

INTERNATIONAL PRACTICE UNIT: DEEMED ANNUAL ROYALTY INCOME UNDER CODE §367(D)

Author

Christine Long

Tags

Code §367(d)

Code §936(h)(3)(B)

Deemed Royalty

Foreign Goodwill

Going Concern

Intangible Property

International Practice Units

LB&I

INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called the "Deemed Annual Royalty Income Under I.R.C. 367(d)." This Practice Unit is concerned with how U.S. taxpayers attempt to reduce or eliminate Federal tax consequences under Internal Revenue Code¹ §367(d) when (i) ownership of valuable intangible property ("I.P.") is transferred to a related corporation outside the U.S. pursuant to an exchange under Code §§351 or 361 and (ii) the related person is resident in a low-tax jurisdiction.

Generally, Code §§351 and 361 apply nonrecognition treatment to the transfer of property solely in exchange for stock in the corporation either (i) as a contribution in which the transferor retains control or (ii) pursuant to a plan of reorganization. However, the Code §§351 or 361 exchange will become taxable under Code §367(d) when a U.S. person or entity transfers any I.P. to a foreign corporation. A contingent sale of the I.P. is deemed to occur when the deemed contingent gain payments are treated as a royalty. Typically, this triggers ordinary income for the U.S. entity. Some U.S. taxpayers attempt to avoid this tax or reduce the amount of the deemed royalty by asserting that most of the transferred intangibles are foreign goodwill and going concern values, which are not covered by Code §367(d). This Practice Unit focuses on how to identify the exploitation of Code §367(d) and the issues that arise in an examination.

BACKGROUND

As a way to reduce the effective tax rate, a U.S. entity may transfer I.P. offshore to another foreign corporation through a nonrecognition transfer pursuant to Code §§351 or 361. Under Code §351, no gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation if immediately after the exchange the group of transferors are in control of the recipient corporation. Under Code §361, no gain or loss is recognized by a corporation that is a party to a reorganization when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. Under Code §367(d), however, these nonrecognition transactions are subject to income tax.

Code §367(d) provides that when a U.S. person transfers any I.P. to a foreign corporation pursuant to Code §§351 or 361, the U.S. transferor is treated as if it sold the I.P. in exchange for a continuing stream of annual payments. Sales of I.P. for

¹ All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

contingent consideration based on productivity or use are generally treated as giving rise to royalty payments, subject to recovery of basis over the course of the payment stream. The deemed royalty is characterized as ordinary income over the useful life of the property, not to exceed 20 years. The annual royalty payment will increase taxable income and the effective tax rate of the U.S. transferor annually. If, within the intangible's useful life, the foreign corporation subsequently disposes of the property to an unrelated party, the U.S. transferor must recognize all inherent gain equal to the difference between the fair market value of the property and its adjusted basis. Code §482 and the accompanying I.R.S. regulations establish the arm's length and commensurate with income standards that are used to determine the amount of the deemed royalty.²

Code §936(h)(3)(B) defines the term "I.P." to mean any

- patent, invention, formula, process, design, pattern, or know-how;
- copyright, literary, musical, or artistic composition;
- trademark, trade name, or brand name;
- franchise, license, or contract;
- method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- any similar item, which has substantial value independent of the services of any individual.

Code §367(d) does not apply to the transfer of foreign goodwill or going concern ("F.G.W.G.C.") value because Treas. Reg. §1.367(d)-1T(b) provides there is no tax on the transfer of F.G.W.G.C. to a foreign corporation in a Code §§351 or 361 transaction.³ Foreign goodwill is defined in Treas. Reg. §1.367(d)-1(T)(d)(5)(iii) as the residual value of a foreign business operation conducted outside the U.S. after all other tangible and intangible assets have been identified. This Practice Unit points out that the identification of transferred tangible and intangible assets is critical in analyzing I.P. transfers and cautions that if a substantial portion of the total transfer value is F.G.W.G.C., the transaction should be evaluated carefully and may require specialized resources.⁴

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of when a U.S. taxpayer's transfer of I.P. to a foreign corporation is treated as a deemed annual royalty income inclusion under Code §367(d) in order to demonstrate how an I.R.S. examiner should perform an audit.

The Practice Unit's fact pattern consists of a U.S. person ("U.S.P.") that is a multi-national technology company. U.S.P. incorporates a controlled foreign corporation

² "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p.3.

³ *Id.*

⁴ *Id.*, p. 4.

