

Proposed Code Sec. 367 Regs Attempt to Tax Foreign Goodwill and Going Concern Value

The transfer of goodwill and going concern value by a domestic corporation to a foreign subsidiary for use in a trade or business outside the United States has never been subject to taxation under Code Sec. 367. Without any legislative change, the IRS and the Treasury in proposed regulations would seek to tax such transfers.¹

As background, Code Sec. 367(a) provides generally that gain on the otherwise tax-free transfer of property by a U.S. person to a foreign corporation is subject to immediate taxation. A broad general exception is provided for the transfer of property for use in the active conduct of a trade or business outside the United States, with a limited list of ineligible items remaining subject to taxation (*e.g.*, inventory and foreign currency).²

Code Sec. 367(a) does not apply to the transfer of “intangible property (within the meaning of section 936(h)(3)(B)).” Rather, a transfer of such property by a U.S. person to a foreign corporation is subject to Code Sec. 367(d). That section treats an otherwise tax-free transfer of Code Sec. 936(h)(3)(B) intangible property as if it were sold for a stream of annual payments contingent on productivity which are includible in the transferor’s income over the useful life of the intangible property (limited to 20 years).³

Code Sec. 936(h)(3)(B) defines intangible property by providing a list of 27 items, including patents, designs, copyrights, trademarks, franchises, contracts, systems, programs and customer lists. The definition ends by including “any similar item” and providing that all included items, whether specifically enumerated or merely “similar,” must have “substantial value independent of the services of any individual.”

The list of intangible property subject to Code Sec. 367(d) does not include goodwill or going concern value,⁴ and the Tax Court held that goodwill and going concern value are not included in Code Sec. 936(h)(3)(B) as “similar” items.⁵ The regulations state that Code Sec. 367(d) “shall not apply to the transfer of foreign goodwill or going concern value.”⁶ In addition, Code Sec. 367(a) does not apply to the transfer of goodwill or going concern value to a foreign subsidiary for use in a trade or business outside the United States.

Congress’s intent to exclude foreign goodwill and going concern value from the scope of Code Sec. 367 is clear from legislative history. This is unequivocally expressed by the Joint Committee on Taxation: “Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax.”⁷

The IRS and the Treasury in proposed Code Sec. 367 regulations would now attempt to tax all transfers to a foreign subsidiary of goodwill and going



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concern value for use in a trade or business outside the United States. Any gain would be subject to taxation either under Code Sec. 367(a) (immediately taxable) or (d) (taxable over the useful life of the property), at the taxpayer's election.⁸

The preamble describes the concern that taxpayers are taking positions that an inappropriately large portion of the value of property transferred to a foreign subsidiary consists of goodwill and going concern value.⁹ The government asserts that taxing goodwill and going concern value is consistent with the legislative history that "the committee 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."

The government does not support its assertion that transfers of foreign goodwill and going concern value are abusively being overvalued, and recent commentary notes that goodwill can represent a majority of the value of a business.¹⁰ Furthermore, the quoted legislative history provides a reason for *not* applying Code Sec. 367 to goodwill and going concern value, not a limitation.

Indeed, the potential abuse described by Congress has

nothing to do with transfer pricing. Congress was concerned that a domestic corporation would receive U.S. tax deductions for the cost of developing intangibles and subsequently transfer the intangibles to a foreign corporation at the point of profitability, and thus Code Sec. 936(h)(3)(B) intangibles were removed from the active trade or business exception and made taxable under Code Sec. 367(d). In contrast, goodwill and going concern value "are generated by earning income, not by incurring deductions," and therefore "the transfer of these (or similar) intangibles does not result in the avoidance of Federal income taxes."¹¹

Therefore, the extra-legislative proposed regulations should be withdrawn.¹² There is no basis for taxing foreign goodwill or going concern value under Code Sec. 367(d) because those items are not within the definition of Code Sec. 936(h)(3)(B) intangible property. Moreover, there is no basis for taxing foreign goodwill or going concern value under Code Sec. 367(a) because those items fall within the exception for transfers of property for use in a foreign trade or business. And Congress unequivocally intended that such transfers *not* be taxed under Code Sec. 367 (which has been reflected in regulations for the past 30 years).

ENDNOTES

¹ REG-139483-13, 80 FR 55,568 (Sept. 16, 2015). The regulations when finalized would apply retroactively to transfers occurring on or after September 14, 2015.

² Code Sec. 367(a)(2); Reg. §1.367(a)-2T.

³ The proposed regulations would remove the 20-year limit. See Lowell D. Yoder, *The Unique Treatment of Code Sec. 367(d) Deemed Payments*, 40 INT'L TAX J. 3, May-June 2014.

⁴ Other definitions of intangible property specifically list goodwill and going concern value. See, e.g., Code Secs. 197(d) and 865(d); Reg. §1.263(a)-4(c)(1)(ix)-(x); Reg. §1.954-2(e)(3); and Reg. §1.861-9T(h)(1)(ii).

⁵ *Veritas Software Corp.*, 133 TC 297, 316, 323, Dec. 58,016 (2009). The definition of intangibles for purposes of Code Sec. 482 is substantially the same as the definition in Code Sec. 936(h)(3)(B). Code Sec. 482 (last sentence cross-references Code Sec. 936(h)(3)(B)); Reg. §1.482-4(b). See also Lowell D. Yoder & Elizabeth Lewis, *Properly Valuing Intangibles Transferred to Foreign Subsidiaries*, 142 TAX NOTES 470 (Apr. 21, 2014).

⁶ Reg. §1.367(d)-1T(b).

⁷ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Dec. 31, 1984), at 428. See S. Rep. No. 169, 98th Cong., 2d Sess., Vol. I, at 365 (1984) ("The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business."); H.R. Rep. No. 432, 98th Cong., 2d Sess., Part 2, at 1320 (1984) (similar statement). The word "ordinarily" refers to the loss recapture rule, which provides that gain otherwise qualifying for the active business exception can be taxable to the extent of accumulated losses in a foreign branch. Code Sec. 367(a)(3)(C).

⁸ Proposed Reg. §1.367(a)-1(b)(5), (d)(5). Consistent with case law, the proposed regulations do not attempt to tax the mere exploitation of a business opportunity by a foreign subsidiary. See *Hospital Corp. of America*, 81 TC 520, Dec. 40,476 (1983); *Merck & Co., Inc.*, 91-2 USTC ¶150,456, 24 ClsCt 73; *Bausch & Lomb Inc.*, 92

TC 525, Dec. 45,547 (1989), *aff'd*, CA-2, 91-1 USTC ¶150,244, 933 F2d 1084.

⁹ Reg. §1.367(a)-1T(d)(5)(iii) (defines foreign goodwill or 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"). The residual method for valuing goodwill and going concern value has been adopted by a number of other provisions and is the accounting definition. See, e.g., Code Secs. 338 and 1060; Reg. §1.338-6(b)(2)(vii).

¹⁰ See Letter to Editor, *Response to Treasury's Crackdown on Goodwill Boom*, 150 TAX NOTES 367 (Jan. 18, 2016).

¹¹ Joint Committee on Taxation, *supra* note 7, at 428.

¹² See *Altera Corp.*, 145 TC No. 3, Dec. 60,354 (July 27, 2015) (unanimous reviewed Tax Court opinion held that Reg. §1.482-7(d)(2) was invalid because the Treasury failed to demonstrate that it engage in reasoned decision-making as required by the Administrative Procedure Act).

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