

The Code Sec. 367(d) Paradox: Peering into the Abyss from a Safe Distance

By Eric B. Sensenbrenner

From such humble beginnings, Code Sec. 367(d) has evolved, through both legislation and implementation, to become a principal element in the overall U.S. legal framework applicable to the cross-border movement of intangible property and associated income. Eric Sensenbrenner examines the role of Code Sec. 367(d), both within the context of Code Sec. 367 and as it relates to the Subchapter C nonrecognition provisions to which it applies more generally.

Introduction

It is often said that there are two aspects of Code Sec. 367(d): the Subchapter C aspect; and the Code Sec. 482 aspect. In a sense that is true. The provision itself is grounded in a transactional framework that is tethered to the Subchapter C provisions that address incorporation and reorganization transactions. Yet its mode of operation departs in significant ways from the gain recognition principles that generally underpin the Subchapter C provisions, and instead adopts the income-oriented approach of Code Sec. 482. Certainly, much of the focus on transactions that implicate the provisions of Code Sec. 367(d), both in terms of administrative pronouncements and in controversy that has arisen between taxpayers and the IRS, has been with respect to the so-called “482” aspects of the provision (*e.g.*, issues

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related to the determination and valuation of intangible property subject to Code Sec. 367(d)), the scope of foreign goodwill and going concern value, and examination of the role of the commensurate with income standard and its relationship to the arm's-length standard. This aspect of Code Sec. 367(d) presents a number of truly interesting questions regarding the scope of income subject to Code Sec. 367(d) and raises important questions regarding the appropriate methodology for measuring intangible income. It also is one that has produced much debate and on which much has been written. By contrast, historically, there has not been as much focus on the so-called "Subchapter C" aspects of Code Sec. 367(d). There are

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the 1986 Temporary Regulations themselves. Although longstanding, the Temporary Regulations nevertheless fail to address a number of important questions regarding the operational interaction of Code Sec. 367(d) and the Subchapter C provisions. Notice 2012-39,¹ issued in July 2012, however, addresses certain Subchapter C aspects of Code Sec. 367(d) and presents an opportunity to explore the IRS's current thinking on some of these issues. Additionally, consideration of the issues presented in the Notice also provides an occasion to look more fundamentally at the role of Code Sec. 367(d) and its relationship to the Subchapter C provisions that govern the transactions to which Code Sec. 367(d) applies.

This article examines the role of Code Sec. 367(d), both within the context of Code Sec. 367 and as it relates to the Subchapter C nonrecognition provisions to which it applies more generally. In examining this role, I will present a perspective on Code Sec. 367(d), along with Code Sec. 367(a) out of which its provisions were carved, as fundamentally a Subchapter C provision that at its core can be described to function as an operating rule of construction for the application of the operative taxing provisions of Subchapter C. When viewed as such, the role of Code Sec. 367(d) may necessarily be more limited in its ability to fundamentally alter the rules of taxation established by operative Subchapter C provisions than the breadth of its methodology for determining and calculating the income

subject to its application might otherwise suggest. The resort by the IRS and Treasury to Code Sec. 367(d), and in particular its Subchapter C operational elements, as a primary tool in its ongoing efforts to combat repatriation transactions, as illustrated in Notice 2012-39, presents a unique opportunity not only to examine its suitability for the chosen task, but also to explore more generally the operation of Code Sec. 367(d) and its proper relationship with the operative Subchapter C provisions.

Code Sec. 367 Policy

The predecessor of Code Sec. 367(a) was originally added in 1932 as subsection (k) to the reorganization provisions of the Code then contained in Code Sec. 112.² The legislative history to the provision³ reveals that Congress was concerned that taxpayers might escape tax by availing themselves of the tax-free reorganization provisions to move appreciated property outside the United States taxing jurisdiction where the gain would be free to be recognized without current U.S. tax.⁴ This was several generations before the enactment of subpart F, and the tools available to the IRS at that time to combat such a shifting of gain outside the taxing jurisdiction of the United States were limited to common-law doctrines, such as the sham transaction doctrine, substance-over-form, and arguments about the identity of the "true" seller. The government's ability to utilize these tools to successfully challenge taxpayers' transfers of property outside the U.S. taxing jurisdiction was generally limited to circumstances where the property was disposed of shortly after its transfer to a foreign corporation.⁵

The history and circumstances surrounding the enactment of Code Sec. 112(k), reveals two important features about Code Sec. 367(a). First, Code Sec. 367(a) should be thought of as fundamentally a part of the fabric of Subchapter C, indeed originally forming part of the same Code section that provided for the applicable rules governing nonrecognition transactions. Second, as an override of the tax-free exchange provisions of the Code, Code Sec. 367(a) essentially exists to address what is a jurisdictional issue, or the inability of the basic Subchapter C paradigm to cope with a loss of taxing jurisdiction in a manner that would provide the same tax results as in a wholly-domestic transaction.

The essential paradigm of Subchapter C's tax-free reorganization and exchange provisions is one of deferral. This deferral model, which is built on the basis provisions of Code Secs. 358 and 362 to preserve built-in gain at both the shareholder and corporate level, is necessarily predicated on the assumption that gain in the hands of the transferee corporation will continue to be subject to

the U.S. taxing jurisdiction following the transfer. In this light, the basic premise of Code Sec. 367(a) could be seen as accelerating the recognition of gain in transferred property⁶ to a point in time immediately before the loss of taxing jurisdiction would otherwise prevent the Subchapter C deferral model from operating as intended.⁷ In examining the relationship between Code Sec. 367(a) and the underlying Subchapter C reorganization provisions to which it relates, then, the role of Code Sec. 367(a) could be viewed as one that is rather limited in its nature, existing to backstop the Subchapter C provisions and impose tax in situations where the continued application of the underlying provisions is frustrated by the loss of taxing jurisdiction.⁸ The relational nature of Code Sec. 367(a) to the underlying taxing provisions of Subchapter C is evident from the language of the provision itself. Even a cursory review of the statute reveals that Code Sec. 367(a) essentially functions as a rule of construction for purposes of applying the Subchapter C provisions, imposing on the enumerated Subchapter C provisions the directive that “such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.”⁹ As such, I would suggest that Code Sec. 367(a) does not impose tax independently of the operative Subchapter C provisions to which it relates, but rather, through the operation of its rule of construction that assigns “non-corporate” status to the transferee, it merely modifies the operation of the Subchapter C rules. I would also suggest that consistent with this relationship, there is an animating feature of Code Sec. 367(a), and to a certain extent, Code Sec. 367 generally,¹⁰ that could be described as reflecting a policy of deference to the operative taxing provisions stepping in only where, and to the limited extent, necessary to accelerate the recognition of gain or income where the paradigm underlying the operative taxing provision would be frustrated due to a loss of taxing jurisdiction.

