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Proposed Regulations Under §367 Depart from Longstanding Policies

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INTRODUCTION

Section 367(a) and §367(d)[1] address the outbound transfer of property by United States persons to foreign corporate transferees in nonrecognition transactions. As the authors have written previously, this area historically has been governed by dual policies: (1) in general, transfers of property to controlled corporations and corporate reorganizations are mere changes in the form of ownership and therefore any gain realized should not be subject to current recognition and tax; and (2) general nonrecognition treatment should give way to current tax in cases where the transfer is motivated by a tax avoidance purpose.[2] For the 80-year history of §367 and its antecedents, a transfer of property to be used in the active conduct of a trade or business outside the United States was considered not to have a tax avoidance purpose, with exceptions for transfers that result in a mismatch of expenses and associated income.[3] In particular, §367(d) was enacted to counteract such timing mismatches by taxing the transferor of §936(h)(3)(B) intangible property on amounts commensurate with the income from such property as if the property had been sold for contingent consideration.[4] Congress believed that certain types of intangible property presented unique concerns in this context.[5] In light of this history, the authors suggested a framework for interpretation and regulation in this area that resolved marginal issues of whether transfers of certain categories of property used in a foreign trade or business — such as operating intangibles, goodwill, going concern value, and workforce in place — should be subject to current taxation under §367(d) based on the extent to which such property gave rise to the unique concerns cited by Congress in enacting §367(d).[6]

On September 14, 2015, the Department of the Treasury and the Internal Revenue Service issued pro-

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[1] All section ("§") references are to the U.S. Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] *See* Layla J. Aksakal and Rocco V. Femia, *Section 367(d), Intangibles, and Base Erosion: A Reassessment*, 54 Tax Mgmt. Memo. 191 (May 20, 2013) (hereinafter "*Reassessment*").

[3] *See Reassessment*, at 197. The rules requiring recapture of branch losses and depreciation on property used in the United States reflect this matching policy. *See* §367(a)(3)(C); Reg. §1.367(a)-4T(b).

[4] The "commensurate with income" standard was added to §367(d) in 1986.

[5] *See Reassessment*, at 199–200; H.R. Rep. No. 98-432, Vol. II, at 1316 (Mar. 5, 1984); and "Intangible Property — §367(d)," below.

[6] *See Reassessment*, at 200–205.

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posed regulations that chart a new course by significantly narrowing the longstanding exception to recognition treatment for property used in a foreign active trade or business, and eliminating the longstanding exception to recognition treatment for foreign goodwill and going concern value. The proposed regulations thereby champion an ahistorical and overbroad variant of the anti-tax avoidance policy of §367 to the exclusion of the general policy of nonrecognition. The Preamble justifies this dramatic shift in policy on the grounds of administrative concerns. While these administrative concerns are real, they do not justify the broad substantive sweep of the regulations.

The next part of this article provides a brief overview of current law to provide context for the remaining discussion. The third part provides a summary of the proposed regulations. The fourth part discusses and analyzes the regulations in light of the stated and unstated administrative and policy justifications. The final part outlines a potential path forward in light of the historical policies of §367(a) and §367(d) and the current administrative difficulties faced by the government.

OVERVIEW OF CURRENT LAW

Section 367(a) provides rules for the taxation of outbound transfers of property by U.S. persons to foreign corporate transferees in transactions that would otherwise qualify for nonrecognition treatment. In general, §367(a)(1) suspends the nonrecognition of gain on a transfer to a foreign corporation in an exchange subject to §332, §351, §356, or §361, subject to exceptions.[7] Section 367(a)(2) provides an exception for transfers of stock or securities of a foreign corporation that is a party to the exchange or reorganization. Section 367(a)(3) provides an ''active trade or business exception'' for transfers of property used in the active conduct of a trade or business outside the United States. In the case of an outbound asset reorganization under §361, neither of these exceptions is available unless the requirements of §367(a)(5) and the regulations thereunder are satisfied.[8] Intangible property as defined in §936(h)(3)(B) does not qualify for the active trade or business exception and is subject to special rules under §367(d).

The Active Trade or Business Exception

The active trade or business exception has historically played an important role in maintaining the balance between dual policies of, on the one hand, permitting tax-free incorporations and reorganizations, and, on the other hand, preventing tax avoidance associated with cross-border transfers of appreciated property.[9] Under §367(a)(3), the active trade or business exception is available, ''[e]xcept as provided in regulations,'' if an asset is transferred to a foreign corporation for use by that corporation in the active conduct of a trade or business outside of the United States. If the active trade or business exception is satisfied, then §367(a)(1) does not apply, and the transfer may qualify for tax-free treatment under the normal nonrecognition rules.

