January 1987

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THE SUPER ROYALTY: THE 1984 AND 1986 TAX ACT AMENDMENTS AFFECTING TRANSFERS OF INTANGIBLES TO FOREIGN SUBSIDIARIES

Thomas Gibson and Janet Brooks*

I. INTRODUCTION

Any United States (U.S.) corporation which establishes a foreign subsidiary may face a substantial impact from a seemingly innocuous seventeen word sentence in the recently enacted 1986 Tax Reform Act: "The amounts taken into account under [Section 367] shall be commensurate with the income attributable to the intangible." This new provision modifies Internal Revenue Code Section 367(d), which imposes a tax upon the transfer of intangible assets to foreign subsidiaries. Because of this change, a U.S. company may see a substantial increase in its U.S. tax burden as a result of transferring to a foreign subsidiary a patent, process, know-how, trademark, or even a customer list. The increase in tax will apply not only to the year of transfer, but for up to twenty years in the future during which the transferred intangible increases in value.

This article addresses the situation in which a U.S. company transfers assets in connection with the establishment or reorganization of a foreign subsidiary. A virtually identical provision applies to licenses between related parties and is not discussed in detail.

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1. Unless otherwise indicated all references and citations to Sections in this article are to sections of the Internal Revenue Code ("Code") of 1954, as amended to the date of publication, and all references to regulations are to Treasury Regulations under the Code, as amended to the date of publication.

here.³

II. TRANSFER OF PROPERTY PURSUANT TO SECTION 367

Intangible assets which have been developed in the U.S. such as proprietary research, production techniques, technical data, and customer lists are frequently transferred by U.S. corporations to foreign manufacturing sites in order to take advantage of low labor costs and tax incentives. When such a transfer is made to a foreign incorporated entity, that asset has in some respects left the reach of the U.S. tax jurisdiction and the transaction is referred to as an out-bound transfer.

Generally, Internal Revenue Code Section 367 provides that when a U.S. person transfers property to a foreign corporation, directly or as a part of a reorganization, the IRS will not recognize that foreign entity as a corporation unless the taxpayer establishes that the exchange is not primarily designed to avoid Federal income taxation.⁴ Since corporate status is essential to a tax-free reorganization, failure to satisfy the IRS interpretation of the requirements of Section 367 can result in the recognition of a taxable gain.

With respect to tangible property, tax free transfers may be accomplished by merely demonstrating that the asset will be used in an active trade or business by the subsidiary.⁵ In reference to intangible assets however, recent changes to Section 367 preclude the availability of the tax free transfers of intangible assets.

Section 367 initially appeared as Section 112(k) in the Revenue Act of 1932.⁶ With the enactment of this section, Congress intended to close a loophole in existing tax law which allowed taxpayers to avoid taxation of the gain on the sale of appreciated property by transferring the property to an entity incorporated in a jurisdiction that imposed no tax on the sale of capital assets.⁷ In Dittler Brothers vs. Commissioner, Judge Forrester stated:

"...prior to the enactment of this prophylactic measure, a domestic corporation, X, could transfer low-basis property to a newly organized and lightly taxed foreign corporation in exchange for stock. The foreign corporation would then sell the appreciated property and organize a new corporation, Y, in the

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United States by transferring the cash received on the sale in exchange for the entire capital stock. Subsequent to this transaction, the foreign corporation then distributes the stock of Y to the original corporate transferor, X. By this series of transactions, a domestic corporation, X, has had appreciated property converted into cash and avoided the Federal income tax.°

A. Treatment of Transfer of Intangibles Prior to the Tax Reform Act of 1984

Prior to the Tax Reform Act of 1984, qualification for tax free treatment in an outbound transfer of tangible or intangible property required approval of the transaction by the IRS. A U.S. corporation was required to file a ruling request prior to the transfer stating that the exchange was not pursuant to a plan of which one of the principal purposes was the avoidance of Federal income tax.