("C.F.C. 1") in a low-tax foreign country. U.S.P. transfers valuable I.P., including assets to operate the business, to C.F.C. 1 in exchange for stock in a Code §351 transaction. C.F.C. 1 was previously a foreign branch of U.S.P. that operated with minimal profits in the prior two years. U.S.P. also transferred a significant number of interrelated license agreements to C.F.C. 1 with an average term of 12 years. U.S.P. valued each license agreement separately (not in the aggregate) in its study.

U.S.P. reported on its tax return that a large percentage of the transferred I.P. consisted of F.G.W.G.C. U.S.P. does not receive a royalty from C.F.C. 1. U.S.P. reported the transaction as a Code §367(d) transaction. U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. to C.F.C. 1 in exchange for stock as part of a Code §351 transaction. Former U.S.P. engineers became employees of C.F.C. 1. These engineers brought significant technical knowhow and reference materials, including manuals and software that were developed by them while being employed by U.S.P. The study provided by U.S.P. identified that a large percentage of the transferred I.P. consisted of F.G.W.G.C. and separately valued the license agreements. In the study, U.S.P. stated that the useful life of the licenses and knowhow is five years. The contracts and other interrelated licenses that U.S.P. transferred to C.F.C. 1 have significant synergistic value.⁵

ISSUES & AUDIT PROCEDURES

The Practice Unit identifies three potential issues that examiners should focus on when a U.S. taxpayer transfers I.P. to a foreign corporation pursuant to Code §§351 or 361 and the income is deemed to be an annual royalty under Code §367(d):

1. Has all the Code §936(h)(3)(B) I.P. transferred from U.S.P. to C.F.C. 1 pursuant to Code §351 been properly identified for purposes of applying Code §367(d)?
2. Did U.S.P. properly value foreign goodwill or going concern pursuant to Treas. Reg. §§1.367(d)-1T(b)?
3. Did U.S.P. properly value the Code §936(h)(3)(B) intangible assets for purposes of computing the Code §367(d) deemed royalty?⁶

The Practice Unit provides a step-by-step approach for conducting an audit of each issue. The first step, which applies to all three issues, is to ensure that the transferred I.P. has been properly identified, for purposes of Code §367(d), by establishing the facts and supporting documentation. The examiner must confirm that U.S.P. actually transferred I.P. to C.F.C. 1 in exchange for stock pursuant to Code §351. In addition, the examiner must confirm that U.S.P. reported this transfer as a Code §367(d) transaction. The examiner must also confirm that the U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. in exchange for stock pursuant to Code §351. Then, the examiner is instructed to determine whether this is in fact a Code §367(d) transaction, and if so, verify if former U.S.P. engineers became employees of the C.F.C. The Practice Unit suggests referring to the following I.R.S. forms:

⁵ *Id.*, p. 5-6.

⁶ *Id.*, p. 8.



- Form 926, *Filing Requirement for U.S. Transferors of Property to a Foreign Corporation*, Part III, Intangible and Part IV, line 17a
- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, Schedule O and Section E
- Form 1120, *U.S. Corporation Income Tax Return*, Disclosures Pursuant to Code §6038B⁷

The Practice Unit also suggests that examiners request or consider the following documents from the U.S.P. or C.F.C. 1 in order to effectively investigate the taxpayers' transactions:

- Transfer pricing documentation and background documentation
- Pre- and post-transfer organizational charts
- Contracts containing critical facts of the I.P. transfer and reorganization
- I.P. valuation

When the documentation is provided, the Practice Unit directs the examiner to

- analyze disclosures made on the tax return pursuant to Code §351 and §367(d) as well as Form 926,
- identify interrelated intangibles from the taxpayer's valuation and transfer pricing studies,
- request the transaction steps,
- verify intangibles transferred from legal documents and contracts, and
- determine if a referral for an economist or engineer is necessary.⁸

Identification of All I.P. Transferred for Purposes of Applying Code §367(d)

In order to address the issue of whether all intangible assets transferred from U.S.P. to C.F.C. 1 have been properly identified for purposes of applying Code §367(d), the Practice Unit emphasizes that the intangibles must clearly be identified. Examiners are aware that taxpayers may transfer intangibles beyond those reported on the return or claimed in the valuation study. The examiner must personally identify and verify all the significant intangibles.

