreign corporation generally is avoided by filing a gain recognition agreement.

Code Sec. 367(a) does not apply to the transfer of “intangible property (within the meaning of section 936(h)(3)(B))” by a U.S. person to a foreign corporation as a contribution or pursuant to an outbound reorganization. Rather, such transfers are subject to Code Sec. 367(d). Code Sec. 936(h)(3)(B) defines intangible property by providing a list of 27 items, including patents, designs, copyrights, trademarks, franchises, contracts, systems, programs, and customer lists, and ends with “and any similar item which has substantial value independent of the services of any individual” (“936 intangibles”). Regulations provide that Code Sec. 367(d) does not apply to foreign goodwill and going concern value.

Under Code Sec. 367(d), gain is not immediately recognized, but the U.S. person recognizes income annually over the useful life of the intangible property, similar to a license arrangement. While the transaction is treated as a sale of the intangible property for payments contingent on the productivity or use of the property, the basis of the property transferred apparently is not taken into account in calculating the amount of income recognized. The annual amounts must be commensurate with the income attributable to the intangible.

The deemed annual payments are treated as royalties for foreign tax credit purposes. Such payments reduce the CFC’s subpart F income to the extent allocable thereto, and reduce the CFC’s earnings and profits. In addition, the CFC can distribute the amount of the deemed payments without additional U.S. taxation.
A common transaction subject to Code Sec. 367(d) is the outbound transfer of a business upon incorporation of a foreign branch. Two disputed issues concern the scope of the exception that applies to foreign goodwill and going concern value.

First, there is a strong position that workforce-in-place is a component of goodwill and going concern value based on the statutory language and case law. The IRS disagrees, asserting that workforce-in-place should be considered as a “similar item” within the meaning of Code Sec. 936, and is subject to Code Sec. 367(d) where it has substantial value independent of the services of any individual member of that workforce (e.g., a large research and development team).  

Second, taxpayers often value each identifiable asset subject to Code Sec. 367(d) separately, and attribute the residual value to goodwill and going concern value. The IRS has sought to minimize the value of goodwill and going concern value by valuing intangibles on an aggregate basis, taking into account the additional value that results from the interrelationship of intangible assets. In addition, the IRS may seek to value intangible property taking into consideration the prices or profits that the U.S. parent could have realized by choosing a realistic alternative to the transactions undertaken.

Another issue involves the treatment of the transfer of U.S. goodwill and going concern value to a foreign corporation. If U.S. goodwill or going concern value is considered a 936 intangible, it would be subject to Code Sec. 367(d), resulting in the inclusion of annual amounts in the income of the U.S. transferor. On the other hand, if such intangibles were not 936 intangibles, the transfer could result in immediate taxation of the entire gain under Code Sec. 367(a), gain would be recognized immediately. Given the IRS's longstanding position that such intangibles are 936 intangibles based on its interpretation of the Code, regulations and legislative history, taxpayers have a strong position that they can hold the IRS to its clearly stated position, with the result that Code Sec. 367(a)(5) does not apply, in which case the transfer of foreign goodwill or going concern value should not be subject to taxation and U.S. goodwill or going concern value should be subject to the annual inclusion rule under Code Sec. 367(d). Meanwhile, taxpayers in different circumstances might be able to mount strong challenges to the IRS's position.

Proposals have been made to “clarify” the above issues, adopting the above IRS approaches. In addition, Code Sec. 367(d) is on the IRS business plan for FY 2012. Stay tuned.

ENDNOTES

1 Code Sec. 367(a)(2) & (3); Reg. §1.367(a)-2T & -3(b).
2 Reg. §1.367(d)-1T(b). The assignment of a corporate opportunity is not subject to Code Sec. 367. See Hospital Corp. of America, 81 TC 520, Dec. 40,476 (1983).
3 See LMSB-04-0107-002 (Feb. 2, 2007); LMSB-04-0108-001 (Feb. 13, 2008); but see Veritas, 133 TC 297, Dec. 58,016 (2009) (court rejected the IRS argument to treat work-force-in-place as a 936 intangible).
4 Reg. §1.367(a)-1T(d)(5)(iii) (“foreign goodwill or going concern value is the residual value of a business”).
5 If Code Sec. 367(a) were to apply, the CFC would take a stepped up basis in the U.S. intangibles, which requires an analysis of the potential application of Code Sec. 956, whereas the basis in the U.S. intangibles would not be stepped up if Code Sec. 367(d) applies.
6 See Joint Committee on Taxation, Description of the Revenue Proposals Contained in the President’s Fiscal Year 2010 Budget Proposal, Part Three (JCX-4-09), Sept. 2009, at 38-39 (describing the IRS view and noting the lack of clarity on this issue under current law). See also AOD 2010-05 (Dec. 6, 2010); TAM 200907024 (Nov. 10, 2008); LTR 9024004 (Apr. 21, 1988).
7 Treating foreign goodwill and going concern value as 936 intangibles should take such property outside the scope of Code Sec. 367(a), even though such intangibles qualify for an exception under Code Sec. 367(d).
8 An outbound reorganization with boot should not accelerate the Code Sec. 367(d) amount because any boot is taxable to the transferee’s shareholder (and not to the transferor). Cf., CCA 200610019 (Nov. 23, 2005), LTR 200845044 (Aug. 4, 2008) (addressing outbound Code Sec. 351 transfers with boot).