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IRS Issues Guidance on Outbound Transfers of Intangible Property in Asset Reorganizations

In Notice 2012-39 (the "Notice"), the IRS issued guidance announcing its intention to issue regulations with respect to certain transfers of intangible property by a U.S. corporation to a foreign corporation in a reorganization described in section 361 of the Internal Revenue Code (the "Code"), citing significant policy concerns involving certain intellectual property transfers that permit U.S. persons to repatriate earnings without U.S. income taxation. The IRS' position in the Notice will impact repatriation planning strategies.

Background

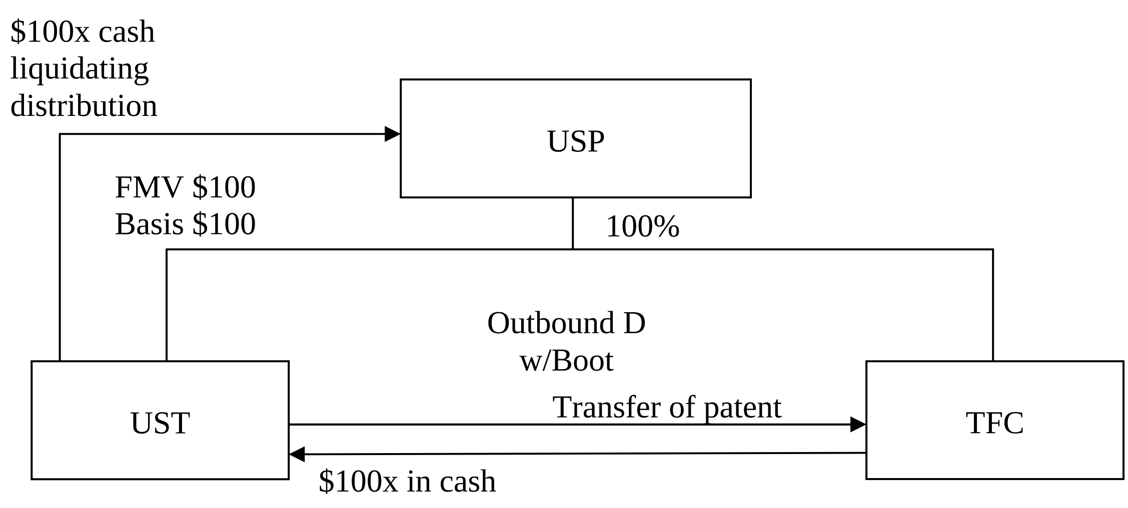
Subject to certain exceptions, under section 367(a), a U.S. person is taxed on income or gain attributable to the transfer of property to a foreign corporation in an exchange described in sections 332, 351, 354, 356, or 361. (One of the major exceptions is for transfers of foreign goodwill.) Section 367(d) treats the transfer of intangible property (within the meaning of section 936(h)(3)(B)) as a sale in exchange for payments that are contingent upon the productivity, use or disposition of such property, stating that section 367(a) shall not apply. Section 367(d)(2)(A) and the related temporary regulations provide that a U.S. transferor shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arm's length charge for the use of the property as determined under section 482 principles. If a U.S. person is required to recognize income, and the amount deemed to be received is not actually paid by the transferee foreign corporation, then the U.S. person may establish an account receivable from the transferee foreign corporation equal to the amount deemed paid that was not actually paid. If a U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a person that is not a related person, the U.S. transferor is treated as having simultaneously sold the intangible property to the unrelated person acquiring the stock of the transferee foreign corporation. The U.S. transferor must recognize gain (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's adjusted basis in that property on the date of the initial section 367(d) transfer. If a U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a U.S. person that is a related person, the related U.S. person, over the useful life of the property, annually includes in gross income a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor.

