TAX CONCERNS ON OUTBOUND I.P. TRANSFERS: PITFALLS & PLANNING

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OVERVIEW

In a 21st century America where new ideas continually create new intangible property ("I.P."), U.S. corporations often desire to contribute their I.P. to a foreign affiliate who then develops and markets the I.P. and its progeny around the world. The desired tax goals are to have the I.P. transferred tax free and defer the U.S. taxation of the profits earned by the foreign affiliate until the profits are repatriated back to the U.S. as a dividend.

When the outbound transfer of I.P. would otherwise receive tax-free treatment under Code §351 (or another tax-free rule), Code §367(d) steps in to prevent tax deferral. Code §367(d) recharacterizes the I.P. transfer as a sale of the I.P. for a future stream of royalties, which are taxable to the U.S. corporate transferor as ordinary income.

In grappling with Code §367(d), careful taxpayer planning is important in many ways. Taxpayer should consider (i) structuring the transfer as a possible taxable sale to avoid Code §367(d); (ii) minimizing the taxable royalty that is imposed under Code §367(d); (iii) separating the I.P. transfer from other steps taken to develop the I.P., such as in a cost sharing arrangement ("C.S.A."); and (iv) grappling with the Code §482 transfer pricing rules that overlay all these actions.

On March 23, 2017, taxpayer planning paid off when the Tax Court delivered the I.R.S. a major defeat in *Amazon.com, Inc. & Subsidiaries v. Commr.*,[1] which dealt with the transfer pricing rules applicable to an outbound I.P. transfer and related C.S.A. This article will explore the rules related to tax-free treatment on outbound transfers of I.P., as well as planning options and the recent *Amazon* case, to reveal the potential tax potholes and the ways that I.P. developers can avoid them or lessen their damage.

BACKGROUND

U.S. pharmaceutical companies, high-tech businesses, and other corporations produce numerous I.P. rights through investment in research and development ("R&D"). This newly developed I.P. is often destined to be held by foreign affiliates engaged in operations around the world.

In such cases, U.S. corporations will generally rely on Code §351 to contribute the I.P. to a foreign corporate affiliate in a tax-free manner. Code §351 will apply if the U.S. corporation owns 80% or more of the foreign affiliate's stock, but the U.S. entity will face additional barriers provided in the Code.

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1 148 T.C. No. 8 (2017).

Barriers to Tax-Free Treatment

One barrier to U.S. tax deferral is the controlled foreign corporation ("C.F.C.") rules. If the foreign affiliate is characterized as a C.F.C.,[2] the income generated by that C.F.C. can be characterized as Subpart F income resulting in immediate taxation to its U.S. shareholders.[3] However, careful structuring of the operations of the C.F.C. can avoid generating Subpart F income.

Royalty income that may be classified as foreign personal holding company income ("F.P.H.C.I."), which generates Subpart F income, can be excluded from F.P.H.C.I. if the C.F.C. derives such income from an active trade or business and receives the royalty from an unrelated person.[4] As a result, the U.S. corporation that created the I.P. may be able to achieve tax deferral by moving the I.P. offshore and accumulating the profits in its foreign affiliate until repatriating those earnings back to the U.S. as a dividend. However, Code §367 is another barrier that must be overcome to achieve that goal.

Section 367(a) Limitations

Code §367(a) creates a general rule, which provides that the Subchapter C non-recognition rules (such as Code §351) do not apply when a U.S. corporation moves assets to a non-U.S. corporation. However, there is a helpful exception to this rule where the transferred assets are used in an active trade or business conducted outside the U.S.[5] This exception can be used to preserve the tax-free transfer of the I.P. if the I.P. is to be used in an active trade or business, which is usually the case.

The active business exception does not apply to certain assets such as inventory and accounts receivable, but these existing limitations do not cover the classic types of I.P. moved offshore.[6] The I.R.S. issued regulations on December 15, 2016, that goodwill and going concern value are not eligible for the active business exception.[7] These regulations provide that a transfer of goodwill or going concern value would be taxable immediately under Code §367(a) or, at the election of the taxpayer, taxable over the useful life of the I.P. under §367(d), as discussed below. Goodwill and going concern value transfers are generally applicable when a business is being moved offshore rather than when select I.P. assets are being transferred. As a result, the I.P. transferor can generally escape the clutches of §367(a), but there is one more Code §367 hurdle: Code §367(d).

Section 367(d) Limitations

Code §367(d) applies to transfers of I.P. from a U.S. corporation to a foreign corporation made under the non-recognition rules of Code §§351 or 361, which applies to corporate reorganizations. This section was created to catch transactions that may escape U.S. taxation until the U.S. taxpayer chooses to repatriate the earnings of its C.F.C. as a dividend or sells or disposes of the C.F.C.