This orientation of Code Sec. 367(a) (and perhaps Code Sec. 367 generally) *vis-à-vis* the operative taxing provisions of Subchapter C is important to consider when examining the role of Code Sec. 367(d), and in particular its current and perhaps future, administration. As a general matter, it is the operative Subchapter C provisions, and not the provisions of Code Sec. 367, that dictate the circumstances and timing of income recognition in connection with reorganization exchanges. Put another way, it is left to the operative Subchapter C provisions to articulate the policy determinations that have been made by Congress regarding the circumstances in which amounts should be taxed, the manner in which they should be taxed, and the timing of the recognition of income. Historically, and consistent with the

statutory scheme, the role of Code Sec. 367 has not been to re-assess those policy judgments, but instead to backstop them by effectively accelerating the incidence of tax where those Subchapter C policies can no longer be implemented.

Code Sec. 367(d) History

Initially conceived in 1982 to prevent taxpayers from circumventing the provisions of Code Sec. 936(h), Code Sec. 367(d) was limited to transfers of possessions-related intangibles. Under the rules in effect at that time, in order to avoid tax on outbound transfers of property, taxpayers were required to obtain a ruling from the IRS establishing that the avoidance of federal income tax was not one of the principal purposes for the transfer. Rev. Proc. 68-23¹¹ set forth the guidelines in effect at that time for obtaining such an advance ruling and generally provided that a favorable ruling would be issued in circumstances where the transfer of property was made to a foreign corporation to be used in an active business conducted outside the United States. However, transfers of patents, trademarks, and similar intangibles to be used in connection with the conduct of a U.S. business, or in connection with manufacturing for sale or consumption in the United States, were generally subject to a toll charge. This left a negative implication that transfers of such intangible property to a foreign corporation for use in a foreign business or for manufacturing for sale or consumption outside the United States would be permitted to be tax-free. In 1982, when Congress changed the rules under Code Sec. 936 applicable to income from possessions-related intangibles, they became concerned that in response, taxpayers would seek to transfer their intangibles to foreign corporations, and such transfers would be tax-free under the guidelines, as discussed above.¹²

In 1984, Congress moved beyond the very limited application of Code Sec. 367(d), which effectively had been a stop-gap measure to prevent avoidance of the Code Sec. 936 provisions, and expanded the reach of Code Sec. 367(d) to all outbound transfers of intangibles. In support of this expansion, Congress sounded many of the policy refrains familiar to practitioners today in supporting the taxation of outbound transfers of intangibles under Code Sec. 367(d), noting the ability of companies to “reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with a [sic] the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.”¹³ Also in 1984, Congress eliminated the advance ruling regime that had been applicable to outbound transfers generally

in a reworking of the Code Sec. 367(a) statutory scheme, and in doing so, effectively codified many of the standards that had been developed by the IRS over the years through the advance ruling process. Importantly, among these codifications was the exception for transfers for use in an active business outside the United States, to which intangible property was now entirely ineligible, by reason of the specific regime contained in Code Sec. 367(d).¹⁴

Finally, in 1986, Congress added the commensurate with income (CWI) standard to Code Sec. 367(d) along with Code Sec. 482. It can be fairly debated whether CWI has really altered in any meaningful way how Code Sec. 367(d) is administered as a substantive matter, but on its face the addition of the CWI standard both reflected a Congressional desire for the computational aspects of Code Sec. 367(d) to track Code Sec. 482 and added a statutory license in support of Code Sec. 367(d)'s claim to the income generated by intangible property.

Impetus for Code Sec. 367(d)

The impetus for enacting Code Sec. 367(d) in its current form, in 1984, can be traced to two factors, both of which are described in the legislative history. First, Congress was concerned about the administration of the existing principal purpose standard, in light of a series of taxpayer victories in the Tax Court that, in Congress' view "threatened to weaken [Code Sec. 367]."¹⁵ In particular, Congress cited the Tax Court's narrow interpretation of the "principal purpose" in *Dittler Brothers, Inc.*,¹⁶ as requiring a showing that a tax-avoidance purpose for the transfer outrank all other purposes in order to deny tax-free exchange treatment.¹⁷ Additional consideration was given to the administrative burden on taxpayers and the increasing demands the advance ruling regime placed on IRS resources.

A second rationale for enacting Code Sec. 367(d), as discussed above, was the concern about taxpayers inappropriately "gaming" the system through the enjoyment of the various incentives available to development expenses in the United States and then, on the cusp of exploitation, transferring valuable intangibles offshore where the associated income would be eligible for deferral. Earlier attempts to address this type of mismatch using Code Sec. 482's clear reflection of income standard had met with limited success. For instance, in *Eli Lilly & Co.*,¹⁸ the IRS was unsuccessful in allocating income generated from a transferred intangible back to the parent company, with the court finding that a Code Sec. 351 transfer in exchange for stock of the transferee company was an arm's-length transaction.¹⁹

Code Sec. 367(d) Policy

At the heart of Code Sec. 367(d) policy is the principle of matching the expenses incurred with the income generated from exploitation of the intangible. This is clear and reflects a concern that is clearly acute in the case of intangible assets. Unlike their tangible counterparts, intangible assets' development costs are generally deducted currently (and may qualify for other incentives such as the research and experimentation credit), and tend to be relatively high when compared to the costs associated with exploitation activities, e.g., manufacturing costs. But, Code Sec. 367(d) is not limited to merely recapturing previously deducted development costs, as is the case, for example, with Code Sec. 367(a)'s branch loss recapture rules. Code Sec. 367(d)'s deemed royalty approach appears to be designed to capture a greater share of the income stream associated with intangible assets and, as such, reflects a conscious policy consideration that recognizes other important factors that differentiate intangible assets from their tangible counterparts. Compared to tangible assets, intangible assets tend to lack a particular geographic locus, and, therefore, the associated income is more capable of being shifted to another jurisdiction, than for instance, a factory with hundreds of employees. And, generally speaking, intangible assets have a greater tendency than tangible assets to generate non-routine returns.

In theory, apart from source and character considerations, one would not expect the income inclusions that are required under Code Sec. 367(d) to produce a greater amount of income on a present-value basis than if gain in the intangible were recognized. As with any income-producing asset, intangibles should be capable of being valued at the time of transfer in a way that accurately reflects the anticipated future income produced. However, the existence of Code Sec. 367(d) and the structure of its provisions, requiring inclusion of amounts "contingent upon the productivity, use, or disposition of such property,"²⁰ together with the CWI standard would seem to reflect a view that traditional gain-recognition concepts, at least as a computational matter, are inadequate in the case of intangible property. Moreover, it could also be argued that the mechanism of income inclusion itself, and annual deemed royalty payments over time, in contrast to gain recognition that is limited to a determination made at a specific point in time, implies a prospective determination of the amount of income to be included, based on actual, rather than anticipated, results.

