New Regulations Address Outbound Transfers and Transfer Pricing

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Paul W. Oosterhuis
Washington, D.C.
202.371.7130
paul.oosterhuis@skadden.com

Nathaniel Carden
Chicago
312.407.0905
nate.carden@skadden.com

Hal Hicks
Washington, D.C.
202.371.7290
hal.hicks@skadden.com

John M. Breen
Washington, D.C.
202.371.7385
john.breen@skadden.com

B. Chase Wink
New York
212.735.2967
b.chase.wink@skadden.com

Moshe Spinowitz
Boston
617.573.4837
moshe.spinowitz@skadden.com

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Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On September 14, 2015, the Internal Revenue Service (the IRS) and Treasury Department proposed new regulations addressing the tax treatment under Section 367 of the Internal Revenue Code (the Code) of certain transfers by U.S. persons to foreign corporations in nonrecognition transactions that occur on or after September 14, 2015. The two most important aspects of the proposed regulations are: (1) a significant narrowing of the scope of property that is subject to the "active trade or business" exception provided in Section 367(a), and (2) the elimination of the exception for transfers of foreign goodwill and going concern value under Section 367(d).

On the same day, the IRS and Treasury issued temporary and final regulations under Section 482 of the Code that apply to: (1) two or more controlled transactions that are interrelated and (2) controlled transactions that implicate two or more provisions of the Code or regulations.

Existing Rules

Section 367(a) Active Trade or Business Exception

Under Section 367(a), a U.S. person that transfers property to a foreign corporation in certain nonrecognition exchanges generally will recognize gain (but not loss) on the transfer. One exception to this rule is that gain generally will not be recognized on the transfer of property to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States, except as provided in regulations.

Existing regulations provide rules for determining whether property is transferred for use by a corporation in the active conduct of a trade or business outside of the United States for these purposes. Under the existing regulations, property generally is eligible for the active trade or business exception unless it is specifically excluded.

Section 367(d) and Foreign Goodwill or Going Concern Value

Section 367(d) provides that, if a U.S. person transfers any intangible property, within the meaning of Section 936(h)(3)(B), to a foreign corporation in certain nonrecognition exchanges, Section 367(d), and not Section 367(a), will apply to the transfer. Section 936(h)(3)(B) defines intangible property as 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.

If a transfer of intangible property is subject to Section 367(d), the U.S. transferor is treated as having sold the intangible property to the foreign corporation in exchange for a series of payments to be received annually over the useful life of the property as determined based on productivity, use or disposition of the property. Under the existing regulations, Section 367(d) explicitly does not apply to the transfer of foreign goodwill or going concern value.

Section 482 and the Arm's Length Standard

Under Section 482 and the implementing regulations, the Secretary of the Treasury is authorized to adjust the results of controlled transactions to clearly reflect the income of commonly controlled taxpayers in accordance with the "arm's length" standard and, in the case of transfers of intangible property (within the meaning of Section 936(h)(3)(B)), so as to be commensurate with the income attributable to the intangible property.

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When analyzing controlled transactions to determine an arm's length result, taxpayers are required to determine the arm's length result under "best method," which is the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. While controlled transactions always remain subject to Section 482, the tax treatment of controlled transactions also is governed by other provisions of the Code and regulations.

Reasons for Change Offered by the IRS and Treasury

Section 367

The IRS and Treasury indicated in the preamble to the proposed Section 367 regulations that they believe that, in the context of outbound transfers, in order to obtain favorable treatment under the rules in Section 367, certain taxpayers were interpreting Section 367 and the regulations under Section 367(a) and (d) in one of two alternative ways.

In the first instance, the preamble states that taxpayers were taking the position that goodwill and going concern value are not Section 936(h)(3)(B) intangibles and therefore not subject to Section 367(d). According to the preamble, under this view the foreign goodwill and going concern value exception provided in the Section 367(d) regulations has no application. These taxpayers were then asserting that gain was not recognized under Section 367(a) on the outbound transfer of goodwill or going concern value because the goodwill or going concern value was eligible for, and satisfied, the active trade or business exception.

The IRS and Treasury also said that other taxpayers were taking the position that goodwill and going concern value are Section 936(h)(3)(B) intangibles, and therefore subject to Section 367(d), but that the exception under Section 367(d) for foreign goodwill and going concern value applies. These taxpayers were asserting that Section 367(a) did not apply to the outbound transfer of foreign goodwill or going concern value because it was subject to Section 367(d) or, in the alternative, because the goodwill or going concern value was eligible for, and satisfied, the active trade or business exception.