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[2] Code §957.

[3] Code §951(a)(1)(A)(i).

[4] Code §954(c)(1).

[5] Code §367(a)(3).

[6] Code §367(a)(3)(B).

[7] Treas. Reg. §1.367(a)-1(b)(5).

Code §367(d) does not, however, apply in the case of an actual sale or license of I.P. by a U.S. person to a foreign corporation.[8] As a result, a taxpayer may choose to do a taxable sale of the I.P. to a foreign affiliate and then only has to ensure that the sales price is acceptable under the Code §482 transfer pricing rules. A taxable sale should be considered since it may produce less aggregate tax over time and eliminate the annual burdens imposed in complying with Code §367(d).

I.P.[9] subject to Code §367(d) includes any of the following:

- Patents, inventions, formulas, processes, designs, patterns, or know-how
- Copyrights or literary, musical, or artistic compositions
- Trademarks, trade names, or brand names
- Franchises, licenses, or contracts
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
- Any similar items

The regulations provide that these items are treated as I.P. without regard to whether they are used or developed in the U.S. or in a foreign country, and without regard to whether they are used in manufacturing or marketing activities.[10] While goodwill and going concern value are not in the statutory list of I.P., recently adopted regulations provide that goodwill and going concern value transfers are taxable under Code §367(a), but, at the taxpayer's election, goodwill and going concern value may be treated as I.P. subject to Code §367(d) rather than being immediately taxable under Code §367(a).[11]

Code §367(d) does not impose full, immediate taxation on the transfer of the I.P. Instead, Code §367(d) creates a sale for a series of annual royalty payments "contingent on the productivity, use or disposition of the intangible property," which are deemed paid by the foreign recipient to the U.S. transferor over the "useful life" of the I.P. The final Code §367(d) regulations adopted on December 15, 2016, eliminated the ability to assume a maximum 20-year useful life. The final regulations[12] revised the definition of "useful life" to include "the entire period during which exploitation of

8 Treas. Reg. §1.367(d)-1T(g)(4)(i). If I.P. is transferred to a related foreign corporation for no consideration, then no sale or license subject to adjustment under Code §482 shall be deemed to have occurred. Instead, the U.S. transferor is treated as having made a Code §367(d) transfer of I.P. (Treas. Reg. §1.367(d)-1T(g)(4)(i)). However, a royalty-free license may not be subject to this rule and may be able to escape taxation, subject to application of the Code §482 regulations.

9 Code §367(d)(1), which adopts the definition in Code §936(h)(3)(B). This definition is similar to that set forth in the Code §482 regulations. Excluded from this list are a copyright; a literary, musical, or other artistic composition; a letter or memorandum; or similar property created by the taxpayer (Treas. Reg. §1.367(a)-5T(b)(2); cross-referenced by Treas. Reg. §1.367(d)-1T(b)).

10 Treas. Reg. §1.367(a)-1T(d)(5)(i), sent. 2; cross-referenced by Treas. Reg. §1.367(d)-1T(b), sent. 1.

11 Treas. Reg. §1.367(d)-1(c)(3)(ii).

12 Treas. Reg. §1.367(d)-1(c)(3).

the property is reasonably anticipated to affect the determination of taxable income, as of the time of the transfer."

The regulations include an exception for property with an indefinite useful life or with a life that is reasonably anticipated to exceed 20 years. The exception allows the transferor to take the amount into income during a limited 20-year period. The only catch is that the annual royalty must be increased to take into account the additional value attributable to the period following 20 years (*i.e.*, a transferor still must take into account the present value of all amounts, including amounts after the 20-year period while the property still has useful life).[13] The Code §367(d) regulations then state that the appropriate charge shall be determined in accordance with the provisions of Code §482.[14] As a result, the U.S. transferor recognizes taxable income over the useful life of the I.P. regardless of whether any dividend is received by it from the foreign affiliate.[15]

The cross-reference to the Code §482 rules invokes Treas. Reg. §1.482-4, which addresses methods to determine taxable income in connection with a transfer (or license) of I.P. The bottom line is that the taxpayer will require the assistance of a transfer pricing expert and study to determine the appropriate, arm's length amount for the royalty payment.