Relationship to Code Sec. 367(a)

While the proper scope of Code Sec. 367(d) may be debated in light of the specific policies and characteristic

features of intangible assets, the fundamental issue that Code Sec. 367(d) is addressing is precisely the same as Code Sec. 367(a), which is the problem of applying the tax-free reorganization provisions where the transfer results in a loss of current taxing jurisdiction. In fact, Code Sec. 367(d) can be thought of as effectively a subset of, or carved-out from, Code Sec. 367(a), which for most of its statutory history governed the outbound transfer of intangible, as well as tangible, assets. Whereas Code Sec. 367(a) as a general matter seeks to bridge the loss of jurisdiction by accelerating the gain recognition event to the time of transfer, Code Sec. 367(d) attempts to assert continued taxing jurisdiction through annual income inclusions.

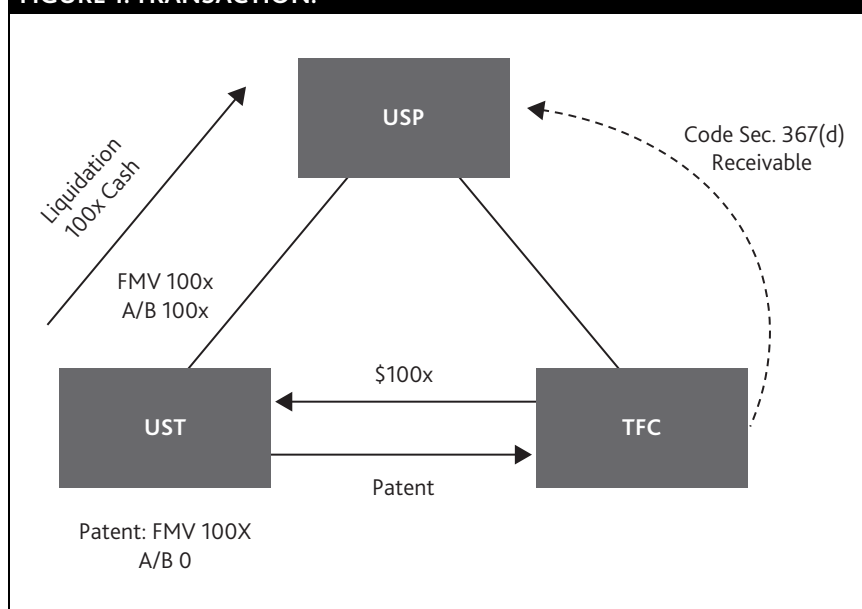
Where Code Sec. 367(a) does not seek to capture the income generated by transferred assets, except perhaps to the extent such income potential is reflected in value, Code Sec. 367(d) on the other hand, might be described as a sort of super-jurisdictional taxing provision, having arguably a stronger claim on the income associated with transferred intangibles than does the gain recognition regime under Code Sec. 367(a) have with respect to their tangible counterparts.

Indeed, it might even be argued that the deemed royalty approach of Code Sec. 367(d) purely as a taxing mechanic, by continuing to tax income generated by the transferred intangible on a current basis, ensures to the greatest extent the continued assertion of taxing jurisdiction over intangible assets. As such, Code Sec. 367(d) stands somewhat apart from Code Sec. 367(a) and its Subchapter C underpinnings of gain recognition and deferral. Because it is divorced from the gain recognition or deferral concepts of Subchapter C, Code Sec. 367(d) has the capacity to impose tax on an amount of income or gain that exceeds the amount that is subject to tax under Subchapter C. This feature of Code Sec. 367(d) may explain, in part, its attractiveness in the eyes of the IRS as a tool to be deployed in its efforts to combat what it views as inappropriate repatriation.

Code Sec. 367(d) as Repatriation Weapon Under Notice 2012-39

In furtherance of its ongoing efforts to frustrate repatriation transactions, Code Sec. 367(d) is being wielded as

FIGURE 1. TRANSACTION.



yet the latest weapon in the IRS's arsenal. This time, the focus is on reorganizations involving the outbound transfer of intangible assets. On July 13, 2012, the IRS issued Notice 2012-39,²¹ to provide guidance with respect to the application of Code Sec. 367(d) to transfers of intangible property to a foreign corporation in an exchange under Code Sec. 361, *e.g.*, outbound asset reorganizations. In identifying the need for guidance, the IRS indicated a concern regarding "transactions intended to repatriate earnings from foreign corporations without the *appropriate* recognition of income."²²

The Notice is interesting in itself and in its application of Code Sec. 367(d) to the types of transactions at which it was aimed, but also because it represents some of the only recent public guidance to be issued by the IRS to address some fairly fundamental aspects of how Code Sec. 367(d) operates and its interaction with the underlying Subchapter C provisions. As such, it is instructional as to the IRS's current thinking about the Subchapter C aspects of Code Sec. 367(d).

The Notice identifies the transaction depicted in Figure 1, at issue.

In the transaction, USP, a domestic corporation, owns all of the stock of UST, a domestic corporation. USP has a basis in the stock of UST equal to its value of \$100x (*e.g.*, it has recently been acquired in a taxable transaction). The only asset of UST is a patent with a value of \$100x and a tax basis of zero. USP also owns all of the stock of TFC, a controlled foreign corporation. UST transfers the patent to TFC in exchange for \$100x of cash and liquidates, distributing the \$100x of cash to USP. This transaction

constitutes a reorganization within the meaning of Code Sec. 368(a)(1)(D), and because the acquiring corporation is foreign, the transaction is subject to the provisions of Code Sec. 367.

The Notice states that the taxpayer takes the position that neither USP nor UST recognizes gain or dividend income on the receipt of the \$100x cash; that USP applies the Code Sec. 367(d) regulations to include amounts in gross income under Reg. §1.367(d)-1T(c)(1) in subsequent years; and, finally, that USP applies the Code Sec. 367(d) regulations to establish a receivable from TFC in the amount of USP's deemed royalty inclusions and takes the position that the repayment of such receivable does not give rise to income. While to any student of Subchapter C and Code Sec. 367, the consequences just described might appear to be in line with the applicable code provisions, the Notice reveals the offending result of their application, "under these positions, the transactions have resulted in a repatriation in excess of \$100x (\$100x at the time of the reorganization and then through repayment of the receivable in the amount of USP's income inclusions over time) while *only* recognizing income in the amount of the inclusions over time."²³