The active trade or business exception itself is subject to several statutory exceptions. Specifically, §367(a)(3)(B) provides that, ''[e]xcept as provided in regulations,'' the active trade or business exception does not apply to certain enumerated types of property. These so-called ''tainted assets'' include inventory, installment obligations, accounts receivable, foreign currency, intangible property (within the meaning of §936(h)(3)(B)), and certain leased property.[10] In addition, under the branch loss recapture rule of §367(a)(3)(C), the active trade or business exception does not prevent recognition of gain realized on the transfer of the assets of a foreign branch to the extent branch losses were previously deducted (less any amounts recaptured under the overall foreign loss rules of §904).[11]

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[7] Specifically, §367(a)(1) suspends the nonrecognition of gain on any transfer of property by a U.S. person to a foreign corporation in an exchange described in §332, §351, §356, or §361. Section 367(a)(1) mandates that in such outbound exchanges, the foreign transferee corporation will not be considered to be a corporation ''for purposes of determining the extent to which gain shall be recognized on such transfer.'' Because the nonrecognition provisions of §332, §351, §356, and §361 are limited to exchanges between corporations, the effect of §367(a)(1) is to require gain recognition.

[8] Section 367(a)(5) and the regulations thereunder require recognition for net asset gain attributable to minority shareholders, and also require gain to be recognized by the ''control group'' members to the extent gain attributable to the control group cannot be preserved by adjusting the stock basis of the members of the control group. Reg. §1.367(a)-7(c)(2)(ii). *See* T.D. 9614, 78 Fed. Reg. 17,024, 17,024 (Mar. 19, 2013) (''The policy underlying section 367(a)(5) is the protection of corporate-level gain on appreciated property following the repeal of the *General Utilities* doctrine.'').

[9] *See Reassessment*, at 197–200.

[10] *See also* Reg. §1.367(a)-5T. In these 1986 temporary regulations, Treasury and the IRS generally adopted the list of tainted assets contained in §367(a)(3)(B), with an exception for certain foreign-currency-denominated property. Under this exception, property denominated in a foreign currency could qualify for the active trade or business exception if it was: (1) denominated in the currency of the country of organization of the transferee foreign corporation; and (2) acquired in the ordinary course of business. Reg. §1.367(a)-5T(d)(2).

[11] The branch loss recapture rule prevents a timing mismatch,

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Longstanding regulations under §367 provide additional ‘‘special rules’’ for applying the active trade or business exception.[12] For example, these rules include a recapture rule requiring the recognition of gain (as ordinary income) on depreciated property used in the United States to the extent necessary to recapture noneconomic depreciation.[13]

Intangible Property — §367(d)

Intangible property generally is not eligible for the active trade or business exception and is instead subject to taxation under §367(d).[14] Section 367(d) imposes U.S. tax on certain outbound transfers of intangible property by treating the U.S. transferor as if it sold the intangible property in exchange for annual payments contingent upon the productivity, use, or disposition of the property, with the amount of this deemed royalty commensurate with the income attributable to the intangible. Section 367(d) defines intangible property by reference to the enumerated list of property in §936(h)(3)(B).[15] Under regulations, the useful life of intangible property is considered to be the entire period during which the property has value, but in no event to exceed 20 years.[16]

Congress enacted §367(d) in order to serve as a backstop to clear reflection of income principles and more specifically to remedy a mismatch between the deduction of intangible development costs against income earned by a U.S. taxpayer and the income resulting from the successful exploitation of the developed intangible property by a foreign subsidiary.[17] The legislative history of §367(d) indicates that Congress was concerned about ‘‘specific and unique’’ problems associated with intangibles.[18] These problems arose because significant deductible intangible development expenses may be incurred before the developed intangible property begins producing income, and because the ownership of certain intangible property is easily separated from the underlying business to which it relates. As the legislative history observed, ‘‘a number of U.S. companies have adopted a practice of developing patents or similar intangibles at their facilities in the United States. When these intangibles appear ready for profitable exploitation, they are transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offers a tax holiday for specific local manufacturing operations).’’[19]

Foreign Goodwill and Going Concern Value

Under current law, an outbound transfer of foreign goodwill and going concern value can qualify for nonrecognition treatment under the active trade or business exception.[20] The legal rationale for this treatment has been the subject of debate over whether foreign goodwill and going concern value constitute ‘‘intangible property’’ within the meaning of §936(h)(3)(B).[21] Regardless of whether foreign goodwill and going concern value constitute intangible property for purposes of the statutory definition, however, longstanding regulations provide that §367(d) does not apply to foreign goodwill or going concern value.[22] These regulations define foreign goodwill and going concern value as the residual value of a foreign business operation after all other tangible and intangible assets have been valued.[23]

The current regulatory treatment of foreign goodwill and going concern value is premised on Congress’s view, when amending §367 in 1984, that it is

in which foreign branch losses ‘‘have reduced the amount of the U.S. taxpayer’s worldwide income subject to U.S. income tax,’’ but ‘‘the incorporation of the foreign branch operations’’ allows the U.S. taxpayer to stop ‘‘currently tak[ing] into account the income to be produced by these operations.’’ S. Rep. No. 98-169, at 362 (Apr. 2, 1984).