Additionally, the determination of the deemed royalty payment may necessitate future adjustments to the deemed royalty payment. The Code §482 regulations provide generally that if I.P. is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it satisfies the "commensurate-with-income" requirement (the "periodic adjustment requirement").[16]

The deemed annual payments under Code §367(d) are characterized as ordinary income of the U.S. transferor, whether or not a sale or exchange of the I.P. would have given rise to capital gain.[17]

Any outbound I.P. transfer is subject to reporting on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.[18] The U.S. transferor must provide and explain the calculation of the deemed payment.[19]

I.P.'S ROLE IN COST SHARING ARRANGEMENTS

I.P. is at the core of C.S.A.'s, which are often undertaken in high-tech, pharmaceutical, and other industries.

A C.S.A. is an arrangement between two parties under which the parties agree to share the costs of developing I.P. in proportion to each party's share of reasonable

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13 Treas. Reg. §1.367(d)-1(c)(3)(ii).

14 Treas. Regs. §§1.367(a)-1(b)(3), (c).

15 Code §367(d)(2)(A)(ii)(I).

16 Treas. Reg. §1.482-4(f)(2)(i).

17 Code §367(d)(2)(C); Treas. Reg. §1.367(d)-1T(c)(1).

18 Treas. Reg. §1.6038B-1(b)(1).

19 Treas. Reg. §1.6038B-1T(d)(1)(v).

anticipated benefits ("R.A.B.") from the I.P.[20] In a C.S.A., buy-in payments – which are referred to as platform contribution transaction ("P.C.T.") payments – are often required to be paid for the transfer of any resource, capability, or right that is reasonably expected to contribute to the development of the I.P.

C.S.A.'s are often undertaken between a U.S. corporation and an affiliated foreign company. This results in income recognition by the U.S. corporation when a P.C.T. payment is received from a foreign affiliate, as well as the application of the Code §482 transfer pricing rules. For transfer pricing purposes, the parties will likely desire to lower the amount of income recognized by the U.S. corporation by selecting an appropriate transfer pricing method for the P.C.T. payment. To achieve this tax goal, the foreign affiliate will pay for the I.P. based on the cost of development, rather than on the value of the development after the I.P. has been created. However, the I.R.S. may disagree with that approach, so as to increase the amount of income recognized by the U.S. corporation.

"The Tax Court determined that the I.R.S.'s valuation method with respect to the buy-in payment was 'arbitrary, capricious, and unreasonable.'"

In the 2009 Tax Court case *Veritas Software Corp. v. Commr.*,[21] a U.S. parent company granted its Irish subsidiary the right to use all its existing technical and marketing intangibles to develop software under a C.S.A. In consideration for such transfer, the Irish subsidiary made a P.C.T. payment to the U.S. parent calculated under the comparable uncontrolled transaction ("C.U.T.") method. Under this method, the payment is based on the amount a third party would have paid the U.S. parent for the intangibles in a comparable transaction.

The I.R.S. did not agree with the taxpayer and asserted that the C.U.T. method was not the right method to use under Code §482. Rather, the I.R.S. asserted that the income method should have been used on an aggregate basis with all related transactions. This method would have determined the appropriate P.C.T. payment based on the future expected income stream from the developed I.P. The I.R.S. position would have led to more than ten times the income actually reported by the U.S. parent. However, the Tax Court held for the taxpayer.

In the absence of specific regulations addressing C.S.A.'s, the Tax Court sustained the use of the C.U.T. method and rejected the I.R.S.'s use of aggregation and the income method. The I.R.S. did not appeal *Veritas* but did issue an Action on Decision stating that it disagreed with the Tax Court.[22]

In 2009, the I.R.S. published proposed and temporary Code §482 regulations, which were adopted two years later in final form.[23] These regulations contain rules for how to value P.C.T. payments and include the income method that the I.R.S. unsuccessfully tried to apply in *Veritas*. These regulations also state that an aggregation approach to valuing transfers involved in a C.S.A. "may" be appropriate to determine the combined effect of multiple contemporaneous transactions that include the C.S.A. and other related I.P. transfers.[24]

On March 23, 2017, the Tax Court reaffirmed its thinking in the *Veritas* transfer

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[20] Robert Weissler *et al.*, "APA Training: Cost Sharing" (presentation, October 15, 2001).

[21] 133 T.C. 297 (2009).

[22] A.O.D. 2010-05, I.R.B. 2010-49 (December 6, 2010).

[23] Treas. Reg. §1.482-7.