In 1968 the IRS developed objective standards that were published as guidelines applicable to Section 367 ruling requests. Insofar as they relate to transfers of intangible assets the guidelines provided that an advance ruling would not be issued if:

1. The transferor is a licensor of the property at the time of transfer (unless the transferee is also a licensee);
2. it is reasonable to believe the property would be licensed by the transferee subsequent to the transfer;
3. the property consists of U.S. patents, trademarks or similar intangibles to be used in connection with (1) conduct of a trade or business in the U.S. or (2) the manufacture in the U.S. or a foreign country of goods for sale or consumption in the U.S.; or
4. the property consists of foreign patents, trademarks or similar intangibles to be used in connection with the sale of goods manufactured in the U.S.°

If the transaction did not satisfy the established guidelines, a favorable Section 367 ruling would not be issued and the U.S. transferor would be required to recognize gain on the entire transaction.

Favorable rulings were denied in transfers involving copyrights, U.S. patents, trademarks, and similar intangibles used in connection with a U.S. trade or business or goods manufactured for use or consumption in the U.S.° Similarly, favorable rulings were denied in cases involving transfers of foreign patents, trademarks

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8. Dittler Brothers vs. Commissioner, 72 T.C. 896, 911 (1979), aff’d, 642 F.2d 1211 (5th Cir. 1981).
and similar intangibles used in connection with the sale of goods manufactured in the U.S.\textsuperscript{11}

With the 1976 Tax Act, Congress amended Section 367 by alleviating some of the difficulties in obtaining ruling requests. The 1976 amendments included a grace period for applying for ruling requests (up to 183 days after the transfer), subjecting ruling requests and denials to judicial review, and authorizing the IRS to promulgate regulations for guidance on the ruling requests.\textsuperscript{12}

During the years from 1974 to 1977, the U.S. Tax Court, pursuant to Section 7477 declaratory judgment procedures, frequently granted review to petitions presented by taxpayers who had their ruling requests denied by the IRS. Prior to 1976, there was no judicial remedy available to taxpayers who received an adverse decision from the IRS. The Section 7477 declaratory judgment procedures permitted taxpayers, who were in the process of an exchange and who had received an adverse determination from the IRS for the exchange, to petition the Tax Court to review the Service's action.\textsuperscript{13}

Pursuant to Section 7477, the Tax Court was required to review and determine whether the IRS position was reasonable. The Tax Court established a standard of review, borrowed from federal agency law, based upon the substantial evidence rule.\textsuperscript{14} Under this rule, the taxpayer merely had to establish that the IRS position was unreasonable and the Tax Court would grant the tax-free treatment of the transfer.\textsuperscript{15} The result of the application of the substantial evidence rule was greater leniency by the Tax Court in allowing tax-free treatment of the transfer previously denied by the IRS.

In one of the first declaratory judgment proceedings under Section 7477, \textit{Dittler Brothers, Inc. vs. Commissioner}, the Tax Court's decision required the IRS to take into account the transferor's intent in planning the transaction, notwithstanding the transferor's ability to satisfy IRS guidelines.\textsuperscript{16} The \textit{Dittler} case involved a transfer of manufacturing know-how from a U.S. company to a foreign subsidiary in exchange for stock. The IRS had issued an adverse determination letter regarding the transfer, prompting Dittler to pe-

\begin{itemize}
  \item \textsuperscript{11} Rev. Proc. 68-23, Section 3.02(1)(b)(iv).
  \item \textsuperscript{13} I.R.C. § 7477, repealed by P.L. 98-369 applicable to transfers after 1984.
  \item \textsuperscript{14} \textit{Dittler Brothers vs. Commissioner}, 72 T.C. 869, 910 (1979), \textit{aff'd}, 642 F.2d 1211 (5th Cir. 1981).
  \item \textsuperscript{15} \textit{Kaiser Aluminum and Chemical Corporation vs. Commissioner}, 76 T.C. 325, 343 (1981).
  \item \textsuperscript{16} \textit{Dittler Brothers vs. Commissioner}, 72 T.C. 869 (1979), \textit{aff'd}, 642 F.2d 1211 (5th Cir. 1981).
\end{itemize}
tion the Tax Court for review. The Tax Court reversed the IRS determination, reasoning that the transferor had not intended to avoid taxation in planning the structure of the business transaction.