[12] Reg. §1.367(a)-4T.

[13] Reg. §1.367(a)-4T(b); *see* J. Comm. Tax’n, ‘‘General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984’’ (JCS-41-84), at 434–35 (Dec. 31, 1984).

[14] §367(a)(3)(B)(iv).

[15] Section 936(h)(3)(B) sets forth a list of items that are considered ‘‘intangible property,’’ as well as any ‘‘similar item.’’ Specifically, intangible property means any: (i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual. A unifying element of each item is that it may be transferred outside of the context of the transfer of a trade or business.

[16] Reg. §1.367(d)-1T(c)(3).

[17] *See Reassessment*, at 199–200.

[18] H.R. Rep. No. 98-432, Vol. II, at 1316 (Mar. 5, 1984).

[19] *Id.* Congress was concerned that U.S. corporations were engaging in outbound transfers of intangible property in order ‘‘to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with 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.’’ *Id.* Moreover, by transferring the intangible to subsidiaries located in low-tax foreign jurisdictions, the U.S. corporation could avoid paying foreign tax on intangible profits as well. *See id.*

[20] *See* Reg. §1.367(d)-1T(b).

[21] *See Reassessment*, at 192 n. 16 (summarizing practitioner disagreement on status of foreign goodwill as intangible property).

[22] Reg. §1.367(d)-1T(b).

[23] Reg. §1.367(a)-1T(d)(5)(iii). For purposes of §367, the value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value.

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appropriate to permit the tax-free incorporation or reorganization of foreign business assets and that foreign goodwill and going concern value are like other foreign business assets in this respect. Congress did not view foreign goodwill and going concern value as giving rise to the mismatch of expenses and income that arose when intangible property is transferred outside of the United States.[24]

PROPOSED REGULATIONS UNDER §367(a) AND §367(d)

The proposed regulations would eliminate the nonrecognition treatment under §367 of the outbound transfer of active trade or business assets other than certain fixed and financial assets. As a result, any built-in gain attributable to foreign goodwill and going concern value would be subject to tax. Under these proposed regulations, a U.S. transferor of foreign goodwill or going concern value would be subject to either deemed royalty treatment under §367(d) or current gain recognition under §367(a).

The proposed regulations include changes to §367(a) as well as §367(d). With respect to §367(d), the proposed regulations would remove the clause in Reg. §1.367(d)-1T(b) that excludes foreign goodwill and going concern value from the application of §367(d). Accordingly, to the extent foreign goodwill and going concern value is §936(h)(3)(B) intangible property, its outbound transfer would result in deemed royalty payments to the U.S. transferor under §367(d). In addition, the proposed regulations would remove the 20-year limit on the useful life of intangible property contained in the current regulations.[25] The proposed regulations do not otherwise provide much-needed updates to the regulations under §367(d), which are outdated in important respects.[26]

More significantly, the proposed regulations would also substantially limit the scope of the active trade or business exception under §367(a). As described above, under current law, all property is eligible for the active trade or business exception unless the property is excluded by §367(a)(3)(B) and the regulations thereunder. Turning the current law approach on its head, the proposed regulations instead provide an exclusive list of property eligible for the active trade or business exception.[27] Eligible property includes tangible property, working interests in oil and gas property, and certain financial interests, with certain specific exclusions consistent with the current regulations (e.g., inventory).[28] Foreign goodwill and going concern value is not included in the list of eligible property, and therefore cannot qualify for the active trade or business exception. To the extent that foreign goodwill and going concern value is not §936(h)(3)(B) intangible property, its outbound transfer would therefore result in gain recognition to the U.S. transferor under §367(a).