Intangibles that satisfy the definition of Code §936(h)(3)(B) are compensable even though the I.R.S. and some taxpayers may disagree as to whether a particular intangible asset meets this definition. The Practice Unit defines "I.P." under the Code §936(h)(3)(B) definition set forth above. Even if the I.P. at issue may not be specifically named on the list of Code §936(h)(3)(B), it should be included if it is considered to be similar to the items specifically listed. The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as F.G.W.G.C.⁹

⁷ *Id.*, p. 9.

⁸ *Id.*, p. 10.

⁹ *Id.*, p. 10-11.

“The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as foreign goodwill or going concern.”

The examiner is directed to perform a functional analysis of the I.P. that was transferred in order to clearly identify all the intangibles and determine their values. To assist with analyzing the transfer, the Practice Unit refers to T.A.M. 200907024; Treas. Reg. §1.367(a)-1T(d)(5)(iii); *Hospital Corp. of America v. Commr*, 81 T.C. 520 (1983); and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

The following are the preliminary questions for the examiner to consider:

- Does the valuation date match the transfer date?
- How was the I.P. valued?
- Does the taxpayer's return position include little or no value for I.P. transferred relative to the business enterprise?
- Did the taxpayer identify the transfer as a non-taxable outbound transfer of foreign goodwill and going concern?
- Was the I.P., in fact, transferred via Code §§351 or 361?¹⁰

After all of the facts are established and the intangibles are properly characterized, the examiner is ready to move to the next issue.

Determining Value of F.G.W.G.C.

In addressing the issue of whether the U.S.P. valued the F.G.W.G.C. properly under Treas. Reg. §1.367(d)-1T(b), the examiners are aware that taxpayers may characterize their transferred I.P. as F.G.W.G.C. in order to avoid tax under Code §367(d). The examiner must determine whether the F.G.W.G.C. value exists, and if so, the examiner must determine its correct value. There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered.¹¹

The Practice Unit explains the crux of the issue as follows:

When a taxpayer transfers its intangibles offshore through IRC 351 and IRC 361 and categorizes substantially all of it as FGWGC, it:

- Minimizes the value of compensable intangibles under IRC 367(d) so that the federal tax impact from the transfer is reduced (also referred to as 'toll charge');
- Maximizes the value of foreign goodwill and going concern value because foreign goodwill and going concern value is not compensable (a 'carve out') under IRC 367(d) and is not subject to U.S. taxation.

Treas. Reg. 1.367(d)-1T(d)(5)(iii) provides foreign goodwill is the residual value of a foreign business operation conducted outside the United States after all other tangible and intangible assets have been identified. Often the identification of only some of the transferred assets will result in a large residual value. [The examiner]

¹⁰ *Id.*, p. 14.

¹¹ *Id.*, p. 15.

“There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered.”

must determine whether this residual value is in fact foreign goodwill or going concern.¹²

Foreign going concern value may exist even if foreign goodwill does not exist. The Practice Unit explains that case law suggests that going concern value is the additional element of value that attaches to property by reason of its existence as an integral part of a going concern. The idea is that even without goodwill, the value of a going concern exists when there is excess earning capacity and the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership.¹³

The I.R.S. is concerned about identifying goodwill and going concern intangibles because U.S. some taxpayers attempt to reduce the amount of the deemed royalty under Code §367(d) by claiming that a significant amount of the intangible value is attributable to F.G.W.G.C.¹⁴ The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C. In the example, U.S.P. attempted to reduce its deemed royalty by reporting a large amount of F.G.W.G.C.¹⁵

The Practice Unit instructs the examiner to focus on the following:

The question is whether intangible value categorized as FGWGC by the taxpayer is really another type of IRC 936(h)(3)(B) intangible. Also, it is important to:

- Consider if all tangible and intangible assets have been identified
- Consider whether the assets are from a foreign business operation conducted outside the United States that may give rise to FGWGC.

In this fact pattern, USP's branch was operating with minimal profit for two years before incorporating, so it is unlikely that the branch would have developed significant FGWGC value during that period.¹⁶

In assessing the goodwill or going concern assets, the Practice Unit instructs the examiner to refer to the relevant Code provisions:

- Treas. Reg. §§1.367(d)-1T(b)
- T.A.M. 200907024
- HR Rep. No. 98-432 (1984) – Committee Reports on Tax Reform Act of 1984
- S. Rep. No. 98-169 (1984) – Committee Reports on Tax Reform Act of 1984
- P.L. No. 99-514, Sec.1231(e) – 1986 Modification to Code §936

¹² *Id.*, p. 16.

¹³ *Id.*, p. 17.

¹⁴ *Id.*, p. 19.

