UNITED STATES OF AMERICA

NEW REGULATIONS ON OUTBOUND TRANSFERS OF ASSETS

On 13 July 2012, the IRS issued Notice 2012-39 (the "Notice") announcing its intention to issue new Regulations under §367(d). IRC §367 imposes a "toll charge" on outbound transfers of assets in what would otherwise be a tax-free transaction (e.g., tax-free reorganisations, contributions to wholly owned subsidiaries, etc.). IRC §367(d) in particular, deals with outbound transfers of intangible assets, as further explained below.

The Notice provides guidance on issues raised when a U.S. corporation transfers intangible property to a foreign corporation in what would otherwise be a tax-free transaction, and provides that the Regulations to be issued under §367(d) will subject certain cash repatriation transactions to immediate U.S. taxation.

Example

The Notice includes a number of examples addressing several types of transactions, and provides the following example as a cash repatriation technique that raises significant policy concerns with the IRS:

> *A U.S. corporation ("USP") wholly owns the interests in a U.S. subsidiary ("UST") and a foreign subsidiary ("TFC"). USP's adjusted basis in its UST stock is USD 100, which equals the stock's fair market value. UST owns an appreciated patent with an adjusted basis of USD 0. UST has no other assets or liabilities.*
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> *In a reorganisation described in IRC §368(a)(1)(D) (i.e., a "D Reorg"), UST transfers the patent to TFC in exchange for USD 100 of cash. Immediately thereafter, UST distributes the USD 100 of cash to USP in liquidation.*

Prior to the issue of the Notice, taxpayers took the position that neither USP nor UST were subject to immediate U.S. taxation in the D Reorg. USP did not recognise gain, because its basis in UST stock was equal to the stock's fair market value. Taxpayers took the filing position that UST did not recognise gain in the D Reorg under IRC §361(b) because the cash it received from TFC was distributed to USP as part of the D Reorg. IRC §361(b) provides that if a corporation transfers appreciated property to another corporation for cash or property and distributes the cash or property pursuant to a plan of reorganisation, the transferor corporation does not recognise gain on the exchange. Using this strategy, taxpayers repatriated foreign earnings without such earnings being subject to immediate U.S. taxation.

In response to this repatriation technique, the Notice provides that if UST transfers any intangible property described in IRC §936(h)(3)(B) to TFC in exchange for boot (i.e., cash or other property besides TFC stock), the Regulations to be issued will ensure that such boot is treated as a prepayment and currently included in taxable income by UST.

In the example above, UST would currently include USD 100 in taxable income.

IRC §367(d) provides that if intangible property is transferred to a foreign corporation in a reorganisation or contribution, the transferor is treated as having sold such intangible property and is required to include deemed royalty payments over the useful life of such intangible property in taxable income. USP, as a qualified successor (i.e., a domestic corporate shareholder of UST that either receives TFC stock in the reorganisation or, immediately after the reorganisation, owns stock of TFC other than stock received in the reorganisation) would step into the shoes of UST and include the "§367(d) payments" over the useful life of the intangible property, but would be able to receive the first USD 100 tax-free because of the USD 100 prepayment included in taxable income by UST. The Notice specifically excludes regulated investment companies, real estate investment trusts, S corporations and individual shareholders from the definition of qualified successor.

If UST has one or more non-qualified successors, UST would include in income an amount equal to the product of (1) the sum of the ownership interest percentages of all non-qualified successors and (2) the amount of gain realised by UST on the intangible property exchanged. To the extent that the intangible property transferred has built-in gain, UST would be required to recognise income regardless of whether any non-qualified successor received cash or other property in the reorganisation.

Foreign goodwill

Hopefully, the IRS will clarify in the Regulations to be issued the application of such rules to foreign goodwill, and whether foreign goodwill is included in intangible property described in IRC §936(h)(3)(B). Section 936(h)(3)(B) provides that the term intangible property means any:

1. Patent, invention, formula, process, design, pattern or know-how;
2. Copyright, literary, musical or artistic composition;
3. Trademark, trade name or brand name;
4. Franchise, license or contract;
5. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or
6. Any similar item, which has substantial value independent of the services of any individual.

If foreign goodwill is not included in the definition of §936(h)(3)(B) property, it appears that the general rules of IRC §367(a) should apply rather than the rules of IRC §367(d) on an outbound transfer of foreign goodwill. IRC §367(a) would subject UST to immediate taxation on an outbound transfer of foreign goodwill.

If foreign goodwill is included in §936(h)(3)(B) property, pursuant to IRC §367(d)(1)(A), the rules under §367(d) rather than §367(a) should generally apply for §936(h)(3)(B) property. Treas. Reg. §1.367(d)-1T(b) provides that a transfer of foreign goodwill in a reorganisation is not subject to tax under §367(d). If foreign goodwill is §936(h)(3)(B) property, an outbound transfer of foreign goodwill presumably should not be subject to U.S. taxation under either IRC §367(a) (because §367(d) rather than §367(a) applies to §936(h)(3)(B) property) or §367(d) (because the Regulations under §367(d) exclude foreign goodwill from taxation).

The Notice indicates that all property transferred to a foreign corporation will be subject to tax under §367(a) or §367(d). In addition, several government officials have commented that future guidance will clarify that transfers of foreign goodwill are subject to tax under the rules of §367(a). However, these comments appear to be contrary to the legislative history under IRC §367. The legislative history indicates that Congress intended for outbound transfers of foreign goodwill to not be subject to U.S. income tax. "[T]he committee does not anticipate that the transfer of goodwill and going concern value by a foreign branch to a newly organised foreign corporation will result in abuse of the U.S. tax system." House Ways and Means Committee Report on the Tax Reform Act of 1984, H.R. Rep. No. 98-432, pt. 2 (1984).

While the Notice does indicate that all assets UST transfers in an outbound §351 or §361 exchange will be subject to tax under either §367(a) or §367(d), the better view appears to be that outbound transfers of foreign goodwill should not be subject to tax under either §367(a) or §367(d) based on the plain language of the statute and legislative history. Hopefully, the Service will clarify this issue and issue Treasury Regulations consistent with Congressional intent.

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