The conclusion above is actually quite remarkable, insofar as it does not appear to relate to the application of Code Sec. 367(d), *per se*, or the taxation of income from the transferred intangible. In the example, we are told the provisions of Code Sec. 367(d) and the regulations operate as intended. The Notice tells us that the taxpayer applies the provisions of Code Sec. 367(d) to include income over time with respect to the intangible. Likewise, the establishment of an account receivable with respect to the Code Sec. 367(d) inclusions hardly seems offensive and is expressly provided for in the regulations.²⁴ Indeed, that leaves only the tax treatment to USP on the receipt of cash under the gain-limitation rule of Code Sec. 356 that is offensive, preventing in the Notice's view, the "appropriate recognition of income."²⁵ The appropriateness of the boot-within-gain rule of Code Sec. 356 is the subject of debate, and there have been administration Treasury proposals to amend the statute to remove this feature;²⁶ nevertheless, it is a longstanding provision that is enshrined in the statutory scheme of Subchapter C. However, the Notice expresses a judgment regarding the appropriate amount of income that should be recognized in the transaction, a determination that historically has been the province of the operative Subchapter C provisions (in this case, Code Sec. 356). The Notice then seeks to apply Code Sec. 367(d) principles to alter this longstanding Subchapter C framework for taxing boot received by shareholders in reorganization transactions under Code

Sec. 356 and does so in a context where Code Sec. 367(d) would otherwise appear to apply as intended to tax the income related to transferred intangibles. This approach represents a significant expansion of the role of Code Sec. 367(d) when measured by historic norms and would appear to fundamentally alter the relationship between Code Sec. 367 and the underlying Subchapter C provisions to which it relates.

Specifically, the Notice states that the IRS and Treasury Department will issue regulations that will:

[E]nsure that, with respect to all outbound section 367(d) transfers, the total income to be taken into account under section 367(d) is either included in income by the U.S. transferor in the year of the reorganization or, where appropriate, over time by one or more qualified successors.²⁷

The Notice achieves this result through one of two mechanisms, a pre-paid royalty mechanism or a gain recognition mechanism. Section 4.02 of the Notice sets forth the pre-paid royalty mechanism and provides that in an outbound Code Sec. 367(d) transfer that is pursuant to a Code Sec. 361 transaction, the U.S. transferor will take into account in the year of the transfer income under Code Sec. 367(d)(2)(A)(ii)(I) (the basic Code Sec. 367(d) deemed royalty regime), with respect to each qualified successor, as a prepayment of the Code Sec. 367(d) deemed royalties. The amount of this prepaid royalty is equal to the percentage that the value of the Code Sec. 367(d) property bears to the total value of all property transferred by the U.S. transferor to the transferee foreign corporation in the Code Sec. 361 exchange, multiplied by the sum of: (i) the money and fair market value of other property received by the qualified successor in exchange for, or with respect to, stock of the U.S. transferor (reduced by the portion of any U.S. transferor distributions received by the qualified successor²⁸); and (ii) the product of the qualified successor's ownership interest percentage multiplied by the amount of nonqualifying liabilities that are either assumed by the transferee foreign corporation in the reorganization or satisfied by the U.S. transferor with money or other property provided by the transferee foreign corporation.²⁹

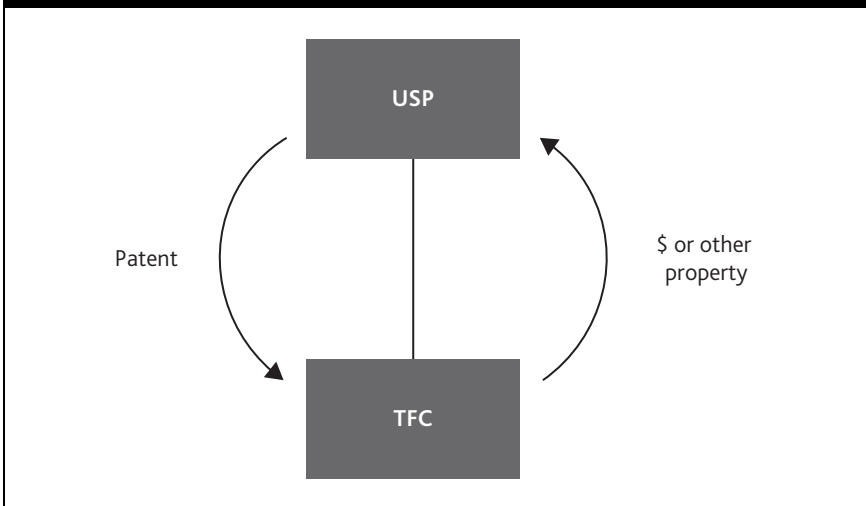
The Notice defines a "qualified successor" as a shareholder of the U.S. transferor that is a domestic corporation, with certain exceptions not relevant here. In the transaction set forth in Figure 1, USP is a qualified successor. Under section 4.02 of the Notice, UST, as the transferor, is required to include in income as a prepayment of the Code Sec. 367(d) royalty, an amount equal to the 100x

of cash (*i.e.*, the Code Sec. 367(d) percentage, 100 percent, multiplied by the “boot” received by the qualified successor, USP). There are no liabilities in the transaction depicted in Figure 1, but if there had been liabilities of UST (other than ordinary course liabilities not arising in the transaction that are owed to third parties) that were either assumed by TFC in the transaction or satisfied by UST with money or property provided by TFC, then such liabilities would be treated in the same manner as the 100x cash “boot” described above.

The notion of boot received in a tax-free exchange as a pre-payment of the Code Sec. 367(d) royalty is not a novel one. In the Code Sec. 351 context, the IRS has considered precisely this question. In a 2005 Chief Counsel Advice Memorandum, the IRS examined the interaction of the Subchapter C rules for taxing boot under Code Sec. 351(b) and the deemed royalty rules of Code Sec. 367(d).³⁰ The facts considered by the IRS in the Chief Council Advice (CCA) involved an outbound transfer of intangibles in a Code Sec. 351 transfer where the transferor was considered to receive taxable boot,³¹ as set forth in Figure 2.

Because the transaction involved the transfer of intangible property in exchange for boot, it presented the potential for the simultaneous application of Code Sec. 351(b), requiring the recognition of gain with respect to the boot received, and also of Code Sec. 367(d), resulting in deemed royalty income with respect to the transferred intangible. The IRS noted that if both sections were to apply, the transferor would be taxed twice with respect to the boot portion of the exchange.³² The IRS examined the legislative history to Code Sec. 367(d) and concluded that Congress did not intend to tax the transfer of intangible property twice.³³ On examination, the taxpayer asserted an ordering rule that effectively prioritized Code Sec. 351(b) over Code Sec. 367(d), with the result that to the extent of the boot received in the exchange, the taxpayer would be taxed under Code Sec. 351(b), and the remaining portion of the intangible treated as transferred in exchange for shares of the transferee foreign corporation subject to Code Sec. 367(d).³⁴ The IRS, however, disagreed based on the structure of Code Sec. 367(d) and finding of the operative language of Code Sec. 367(a) that referenced the treatment “not ... be considered to be a corporation”³⁵ to evidence a Congressional desire that Code Sec. 367(d) trump Code Sec. 351(b). Specifically, the CCA reasoned that in enacting Code Sec. 367(d), Congress intended

