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Proposed Regulations Nix Foreign Goodwill Exception to Tax on Outbound Transfers

The IRS and Treasury recently issued proposed regulations under Section 367 with bad news for taxpayers. Citing aggressive taxpayer positions, the proposed rules do away with the foreign goodwill exception and restrict the type of property eligible for the active business exception to gain or income recognition for outbound transfers under Section 367(a) or (d). The regulations are generally proposed to apply to transactions on or after September 14, 2015.

Temporary regulations under Section 482, issued contemporaneously with the proposed regulations, coordinate the application of the arm's length standard and best method rule for controlled transactions in conjunction with other Code provisions, such as Section 367.

Some commentators have questioned the IRS's authority to remove the foreign goodwill exception entirely by regulation where the legislative history shows that Congress expected that foreign goodwill and going concern value would ordinarily fall outside the scope of Section 367 taxation. They suggest that keeping the exception with modifications tailored to attack the perceived abuse would have been more appropriate, especially given the immediate effective date.

Background

Section 367(a) generally requires a U.S. person to recognize gain (but not loss) on the transfer of property to a foreign corporation in what might otherwise be a nonrecognition exchange under Section 332, 351, 354, 356 or 361. The Code provides an exception to this general recognition rule for transfers of property that is used by the foreign corporation transferee in the active conduct of a trade or business outside the United States (the "active business exception"). Certain types of property, however, are not eligible for the active business exception, such as certain intangible property (IP).

Congress enacted Section 367(d) of the Code to address "specific and unique problems" for transfers of IP. Subject to limited exceptions, Section 367(d), not Section 367(a), applies to outbound transfers of IP. Under Section 367(d), a U.S. person that transfers IP (as defined in Section 936(h)(3)(B)) to a foreign corporation in a Section 351 or 361 exchange is treated as having sold the IP in exchange for payments contingent on the productivity, use or disposition of the IP. The U.S. transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received (1) annually over the IP's useful life (e.g., royalties) or (2) at the time of disposition, in the case of a disposition after the transfer.

Under existing temporary regulations, Section 367(d) does not apply to the transfer of foreign goodwill or going concern value (the "foreign goodwill exception"). Current regulations define foreign goodwill and going concern value as "the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued."

Reasons for Change

In the preamble to the recent proposed regulations, the IRS observes that taxpayers interpret Section 367 and the regulations in one of two ways when claiming favorable treatment of foreign goodwill and going concern value. One interpretation argues that goodwill and going concern value are not IP within the meaning of Section 936(h)(3)(B) and thus not subject to Section 367(d), but may qualify for the active business exception. This view finds no application for the foreign goodwill exception. The other view argues that goodwill and going concern value are within the scope of Section 936(h)(3)(B) IP, but the foreign goodwill exception applies. Those of the latter view further claim that Section 367(a)'s general rule does not apply to foreign goodwill or going concern value—either because Section 367(d) preempts the general rule as to such property or because of the active business exception.

Under either view, taxpayers, according to the IRS and Treasury, attempt to avoid gain and income recognition under Sections 367(a) and (d) by asserting that "an inappropriately large share" of the value of transferred property is foreign goodwill or going concern value. Specifically, the IRS and Treasury are aware that some taxpayers value property contrary to Section 482 principles to minimize the value of IP for which Section 367(d) requires deemed income inclusions or broadly interpret "foreign goodwill" to include, for example, goodwill associated with a business that is primarily operated by personnel in the United States but earns income remotely from foreign customers.

The preamble states that taxpayer views and positions on foreign goodwill and going concern value raise significant policy concerns—chiefly, that the U.S. tax base is being eroded due to the incentives taxpayers have to "exploit" the favorable treatment of foreign goodwill and going concern value through the use of "aggressive" transfer pricing positions.

2015 Proposed Regulations

The proposed regulations eliminate the foreign goodwill exception of Section 1.367(d)-1T. Section 367(d) applies to any outbound transfer of IP, without exception. Proposed Section 1.367(a)-1(d)(5) modifies the definition of IP for Section 367 purposes in a way that both removes the foreign goodwill exception and allows a U.S. transferor to apply Section 367(d) to an outbound transfer that would otherwise be subject to Section 367(a), depending on the taxpayer's interpretation of Section 936(h)(3)(B). The modified definition of IP includes property described in

Section 936(h)(3)(B) or property to which a U.S. transferor applies Section 367(d) (rather than Section 367(a)). The proposed regulations would make coordinating changes to existing temporary regulations, such as deleting what would become unneeded definitions of foreign goodwill and going concern value in Section 1.367(a)-1T(d)(5)(iii).

The proposed rules also jettison the existing rule that limits the useful life of IP to 20 years because the limitation may prevent full income recognition for property with a longer useful life. Instead, proposed Section 1.367(d)-1(c)(3) provides that the useful life is the entire period over which exploitation of the IP is reasonably anticipated, determined as of the time of transfer. Importantly, exploitation includes use of the IP in research and development. The proposed rule is intended to be consistent with principles in the cost-sharing arrangement rules of the Section 482 regulations.

Apart from the IP-specific provisions, the proposed regulations make changes to the active business exception regulations. In addition to consolidating some of the various regulations regarding the exception, the proposed rules limit the type of property eligible for the active business exception to tangible property, including working interests in oil and gas, and certain financial assets. Four types of property in the existing regulations remain ineligible for the active business exception: inventory, receivables, foreign currency and certain leased tangible property. The IP exception in the existing regulations is dropped.

The exclusive list of eligible property is intended to thwart taxpayer incentives to undervalue IP subject to Section 367(d). Consequently, an outbound transfer of any IP, including foreign goodwill or going concern value, will be subject to gain recognition under Section 367(a) or deemed income inclusions under Section 367(d).

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