The proposed regulations expressly allow the U.S. transferor of foreign goodwill and going concern value to elect between gain recognition under §367(a) or deemed royalty treatment under §367(d). Specifically, a U.S. transferor may apply §367(d) to a transfer of foreign goodwill and going concern value that would otherwise be subject to §367(a).[29]

Accordingly, under the newly proposed regulatory scheme, the taxation of outbound transfers does not depend on the characterization of foreign goodwill and going concern value as ''intangible property.'' The Preamble to the proposed regulations states that Treasury and the IRS are aware that many taxpayers and commentators have taken the position that foreign

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[24] This history is discussed at length in *Reassessment* at 199–200. *See also* H.R. Rep. No. 98-432, at II-1317 (Mar. 5, 1984) (''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.''); S. Rep. No. 98-169, at 361 (Apr. 2, 1984) (''The committee does not anticipate that the transfer of goodwill or going concern value (or certain similar intangibles) developed by a foreign branch to a foreign corporation will result in abuse of the U.S. tax system (regardless of whether the foreign corporation is newly organized.)''); J. Comm. Tax'n, ''General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984'' (JCS-41-84) (''1984 Blue Book''), at 428 (Dec. 31, 1984) (''Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes.'').

[25] *See* Prop. Reg. §1.367(d)-1(c)(3).

[26] For example, the proposed regulations do not implement Notice 2012-39. *See Reassessment*, at 195. Other aspects of the §367(d) regulations that may be in need of clarification include the operation of the deemed sale election for operating intangibles, the treatment of §367(d) inclusions as royalties for purposes of determining source, and the question of basis recovery on intangibles that are subject to §367(d).

[27] Prop. Reg. §1.367(a)-2(a)(2).

[28] Prop. Reg. §1.367(a)-2(b). Specifically, eligible property does not include the types of ''tainted'' property listed in §367(a)(2)(B)(i), §367(a)(2)(B)(ii), §367(a)(2)(B)(iii), and §367(a)(2)(B)(v). Prop. Reg. §1.367(a)-2(c). The regulations also eliminate the exception in the 1986 temporary regulations for foreign-currency-denominated property acquired in the ordinary course of business.

[29] Prop. Reg. §1.367(a)-1(b)(5). The election is only available for property that is not ''eligible property'' for purposes of the active trade or business exception, determined without regard to the four categories of tainted assets excluded under Prop. Reg. §1.367(a)-2(c).

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goodwill and going concern value is not §936(h)(3)(B) intangible property, and therefore that it may be transferred tax-free to the extent the conditions of the active trade or business exception are met.[30] By taking action under §367(a) as well as §367(d) and by providing taxpayers with an election to apply either section, however, Treasury and the IRS effectively sidestepped the debate over whether foreign goodwill and going concern value is §936(h)(3)(B) intangible property.[31]

When finalized, these regulations would be effective with respect to transfers occurring on or after September 16, 2015, or transfers occurring before that date resulting from check-the-box elections filed on or after September 16, 2015. Government officials have explained the immediate effective date on the basis that the regulations are intended to put an end to abusive transactions.[32]

ANALYSIS OF POLICIES UNDERLYING THE PROPOSED REGULATIONS

Stated Policy Rationale for the Proposed Regulations

In the Preamble to the proposed regulations, Treasury and the IRS express concern that ''certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367.'' The Preamble cites two primary concerns: first, a concern about transfer pricing and valuation methodologies employed by taxpayers, and second, a concern about the definition of foreign goodwill and going concern value.

With respect to transfer pricing and valuation, the Preamble states that taxpayers have valued intangible property ''in a manner contrary to section 482'' by: (1) using valuation methods on an item-by-item basis when an aggregate basis would achieve a more reliable result; or (2) not properly performing a full factual and functional analysis of the business. Given its ongoing ''challenges in administering the transfer pricing rules,'' Treasury and the IRS concluded that any attempt to retain the nonrecognition treatment for foreign goodwill and going concern value that is provided by current law ''would be impractical to administer.''

The Preamble also states that taxpayers have taken overly broad positions regarding the definition of foreign goodwill and going concern value. In particular, it cites positions that ''broadly interpret the meaning of foreign goodwill and going concern value'' to include value ''associated with a business operated primarily by employees in the United States'' or ''value created through customer-facing activities occurring within the United States.''

The Preamble further states that Treasury and the IRS considered, but ultimately rejected, a narrower rule that would retain the current law nonrecognition treatment for foreign goodwill and going concern value ''while protecting the U.S. tax base through regulations expressly prescribing parameters for the portion of the value of a business that qualifies for the favorable treatment.'' For example, the Preamble states that such a rule could require that ''value must have been created by activities conducted outside of the United States through an actual foreign branch that had been in operation for a minimum number of years and be attributable to unrelated foreign customers.'' Treasury and the IRS believe that a narrowly tailored exception for foreign goodwill and going concern value would be ''impractical to administer,'' because ''taxpayers will continue to have strong incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value, however defined, and thereby erode the U.S. tax base.''