With this in mind, the IRS and Treasury expressed concern that taxpayers were asserting that an inappropriately large portion of the value of property transferred in an outbound transaction consisted of foreign goodwill or going concern value that was eligible for favorable treatment under Section 367. The preamble asserts that some taxpayers were valuing the property transferred in a manner contrary to the rules under Section 482 in order to minimize the value of property described in Section 936(h)(3)(B) and the corresponding deemed income inclusion that would be required under Section 367(d).

The IRS and Treasury indicated they were also focused on taxpayers broadly interpreting the meaning of foreign goodwill and going concern value for purposes of Section 367. The existing Section 367 regulations define foreign goodwill and going concern value by reference to business operations conducted outside of the United States. The IRS and Treasury expressed concern regarding businesses operated primarily from the United States, including customer-facing activities occurring within the United States where value is associated with foreign customers.

Ultimately, the IRS and Treasury asserted that these positions are inconsistent with the expectation, expressed in the legislative history to Section 367, that the transfer of foreign goodwill or going concern value is unlikely to result in abuse of the U.S. tax system. According to the preamble, the IRS and Treasury considered ways to adhere to the expressed congressional intent to permit assets used in a foreign active trade or business to be transferred without immediate gain recognition for foreign goodwill and going concern value by prescribing parameters for the value of a business that could qualify for the favorable treatment. However, the IRS and Treasury asserted that they ultimately concluded that any such rules would be impractical to administer and that strong incentives would cause taxpayers to continue to take aggressive positions.

Section 482

Similarly, the IRS and Treasury indicated in the preamble to the Section 482 regulations that they were concerned that inconsistent or uncoordinated applications of Section 482 to interrelated controlled transactions that are subject to tax under different Code and regulatory provisions, including Section 367, may lead to inappropriate conclusions.

Based upon taxpayer positions that the IRS has encountered in examinations and controversy, the IRS and Treasury indicated that they are particularly concerned that taxpayers are making an incomplete assessment of the relevant functions, resources and risks, and an inappropriately narrow analysis of the scope of the transfer pricing rules when reflecting the form or character of their controlled transactions and arrangements. The IRS and Treasury specifically identified concerns with respect to situations in which controlled groups evaluate economically integrated transactions in a manner that the IRS and Treasury believe misapplies the best method rule and fails to reflect an arm's length result because, for example, different statutes (such as Section 367) apply to one transaction but not the other. The new regulations are intended to merge the application of Section 482 and other Code and regulatory provisions.

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Explanation of New Proposed Regulations Under Section 367

As mentioned above, the IRS and Treasury indicated that there is some uncertainty regarding whether goodwill and going concern value are intangible assets described in Section 936(h)(3)(B). The proposed regulations explicitly do not attempt to resolve this uncertainty. Rather, in an endeavor to guarantee that all property (including foreign goodwill and going concern value), except for certain identified categories, is subject to gain or income recognition under Section 367 (whether under Section 367(a) or Section 367(d)), the proposed regulations, among other things, significantly limit the scope of property that is eligible for the active conduct of a trade or business exception in Section 367(a), provide an election to taxpayers to recognize income under Section 367(d), instead of gain under Section 367(a), with respect to certain intangible property, and eliminate the foreign goodwill and going concern value exception in Section 367(d).

Section 367(a) Active Trade or Business Exception

In order to limit the scope of property that may be eligible for the active trade or business exception under Section 367(a), and specifically to eliminate the incentive for taxpayers to take the position that certain intangible property is not described in Section 936(h)(3)(B), the proposed regulations flip the presumption regarding whether assets are eligible for the active trade or business exemption and provide that only certain enumerated types of property are eligible for such exception.

Under the proposed regulations, "eligible property" includes only tangible property, working interests in oil and gas property, and certain financial assets, in each case, other than (1) inventory or similar property, (2) installment obligations, accounts receivable or similar property, (3) foreign currency or certain other property denominated in foreign currency, and (4) certain leased tangible property.

Consequently, in an outbound transfer, no intangible property or goodwill or going concern (whether foreign or U.S.) can qualify for the active trade or business exception under Section 367(a), even if the intangible property transferred is in fact used in a trade or business outside of the United States.

