Transfer Pricing and Outbound Transfers of Intangible Property

IRS and Treasury Department Issue Proposed Regulations Relating to Outbound Transfers of Intangibles and Temporary Regulations Clarifying the Application of Transfer Pricing Rules to Such Transactions

SUMMARY

On September 14, 2015, the IRS and Treasury Department released proposed regulations under Section 367 (the “367 Proposed Regulations”) that, when finalized, will tax otherwise tax-free transfers of foreign goodwill and going concern value to foreign corporations. Under the 367 Proposed Regulations, upon an outbound transfer of foreign goodwill or going concern value, a United States transferor will be subject to either current gain recognition under Section 367(a)(1) or to the deemed royalties rule of Section 367(d) even if the value of the transferred property was created exclusively through offshore activities. This is a significant departure from current rules, and would significantly affect transactions such as foreign branch incorporations by United States taxpayers (including deemed incorporations resulting from “check-the-box” elections). The 367 Proposed Regulations, if adopted, will tax transfers happening on or after September 14, 2015.

In addition, on September 14, 2015, the IRS and Treasury Department released temporary regulations under Section 482 (the “482 Temporary Regulations”) “clarifying” the application of the arm’s-length standard and the best method rule to offshore transfers of intangible property as well as to transactions governed by other provisions of the Code.
SECTION 367 – TRANSFERS OF PROPERTY TO FOREIGN CORPORATIONS

A. OUTBOUND TRANSFERS OF INTANGIBLE PROPERTY

Section 367(a)(1) generally requires the recognition of gain with respect to certain outbound transactions (i.e., United States-to-foreign) that otherwise would have qualified for nonrecognition treatment. Subject to certain exceptions, the general gain recognition rule does not apply to outbound transfers of property to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside the United States (the “ATB exception”). Transfers of intangible property (within the meaning of Section 936(h)(3)(B)), however, are not eligible for the ATB exception. Section 936(h)(3)(B) defines intangible property to include patents, know-how, copyrights, trademarks, trade or brand names, franchises, licenses, contracts, customer lists and any similar item which has substantial value independent of the services of any individual (the “936(h)(3)(B) intangibles”).

Section 367(d) replaces the general gain recognition rule of Section 367(a) with respect to outbound transfers of 936(h)(3)(B) intangibles in nonrecognition transactions, and requires inclusion of deemed royalties following such outbound transfers. Under Section 367(d), the United States transferor is generally treated as having sold the intangible property for annual payments (regardless of whether they are in fact made by the transferee) that are contingent on the productivity, use or disposition of the intangible and that are to be commensurate with the income attributable to the intangible. Accordingly, the United States transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such intangible, or in the case of a disposition of the intangible following such transfer (whether direct or indirect), at the time of the disposition. The treatment under Section 367(d) is potentially worse than the denial of tax-free treatment under Section 367(a) because amounts taken into account under Section 367(d) are generally treated as ordinary income.

Under existing temporary regulations, supported by statements by Congress when Section 367(d) was enacted, outbound transfers of foreign goodwill and going concern value are afforded favorable treatment and are not subject to Section 367(d) (the “foreign goodwill exception”). Therefore, to the extent such outbound transfers qualify for the ATB exception, the transfer of the foreign goodwill or going concern value to the foreign corporation generally would not be subject to United States tax.

The 367 Proposed Regulations would eliminate the foreign goodwill exception and would limit the scope of the ATB exception such that it would not apply to outbound transfers of intangibles. Accordingly, any outbound transfer of intangible property, including foreign goodwill and going concern value, would generally be subject to tax in the United States even if the value of such property was created exclusively through offshore activities. Such outbound transfers of foreign goodwill and going concern value would be subject to either current gain recognition under Section 367(a)(1) or deemed royalty treatment under Section 367(d).
Under the 367 Proposed Regulations, a United States transferor may apply Section 367(d) in lieu of Section 367(a) to an outbound transfer of an intangible that otherwise would be subject to Section 367(a), provided that the United States transferor (and other related United States transferors) consistently apply the same rules to all property transferred outbound pursuant to a plan.\(^{13}\)

As further discussed below, the 367 Proposed Regulations also provide, consistently with the 482 Temporary Regulations, that in cases where an outbound transfer of property subject to Section 367(a) constitutes a controlled transaction, the value of such transferred property would be determined in accordance with Section 482 and the regulations thereunder.\(^{14}\) This does not seem to eliminate the different outcomes between Section 367(a) and Section 367(d).

