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Memorandum

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to: Lead International Examiner (Group)
(Large Business & International)

from: Associate Area Counsel ()
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subject:

Disposition under I.R.C. § 367(d)¹

DISCLOSURE STATEMENT

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ISSUE

Whether an indirect disposition of transferred intangibles occurred requiring _____ to recognize a disposition payment under section 367(d)(2)(A)(ii)(II) in its tax year ended _____, _____ ?

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect during the tax year at issue, and to the Treasury regulations promulgated thereunder.

CONCLUSION

Yes. Under section 367(d)(2)(A)(ii)(II) and its legislative history, an indirect disposition occurred that caused to receive a deemed disposition payment during its tax year ended

FACTS

- 1)
- 2)
- 3)

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² Section 6038B requires disclosure of the transfer of property to a foreign corporation to prevent being subjected to a penalty equal to 10% of the property transferred.

LAW

Section 367 – Generally

Section 367 generally provides rules regarding an exchange of property from a U.S. person to a foreign corporation (i.e., an “outbound” transfer) that would otherwise be tax-free. See section 367. In particular, section 367(a) generally provides that, in connection with an exchange described in section 332, 351, 354, 356, or 361 (i.e., a non-recognition transaction), if a U.S. person transfers property to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on the transfer, the foreign corporation shall not be considered a corporation. Section 367(a)(1).

Section 367(d) – Transfer of Intangibles

Section 367(d) applies to transfers of intangibles and states in relevant part:

(d) Special rules relating to transfers of intangibles.—

(1) In general.—Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation described in an exchange described in section 351 or 361—

- (A) subsection (a) shall not apply to the transfer of such property, and
- (B) the provisions of this subsection shall apply to such transfer.

(2) Transfer of intangibles treated as transfer pursuant to sale of contingent payments.—

(A) In general.—If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

- (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and
- (ii) receiving amounts which reasonably reflect the amounts which would have been received—

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

Section 936(h)(3)(B) defines “intangible property” as any:

- (i) patent, invention, formula, process, design, pattern, or know-how;
- (ii) copyright, literary, musical, or artistic composition;
- (iii) trademark, trade name, or brand name;
- (iv) franchise, license, or contract;
- (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- (vi) any similar item,

which has substantial value independent of the services of any individual.

See also section 1.367(a)-1T(d)(5) (defining "intangible"). Note that the determination of an intangible for purposes of section 367 is without regard to whether the intangible is used in the U.S. or in a foreign country. Section 1.367(a)-1T(d)(5)(i). Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the U.S. after all other tangible and intangible assets have been identified and valued. Section 1.367(a)-1T(d)(5)(iii). Section 367(d) does not apply to the transfer of foreign goodwill and going concern. Section 1.367(d)-1T(b). The transfer of those items to a foreign corporation is subject to the rules in section 1.367(a)-6T. See section 1.367(d)-1T(b).

Legislative History

The current version of section 367(d) was enacted in the Tax Reform Act of 1984 as part of the Deficit Reduction Act of 1984, Pub. L. 98-369 to prevent the tax-free transfer of intangible property abroad, where development of the property generated significant U.S. tax benefits. Particularly regarding intangibles, as reflected in the House Report, Congress expressed concern that U.S. persons may avail themselves of tax incentives for research³ yet transfer the intangibles outside of the U.S. so that income derived from the intangible escapes U.S. tax. H. Rpt. 98-432(II), pp.1312, 1316, *available at* 1984 WL 37400.

While the bill was in the Conference Committee, the Senate amended the bill to address the circumstance when a U.S. transferor disposes of stock in the foreign-transferee corporation. The Conference Report states:

If, subsequent to a transfer of an intangible to a foreign corporation, the U.S. transferor disposes of its stock in the foreign-transferee corporation, then part of the gain on the disposition of the stock is treated as being U.S.-source ordinary income attributable to the disposition of the intangible.^[4] Similarly, if the foreign transferee corporation disposes of the intangible, the U.S. transferor is deemed to receive a U.S.-source payment of ordinary income with respect to the intangible at that time.