[24] Treas. Reg. §1.482-7(g)(2)(iv).

pricing case in *Amazon.com, Inc. & Subsidiaries v. Commr*.[25] In the latter case, Amazon.com, Inc. and its domestic subsidiaries (collectively "Amazon") entered into a C.S.A. with a Luxembourg subsidiary and gave the subsidiary the right to use some of its I.P. The subsidiary agreed to make an up-front payment as well as annual payments to Amazon to compensate for the use of the I.P. The I.R.S. disagreed with Amazon's pricing methodology and instead called for the use of a method that, Amazon asserted, was the same one rejected by the Tax Court in the *Veritas* decision. Once again, the Tax Court rejected the I.R.S. claim and held for the taxpayer.

The Tax Court determined that the I.R.S.'s valuation method with respect to the buy-in payment was "arbitrary, capricious, and unreasonable." The court held that Amazon's use of the C.U.T. method, with adjustments, was the best method to determine the buy-in payment. The court also accepted Amazon's use of the cost allocation method, whereby parties that have entered into a C.S.A. share "all of the costs incurred . . . related to the intangible development,"[26] to determine later year payments.

The decision shows that the taxpayer's choice of transfer pricing method is important to reduce tax. In *Amazon*, the taxpayer chose an allocation method essentially similar to that used in the *Veritas* decision and, like the taxpayer in that earlier case, achieved a major victory. While the I.R.S. may try to require use of a method that produces a higher tax bill, the Tax Court has been supportive of the taxpayer's choice of method.

OVERLAP BETWEEN CODE §§367 AND 482

One multi-transaction scenario that concerns the I.R.S. occurs when (i) I.P. is transferred to a foreign subsidiary in a Code §351 tax-free contribution, which triggers application of Code §367(d), and then (ii) a C.S.A. is entered into between the U.S. parent and its foreign subsidiary for which P.C.T. payments are made, which triggers application of Code §482.

On September 14, 2015, the I.R.S. published temporary regulations under Code §§482 and 367(d), which specifically indicated that the I.R.S. could consolidate two such related transactions for the purposes of Code §§367(d) and 482:

> The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of § 1.482-1(c).[27]

The temporary regulations included an example in which the U.S. parent wanted to separate two transactions so as to reduce its aggregate tax exposure. In the first transaction, P, a U.S. corporation, contributes the foreign rights to conduct its business, including the foreign rights to its I.P., to a newly-incorporated, wholly-owned

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[25] 148 T.C. No. 8 (2017).

[26] Treas. Reg. §1.482-7(d)(1).

[27] Treas. Reg. §1.482-1T(f)(2)(i)(E).

foreign subsidiary, S1. In the second transaction:

> P and S1 enter into a cost sharing arrangement ("CSA") to develop and exploit the rights to conduct the Business. Under the CSA, P is entitled to the U.S. rights to conduct the Business, and S1 is entitled to the rest-of-the-world ("ROW") rights to conduct the Business. P continues after Date Y to perform the Support, employing resources, capabilities, and rights that as a factual matter were not contributed to S1 in the Date X transaction, for the benefit of the Business worldwide. Pursuant to the CSA, P and S1 share the costs of P's Support in proportion to their reasonably anticipated benefit shares from their respective rights to the Business.[28]

"While the ruling may not diminish the I.R.S.'s desire to maximize an I.P. transferor's income, careful planning on the part of the taxpayer could deter I.R.S. challenges."

In the example, the taxpayer took the position that these were two separate transactions:

> P treats the Date X transaction as a transfer described in section 351 that is subject to 367 and treats the Date Y transaction as the commencement of a CSA subject to section 482 and § 1. 482-7. P takes the position that the only platform contribution transactions ("PCTs") in connection with the Date Y CSA consist of P's contribution of the U.S. Business IP rights and S1's contribution of the ROW Business IP rights of which S1 had become the owner on account of the prior Date X transaction.[29]

The I.R.S. disagreed with the taxpayer and maintained that the two transactions could be collapsed together if doing so would produce greater income recognition for the U.S. parent than if the two transactions were treated separately.

CONCLUSION

I.P. transfers to offshore entities are often made by U.S. multinational corporate groups. The I.R.S. has focused on these transactions under two separate anti-deferral regimes: Code §§367(d) and 482. While these rules are difficult enough to deal with on their own, more complexity was added when the I.R.S. adopted regulations that will allow them to apply these rules on an aggregate basis if that may produce greater income recognition. However, the Tax Court's recent *Amazon* decision shows that the court has been deferential to taxpayers who prepare and document a comprehensive transfer pricing analysis. While the ruling may not diminish the I.R.S.'s desire to maximize an I.P. transferor's income, careful planning on the part of the taxpayer could deter I.R.S. challenges. If not, the road ahead may have more potholes for the I.R.S. than the taxpayer.

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[28] *Id.*, ex. 6.

[29] *Id.*

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