Section 367(d) and the Foreign Goodwill and Going Concern Value Exception

In order to coordinate the application of Section 367(a) and Section 367(d) in light of the uncertainty regarding whether any particular intangible asset is described in Section 936(h)(3)(B) (and the IRS and Treasury's decision not to take a position on the issue), the new proposed regulations permit taxpayers to apply Section 367(d), in lieu of Section 367(a), to certain outbound contributions of property (potentially including goodwill and going concern value, depending on the taxpayer's view regarding the scope of Section 936(h)(3)(B)) that would otherwise be subject to gain recognition under Section 367(a). This election is available with respect to property that is not "eligible property" under Section 367(a) (without regard to the four excluded categories described above).

In addition to changing the definition of "intangible property" to include property to which a U.S. transferor elects to apply Section 367(d), the proposed regulations eliminate the existing regulatory exception under Section 367(d) for foreign goodwill and going concern value. This means that, to the extent a taxpayer chooses to apply Section 367(d) instead of Section 367(a) to any foreign goodwill or going concern value, the taxpayer will be subject to deemed income inclusions with respect to such goodwill or going concern value over its useful life, which is no longer limited to 20 years as is true under the currently applicable regulations.

Explanation of New Regulations Under Section 482

The new Section 482 regulations purport to impose consistent methods for evaluating controlled transactions for purposes of Section 482 and any other Code provisions that apply to the transactions, such as Section 367. The preamble claims that analysis of two or more controlled transactions on an aggregate basis is considered particularly appropriate when the facts and circumstances indicate that synergies are present among those controlled transactions.

In addition, the best method under Section 482 must be selected and applied so as to achieve consistent results between Section 482 and other Code provisions, as well as among specific provisions of the Section 482 regulations (*e.g.*, distinct methods for intangible property and controlled services). The IRS and Treasury claim that the purpose of these requirements is to ensure that the economic result of the controlled transactions, as opposed to the form or character of those transactions (or, more generally, their treatment under other provisions of the tax law), is the primary consideration in applying Section 482.

The following summaries track the individual subsections of the new regulations.

In General (Section 1.482-1T(f)(2)(i)(A))

Under the new Section 482 regulations, "all value" provided between controlled taxpayers as a result of controlled transactions must be fully accounted for and must receive an arm's length amount of compensation. In this context, the value of a transfer is determined without regard to the form or character of the arrangement between the controlled parties, and the determination takes into account all contractual terms, whether

written or implied. The analysis is required to take into account the entire arrangement, including any contractual provisions that are imputed based on the economic substance of the controlled parties' dealings.

The new regulations take a novel approach of emphasizing transactional "value" as an item that must be determined and then allocated among the controlled parties. The existing regulations under Section 482 provide methods for determining the arm's length price of specific types of controlled transactions, and rules for coordinating between these provisions. The new regulations, in contrast, call for a threshold analysis to determine the economic value of the controlled transactions on an aggregate basis, and then require a determination of the arm's length compensation for transfers of this value, apparently without regard for the general tax treatment of the underlying transactions under existing law.

Aggregation (Section 1.482-1T(f)(2)(i)(B))

The new regulations modify the application of the general principle that an aggregate analysis of two or more separate transactions is appropriate if the transactions are so interrelated that aggregation will provide the most reliable measure of an arm's length result under the best method rule of Section 1.482-1(c). Thus, under the new regulations, an aggregate analysis is appropriate to the extent that the controlled transactions are "economically interrelated" and provided that an aggregate analysis is more reliable than a separate analysis.

The temporary regulations eliminate the provision in former Section 1.482-1(f)(2)(1)(A) that indicated that aggregation was limited to controlled transactions involving "related products or services" within the meaning of Section 1.6038A-3(c)(7)(vii). According to the preamble, the IRS and Treasury believe that taxpayers potentially misinterpreted that reference as unduly preventing the use of aggregation. In addition, the IRS and Treasury assert that aggregate analysis of two or more controlled transactions may be necessary to determine whether the compensation provided is consistent with the value provided, with value for these purposes interpreted to include any synergies that exist between the items and services provided. This provision strongly suggests that taxpayers will be required to perform an aggregate analysis of the controlled transactions in any event, if only because the regulations call for a comparison between the aggregate and the separate analysis.

Coordinated Best Method Analysis and Evaluation (Section 1.482-1T(f)(2)(i)(C))

The new regulations also call for a coordinated application of the best method rule in any case that involves two or more controlled transactions or multiple provisions of the Code or regulations. Again, the IRS and Treasury claim that a coordinated approach is considered necessary to ensure a consistent measure of the arm's length result for purposes of all relevant statutory and regulatory provisions. In particular, the analysis must yield the total value of the controlled transactions, including any synergies, regardless of the general tax treatment of the transaction under other Code sections. The former regulation simply required aggregate analysis of controlled transactions that met certain specific conditions. There was no requirement that taxpayers apply a consistent approach to two or more interrelated transactions or to controlled transactions subject to multiple provisions of the Code or regulations. Nor was it necessary under the former regulations to determine the total value that resulted from the interrelated transactions. Consequently, this provision will require a fundamentally different analysis, as compared to practice under the former regulations.