* * * * *

The conferees intend that disposition of (1) the transferred intangible by a

³ For example, the Committee Report cites the current deduction (rather than capitalization) under section 174 for research and experimentation expenses, the credit under section 44F for research expenses, and the reduction of income for purposes of calculating available foreign tax credits. H. Rpt. 98-432(II), p.1311.

⁴ Note that the special sourcing rule resulting in U.S.-source income was repealed in 1997 in the Taxpayer Relief Act of 1997, Pub. L. 105-34 § 1131(b)(4).

transferee corporation, or (2) the transferor's interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor. The amount of U.S.-source ordinary income will depend on the value of the intangible at the time of the second transfer.

H.R. Conf. Rpt. 98-861, pp.954-955, *available at* 1984 WL 37401. See also General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress), December 31, 1984 ("Bluebook") (same), which also clarifies: "Except as provide in regulations, a transfer described in section 351 of intangible property to a controlled corporation or in certain corporate reorganizations described in section 361 is treated as a sale." Bluebook, p.432.

Regulations under Section 367

The section 367 regulations define a "United States person" as including persons described in section 7701(a)(30), including a domestic corporation. A foreign corporation is not considered a United States person. Section 1.367(a)-1T(d)(1). The regulations also clarify how a reorganization under section 368(a)(1)(F) should be viewed. Section 1.367(a)-1T(f) provides:

In every reorganization under section 368(a)(1)(F), where the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation, there is considered to exist—

A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;

(1) A distribution of stock (or stock and securities) of the acquiring corporation by the transferor corporation; and

(2) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of the stock of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

For this purpose, it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation.

Rules concerning transfers of intangible property by U.S. persons to foreign corporations under section 351 or 361 are contained in section 1.367(d)-1T. Section 1.367(d)-1T(e)(3) states:

(3) Transfer to related foreign person not treated as disposition of intangible property. If a U.S. person transfers intangible property that is

subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 and 361, and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more foreign persons that are related to the transferor within the meaning of paragraph (h) of this section, **then the U.S. transferor shall continue to include in its income** the deemed payments described in paragraph (c) of this section in the same manner as if the subsequent transfer of stock had not occurred. The rule of this paragraph (e)(3) shall not apply with respect to the subsequent transfer by the U.S. person of any of the remaining stock to any related U.S. person or unrelated person.

(Emphasis added.) The last modification to section 1.367(d)-1T was made in T.D. 8770, 1998-2 C.B. 3. The preamble to T.D. 8770 states:

The regulations under section 367(d) do not address the tax consequence when the U.S. transferor goes out of existence pursuant to the transaction. The IRS and the Treasury Department are studying the manner in which the rules under section 367(d) should operate when the U.S. transferor goes out of existence contemporaneously with (or subsequent to) its outbound transfer of an intangible. Comments are requested with respect to this issue.

ANALYSIS

The parties agree that section 367(d) governs _____'s transfer of intangibles. The dispute arises over whether a disposition followed the transfer of intangibles, which would require _____ to recognize gain based on the value of the intangibles as a lump sum at the time of the disposition, rather than over the life of the intangible. In other words, whether the so-called "general rule" in section 367(d)(2)(A)(ii)(I) applies or whether the so-called "disposition rule" in section 367(d)(2)(A)(ii)(II) applies.

Applying the mechanics of an F reorganization described in Treas. Reg. § 1.367(a)-1T(f), first, _____, the transferor corporation, transferred its assets (including intangibles) to _____ in exchange for stock of _____. Second, _____ is treated as distributing the stock of _____ to its shareholder, _____. Third, _____, the shareholder of the transferor is treated as exchanging the stock of the transferor, _____, for the stock of the acquiring foreign corporation, _____. The question is whether an indirect disposition following the transfer of intangibles occurred as a result of _____ deemed distribution of the stock of _____, the transferee, and _____ exchange by _____, the transferor's owner, of the transferor's stock for the transferee's stock.