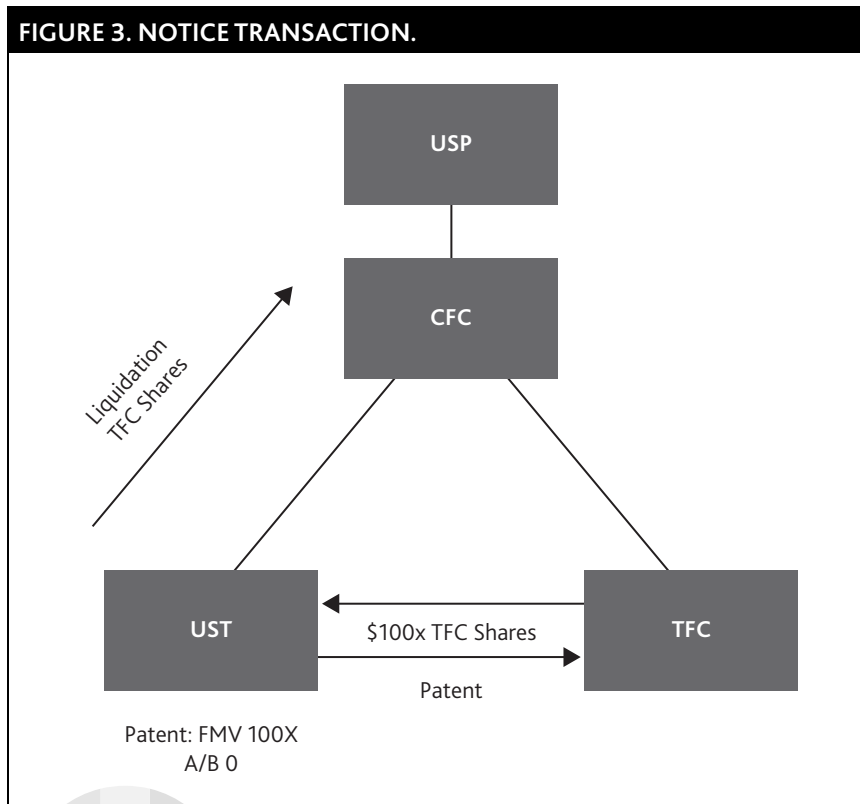
FIGURE 2. CODE SEC. 351 TRANSFER.



transfers of intangibles to foreign corporations to receive different treatment than an ordinary sale and prescribed the consequences set forth in Code Sec. 367(d) applicable to such transfers. Accordingly, the IRS concluded that the transfer at issue should be subject only to the provisions of Code Sec. 367(d) and that the boot received in the transaction must be treated as a Code Sec. 367(d) payment.

The logic of the CCA is compelling, and the result in that context appears to be correct. In a Code Sec. 351 exchange, the Subchapter C rules evidence a judgment that the transferor of property who receives non-qualifying consideration should be taxed with respect to that consideration. From a Code Sec. 367(d) perspective, that person to whom the Subchapter C provisions ascribe the incidence of taxation is also the transferor of the intangible property. Therefore, there is an identity of interest between the person that is subject to tax on the transfer under the operative Subchapter C rules and the transferor who is required to include annual deemed royalties under Code Sec. 367(d). And, because Code Sec. 367(d) merely determines the manner in which the transferor of intangibles is taxed, the result set forth in the CCA does no violence to the Subchapter C paradigm, but only alters the manner (and in some cases, the amount) of taxation³⁶ of the person who the Subchapter C rules have determined is to be taxed. As the CCA concludes, this result appears consistent with the statutory framework and the policies underlying the provisions of both Code Secs. 351 and 367(d).

The extension of these principles to the Code Sec. 361 context, however, leads to some unsettling questions. In contrast to a Code Sec. 351 exchange, in the Subchapter C paradigm applicable to a Code Sec. 361 transfer, there is a distinction between the two levels of the transaction—the transferor of the intangible property



who is subject to Code Sec. 367(d) on the transfer and the shareholder of the transferor who is subject to tax on boot received.³⁷ Under the applicable Subchapter C rules, the transferor of the property is expressly not subject to tax on the receipt of boot, provided the boot is distributed to its shareholder(s), which has been required in asset reorganizations since 1984. Therefore, a Code Sec. 361 transaction does not present the same identity of interest between the person who is taxed on the boot under Subchapter C and the transferor of the intangible property who is subject to the rules of Code Sec. 367(d) and does not present the acute issue considered in the CCA of the potential to be taxed twice on the same transfer. Put another way, the Subchapter C rules applicable to the taxation of boot and the provisions of Code Sec. 367(d) are capable of simultaneous operation without apparent conflict.³⁸

The Notice begins by articulating a judgment that the transaction (and in particular, the operation of the Subchapter C provisions contained in Code Sec. 356) does not produce an “appropriate” income inclusion. However, the tax consequences applicable to a shareholder in a Code Sec. 361 transaction are not governed by Code Sec. 367, because the Code Sec. 356 exchange does not involve a transfer to a foreign corporation.³⁹ The application of Code Sec. 367(d) to correct what is perceived to be a failure of the operative Subchapter C provisions to produce the

“appropriate” recognition of income represents a significant alteration of the basic relationship of Code Sec. 367 to these operative rules.

Moreover, even if one accepts the approach taken in the Notice, because the rules set forth therein are grounded in Code Sec. 367(d), and not the operative Subchapter C provisions, they do not appear to coordinate their changes with the operative taxing provisions. For instance, how would the rules in section 4.02 of the Notice apply to the transaction set forth in Figure 1 if there was built-in gain in the stock of UST held by USP? In such a case, under Code Sec. 356, the gain would be recognized to USP. Would the Notice conclude, in that case, that there has been an “appropriate” recognition of income? If so, would the Notice then call off the application of Code Sec. 367(d)? To the extent that the cash or other property is also taxed under Code Sec. 367(d) in the year of the transfer under the rules

set forth in the Notice, double-tax would result. Should we expect that regulations to be issued under the Notice would provide some coordination with respect to gain recognized under Code Sec. 356 to avoid double tax?

As described above, there is not an identity of interest between the person who is taxed under Code Sec. 367(d) and the person who recognizes income with respect to the boot. The boot represents an amount that is taxable to the shareholder, USP, measured with respect to its gain in the UST shares, and the Code Sec. 367(d) income is taxable to the transferor, UST, with respect to its Code Sec. 361 transfer of the intangible asset. However, the Notice effectively conflates the two levels of the transaction, and in subjecting the boot to current tax under Code Sec. 367(d) in a situation where there is Code Sec. 356 gain recognition, this ironically would create the very prospect of double taxation that was addressed in the CCA.