B. Transfer of Intangibles Pursuant to Tax Reform Act of 1984

The Tax Reform Act of 1984 (The 1984 Act) eliminated the ruling request requirement and the tax avoidance purpose standard when analyzing transfers of property for stock. The declaratory judgment provision of Section 7477, granting the tax court jurisdiction to review the reasonableness of the IRS rulings, was repealed. The 1984 Act is applicable to transfers occurring after December 31, 1984. A special transitional rule, applicable to transfers of intangible property occurring after June 6, 1984 and before January 1, 1985, states that such transfers were deemed to be pursuant to a plan in which the principal purpose was tax avoidance. Consequently, these transfers were ineligible for nonrecognition treatment under pre-1984 rules.

If an exchange involves a transfer of intangibles pursuant to Section 351 (exchange of property for stock) or Section 361 (exchange involving reorganizations) the transfer is governed by the new Section 367(d). If the exchange involves a transfer of intangibles pursuant Section 332 (complete liquidation of a subsidiary), Section 354 (exchange of stock and securities in reorganization), Section 355 (distribution of stock and securities of a controlled corporation), or Section 356 (receipt of additional consideration), the transfer is governed by the revised Section 367(a).

This article focuses primarily on the treatment of intangibles transferred pursuant to Section 367(d). Suffice it to say that for Section 367(a) transfers, the exchange will be accorded tax free treatment so long as the property is transferred to a foreign corporation for use in the active conduct of a trade or business outside the U.S.

Section 367(d) is designed to curb abuses by U.S. companies which develop patents or other intangibles in the U.S. and transfer them to a foreign subsidiary in a low tax jurisdiction. Profits generated by the exploitation of the transferred intangibles would be ex-

18. Id.
empt from U.S. taxation. Section 367(d) addresses the situation by treating an outbound transfer of an intangible as a sale of property.\textsuperscript{23} The transferor is treated as receiving annually the amounts that reasonably reflect the amounts that would have been received under an arm's length agreement providing for payments contingent on the productivity, use, or disposition of the property.\textsuperscript{24} In the case of a disposition by the transferee immediately following the original transfer, the appropriate amount must be recognized by the original transferor at the time of the subsequent disposition.\textsuperscript{25}

The new rules of Section 367(d) create a number of problems. First, income must be recognized currently, where none would have been reported before. Second, that income is considered to be from a U.S. source and therefore ineligible for foreign tax credit relief. Third, the quantification of the appropriate income amount is extremely subjective. Finally, the foreign taxing authorities are not likely to allow the foreign transferee a deduction for the deemed payment to the U.S. transferor.

1. Intangible Defined

The term intangible property is defined by Section 936(h)(3)(B) to mean 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 which has substantial value independent of the services of any individual.\textsuperscript{26} The intangible must be transferred pursuant to a Section 351 or 361 transaction to be subject to Section 367(d).

A Section 351 exchange occurs when one or more persons transfer property to a corporation in return for stock or securities in the corporation, and immediately following the transfer the person(s) owns at least 80% of the total voting power in addition to at least 80% of the total shares of all non-voting classes of stock in the corporation.\textsuperscript{27} In a qualified Section 351 exchange there is no recognition of gain or loss.

A Section 361 exchange occurs when a corporation exchanges

\textsuperscript{25} I.R.C. § 367(d)(2)(A)(ii)(II).
\textsuperscript{27} I.R.C. § 351(a) (L. Ed. 1983); I.R.C. § 368(c) (L. Ed. Supp. 1986).
property for stock or securities in another corporation in accordance with a plan of reorganization. Again, absent the application of Section 367, the transferor corporation would not recognize gain or loss.\textsuperscript{28}

C. Treatment of Specific Intangible Property

Transfers of specific types of intangible property have been addressed by case law as well as by revenue rulings and procedures.

1. Patents

A U.S. patent is a grant from the federal government that protects a particular invention from use by others for seventeen years. The U.S. company should review the rules applicable to foreign patents in accordance with the specific laws of the country dealt with in a given transaction.