These concerns may best be described as administrative concerns. Treasury and the IRS acknowledge that Congress in 1984 intended for transfers of foreign goodwill and going concern to qualify for nonrecognition treatment, but they assert that Congress did not anticipate the practical difficulties that the IRS would face in: (1) distinguishing foreign goodwill and going concern value from §936(h)(3)(B) intangibles; or (2) distinguishing foreign goodwill and going concern value from goodwill and going concern value that is attributable to a U.S. business. In light of the difficulty that the IRS has experienced in administering this aspect of the statute, Treasury and the IRS have proposed to require taxpayers to recognize gain on all property other than tangible property and certain financial interests.

Given the administrative concerns that underlie the policy rationale for the proposed regulations, the pro-

[30] NPRM, 80 Fed. Reg. 55,568, 55,570 (Sept. 16, 2015).

[31] The Administration has proposed statutory changes to resolve this debate in favor of treating goodwill and going concern value as §936(h)(3)(B) intangible property. *See, e.g.,* U.S. Department of the Treasury, ''General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals'' (Feb. 2015) (the ''2016 Greenbook''), at 24.

[32] The immediate effective date would not apply to the removal of the exception for foreign-currency-denominated property acquired in the ordinary course of business. Presumably, policymakers do not view reliance on that exception in the current regulations as abusive.

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posed regulation is overbroad. Taking the Preamble at its word, the government has decided to throw the proverbial baby out with the bathwater.[33] The statutory scheme and legislative history of §367 clearly contemplate a robust active trade or business exception, and the elimination of foreign goodwill and going concern from that exception is a substantial departure from established policy. The Preamble's response to the 1984 legislative history is that Congress did not anticipate the taxpayer ''abuse'' that resulted from the treatment of foreign goodwill and going concern value, but what Treasury and the IRS deem to be an ''abuse'' hinges on a dispute over valuation of §936(h)(3)(B) intangibles and the allocation of goodwill and going concern value between foreign and U.S. businesses.

The proposed regulations resolve what should be a line-drawing exercise in valuation and allocation in an arbitrary manner, i.e., either: (1) all residual value is deemed attributable to §936(h)(3)(B) intangibles and taxed under §367(d); or (2) all goodwill and going concern value is deemed attributable to the U.S. business and therefore taxed under §367(a). The first alternative is arguably not supported by the statutory text, given that goodwill and going concern value are not listed in §936(h)(3)(B) and cannot be transferred separate from the transfer of a business. And the second alternative is not supported by any evidence: in any incorporation of a customer-facing business operating in a foreign country, there is goodwill and going concern value attributable to the foreign business.[34]

Government officials have pointed to the controversy surrounding the amortization of identifiable intangibles similar to goodwill or going concern value, which culminated in the enactment of §197, as a useful precedent for the proposed regulations. This reflects a misunderstanding of the policies at issue in that context. Goodwill and going concern value historically were not depreciable because they were believed to have no determinable useful life.[35] Taxpayers were able to successfully demonstrate as a factual matter that elements of goodwill or going concern value, such as an at-will subscriber base, do have a determinable life.[36] Congress stepped in to codify and extend taxpayer victories. It is useful to reflect on what lessons should be drawn from this experience. Section 197 draws legitimacy first and foremost because it is an act of Congress that balanced the competing positions of all stakeholders. Even if it had authority to do so, it is unlikely that the IRS that had litigated *Ithaca Industries* and *Newark Morning Ledger* would have developed such a balanced solution to the issue through administrative guidance. Section 197 also draws legitimacy from the fact that, in substance, the rules seem fair and broadly consistent with clear reflection principles. Congress could have resolved the administrative concerns of policing the line between goodwill and similar assets that were amortizable by permitting immediate cost recovery, or by permitting cost recovery over 50 years. It chose a middle path.[37]

As it considers finalizing these proposed regulations, Treasury and the IRS should give serious

[33] To extend this unpleasant analogy, the Preamble makes no effort to delineate the baby from the bathwater before throwing both out. The policy basis for subjecting several classes of §936(h)(3)(B) intangibles, such as know-how specific to a foreign facility or marketing intangibles specific to a local market, to §367(d) is not altogether clear. *See Reassessment*, at 200–202. It is possible to resolve the administrative difficulties of disentangling the value of foreign manufacturing facilities and related know-how, or the value of foreign retail sites and related customer-based intangibles, in favor of exempting both sets of property (and associated goodwill and going concern value) under an reinvigorated active trade or business exception that is true to the intent of Congress. In this regard, Congress provided Treasury with specific regulatory authority to designate additional exclusions from gain recognition under §367(a). *See* §367(a)(6). Furthermore, the 1984 legislative history to §367 indicates that Congress intended for the exclusion for foreign goodwill and going concern value to apply to certain marketing intangibles as well. *See* 1984 Blue Book, at 435 (''The Act contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill, going concern value, or marketing intangibles (such as trademarks or trade names) developed by a foreign branch to a foreign corporation'').