Section 368 provides rules applicable to corporate reorganizations. A transaction fitting within one of the prescribed models is eligible for tax-free treatment. Section 361 describes the treatment of the corporation whose stock or assets are being transferred. In general, under section 361(b), boot can be distributed without causing taxation to the distributing corporation. Section 356 describes the treatment to the parties to the exchange. In general, tax-free status is available to the parties to an exchange. However, boot (typically cash) is generally taxable to the recipient. Under section 356(a), boot distributed to the exchanging shareholders will be taxable to the holders to the extent of any gain realized in the exchange. This is so even if the property received is considered to be a dividend for tax purposes. This is commonly referred to as the "boot within gain" limitation. There have been several proposals in recent years to eliminate the boot within gain rule. The Administration's FY 2011 Budget states that "there is not a significant policy reason to vary the treatment of a distribution that otherwise qualified as a dividend by reference to whether it is received in the normal course of a corporation's operations or is instead received as part of a reorganization exchange." In addition, the Administration has identified specific abuses of this rule in cross-border reorganizations, stating that "in cross-border reorganizations, the boot-within-gain limitation can permit U.S. shareholders to repatriate previously-untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences."

<u>Notice Fact Pattern</u>

The Notice describes the following fact pattern:

USP, a domestic corporation, owns 100 percent of the stock of UST, a domestic corporation. USP's basis in its UST stock equals its value of $100x. UST's sole asset is a patent with a tax basis of zero. UST has no liabilities. USP also owns 100 percent of the stock of TFC, a foreign corporation. UST transfers the patent to TFC in exchange for $100x of cash and, in connection with the transfer, UST distributes the $100x of cash to USP and liquidates.



The taxpayer takes the position that neither USP nor UST recognizes gain or dividend income on the receipt of the $100x of cash. That is, (i) under section 361(b)(1)(A), the $100x received by UST is not taxable because it is distributed to USP pursuant to the plan of reorganization, and (ii) under the boot within gain

> rule, the $100x received by USP is not be taxable due to USP's high basis in its UST stock. USP then applies the section 367(d) regulations to include amounts in gross income under Treasury Regulations section 1.367(d)-1T(c)(1) in subsequent years. USP also applies the section 367(d) regulations to establish a receivable from TFC in the amount of USP's aggregate income inclusion. USP takes the position that TFC's repayment of the receivable does not give rise to income (notwithstanding the prior receipt of $100x in connection with the reorganization). Accordingly, 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.

The Notice attacks this transaction by setting forth a paradigm for regulations which would treat the cash received by UST as a prepayment rather than boot subject to section 361(b)(1)(A) and, thus, as taxable income. It is worth noting that, prior to the issuance of the Notice, the IRS had issued written guidance treating cash received by a transferor of intangibles in a section 351 transaction as a prepayment under section 367(d) instead of as boot subject to section 351(b), which limits income recognition to the lesser of the gain inherent in the property contributed in the section 351 transaction or the amount of boot received. Thus, if, prior to the issuance of the Notice, the transaction described above were structured as a section 351 transaction (i.e., if UST were not liquidated) it would not have been very attractive because UST generally would be taxed in the same manner as is described in the Notice (and in any event, even if section 351(b) did apply, it would not limit UST's income recognition due to UST's zero basis in the patent). However, prior to the issuance of the Notice, there had been no written guidance with respect to whether section 367(d) overrides section 361(b)(1)(A) for purposes of determining the treatment of boot received for intangible property in an outbound reorganization. In the absence of guidance, some taxpayers took the position that section 367(d) did not override section 361(b) because, unlike section 367(a), section 367(d) does not explicitly provide that a foreign corporation will not be considered to be a corporation for purposes of transfers described in section 332, 351, 354, 356 or 361 by U.S. persons to foreign corporations. However, in a 2010 comment letter, the New York State Bar Association (the "NYSBA"), suggested that Treasury regulations be promulgated to reconcile the taxation of boot under the reorganization provisions with the taxation of deemed section 367(d) payments. In this regard, the NYSBA proposed that taxpayers be required to allocate the amount of boot among all the assets transferred in such a reorganization and then to treat amounts allocated to intangibles as prepayments of the resulting deemed section 367(d) payments. The Notice generally adopts this approach.