### B. OTHER CHANGES

- The 367 Proposed Regulations would eliminate the existing rule limiting the useful life of intangible property for purposes of Section 367(d) to 20 years. Under the 367 Proposed Regulations, the useful life of intangible property would be the entire period during which the exploitation (including use in R&D) of the intangible property is reasonably anticipated to occur, as of the time of transfer.\(^{15}\) If use of the intangible property is reasonably anticipated to contribute to its own further development, or to the development of other intangibles, then the period of exploitation includes the period, reasonably anticipated at the time of transfer, of exploiting such further development.\(^{16}\) This is consistent with the IRS’s position under the cost sharing rules that intangibles may have perpetual useful life.

- The 367 Proposed Regulations would limit the ATB exception to an exclusive list of property (as opposed to any property unless it is specifically excluded) that is transferred for use in the active conduct of a trade or business outside the United States.\(^{17}\)

- The 367 Proposed Regulations would eliminate the exception that allows certain property denominated in the foreign currency of the country in which the foreign corporation is organized to qualify under the ATB exception if that property was acquired in the ordinary course of the business of the United States transferor that will be carried on by the foreign corporation.\(^{18}\) Accordingly, outbound transfers of such foreign currency denominated instruments would generally be subject to tax under the 367 Proposed Regulations.

- The 367 Proposed Regulations would eliminate the exception to the ATB exception with respect to a transfer of stock and securities, when at the time of the transfer, it is reasonable to believe that, in the reasonably foreseeable future, the transferee will sell or otherwise dispose of any material portion of the transfer stock or securities in the ordinary course of business.

- Proposed regulations would make conforming changes to reporting requirements in order to obtain the information that these rules require.\(^{19}\)

### C. EFFECTIVE DATE

The 367 Proposed Regulations would generally apply to transfers occurring on or after September 14, 2015 and to transfers occurring before September 14, 2015 resulting from entity classification elections under the check-the-box regulations filed on or after September 14, 2015.

### SECTION 482 – TRANSFER PRICING RULES

Generally, Section 482 and its accompanying regulations authorize the IRS to adjust the results of certain transactions among commonly owned or controlled taxpayers to clearly reflect the income of these
taxpayers in accordance with the arm’s-length standard and, in the case of a transfer of 936(h)(3)(B) intangibles, so as to be commensurate with the income attributable to the intangible. While the determination of arm’s-length standard for controlled transactions is governed by Section 482, the tax treatment of controlled transactions is also governed by other Code and regulatory rules applicable to both controlled and uncontrolled transactions. Consistent analysis and valuation is required to satisfy the best method rule, which requires the use of the method that, under the facts and circumstances, provides the most reliable measure of an arm’s-length result. The 482 Temporary Regulations state that they are clarifying the application of Section 482 to transfers of intangibles offshore to related parties as described above and also to transactions governed by other Code and regulatory provisions.

Specifically, the 482 Temporary Regulations:

- Provide that in determining arm’s-length compensation under the best method rule, the taxpayer must consider the entire arrangement between the parties to a controlled transaction in order to account for all the value provided between parties, without regard to the form or character of the transaction.

- “Clarify” that the aggregation principle, according to which the combined effect of two or more separate transactions may be considered if such transactions, taken as a whole, are so interrelated that an aggregate analysis of such transactions provides the most reliable measure of an arm’s-length result under the best method rule, also applies for purposes of an analysis under multiple provisions of the Code or regulations. Application of the “aggregation principle” was at issue in the significant 2009 taxpayer victory in Veritas v. Commissioner, and this Regulation may assist the IRS in relitigating the issue in similar situations. Transactions need not involve related products or services in order to be aggregated under this principle.

- Provide that, for one or more controlled transactions governed by more than one provision of the Code and regulations (e.g., a transfer of property subject to Section 367(a) and an interrelated transfer of property subject to Section 367(d)), a coordinated best method analysis may be necessary to ensure that the overall value provided (including any synergies) is properly taken into account. The 482 Temporary Regulations state that this generally requires a consistent consideration of the facts and circumstances and a consistent measure of the arm’s-length results for purposes of all relevant Code and regulatory provisions. To the extent it is necessary to allocate an arm’s-length result between interrelated transactions, such allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm’s-length result for each allocated amount.