[34] The Preamble appears to acknowledge that, in at least some cases, foreign goodwill and going concern value does in fact exist, in its reference to its unsuccessful efforts to craft a rule requiring that ''the value must have been created outside of the United States through an actual foreign branch that had been in operation for a minimum number of years and be attributable to unrelated foreign customers.''

[35] *See* Reg. §1.167(a)-3(a) (''An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.'').

[36] *See Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993) (permitting depreciation of purchase price allocated to ''paid subscribers'' where taxpayer demonstrated that asset could be valued and had a limited useful life). In contrast, in *Ithaca Industries, Inc. v. Commissioner*, 17 F.3d 684 (4th Cir. 1994), the taxpayer was not permitted to depreciate a workforce acquired in the purchase of a business because the court found that there was no ''sufficiently accurate means of estimating its useful life.'')

[37] The adoption of a single amortization period of 15 years for all amortizable §197 intangibles resulted in an amortization period longer than the economic life of some intangibles and shorter than the economic life of others. The single 15-year amortization period was chosen to eliminate controversies between the IRS and taxpayers and to simplify the amortization of intangibles. For a comprehensive discussion of the history of §197, see Michael J. Douglass, *Tangible Results for Intangible Assets: An Analysis of New Code Section 197*, 47 Tax Law. 713 (1994).

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thought to whether its concerns about ''sound tax administration'' can bear the weight of such a dramatic change in tax policy relating to §367, particularly absent an act of Congress.[38] It is noteworthy that other areas of the tax law require taxpayers and the government to divide the purchase price or value of a business among various classes of assets, including tangible assets, identifiable intangibles, and goodwill and going concern value.[39] Like the current temporary §367 regulations, these rules assign to goodwill and going concern the residual value of a business once the value of all identifiable assets has been determined, and were developed in part to simplify the allocation of value among assets.[40] Even the division of goodwill between foreign goodwill and U.S. goodwill can be relevant in other contexts, for example, in determining the extent to which a disposition of a business constitutes a disposition of ''property used or held for use predominantly without the United States'' for purposes of the overall foreign loss rules of §904(f)(3).[41] Indeed, because §367(a)(1) requires the recognition of gains, but not losses, on an asset-by-asset basis, taxpayers and the IRS must still divide the aggregate value of transferred property among different types of property.

Use of §367 to Support Unstated Policies

The extent of the policy shift reflected by the proposed regulations suggests that Treasury and the IRS may be motivated by concerns beyond the administrative concerns expressed in the Preamble. The Preamble refers to taxpayers' efforts to ''erode the U.S. tax base'' and to positions taken by taxpayers that are ''inconsistent with the policies of section 367.'' As we have seen, however, the historic ''policies of section 367'' are two-fold: Congress intended for §367(a) to permit taxpayers to engage in nonrecognition transactions in the cross-border context in situations where they were merely incorporating or reorganizing an active business outside the United States, but Congress also intended to limit nonrecognition treatment where such treatment resulted in a mismatch of expenses and related income. It is not clear how the rule in proposed regulations furthers either of these policies.

Rather, these non-specific references to base erosion and the ''policies of section 367'' suggest that Treasury and the IRS may have a more general discomfort with the current U.S. international tax system. Under the current system, U.S. tax on the income of a U.S. controlled foreign corporation (CFC) in general is deferred until its income is repatriated to its U.S. shareholders. U.S. shareholders, however, are subject to current tax on certain classes of mobile or passive income earned by CFCs under the anti-deferral rules of Subpart F. In the typical §367(a) outbound transfer that satisfies the active trade or business exception, the foreign transferee corporation is a CFC, i.e., a deferral vehicle. Often the deferral vehicle is located in a low-tax jurisdiction and is structured with an eye toward avoiding the anti-deferral rules. Policymakers have expressed concern about the efficacy of the anti-deferral rules in these situations. These concerns can be seen, for example, in the Administration's ''minimum tax'' proposal.[42] It is noteworthy that the proposed minimum tax would not apply to routine returns on equity investments in tangible business assets and other assets that do not generate foreign personal holding company income, consistent with the favorable treatment provided such assets under the proposed regulations.

If the proposed regulations under §367 are seen through the lens of bolstering the anti-deferral rules, then they may be better understood as staking an up-front claim on the future earnings of CFCs in the guise of an exit tax on the appreciated value of transferred property. To the extent that value is associated with property covered by §367(d), the commensurate with income standard could extend the government's claim to future earnings that were not anticipated at the time of the transfer and therefore had not accrued as an economic matter in any item of property.