The Notice, in section 4.03, also provides for regulations that would apply to the extent that the shareholder in a Code Sec. 361 transaction is not treated as a qualified successor. The rules described in this section of the Notice are grounded in an interpretation of rule of Code Sec. 367(d)(2)(A)(ii)(II) and the provisions contained in Temporary Reg. §1.367(d)-1T(e)(3). An example of a transaction that implicates this aspect of the Notice is set forth in Figure 3.

The example in Figure 3 is not all that different from the transaction set forth in Figure 1; however, UST is owned by a CFC of USP rather than USP itself. In the transaction, which may constitute a “D” or “F” reorganization, UST transfers its assets, consisting of the patent with a value of 100x, to TFC in exchange for TFC shares and then liquidates, distributing the TFC shares to its shareholder, CFC.

By contrast to the transaction set forth in Figure 1, here the CFC in Figure 3 is not a qualified successor, and under the Notice we are told that as a result the U.S. transferor, UST, must recognize gain on the Code Sec. 367(d) property transferred in the Code Sec. 361 exchange, the patent. The Notice does not provide detailed reasoning for this result, except to provide that based on this rule the income is taken into account under Code Sec. 367(d)(2)(A)(ii)(II), the statutory disposition rule. Code Sec. 367(d)(2)(A)(ii)(II) provides that, “in the case of a disposition following [the initial outbound] transfer (whether direct or indirect),” that the income required to be taken into account under Code Sec. 367(d) is taken into account at the time of the disposition.

The Treasury Regulations under Code Sec. 367(d) expand on the statutory disposition rule to provide specific provisions that are applicable in the case of a disposition of the transferred intangible, as well as in the case of a disposition of stock of the transferee foreign corporation. With respect to the latter, the regulations differentiate between transfers to unrelated persons (treated as a disposition of the transferred intangible) and transfers to related persons; the regulations further differentiate between related U.S. persons and related foreign persons. Under these rules, subsequent transfers of stock of the transferee foreign corporation to a related U.S. person carry with them a proportionate amount of the Code Sec. 367(d) receivable, with the result that in the case of such a transfer, the transferee U.S. person essentially steps into the transferor’s shoes with respect to any remaining income inclusions under Code Sec. 367(d).⁴⁰ In contrast, where the U.S. transferor transfers stock of the transferee foreign corporation to a related foreign person, the regulations provide that the U.S. transferor must continue to include Code Sec. 367(d) amounts in income as if the transfer had not occurred.⁴¹

By treating the transaction set forth in Figure 3 as one that results in an income inclusion under Code Sec. 367(d)(2)(A)(ii)(II), the Notice appears to treat the distribution of stock of the transferee foreign corporation in the Code Sec. 361 transaction as a “subsequent” disposition of those shares. It is a curious feature of the Temporary Regulations under Code Sec. 367(d) that although their provisions clearly are intended to apply to Code Sec.

361, as well as Code Sec. 351, transfers, and despite containing highly specific rules dealing with dispositions of stock or the transferred intangible in a variety of different circumstances, they contain no express provisions actually addressing the situation where the transferor goes out of existence in the transaction.⁴² This has been the case even though the operative provisions of Subchapter C have required the transferor in a Code Sec. 361 transaction to liquidate in connection with the transaction since 1984.

Notice 2012-39 represents the most recent public guidance regarding certain of the transactional or Subchapter C aspects of Code Sec. 367(d).

The approach taken in section 4.03 of the Notice, then, appears to be an approximate attempt to fit the transaction into the existing framework under the regulations applicable to subsequent transfers of stock of the transferee foreign corporation.⁴³ If the Code Sec. 361 distribution of the shares of the transferee foreign corporation is treated as a disposition, then in the case of a nonqualified successor it is a disposition to a related foreign person. As such, it ordinarily would be one in which the U.S. transferor would continue to include amounts under Code Sec. 367(d). However, because this disposition occurs pursuant to a Code Sec. 361 transaction and as a consequence the U.S. transferor does not survive the transaction, the result is the recognition of gain with respect to the transferred intangible, a result that is typically reserved for dispositions of the transferred intangible itself (and presumably also the default treatment in any case where either the original transferor or the transferee cannot continue to include amounts under Code Sec. 367(d)).

The rules of section 4.03 of the Notice, then, appear to reflect an approach to the application of Code Sec. 367(d) that is somewhat broader than the rules set forth in section 4.02, in that they are not overtly aimed at repatriation. Whereas the provisions of section 4.02 of the Notice would seem to reflect an anti-abuse principle that is aimed at repatriation (whether directly through cash or other property consideration, or indirectly through the assumption of nonqualifying liabilities) in reorganization transactions, the provisions of section 4.03 appear to articulate a more general rule of application regarding the provisions of Code Sec. 367(d). In contrast to the accelerated royalty

regime set forth in section 4.02 of the Notice, the gain recognition regime set forth in section 4.03 does not appear to turn on whether UST was acquired by CFC for an exchange for cash or its own shares. In fact, the rules do not appear to depend on whether UST was acquired at all or whether the ownership of UST stock by CFC has given rise to taxable inclusions under Code Sec. 956. Rather, the approach taken in section 4.03 of the Notice appears to reflect a broader view regarding the application of Code Sec. 367(d) and the inability of the basic Code

With the only meaningful guidance on the shelf in the form of 28-year-old Temporary Regulations, the Notice presents a welcome opportunity to gain insight into the IRS's current thinking with respect to these aspects of Code Sec. 367(d).

Sec. 367(d)-deemed royalty regime to operate in the Code Sec. 361 context where the immediate shareholder is not a U.S. person. Of course, by treating the Code Sec. 361 distribution as a subsequent transfer and then attempting to shoehorn the transaction into the existing regulatory framework applicable to such transfers, this conclusion⁴⁴ is preordained. It also is one that produces a curious result from the government's perspective.

If one accepts that the enactment of Code Sec. 367(d) reflects a Congressional policy judgment that outbound transfers of intangibles should be subject to a regime that requires income inclusions over time based on the use or productivity of the property and commensurate with the income produced, and a rejection of the basic gain recognition regime of Code Sec. 367(a) applicable to tangible property, then a result that calls off the specific Code Sec. 367(d) deemed royalty regime applicable to intangible property in favor of gain recognition is rather surprising. Of course, such a result is just what is prescribed under both the statute and the Temporary Regulations but only as a last resort in situations where the Code Sec. 367(d) regime cannot continue to be applied. The statutory scheme would seem to reflect this notion, providing generally for annual inclusions, but in the case of a disposition, at that time (presumably as a "last chance" at taxing the transfer where the basic, preferred, deemed royalty regime cannot operate any longer). It is even clearer under the Temporary

Regulations, which devise specific mechanisms that continue to apply the deemed royalty regime where possible following transfers (*e.g.*, in the case of transfers of either stock or the intangible) to related persons, by treating the Code Sec. 367(d) receivable as either transferred or retained, only require the recognition of gain in the case of transfers (again, either stock or the intangible) to unrelated persons.