As an illustration of some of these rules, suppose P (a domestic corporation) owns the worldwide rights to manufacturing and marketing intangibles that it uses to manufacture and market a product in the United States (“US intangibles”) and the rest of the world (“ROW intangibles”). P then transfers all the ROW intangibles to S1 (a foreign corporation) in a Section 351 exchange, while retaining the US intangibles. P and S1 then enter into a cost sharing arrangement that covers research and development of intangibles conducted by the parties. A realistic and available alternative, which would have involved the parties to the controlled transaction performing similar functions, employing similar resources, and assuming similar risks, was for P to transfer all ROW intangibles to S1 upon entering into the cost sharing agreement in a platform contribution transaction, rather than in a Section 351 exchange immediately before entering into the cost sharing agreement. Under the 482 Temporary Regulations, the arm’s-length compensation for the ROW intangibles must correspond to the value provided between parties, regardless of the form of the transaction. Accordingly, the arm’s-length compensation for the ROW intangibles must be the same in both scenarios, and the analysis of the amount to be taken into account under Section 367(d) should include consideration of the amount that P would have charged for the realistic alternative determined under Section 482.
The 482 Temporary Regulations are effective immediately, as of September 14, 2015.

T.D. 9738.

Section 367(a)(3)(A). See Treasury Regulations Section 1.367(a)-2 and Temporary Treasury Regulations Section 1.367(a)-2T for rules for determining whether property is transferred for use by a transferee foreign corporation in the active conduct of a trade or business outside the United States.


Outbound transfers of 936(h)(3)(B) intangibles described in Sections 332, 354 or 356 generally are not subject to Section 367(d) and do not qualify for the ATB exception.

See, also, Temporary Treasury Regulations Section 1.367(d)-1T(a).

Section 367(d)(2)(A)(ii).

Section 367(d)(2)(C); Temporary Treasury Regulations Section 1.367(d)-1T(c)(1).

See, e.g., S. Rep. No. 169, 98th Cong., 2d Sess., at 365 (“The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business.”)

Temporary Treasury Regulations Section 1.367(d)-1T(b).

See, e.g., Section 367(a)(5) and the branch loss recapture rules of Section 367(a)(3)(C) and Temporary Treasury Regulations Section 1.367(a)-6T.

In the preamble of the 367 Proposed Regulations, the Treasury Department and the IRS explicitly state, as a reason for the change, that they believe that certain taxpayers take aggressive positions to maximize the value of the property that is transferred outbound in a tax-free manner and exploit the favorable treatment afforded to foreign goodwill and going concern value. The Treasury Department and the IRS considered whether the favorable treatment for foreign goodwill and going concern value under current law could be preserved while protecting the United States tax base through regulations expressly prescribing parameters for the portion of the value of a business that qualifies for the favorable treatment, and determined that such an approach would be impractical to administer. See preamble to the 367 Proposed Regulations, Background, Section II.

Proposed Temporary Regulations Section 1.367(a)-1(b)(5).

Proposed Treasury Regulations Section 1.367(a)-1(b)(3).

Proposed Treasury Regulations Section 1.367(d)-1(c)(3).

See, also, Treasury Regulations Section 1.482-7(g)(2)(ii)(A).

Proposed Treasury Regulations Section 1.367(a)-2(a)(2)(i) and Proposed Treasury Regulations Section 1.367(a)-2(b).

Proposed Treasury Regulations Section 1.367(a)-2(c)(3) and Proposed Treasury Regulations Section 1.367(a)-2(k)(2).

Proposed Treasury Regulations Section 1.6038B-1(c)(4).

Section 482; Treasury Regulations Section 1.482-1(b).

Treasury Regulations Section 1.482-1(c).

Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(A).
23 133 T.C. 297.
24 Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(B).
25 Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(C).
26 Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(D).
27 Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(E), Example 8.
28 Temporary Treasury Regulations Section 1.482-1T(f)(2)(i)(A).
29 See Treasury Regulations Section 1.482-1(b)(2)(iii) and Treasury Regulations Section 1.482-4(g).
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