As part of the F reorganization, _____ is treated as distributing the stock of the transferee. This distribution is a subsequent indirect disposition under the statute, an interpretation supported by the language in the Conference Report, which describes the distribution of stock as a "disposition of . . . of the transferor's interest in the transferee corporation [that] will result in recognition of U.S.-source ordinary income to the original transferor." This conclusion that an indirect disposition occurred requiring a lump-sum payment makes sense given that the U.S. person, _____, ceased to exist and therefore has no ongoing ability to collect a deemed royalty payment subject to U.S. tax. The legislative history is unequivocal that section 367(d) was intended to capture income from U.S-created intangibles and prevent it from escaping U.S. taxation. H. Rpt. 98-432(II), pp.1312, 1316.

The conclusion that the F reorganization was an indirect disposition requiring a lump-sum payment for a disposition is not altered by the regulations.

As stated previously, the rules of section 367(d) apply "except as provided in the regulations." Section 367(d)(2)(A)(ii)(II) states that a U.S. person transferring intangibles to a foreign corporation is treated as having received a lump-sum payment at the time of the disposition if the property is disposed of (either directly or indirectly) after the transfer. The legislative history clarifies that a disposition includes the disposition of the transferor's interest in the transferee corporation. Therefore, unless the regulations provide otherwise, [redacted] should be treated as having received a lump-sum payment at its deemed disposition of the stock of the transferee,

The preamble to the regulations state that the regulations do not address the tax consequence when the U.S. transferor goes out of existence pursuant to the transaction. See T.D. 8770. Therefore, the regulations cannot be interpreted as providing an exception in this case to the language in the statute.

In addition to the language in the preamble that states the regulations do not support the arguments in [redacted], a straightforward reading of the text of (e)(3) makes clear that the exception provided by that paragraph cannot apply to [redacted]'s disposition of its [redacted] stock. Specifically, (e)(3) provides that if a U.S. person transfers intangible property to a foreign corporation and the U.S. transferor later transfers stock of the transferee to one or more related foreign persons, then the U.S. transferor shall continue to include in income annually the deemed royalty payments as if the subsequent transfer had not occurred. Paragraph (e)(3) cannot apply to the present case because the U.S. transferor no longer exists; therefore, the transferor cannot include a deemed royalty in income each year. Paragraph (e)(3) applies when each of the following steps occurs:

- 1) Initial Transfer. A U.S. person transfers intangible property to a foreign corporation in an exchange under sections 351 or 361;
- 2) Subsequent Disposition. The U.S. transferor subsequently transfers the stock of the foreign corporation to one or more foreign persons related to the transferor; and
- 3) U.S. Transferor's Income Inclusion. The U.S. transferor continues to include in income the deemed royalty payments as if the stock transferred had not occurred.

The steps in paragraph (e)(3) are simply a mechanical analysis with no subjectivity. Here, because no U.S. transferor continues to exist, the third step of paragraph (e)(3) cannot occur and therefore (e)(3) does not apply.

The title, however, describes an exception for which does not qualify, as explained previously. Furthermore, the law is clear that the title of a statute or regulation cannot limit the plain meaning of the text. See Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 47 (2008); Pennsylvania Dept. of Corrections v. Yeskey, 524 U.S. 206, 212 (1998); Trainmen v. B&O R.R., 331 U.S. 519, 528-529 (1947). The plain meaning of the text states that the U.S. transferor receives the deemed royalty annually. When the U.S. transferor ceased to exist, as in this case, the U.S. transferor cannot include in income a deemed royalty.

Notice 2012-39 provides guidance under section 367(d) applicable to outbound asset reorganizations occurring on or after July 13, 2012.

Note, however, that section 5 of the notice states that no inference based on the language of the notice is intended as to the treatment of transactions described in the notice under current law and that the IRS may challenge such transactions under applicable provisions of the Internal Revenue Code or judicial doctrines. Under then-current law (which remains current law), both the statute and the legislative history support, and the regulations do not alter, concluding that should have recognized in income a disposition payment in its final tax year.