The transfer or exchange of patent rights constitutes a transfer of property (i.e., a sale or exchange as opposed to a license) only when the grant consists of all substantial rights to the patent.\textsuperscript{29} If the transferor retains rights such as the right to import, use, or sell the product that embodies the patent, a transfer of substantial rights has not occurred. Under these circumstances, the transaction is considered a license and Section 367(d) does not apply.\textsuperscript{30}

A patent is effectively transferred when the exclusive right to use the patent for its full life (the shorter of its remaining useful life or the remaining statutory length of the patent) is transferred.\textsuperscript{31} In \textit{E.I. Du Ponts de Nemours & Company v. U.S.}, the court clarified the meaning of transfer of property as defined by Sections 351 and 367 of the Code.\textsuperscript{32} \textit{Du Pont} involved the conveyance of a U.S. parent corporation’s nonexclusive license to its wholly owned French subsidiary. The license was royalty-free, prohibited most sublicensing, and was to run for the remaining life of the patent. The court held that the transfer qualified as a conveyance of property within Section 351. In so holding, the court rejected the argument that Section 351 requires a transaction that qualifies for capital gain purposes. The court’s rationale was that the rights transferred were “perpetual, irrevocable and quite substantial in value.”\textsuperscript{33}

\begin{itemize}
\item \textsuperscript{28} I.R.C. § 361(a) (L. Ed. 1983).
\item \textsuperscript{29} A.E. Hickman et al vs. Commissioner, 29 T.C. 864 (1958).
\item \textsuperscript{30} Rev. Rul. 69-156, 1969-1 C.B. 101.
\item \textsuperscript{31} Rev. Rul. 71-564, 1971-2 C.B. 179.
\item \textsuperscript{32} E.I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973).
\item \textsuperscript{33} \textit{Id.} at 1219 n. 21.
\end{itemize}
Counsel Memoranda released after the *Du Pont* case stated that *Du Pont* was correct and should be followed by the IRS.\(^\text{34}\)

2. **Know-how**

The concept of know-how refers to specific knowledge that gives the holder the ability to produce a particular product. The transfer of know-how is subject to Section 367 if certain criteria are met. Specifically, proof must be offered that the information is (1) secret and guarded against unauthorized disclosure; (2) an original and unique discovery; (3) not the subject of a patent application; (4) not a right to tangible evidence or physical material; and (5) not specifically developed for the transferee.\(^\text{35}\)

Additional factors which have been applied to the evaluation of the property status of know-how include a determination of whether the transferee’s country of operation affords substantial legal protection against unauthorized disclosure and use of the know-how, and whether the transfer includes all substantial rights within the territory of one or more countries.\(^\text{36}\)

3. **Trademarks and Trade Names**

A trademark is a distinctive name, mark or symbol that serves to identify a product, service or company. A trademark can be and often is protected by registration with the U.S. Patent and Trademark Office. A trademark is registered for twenty years and can be renewed indefinitely. Once requested, a trademark is the exclusive property of its owner.

The IRS position with regard to the transfer of trademarks is similar to its position on patents and know-how. In general, to accomplish a transfer of a trademark, the exclusive right to use the mark must be transferred in perpetuity.\(^\text{37}\) For example, the transaction would be treated as a license if the transferor retained a remainder interest in the property, while giving the transferee the use of the trademark for the property.\(^\text{38}\)

In many foreign countries, property rights to a trademark are

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\(^{34}\) Gen. Couns. Mem. 36922 (November 16, 1976) and Gen. Couns. Mem. 37178 (June 24, 1977). (Note: General Counsel Memorandums are rulings issued by the Internal Revenue Service applying tax laws to specific situations, generally constituting official replies to taxpayer inquiries regarding a proposed transaction.)


not based on prior adoption and use of the trademark as they are in the U.S. \(^{39}\) Rather, registration in that country as a trademark constitutes the origin of the property right. \(^{40}\) Consequently, if the newly established subsidiary is the first to register a trademark in a particular foreign country, it has obtained that protectable right without any transfer from a U.S. parent company and Section 367 does not apply.

4. Contract Rights

Contract rights have typically been included within the scope of intangible property. In *Hospital Corporation of America and Subsidiaries vs. Commissioner*, a pre-Section 367(d) case, the Tax Court held that the right to enter into and perform a hospital management contract in Saudi Arabia represented a business opportunity rather than a legally enforceable right in specific property. \(^{41}\) In discovering this business opportunity and making it available to the subsidiary, the U.S. parent was simply performing a service for which it was entitled to reasonable compensation. Consequently, a Section 367 property transfer had not occurred.