By contrast, the "subsequent" transfer in Figure 3 is made to a related person. The inability to continue to apply the deemed royalty regime does not appear to result from any particular policy distinction compared to the rules applicable to other transfers that are made to related persons. Instead, the inability appears to result from the technical application of the existing Temporary Regulations (which do not expressly address the situation where the transferor goes out of existence in a Code Sec. 361 transaction) and from the conclusion that it is the U.S. transferor that is required to continue including the Code Sec. 367(d) royalty, but cannot due to its inexistence. The disposition rules of the Temporary Regulations are predicated on the continued existence of the transferor (*i.e.*, a Code Sec. 351 model), and the alternative is not contemplated. If, on the other hand, the Code Sec. 361 distribution were not treated as a subsequent transfer subject to the existing regulations' rules regarding such transfers, the impossibility of continuing to apply the intended Code Sec. 367(d) regime to the transaction would not be a foregone conclusion. For instance, it does not appear that treating the Code Sec. 367(d) receivable as being transferred to USP as the immediate U.S. person in the ownership chain would involve a tremendous leap of logic.⁴⁵ And, surely such a result would not do violence to any underlying policy of Code Sec. 367(d). On the contrary, such a result actually would serve to promote the continued application of the intended regime, requiring annual inclusions that are contingent on use or productivity, rather than the alternative of last resort, gain recognition.

The provisions in the Notice under sections 4.02 and 4.03 can be viewed as very different from each other insofar as the role of Code Sec. 367(d) is concerned. While section 4.02 would expand the role of Code Sec. 367(d) beyond its historic context, to address matters historically relegated to the Subchapter C provisions, specifically the tax treatment of boot under Code Sec. 356 in the hands of a person that is not otherwise subject to Code Sec. 367, section 4.03 takes a very limited approach to the application of Code Sec. 367(d) and resorts to gain recognition in circumstances where, arguably, the provisions of

Code Sec. 367(d) and its basic deemed royalty regime could continue to apply. While section 4.02 of the Notice appears narrowly tailored in its application to transactions the IRS views as raising significant policy concerns, section 4.03 seems to articulate a broad rule of general application. Yet, the interpretive approach to Code Sec. 367(d) that is taken in both sections of the Notice appear to be heavily influenced by the transactions at issue identified therein.

Conclusion

Notice 2012-39 represents the most recent public guidance regarding certain of the transactional or Subchapter C aspects of Code Sec. 367(d). With the only meaningful guidance on the shelf in the form of 28-year-old Temporary Regulations, the Notice presents a welcome opportunity to gain insight into the IRS's current thinking with respect to these aspects of Code Sec. 367(d). Moreover, with an active guidance project underway to replace the Temporary Regulations, the Notice also may offer a glimpse into the IRS's approach to Code Sec. 367(d) in prospective guidance.

The approach taken in the Notice suggests a rather significant shift in the role of Code Sec. 367(d) (and perhaps Code Sec. 367 more generally) and its relationship with the Subchapter C provisions to which its provisions relate. While the rules of Code Sec. 367 essentially operate within the statutory scheme as rules of construction that modify certain aspects of the underlying Subchapter C provisions as they relate to cross-border reorganization transactions, they have historically done so in a limited manner that is generally consistent with the Subchapter

C paradigm. The Notice suggests an expansive role for Code Sec. 367 that dictates the basic tax treatment of reorganization transactions and of elements of such transactions that have not previously been subject to its reach. As such, the Notice would appear to posit a role for Code Sec. 367 that is not limited to merely backstopping the Subchapter C regime, stepping in only to the extent that the underlying policies are frustrated through a loss of taxing jurisdiction, but rather one in which Code Sec. 367 provides affirmative rules of taxation in a manner that is inconsistent with the underlying Subchapter C paradigm onto which Code Sec. 367 is grafted. However, the application of Code Sec. 367(d) to tax the movements of cash or other property in reorganization transactions in a manner that is inconsistent with the underlying Subchapter C provisions would represent a significant expansion of the scope of Code Sec. 367(d) when compared to its historic role and may imply a more fundamental change in the nature of the basic relationship between Code Sec. 367 and the taxing provisions of Subchapter C.

Yet, the Notice was not issued to provide generally applicable guidance under Code Sec. 367(d), but rather specifically to address what the IRS viewed as significant policy concerns raised by the transactions at issue identified therein. As such, the extent to which the specific considerations relevant to the transactions identified in the Notice, and the suggested approach to applying Code Sec. 367(d) in that context, ultimately dictate the approach to Code Sec. 367(d) that is taken in future regulations as rules of general application to a broad range of transactions involving outbound transfers of intangibles, remains to be seen.

ENDNOTES

¹ Notice 2012-39, 2012-31 IRB 95 (July 2012).

² At the time, Code Sec. 112 contained the predecessor provisions now contained in Code Secs. 351, 332 and 368, along with the associated provisions of Code Secs. 354, 356, etc.

³ Revenue Act of 1932 (P.L. 72-154), 47 Stat. 139.

⁴ The House Report to the 1932 Act described what it considered to be a "serious loophole for avoidance of taxes," whereby, "[t]axpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided." H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932), reprinted in 1939-1 CB (Pt. 2) 457, 471.

⁵ See, e.g., *Kaspere Cohn, Co.*, 35 BTA 646, Dec. 9604.

⁶ The gain recognition agreement provisions of Reg. §1.367(a)-3 also could be seen as providing a mechanism (albeit a different one) that is aimed at addressing the problem of a loss of taxing jurisdiction. Consistent with the original focus of Code Sec. 367(a), these rules are limited in requiring current gain recognition to situations where the transferred stock or securities are disposed of within a relatively short period of time following the outbound transfer (i.e., five years) and do not appear to articulate a policy mandate that such gain remain subject to current U.S. tax in perpetuity.

⁷ I appreciate that this is not a complete explanation, in that it fails to explain, for instance, why transfers of appreciated property to controlled foreign corporations where the gain on a subsequent disposition would constitute subpart F are not permitted without recogni-

tion of gain. A reasonable explanation might simply be that the provision pre-dated the enactment of subpart F (by 30 years) and once the basic framework was established, it was not revisited in light of subsequent provisions that otherwise might have bridged the same jurisdictional considerations underlying Code Sec. 367(a).

⁸ In a certain sense, it could be argued that the Subchapter C deferral model is unaffected by outbound transfers, because any gain recognized on a subsequent disposition of the transferred property would be reflected in earnings and profits that would remain "in the system," so to speak, and would be subject to U.S. tax (e.g., in the event of a repatriating distribution) under Code Sec. 367(b) in the case of a tax-free inbound liquidation or reorganization of the transferee foreign corporation, or under Code

Sec. 1248 on a subsequent disposition. Accordingly, it might be more accurate to describe the policy of Code Sec. 367(a) as preserving the current taxation of gain.