First, although often repeated, it bears stating that because neither ruling was issued to, the rulings cannot be cited as precedent. Section 6110(k)(3).

Second, with closer analysis, in the PLRs, the U.S. parents included the deemed royalty under section 367(d) into income, as dictated by Treas. Reg. § 1.367(d)-1T(e)(1), the provision applicable to the facts in those PLRs.

⁵ On that basis alone, the PLRs offer no support for the representatives' conclusion that a disposition payment is not triggered. Notwithstanding, a discussion of each PLR may be helpful in illustrating both why those rulings were correct under the regulations and why the rulings are consistent with the conclusion that received a deemed disposition payment.

The facts of PLR 9024004 are that (1) a domestic corporation ("Target") transferred intangibles to a foreign corporation ("Acquiring"); (2) Target liquidated; and (3) in exchange, the shareholders of Target, each of whom was an individual who was a U.S. citizen, received stock of Acquiring. The PLR concluded that deemed royalty payments for the going concern value of Target were imputed to Target's shareholders over the life of the intangible, citing Treas. Reg. § 1.367(d)-1T(c)(3) and (e).

Paragraph (1) of Treas. Reg. § 1.367(d)-1T(e) states in part:

(1) Transfer to related U.S. person treated as disposition of intangible property. If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361 **and, within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor** within the meaning of paragraph (h) of this section, then the following rules shall apply:

(i) Each such related U.S. person shall be treated as having received (with the stock of the transferee foreign corporation) a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor under paragraph (c) of this section.

(ii) Each such related U.S. person shall, over the useful life of the property, annually include in gross income a proportionate share of the amount that would have been included in the income of the U.S. transferor pursuant to paragraph (c) of this section. Such amounts shall be treated as ordinary income from sources within the United States.

(Emphasis added.)

Again, the facts in PLR 9024004 were that (1) Target, a U.S. transferor, transferred an intangible to Acquiring, a foreign corporation; (2) Target liquidated; and (3) in exchange for Target's assets, the shareholders of Target received shares of Acquiring. Thus, within the useful life of the transferred intangible, the U.S. transferor, Target, transferred the stock of the foreign corporation, Acquiring, to Target's shareholders, who are U.S. persons related to the transferor. Therefore, as dictated by (i), each related U.S. person is treated as receiving a proportionate share of the contingent annual payments otherwise deemed to have been received by the U.S. transferor.

In PLR 9731039, the facts are: (1) "Controlled," a U.S. corporation, contributed intangible property to a foreign subsidiary in a transaction described in section 351; (2) Controlled, in an outbound asset reorganization described in § 368(a)(1)(F), then subsequently transferred the stock of the foreign subsidiary to New Controlled, a related foreign person; and (3) as part of the F reorganization, Controlled distributed the stock of New Controlled to Controlled's sole shareholder, Distributing, a U.S. corporation. The transfer to Distributing was a transfer to a related U.S. shareholder described in (e)(1). Accordingly, Distributing recognizes the deemed royalty payments in income.

To explain, PLR 9731039 concludes that the U.S. person includes the deemed royalty payment by mechanically walking through the steps; the conclusion does not result simply by electing to include the payment in a U.S. shareholder's income. In the PLR, walking through the steps, the initial transfer occurred when Controlled, a U.S. corporation, contributed intangible property to a foreign subsidiary in a section 351 transaction. The subsequent disposition occurred when Controlled transferred the stock of the foreign subsidiary to New Controlled, a related foreign person and Controlled distributed the stock of New Controlled to Controlled's sole shareholder, Distributing, a U.S. corporation. By doing so, Controlled transferred the stock of New Controlled, the transferee foreign corporation, to a related U.S. person. Under (e)(1), the related U.S. person is deemed to receive an annual royalty included in the U.S. person's gross income.

* * * * *

If you have any questions, please contact

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