In *U.S. vs. Stafford*, the court concluded that a letter of intent encompassed a “sufficient bundle of rights and obligations” to be deemed property. Again, the issue of whether a taxpayer’s full or substantial interest was transferred was determinative in the court’s decision. \(^{42}\)

5. Technology

Technology encompasses the body of knowledge applicable to the development of new products and materials. For example, a discrete set of instructions as employed in computer software has been specifically defined as meeting the criteria for the definition of property. \(^{43}\) Production techniques, proprietary research, the products of research and development efforts may all be considered intangible property within the broad definition of Section 367(d). Consequently, transfers of these intangibles will trigger gain recognition if the fair market value exceeds the taxpayer’s adjusted basis in the intangible.

40. *Id.*
41. *Hospital Corporation of America and Subsidiaries vs. Commissioner*, 81 T.C. 520, at 590 (1983).
42. *U.S. vs. Stafford*, 727 F.2d 1043 (11th Cir. 1984).
III. **Regulations Pertaining to 367(d)**

The Proposed and Temporary Regulations relating to Section 367(d) were filed May 15, 1986 and appeared in the Federal Register on May 16, 1986. The regulations reiterate the Code provision that a U.S. transferor is treated as receiving annual payments, contingent upon productivity or use of transferred property over the useful life of the property, regardless of whether payments are in fact made by the foreign transferee to the U.S. transferor.\(^\text{44}\)

The regulations specify transfers that are subject to Section 367(d) and provide rules concerning the consequences of such transfers. The intangible property referred to in the regulations is consistent with the Code and other regulatory definitions of intangibles.\(^\text{45}\) No distinction is made for property used in marketing or manufacturing activities.\(^\text{46}\) Certain marketing intangibles, however, such as trademarks, trade names and others developed by a foreign branch transferred after December 31, 1984 and before May 16, 1986, are treated as foreign goodwill or going concern value and may be transferred tax free provided the active business exception of Section 367(a) is satisfied.\(^\text{47}\) Foreign goodwill and going concern value are defined as the residual value of a business operation conducted outside the U.S. after all other tangible and intangible assets have been identified and valued.\(^\text{48}\)

Excluded from the definition of intangibles are working interests in oil and gas properties, foreign goodwill or going concern value, copyrights, and literary, musical or artistic compositions.\(^\text{49}\) Letters and memoranda, such as manuscripts, diaries and correspondence held by the taxpayer who personally created the property are excluded from Section 367(d) treatment but are subject to Section 367(a).\(^\text{50}\)

I.R.C. Section 367(d) and the new regulations do not apply to transfers of foreign goodwill or going concern value.\(^\text{51}\) There remains a question as to the treatment of intangible property that can be considered an integral part of goodwill, as well as an operating asset, such as customer lists. If the intangible is within the defini-
tion of an operating intangible, the transfer will be taxable.\textsuperscript{53} An operating intangible is any intangible property not ordinarily licensed or transferred in transactions between unrelated parties for consideration contingent upon the transferee’s use of the property.\textsuperscript{54}

All transfers of intangibles from a U.S. transferor to a foreign transferee pursuant to Section 351 or 361 are subject to the Section 367(d) regulations. These provisions apply regardless of whether the property is to be used in the U.S., connected with goods sold or consumed in the U.S., or connected with a trade or business outside the U.S.

In order to comply with the Code section, a U.S. transferor must include annual payments in gross income amounts equal to what would have been received in an arm’s-length transaction. Such amounts are determined by reference to the useful life of the property, not to exceed a maximum of twenty years. Presumably, the twenty year cap is designed to provide limits to intangible property which has an indeterminate useful life, such as know-how, trade names and trademarks. If intangible property derives its value from secrecy or legal protection, the useful life will terminate when the property is no longer secret or protected.\textsuperscript{55}

The regulations provide no objective standards with respect to the valuation of the property. The includable amount must, however, represent an “appropriate arms-length charge” determined in accordance with Code Section 482.\textsuperscript{56} A Section 482 arms-length charge is that amount that would be paid by an unrelated party for similar property under similar circumstances. The Section 482 regulations applicable to the transfer of intangible property indicate that the arms-length charge is generally the same as that agreed upon by unrelated parties for the use of the same or similar intangibles.\textsuperscript{57} If comparable intangibles are nonexistent, factors such as the license terms, protection available under foreign law, anticipated profits, start-up costs, costs of development and prevailing industry rates are examined in an attempt to determine an appropriate charge. The payments can be reduced by royalties or other periodic payments made or accrued by the transferee to an unrelated party during the year, regarding the right to use the intangible property. The income is characterized as ordinary income.