As set forth in the Notice, in an outbound section 367(d) transfer, the U.S. transferor will take into account income under section 367(d)(2)(A)(ii)(I) with respect to each "qualified successor," if any, by treating as a prepayment, the product of the "section 367(d) percentage" multiplied by the sum of: (i) the money and fair market value of other property (within the meaning of section 356) 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 successor; and (ii) the product of the qualified successor's ownership interest percentage multiplied by the amount of non-qualifying 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 (within the meaning of section 361) provided by the transferee foreign corporation. Thus, boot and liabilities assumed could give rise to a prepayment and current income recognition. A "qualified successor" is a shareholder of the U.S. transferor that is a domestic corporation (with exceptions for RICs, REITS and S corporations) provided the shareholder received qualified stock in the reorganization or immediately after the reorganization otherwise owns qualified stock. "Qualified stock" means stock in the transferee foreign corporation. The Notice goes on to state that as a prepayment of such income, the amount is included in income by the U.S. transferor in the year of the outbound section 367(d) transfer, regardless of the productivity of the transferred section 367(d) property in the year of the transfer or in subsequent years. In effect, by taxing the transferor corporation, the Notice gives section 367(d) precedence over section 361(b), which would otherwise allow deferral.

Different rules apply to non-qualified successors. Taxable income arises regardless of whether any non-qualified successors receive boot or if the U.S. transferor has non-qualifying liabilities assumed in the section 367(d) transfer. The U.S. transferor will recognize income equal to the sum of each non-qualified successor's ownership percentage times the gain realized on all of the section 367(d) property transferred in the section 361 exchange. No prepayment account is established for income recognized by the U.S. transferor with respect to non-qualified successors.

The Notice also makes clear that property will be taken into account under either section 367(a) or section 367(d), notwithstanding arguments that some property could escape both sections, stating: "income or gain attributable to the transfer of property by a U.S. person to a foreign corporation in an exchange described in section 351 or 361 is taken into account either in accordance with section 367(d)(2)(A)(ii)(I) or (II) . . . or in accordance with section 367(a)." This approach also is reiterated in the definition of "property." "Section 367(d) property" is any property described in section 936(h)(3)(B). "Section 367(a) property" is any property other than section 367(d) property. Treating goodwill as section 367(a) property is significant because it affects the amount of stock that can be issued in the exchange under Prop. Treas. Reg. § 1.367(a)-7(c) relating to section 367(a)(5) exchanges.

<u>Application to Liabilities</u>

The prepayment provisions also apply to liabilities assumed that are non-qualifying. Non-qualifying liabilities include all liabilities of the U.S. transferor other than a liability that:

(a) was incurred in the ordinary course of the U.S. transferor's active trade or business (within the meaning of section 367(a)(3)), if any,

(b) did not arise in connection with the reorganization, and

(c) is owed to an unrelated person.

The amount of non-qualifying liabilities is further increased, but not in excess of the U.S. transferor's total liabilities, by an amount equal to the sum of any distributions made by the U.S. transferor (or any predecessor) with respect to its stock, including distributions in redemption of its stock, during the two-year period immediately preceding the reorganization.

Interestingly, the fact that the Notice includes liabilities in the calculation in addition to cash boot suggests that the Notice would continue to apply even if the Administration's proposal regarding section 356 is adopted.

Application to Partnerships

The Notice treats partnerships on an aggregate basis (i.e., stock of the U.S. transferor held by a partnership (domestic or foreign) is treated as held proportionately by its partners). Therefore, if a partnership is a shareholder of the U.S. transferor and receives qualified stock in the reorganization, the partners in the partnership are treated as receiving the qualified stock for purposes of the Notice, including for purposes of identifying a qualified successor.

Illustration of the New Rule

The Notice illustrates operation of the new rule with the following example:

> USP, a domestic corporation, owns 100 percent of the stock of UST, a domestic corporation. USP's basis in its UST stock equals its value of $100x. UST's assets are a patent with a tax basis of zero and a value of $60x, and asset A which is section 367(a) property with a value of $40x. UST has no liabilities. USP also owns 100 percent of the stock of TFC, a foreign corporation. UST transfers the patent and asset A to TFC in exchange for $70x of stock and $30x of cash. In connection with the transfer, UST distributes the cash and securities to USP and liquidates. UST's transfer of the patent and asset A to TFC qualifies as a section 361 exchange. USP is treated as exchanging its UST stock for $70x of TFC stock and $30x of cash pursuant to section 356.