The proposed regulations are a poor substitute for reform of the anti-deferral rules for two reasons. First, the proposed rule, reasonably administered, would result in differential treatment of similarly situated taxpayers and create traps for the unwary. Given these proposed regulations, taxpayers would be ill advised to begin foreign businesses in branch form.[43] Existing foreign branch operations will be subject either to an

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[38] The Administration has proposed statutory changes to achieve the same result. *See, e.g.,* 2016 Greenbook, at 24.

[39] *See, e.g.,* Reg. §1.338-6(b), §1.1060-1(c) (allocation of purchase price to classes of assets).

[40] *See General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987), at 355–360.

[41] Reg. §1.904(f)-2(d)(1); *see also* §865(d)(3) (source of income from the sale of goodwill is determined by reference to the country in which such goodwill was generated).

[42] *See* 2016 Greenbook, at 20 (''The opportunity to defer U.S. tax on CFC earnings, together with the ability to currently deduct expenses attributable to deferred earnings, provide U.S. multinationals with the incentive to locate production overseas and shift profits abroad, eroding the U.S. tax base.'').

[43] It has not heretofore been considered an ''abuse'' to operate a foreign business through a subsidiary rather than in branch form. For example, the legislative history to §7701(o) acknowledges that ''a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment'' is one of several ''basic business transactions that, under longstand-

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exit tax on appreciation in the business attributable to foreign goodwill and going concern value under §367(a) or to an ongoing deemed royalty under §367(d), whereas taxpayers that begin their foreign businesses as foreign corporations may not be subject to tax under either provision. But the implications of deferral are the same in either scenario. If anti-deferral policies are at work, then this application of §367 is arbitrary.

Second, the proposed response invites aggressive administration and is likely to lead to disputes. If the proposed regulations are administered to support anti-deferral policies, the IRS may be inclined to take aggressive positions even in the ''start-up'' scenario where a taxpayer incorporates its foreign business from the outset. The IRS may argue, for example, that the taxpayer has transferred valuable property to its subsidiary in a §367 transaction by making available resources or capabilities that permit the subsidiary to successfully establish and grow a new market, and that the value of such ''property'' must equal the expected net present value of the future operations of the subsidiary.[44] Such arguments do not find strong support in current law.[45] The potential controversy over whether there has been a transfer of ''property'' that would be subject to §367, or whether value has otherwise been provided, illustrates the problems inherent in applying §367 as an anti-deferral statute. Effective anti-deferral rules operate on income as it is earned, not on income to be earned in the future. The proposed regulations will invariably lead to disputes regarding whether the allocation of nascent foreign business opportunities rise to the level of compensable transactions and, if so, how best to determine the value of such opportunities.

If the unstated rationale for the proposed regulations is that taxpayers inappropriately ''erode the U.S. tax base'' when they conduct foreign business in deferral vehicles in low-tax jurisdictions in structures that do not give rise to Subpart F income, then the real policy objection is to the U.S. anti-deferral rules, and not the rules for outbound transfers.

RECOMMENDATIONS FOR A PATH FORWARD

Taking the policy rationale expressed in the Preamble at face value, the proposed regulations fall short. If the root cause of the government's discontent is difficulty in administering §367(d), then the solution is to craft a rule that addresses these administrative concerns in a way that remains consistent with the dual policies of §367. If it is not possible to do so, then it is incumbent on Treasury and the IRS to explain why these boundaries cannot be administered in the context of §367 even though similar lines exist in other contexts, and why administrative concerns trump clear Congressional intent and longstanding policy related to the active trade or business exception.[46] The characterization of all outbound transfers involving foreign goodwill and going concern value as an ''abuse,'' and the corresponding immediate effective date of the proposed regulations, hit a particularly off note.

Alternatively, Treasury and the IRS can choose to focus more precisely on the types of §936(h)(3)(B) intangibles that create a true risk of mismatch between income and expense and address administrability concerns with presumptions or specific valuation rules. For example, a presumption could apply in cases where the value of §936(h)(3)(B) intangibles comprises substantially all (or the majority) of the value of identifiable business assets transferred. In such a case, any residual value not attributable to identifiable tangible or intangible property could be allocated among §936(h)(3)(B) intangibles and other property based on relative value unless the taxpayer could demonstrate that a different allocation was more ap-

ing judicial and administrative practice are respected'' and therefore not subject to the economic substance doctrine. *See* J. Comm. Tax'n, Technical Explanation of the Revenue Provisions of the ''Reconciliation Act of 2010, as amended, in Combination with the 'Patient Protection and Affordable Care Act,' '' JCX-18-10 (Mar. 21, 2010), at 152.