⁹ Code Sec. 367(a)(1).

¹⁰ A similar feature is embodied in Code Sec. 367(b), for instance in the provisions of Reg. §1.367(b)-4, which accelerates the recognition of Code Sec. 1248 income in a reorganization in the limited circumstance where the underlying provisions of Code Sec. 1248 cannot continue to apply, due to a loss of Code Sec. 1248 status. Essentially, this too involves a situation where there is a loss of taxing jurisdiction.

¹¹ Rev. Proc. 68-23, 1968-1 CB 821.

¹² The Conference Report to the Tax Equity and Fiscal Responsibility Act of 1982 states "the conferees are aware that, as a result of this legislation [936(h)], some taxpayers have stated that they would remove investment from Puerto Rico and transfer possession-related intangibles to foreign jurisdictions. The conferees believe that such transfers would ordinarily have as one of their principal purposes the avoidance of federal income tax." S. Conf. Rep. No. 530, 97th Cong., 2d Sess. 512 (1982).

¹³ Tax Reform Act of 1984, H.R. Rep. No. 432 (II), 98th Cong., 2d Sess. 1316 (Mar. 5, 1984).

¹⁴ Under Rev. Proc. 68-23, 1968-1 CB 821, transfers of intangible property for use in a business outside the United States and for manufacture of property for consumption outside the United States could have qualified for tax-free treatment.

¹⁵ *Supra* note 13, 2d Sess. 1315.

¹⁶ *Dittler Brothers, Inc.*, 72 TC 896, Dec. 36,266 (1979), *aff'd mem.*, CA-5, 642 F2d 1211 (1981).

¹⁷ *Supra* note 15.

¹⁸ *Eli Lilly & Co.*, 84 TC 996, Dec. 42,113 (1995), *aff'd in part, rev'd in part*, CA-7, 88-2 ustrc ¶9502, 856 F2d 855.

¹⁹ The IRS had a better track record reallocating income or loss under Code Sec. 482 in situations where the property was sold shortly following the transfer. See, e.g., *National Securities Corp.*, CA-3, 43-2 ustrc ¶9560, 137 F2d 600; *Central Cuba Sugar Co.*, CA-2, 52-2 ustrc ¶9390, 198 F2d 214.

²⁰ Code Sec. 367(d)(2)(A)(i).

²¹ *Supra* note 1.

²² *Id.* (emphasis added).

²³ *Id.* (emphasis added).

²⁴ Temporary Reg. §1.367(d)-1T(g).

²⁵ *Id.*

²⁶ See, e.g., Treasury Dep't, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, at 96 (Mar. 2014).

²⁷ *Supra* note 1, §4.01.

²⁸ Under Code Sec. 361(c)(2)(A), any retained property that is distributed by the transferor corporation to its shareholders would result in the recognition of gain to the transferor.

²⁹ *Supra* note 1, §4.02.

³⁰ CCA 200610019 (Mar. 10, 2006).

³¹ A separate issue considered in the CCA was whether the receipt of Code Sec. 351(g) stock and its subsequent redemption for cash and notes should be collapsed. In either event, the transfer was governed by the boot rules of Code Sec. 351(b).

³² *Supra* note 30.

³³ *Id.*

³⁴ *Id.*

³⁵ Code Sec. 367(a).

³⁶ That is, treating the boot as ordinary income, sourced as a royalty under Code Sec. 367(d)(2)(C). The treatment of boot under Code Sec. 367(d) does, however, differ from its treatment under Code Sec. 351(b), insofar as the Temporary Regulations would not permit any recovery of basis. In this way, the application of Code Sec. 367(d) does fundamentally alter the tax consequences of the transaction compared to the gain-recognition principles of Code Sec. 351(b).

³⁷ In fact, the rules of Code Sec. 367(a) applicable to reorganization exchanges involving transfers of stock or securities to a foreign corporation, contained in Reg. §1.367(a)-3, also respect this distinction. Under these rules, either the Code Sec. 354 exchange or the Code Sec. 361 asset transfer, but not both, constitutes a transfer to a foreign corporation for purposes of Code Sec. 367(a). Importantly, these rules provide that in a Code Sec. 361 asset reorganization, the shareholder's Code Sec. 354 exchange is not a transfer to a foreign corporation that is subject to Code Sec. 367(a) (provided that the transaction does not constitute an indirect stock transfer).

³⁸ Admittedly, because the transferor must liquidate, and the resulting "disposition" results in the shareholder being treated as receiving the Code Sec. 367(d) receivable under Temporary Reg. §1.367(d)-1T(e)(1), ultimately the same person who incurred tax on the boot will include

the Code Sec. 367(d) royalties. However, the Subchapter C paradigm applicable to Code Sec. 361 transactions (and the distinction between the two levels of the transaction and the associated tax consequences) is very different than that applicable to a Code Sec. 351 transfer, and the capacity in which the shareholder would include Code Sec. 367(d) royalties is that of a successor or distribute and not a transferor of the intangible property.

³⁹ See Reg. §1.367(a)-3(a). Provided, of course, that the transaction does not constitute an indirect stock transfer under Reg. §1.367(a)-3(d).

⁴⁰ Temporary Reg. §1.367(d)-1T(e)(1).

⁴¹ Temporary Reg. §1.367(d)-1T(e)(3).

⁴² The preamble to the 1998 Code Sec. 367 regulations notes this anomaly. T.D. 8770, 1998-2 CB 3.

⁴³ In one private letter ruling, the IRS has attempted to bridge the failure of the existing Temporary Regulations to specifically address the mechanics and operation of Code Sec. 367(d) in a Code Sec. 361 transaction where the U.S. transferor goes out of existence through resort to the disposition rule of Code Sec. 367(d) and the Temporary Regulations. In LTR 9731039 (Aug. 1, 1997), Controlled, a U.S. corporation, transferred IP to a foreign corporation, Subsidiary, and then underwent an outbound "F" reorganization in which it was deemed to transfer all of its assets to a foreign corporation, New Controlled. The IRS ruled that the transfer of the stock of Subsidiary to New Controlled was governed by the disposition rule of Temporary Reg. §1.367(d)-1T(e)(3), despite the fact that Controlled ceased to exist as a result of the transaction.

⁴⁴ That is, the conclusion that as a subsequent transfer of stock of the transferee foreign corporation to a related foreign person, the U.S. transferor is required to continue to include the Code Sec. 367(d) amounts in income but is incapable of doing so because it ceases to exist; therefore gain must be recognized.

⁴⁵ Alternatively, in the situation where the shareholder is a controlled foreign corporation, the Code Sec. 367(d) receivable could be treated as having been transferred along with the stock in the same manner as where the transfer is to a related U.S. person, and the annual Code Sec. 367(d) royalties would produce subpart F income.

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