\textsuperscript{53} Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(ii).
\textsuperscript{54} Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(ii).
\textsuperscript{55} Temp. Treas. Reg. § 1.367(d)-1T(c)(3).
\textsuperscript{56} Temp. Treas. Reg. § 1.367(d)-1T(c).
\textsuperscript{57} 26 C.F.R. § 1.482-2(d)(2)(ii), (iii) (1986).
Both the Code and the regulations provide that the foreign corporation's earnings and profits are reduced by the amount of each deemed payment. Similarly, a foreign subsidiary may treat the payment as an expense under the rules for computing controlled foreign corporations income under Subpart F of the Internal Revenue Code. Such transactions will affect the transferee's U.S. shareholders, whose taxability may be affected by the foreign transferee's earnings and profits. An account receivable can be established by the U.S. transferor to account for payments deemed paid but not actually received. The account must be established each tax year and payments actually received from the transferee are to be deducted from the account. It is unnecessary to accrue or pay interest on the account receivable. At the end of the third tax year of an established account receivable, the unpaid portion is treated as having been paid and contributed to the capital of the foreign transferee.

A. Subsequent Disposition of Intangible Property

If a U.S. person engages in a Section 351 or 361 transfer of intangible property that is subject to Section 367(d), and then disposes of the transferee foreign corporation's stock within the useful life of the intangible property, the U.S. transferor is deemed to have sold the intangible property to the person acquiring the stock. The U.S. transferor will recognize U.S.-source gain, as opposed to foreign-source gain, in an amount equal to the difference between the fair market value of the intangible property on the date of the stock sale and the U.S. transferor's former adjusted basis.

A somewhat different result occurs upon the subsequent disposition of the transferee foreign corporation's stock when the subsequent transferee is a U.S. person that is a related party to the transferor. Each related U.S. transferee is to include annually in gross income over the useful life of the intangible property a proportionate share of ordinary U.S.-source income. The application of

58. Id.
60. Temp. Treas. Reg. § 1.367(d)-1T(d).
65. Temp. Treas. Reg. § 1.367(d)-1T(e)(i) to (iii).
percentage ownership in determining whether persons are related is 10%.66

B. Marketing Versus Manufacturing Intangibles

Businesses such as banks, insurance companies, financial institutions and construction and engineering firms will feel the impact of new Section 367(d) as well as manufacturing companies. Assets of these businesses often include intangibles such as the ability to provide a service, value of advertising, trademarks, trade names, and marketing data, all of which are subject to 367(d). Sale or licensing of these assets may be economically impractical due to the inability to ascertain a market price equivalent to the value received.

The legislative reports pertaining to Section 367(d) had indicated that marketing intangibles may be spared from the scope of the new provisions. The Senate Report implied that gain recognized on transfers of goodwill, going concern value, trademarks and trade names would be excluded from taxation.67 The regulations, however, provide only temporary relief for transfers of marketing intangibles by creating a window for transfers occurring after December 31, 1984 and before May 16, 1986. Such transfers are subject only to the requirement that the transferred property will be used in the active conduct of a trade or business outside the U.S.68

Although a manufacturing company’s assets may consist of machinery and equipment, the transfer of which generally qualifies for tax free treatment under Section 367(a), manufacturing companies do not necessarily escape the new 367(d) rules unscathed. A manufacturing operation typically includes intangible property such as design patents, use or formula patents, software, know-how and trade secrets all of which are subject to Section 367(d). Additionally, equipment qualifying under 367(a) may run afoul of Section 367(d). For instance, equipment that contains an element of intangible property, such as the software that controls a machine’s operation or robotic function is subject, at least in part, to Section 367(d).

IV. 1986 TAX REFORM ACT CHANGES TO SECTION 367(D)

A deceptively simple provision of the 1986 Tax Reform Act makes major changes to the application of Section 367(d). The

amendment provides that amounts includable in gross income under Section 367(d) shall be commensurate with the income attributable to the intangible. A brief look at the legislative history of this provision explains its intended impact. The effect of this provision is to require the U.S. taxpayer to adjust the deemed royalty amount to reflect an arms-length charge. This concept of annual adjustment has been given the term “super royalty.” The super royalty payments will, in the case of an appreciating intangible, increase from year to year, as opposed to previous practice whereby royalty payments were fixed at the time the contract was negotiated.