¹⁵ *Id.*

¹⁶ *Id.*, p. 21.

“The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C.”

- I.R.M. Exhibit 4.61.3-4 – Transfer Pricing Functional Analysis Questionnaire

The Practice Unit also suggests referring to the following cases:

- *Conestoga Transportation Co. v. Commr*, 17 T.C. 506, 514 (1951)
- *United States v. Cornish*, 348 F.2d 175 (9th Cir. 1965)
- *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971)
- *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975)
- *VGS v. Commr*, 68 T.C. 563 (1977)

Proper Valuation of I.P. When Applying Code §367(d)

According to the Practice Unit, the last issue addressed in an audit is whether U.S.P. properly valued the I.P. for purposes of computing the deemed royalty under Code §367(d). Since it is difficult to determine the synergistic value between intangibles, the Practice Unit suggests following the case law to determine the proper value of the transferred I.P. The case law¹⁷ supports valuing interrelated assets in the aggregate so that the synergistic value of the entire collection of assets is reflected in the computation.¹⁸ This reflects a view that the value of the whole is greater than the sum of its parts.

The Practice Unit expands on this critical issue of determining the proper value in great detail:

As a matter of economic reality and fundamental valuation principles, USP transferring intangibles at arm's length would conclude that the assets should be valued in the aggregate in a manner that properly reflects any synergistic relationships. In a scenario where numerous assets are used as a single integrated asset, it would be inappropriate to value the assets on a separate, stand-alone basis when they have functioned in the past, and will function in the future, as a single asset. Treas. Reg. 1.482-1(f)(2)(i) recognizes such economic realities by providing that multiple transactions should be valued in the aggregate if such transactions, taken as a whole, are so interrelated that an aggregated valuation is the most reliable means of determining the arm's length consideration for the transactions.

- USP may have undervalued IRC 936(h)(3)(B) intangibles by disregarding synergies between separate intangibles that increase their aggregate value. Because FGWGC is a residual, undervaluing IRC 936(h)(3)(B) intangibles overvalues FGWGC.
- Synergies between separate IRC 936(h)(3)(B) intangibles should be considered when valuing those intangibles. Often,

¹⁷ See *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975) and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

¹⁸ "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p. 22.



“I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied.”

valuing IRC 936(h)(3)(B) intangibles in the aggregate, taking synergies into account, will be the most reliable means to value them.

- USP did not identify knowhow that was transferred. The technical manuals, processes, transferred to CFC1 likely constitute valuable intangibles and CFC1 should compensate USP at an arm’s length rate.
- USP may contend that the useful life of an intangible is short, and therefore, the present value period for computing the royalties is also short.¹⁹

In the example, the examiner must scrutinize the contracts and interrelated licenses that U.S.P. transferred to C.F.C. 1 in order to determine if they have significant synergistic value. The examiner must also confirm (i) that U.S.P.’s study separately valued the license agreements, (ii) whether the technical knowhow and reference materials were in the study, and (iii) the useful life of the technology and whether it should be 12 years, not five years as U.S.P. stated in its study.²⁰

The Practice Unit concludes that the study performed by U.S.P. in the fact pattern did not value the synergistic effect of the interrelated technology license agreements because these licenses have a 12-year term, which means the useful life may be 12 years and not five years as U.S.P. stated. The examiner should coordinate with an economist or engineer to determine the proper value of the I.P. since its useful life should be adjusted. The study by U.S.P. also neglected to include the large amount of knowhow when it transferred the engineers with their technical manuals and software. Therefore, an arm’s length price for this I.P. should be determined in order to properly adjust the value.²¹

Finally, once the intangible properly is identified and valued, the examiner computes the Code §367(d) annual deemed royalty, which cannot exceed 20 years. The deemed royalty amount must be determined in accordance with the arm’s length and commensurate with income standards of Code §482 and the regulations thereunder.²²

CONCLUSION

When a U.S.-based multinational group expands operations abroad, a transfer of tangible assets is accompanied by a transfer of I.P. to an attractive location abroad, typically one in which I.P. box tax rules are in existence. Financial management is often focused on the tax benefits that may be derived from the global structure; tax management is often focused on the value of F.G.W.G.C. so that the effect of Code §367(d) is reduced. In this fact pattern, it is often forgotten that I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied.

¹⁹ *Id.*, p. 22-23.

²⁰ *Id.*, p. 24.

²¹ *Id.*, p. 25.

²² *Id.*, p. 26.