[44] For example, temporary regulations issued under §482 along with the proposed regulations under §367(a) and §367(d) state that arm's-length compensation ''must be consistent with, and must account for all of, the value provided between the parties in the transaction.'' Reg. §1.482-1T(f)(2)(i)(A).

[45] Cases have held that an allocation of a business opportunity to a foreign subsidiary does not constitute a transfer of intangible property and therefore may not be compensable. *See Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991), and *Hospital Corp. of Am. v. Commissioner*, 61 T.C. 520 (1983). In addition, the §482 regulations do not require or permit a charge to a subsidiary to reflect any benefit resulting from its status as a member of a controlled group of companies. Reg. §1.482-9(l)(3)(iv).

[46] It is premature to assess the extent to which the proposed regulations, if finalized, would be vulnerable to challenge. Among the factors that could be considered in a challenge to the final regulations is the extent to which the final rules are rationally connected to the facts found by the government or presented to it by commentators. *See Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983) (articulating a ''reasoned decisionmaking'' standard); *see also Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015) (applying *State Farm* reasoned decisionmaking standard to invalidate regulation under §482). The legal standards for applying the *State Farm* standard to tax regulations this area are evolving, and the Tax Court's decision in *Altera* may yet be appealed. But the trend in this area of law suggests that the facts presented during the notice and comment period, as well as the government's response to such facts, may be critical to an ultimate determination of the validity of the regulations.

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propriate.[47] While taxpayers would continue to have an incentive to undervalue §936(h)(3)(B) intangibles, that incentive would be reduced, especially in a case where the value of the tangible property transferred is *de minimis*.[48] Such a rule would help resolve controversy in this area by dispensing with the concept of goodwill and going concern value and focusing instead on the identifiable assets transferred. In this regard, Treasury and the IRS could also reconsider exercising their authority to except from §367(d) intangibles that do not raise mismatch concerns and are inexorably tied to a foreign business, such as know-how specific to a foreign manufacturing facility or customer relationships maintained by a longstanding foreign customer-facing business. These two steps would refocus the rules on intangible property that raises the mismatch concerns that led to the enactment of §367(d), rather than distinguishing identified intangibles from goodwill and going concern value.

To the extent the concept of goodwill and going concern value is retained, specific guidance on the extent to which goodwill and going concern value are considered used in a foreign trade or business could likewise help to resolve controversies over distinguishing foreign from U.S. goodwill and going concern value. For example, guidance could provide that goodwill and going concern value is considered used in a foreign trade or business only to the extent that business has foreign customers or is otherwise tied to a foreign location. Alternatively, guidance could specify the circumstances in which goodwill and going concern value is not considered to be used in a foreign trade or business.

On the other hand, if the true concern motivating guidance under §367(a) and §367(d) is the perceived inadequacy of the anti-deferral rules, then the solution is to redouble efforts to persuade policymakers that action is needed in the Subpart F rules. If those efforts are unsuccessful, the reason may be that there is no consensus around the need for strengthening Subpart F, and no consensus that the current rules result in widespread ''abuse'' or erosion of the U.S. base. The trend over the past 20 years has been to loosen the anti-deferral rules, both through administrative guidance and through legislation.[49] If policymakers are not persuaded that Subpart F should be strengthened, then it is no response to attempt to bolster anti-deferral policies by taxing outbound transfers in a way that is inconsistent with the policies of §367.

The valuation and other administrative difficulties faced by Treasury and the IRS in this area undoubtedly are real. But those difficulties do not justify disregarding 80 years of policy and clearly expressed Congressional intent. Sweeping changes to longstanding international tax rules should wait for the consensus necessary to enact meaningful changes in law. In the meantime, it is incumbent on commentators, Treasury, and the IRS to get to work on crafting practical and realistic solutions to these administrative difficulties that are compatible with the dual policies of §367(a) and §367(d).

[47] This is similar to the way in which intangible asset value is apportioned among statutory or residual groupings of income under the fair market value method of the interest expense allocation rules. *See* Reg. §1.861-9T(h)(2).

[48] For example, in TAM 200907024 (Nov. 10, 2008), the taxpayer's reporting position with respect to an outbound transfer of foreign contractual arrangements used in a global delivery business allocated 97% of the value of the transferred assets to foreign goodwill or going concern value.

[49] For examples of administrative guidance tending to relax the impact of Subpart F, see Reg. §301.7701-3 (''check-the-box'' entity classification rules), Reg. §1.954-3(a)(4)(iv) (''substantial contribution'' test for determining whether property is ''manufactured'' by a CFC), and Notice 2007-13 (stating an intention to narrow the ''substantial assistance'' rule under the rules for foreign base company services income). For legislation consistent with this trend, see §954(c)(6) (CFC look-through rule) and §954(h) (active finance exception to foreign personal holding company income).

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