Under the Notice, the following results:

- Because there is no gain on the transfer, the $30x distribution to USP would not be taxable under the boot within gain rule.

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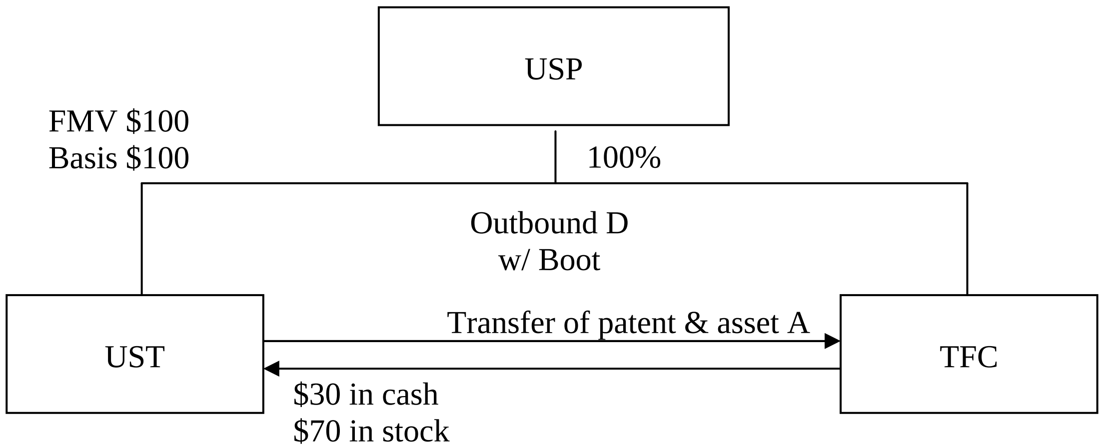
- The $18x of the cash received is taxable to UST as a prepayment ($30x times 60%, the "section 367(d) percentage"), implicitly suggesting that section 361(b)(1)(A) does not apply; and

- The first $18x of contingent annual payments deemed received by USP determined under the U.S. transfer pricing rules with respect to the transfer are not taxable to USP because UST included that amount in taxable income in the year of the reorganization.



Effective Date

The Notice is effective for transfers occurring on or after July 13, 2012. The Notice states that no inference is intended for transactions preceding the effective date of the Notice and the IRS may challenge such transactions under the Code or applicable judicial doctrines.

Other Transactions

The Notice indicates that the IRS will apply it to other transactions involving an unrelated party which may thwart future transactions structured like the recent transaction involving JNJ's acquisition of Synthes, a U.S. corporation, through a U.K. subsidiary:

> Similar results may also be achieved in cases in which a controlled foreign corporation uses deferred earnings to fund an acquisition of all or part of the stock of a domestic corporation from an unrelated party for cash, followed by an outbound asset reorganization of the domestic corporation to avoid an income inclusion under section 956. The IRS and the Treasury Department believe that these transactions raise significant policy concerns, and accordingly, intend to revise the regulations under section 367(d) in the manner described in this notice.

Comments Requested

The IRS and the Treasury Department request comments on the regulations to be issued under the Notice. Specifically, comments are requested regarding whether certain domestic corporations that are related to the U.S. transferor but not subject to provisions in the Notice regarding the treatment of qualified successors should nevertheless be subject to such provisions. For example, the IRS and the Treasury Department are considering whether the rules relating to the treatment of qualified successors in the Notice should apply to transactions in which a domestic corporation is not a qualified successor because it indirectly owns the U.S. transferor through a controlled foreign corporation. This would address the question raised in the Synthes acquisition. In addition, comments are requested as to the proper recovery of basis in the section 367(d) property transferred.

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