Allocations of Value (Section 1.482-1T(f)(2)(i)(D))

This provision provides that it may be necessary to allocate among the controlled parties one or more portions of the arm's length result determined under the coordinated best method analysis. In performing this discrete allocation, the best method rule applies. The current regulations under Section 482 permit the Commissioner of the IRS to allocate income, deductions, credits, etc., as necessary to achieve an arm's length result in connection with one or more controlled transactions, but they do not contemplate allocation of the arm's length result between the controlled parties. This new terminology suggests that, once the Commissioner has determined the total value of a transaction using a coordinated analysis, he will allocate that value among the controlled participants "in a manner that provides the most reliable measure of each allocated amount." Stated differently, the principles of the best method rule will govern the allocation of the total value of the transaction, where it must be performed.

Examples (Section 1.482-1T(f)(2)(i)(E))

Examples 1 through 4 of the new regulations are adopted from the former regulations with minor changes. Examples 5 through 11, in contrast, are new examples that illustrate applications of the revised provisions. For the most part, these new examples involve relatively complex fact patterns but, in each case, the new example shows the new rules being applied to increase the total compensation associated with the controlled transfers by starting with the total value considered by the IRS and Treasury to have been transferred to a non-U.S. person. Many of the items for which compensation is required are items traditionally considered to be outside the scope of Section 482, Section 367, or both.

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Effective Dates

The proposed Section 367 regulations provide for a 90-day notice and comment period; however, if they are finalized in their current form, they will be effective for contributions occurring on or after September 14, 2015, as well as contributions occurring before September 14, 2015, that result from entity classification elections filed on or after September 14, 2015. The new Section 482 regulations, on the other hand, apply to taxable years ending on or after September 14, 2015.

Assessment

Ultimately, the proposed Section 367 regulations, if adopted, would mean that, in an outbound asset transfer, the only assets that generally can be transferred on a tax-free basis are tangible and financial assets. Any intangible assets or goodwill or going concern value transferred will be subject to tax under either Section 367(a) or Section 367(d), regardless of whether the particular intangible asset is or is not described in Section 936(h)(3)(B) and regardless of whether the goodwill or going concern value attaches to the transferred tangible assets that are used in an active foreign trade or business. This is a significant departure from the IRS and Treasury's historical policy regarding the treatment of foreign goodwill and going concern value and will likely directly affect the commercial decisions made by many organizations, including multinational enterprises that choose to first enter, or explore entering, a foreign market through a branch and later decide to incorporate those branch operations.

In light of the intent expressed by Congress in the legislative history to Section 367 that, "ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business," and that Congress "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system," it is unclear whether the proposed Section 367 regulations' complete elimination of the foreign goodwill and going concern value exception, even in the case of a basic foreign branch incorporation, would withstand a challenge to their validity. (See *Altera Corp. v. Comm'r*, 145 T.C. 3 (2015); Mayo Foundation for Medical Education & Research v. U.S., 131 U.S. 704 (2011); *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); and *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.,* 463 U.S. 29 (1983).)

Assuming final regulations are enacted as proposed, those who may become subject to these proposed Section 367 regulations must consider whether an election to apply the income recognition rules under Section 367(d) with respect to eligible property provides more favorable results than current gain recognition under Section 367(a).

With respect to the new Section 482 regulations, while they purport to restate the aggregation principles that applied under the prior regulation, the new regulations purport to require aggregate analysis of a much wider group of controlled transactions. The new regulations also mandate consistent and coordinated application of the best method rule, including with respect to transfers that implicate Code provisions other than Section 482. For purposes of this analysis, the IRS may raise additional arguments under the new regulations, including consideration of realistic alternatives to the controlled transactions and implied contractual terms based on the economic substance of the parties' dealings. Collectively, the stated goal of these provisions is to identify, and to require compensation for, "all value" provided between the controlled taxpayers, regardless of the operating history of the foreign business, the transaction form and the receipt of subsidiary stock in connection with the transfer.

The full text of the proposed Section 367 regulations is available at http://federalregister.gov/a/2015-23279.

The full text of the new temporary and final Section 482 regulations is available at http://federalregister.gov/a/2015-23278.