The super royalty concept is a product of various proposed adjustments to certain rules relating to operations in U.S. possessions and related tax abuses perceived by Congress. As the legislative process proceeded, the House of Representatives expressed concern that U.S. transferors of intangibles were not adequately reporting income attributable to intangibles.

The 1986 Tax Reform Act change may best be illustrated by way of example. Assume that a U.S. company has developed a method for manufacturing magnetic tape. In connection with the establishment of a Singapore subsidiary, the U.S. company allows its subsidiary to use its patented method. At the time of the establishment of the subsidiary the value of this patent was independently measured at one million dollars. In the following year, however, increased use of this particular kind of tape renders the value of that intangible much higher. Prior to the 1986 Act change, the U.S. company would be required to include a pro rata portion of the one million dollar amount over the useful life of the patent. The 1986 Act revision, however, mandates that the company re-value the use of the intangible each year and, under these circumstances, include a higher amount for the subsequent years.

V. ALTERNATIVES TO TRANSFERRING INTANGIBLES TO FOREIGN CORPORATIONS

Due to the problems associated with Section 367(d) now encountered by corporations wanting to transfer intangible property, the structure of business transactions warrants much greater attention and scrutiny. Licensing, outright sales and cost-sharing arrangements are alternatives which can avoid the impact of Section 367(d).

A. Licensing Arrangements

A U.S. company may avoid the application of Section 367(d) by licensing the use of intangibles. In return for such use, the foreign company pays a royalty which qualifies as foreign-source income to the U.S. licensor. The U.S. company receives foreign-source income and the foreign company will generally be entitled to a deductible expense.

A licensing arrangement may be partially useful in saving U.S. taxes if the U.S. company has excess or carryover foreign tax credits and minimal foreign tax is paid on the licensing income. However, pursuant to the regulations, a license for the use of intangibles to a foreign corporation in which the U.S. company holds or is acquiring an interest, may, under certain circumstances, be recharacterized as a transfer subject to Section 367(d). In drafting a licensing agreement, it is important to ensure the contract is treated as a license and not a transfer. Characterization as a transfer could subject the exchange to Section 367(c) and 367(d) even though no stock was issued. The regulations introduce an economic substance test, whereby the terms and practical application of a licensing agreement are evaluated to determine if the transaction is simply a sham. Economic substance is determined by reference to the nominal terms of the parties' agreement and the actual practice of the parties under that agreement.

As previously mentioned, the 1986 Tax Reform Act has amended Section 482 to provide that the annual royalty income shall be "commensurate with the income attributable to the intangible." As a result of this recent change, a long-term license agreement which was negotiated even under an arms-length standard will not be recognized where the value of the license increases. In other words, the U.S. licensor will be required to include in income an amount which is greater than that required by the license arrangement where the value of the intangible has increased. This new provision is a bold step insofar as it ignores (for tax purposes) a legally enforceable agreement which was negotiated at arms length between related parties.

B. Sale of Intangibles

As Section 367(d) applies only to Section 351 and 361 exchange.

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changes, an outright sale of intangibles to a foreign company will circumvent the impact of Section 367(d). A valuation of the intangible will be necessary in accordance with Section 482’s arms-length requirement. Although the transferor will bear an immediate tax burden, a sale may be beneficial in certain situations, for example where the transferor has expiring tax benefit carryovers.

The 1986 Tax Reform Act changes to Section 482 also apply to sales of intangibles between related parties. Consequently, it would appear that if the U.S. transferor sells an intangible to a related party for an arms-length price, and subsequent to that transaction, the intangible increases in value, additional income would be required to be reported by the U.S. transferor. As a result, the benefit of selling untested or unproven intangibles at a low price is greatly diminished as a tax planning opportunity.

Another planning device available to those wishing to avoid the consequences of Section 367(d) with respect to certain intangibles, is for the U.S. company to elect to treat the capital contribution of an intangible as a sale. The deemed royalty provisions of Section 367(d) will not apply if the U.S. transferor elects to recognize gain as U.S.-source ordinary income in the year of transfer. This election applies only where the intangible is an operating intangible such as long-term purchase or supply contracts, surveys, customer lists, or studies.74 Transferring any other intangible as part of the foreign corporation’s original capitalization (within the first three months of organization)75 will qualify for this special election if immediately after the transfer the U.S. company owns at least 40% but not more than 60% of the stock, at least 40% of the stock is owned by unrelated foreign persons, the intangible is at least 50% of the fair market value of the property transferred by the U.S. person and the intangible will be used in the active conduct of a trade or business outside the U.S.76 If this special election applies, the recognition of ordinary income upon the sale will occur in the year of transfer in an amount equal to the difference between the fair market value and the U.S. transferor’s adjusted basis.77

C. Cost-Sharing

The advent of Section 367(d) will cause many companies to consider the use of cost-sharing. Cost-sharing for the development

77. Id.
of an intangible involves both the would-be transferor and trans-
ferree sharing the costs in developing the intangible. When cost-
sharing is used, both parties share ownership of the intangible and
there is no need for a transfer or a license. A bona fide cost-sharing
arrangement must, however, reflect a good faith effort by all the
parties to bear their proportionate share of all development on an
arms-length basis. 78

Cost-sharing is only available with respect to intangibles in the
development stage. Consequently, the foreign company bears the
risk in contracting for an unknown, which in this case is the tenta-
tive ultimate success of the finished product. Also, to the extent
that research and development is shared by a related foreign entity,
the U.S. company will receive fewer tax benefits, i.e., deductions
and credits, associated with the research and development. Costs
that will be shared in a typical cost-sharing agreement include the
direct and indirect costs incurred by the participants, amounts allo-
cable for assistance of related group members, and amounts equal to
the value of existing intangible property made available to the group
by participating members.

Although the full effects of the 1986 Tax Reform Act changes
on cost-sharing arrangements have yet to be determined, the com-
ments in the conference agreement indicate an intent to apply the
super royalty provisions even in the case of a bona fide cost-sharing
arrangement. The statutory language of the 1986 Tax Reform Act
contains no such provisions however.

VI. REPORTING TRANSFERS TO FOREIGN CORPORATIONS

A transfer subject to Section 367(d) must be reported on Form
926, Return by Transferor of Property to a Foreign Corporation,
Foreign Estate or Trust, or Foreign Partnership. 79 Form 926 is to
be filed with the transferor’s income tax return for the tax year that
includes the date of the transfer. 80 If a transfer occurred before
June 16, 1986, Form 926 must be filed by September 16, 1986, if
that date is later than the filing date that would be imposed under
the general rule. 81

The date of the transfer is the first date on which title to or

provides that an R & D cost-sharing arrangement would be recognized as appropriate if the
proportionate shares are determined based upon relative profits of the various entities.
81. Id.
possession of property passes, not the date on which a Board of Director's decision is made. 82

Information to be included in reporting the transfer includes the identity of the U.S. transferor and foreign transferee, a description of the transfer, consideration received by the U.S. transferor, and a description of the property transferred. Failure to file Form 926 tolls the applicable statute of limitations, and subjects the transferor to a twenty-five percent penalty on the amount of gain realized on the exchange of the property. 83

VII. CONCLUSION

In response to the imposition of Section 367(d), U.S. corporations must alter the way they have traditionally conducted business abroad. Although Section 367(d) only affects businesses that profit from transfers of intangibles, that circle of companies is expanding rapidly. A U.S. company contemplating a transfer of an intangible to a foreign subsidiary must carefully plan for the related U.S. and foreign tax consequences. In particular, a valuation of the intangible and the appropriate royalty that would be charged for its use must be determined prior to the transfer. Subsequent valuations will also be required to determine the applicability of the super royalty provisions of the 1986 Tax Reform Act. Such valuations will undoubtedly become a source of controversy among the IRS, the foreign jurisdiction, and the U.S. taxpayer. Once the very subjective preliminary valuation is determined, the company must then consider whether the intangible should be contributed to the capital of the subsidiary, licensed, or sold to the subsidiary. In addition, the company must plan for future technology and the extent to which foreign subsidiaries should share in the costs of developing that technology. Only through careful planning, accurate valuations, and the use of cost-sharing for future intangibles can a U.S. company mitigate the detrimental impact of Section 367(d).