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CLIENT ALERT

IRS Intends to Issue New Tax Regulations on Outbound Transfers of Intangible Property

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On July 13, 2012, the IRS released Notice 2012-39 announcing its intention to issue new regulations under section 367(d) of the Internal Revenue Code focused on outbound transfers of intangible property that may avoid taxation under the current rules. The Notice targets tax-free and tax-deferred repatriations from foreign subsidiaries and certain outbound reorganizations to ensure that the gain on intangible assets is taxed either up front or over time.

The regulations described in the Notice will apply prospectively to outbound section 367(d) transactions occurring on or after July 13, 2012. The extent to which the IRS will challenge transactions occurring before the effective date of the Notice remains unclear, although the Notice states that the IRS may challenge pre-Notice transactions under applicable Code provisions or judicial doctrines.

Background

Section 367(d) applies to outbound transfers of intangible property that would otherwise not be subject to current taxation pursuant to Code sections 351 or 361. The provision treats the U.S. person as selling the intangibles in exchange for an annual deemed royalty contingent upon the productivity, use, or disposition of such property. This deemed royalty stream is ordinary income to the U.S. transferor and must be "commensurate with the income attributable to the intangible."

If the U.S. transferor later disposes of its stock in the foreign transferee, current Temporary Regulations provide for immediate gain recognition, subject to exceptions for certain stock transfers to related parties. However, the Temporary Regulations do not provide clear guidance on situations in which the U.S. transferor disappears or in which the successor to the U.S. transferor is a partnership. This lack of guidance has enabled taxpayers to engage in transactions that the Notice now labels as "inappropriate."

Notice 2012-39 and Repatriation Strategies

Notice 2012-39 addresses "significant policy concerns" raised by certain transactions not explicitly covered by the Temporary Regulations. The Notice provides an example of a U.S. group that engages in an outbound transfer of an intangible through a reorganization designed to take advantage of the "boot within gain rule." In the example, the U.S. parent has no gain on the stock that it exchanges in the reorganization. Accordingly, when it receives boot (i.e., cash) on the exchange, the U.S. parent takes the position that it does not have to include the boot in income. Later, over the life of the intangible, the parent is taxed based on the deemed receipt of a royalty stream under section 367(d), and the regulations allows the group to repatriate cash in the amount of the deemed royalty. Thus, the parent effectively repatriates foreign earnings twice, but only recognizes income in the amount of the section 367(d) regulatory inclusions over time.

To address this and similar transactions, the Notice provides that certain amounts be recognized for tax purposes, notwithstanding the boot within gain rule. The amount recognized depends on whether the successor to the U.S. transferor is a "qualified successor." The U.S. transferor must treat any boot received by a qualified successor (i.e., the U.S. parent) as income currently. The income is treated as a prepayment of royalty income under section 367(d) so that there is no later double inclusion.

If the successor is not a qualified successor, the U.S. transferor recognizes up-front its gain on the section 367(d) property, which can be more than the boot.

For this purpose, a "qualified successor" is a shareholder of the U.S. transferor that is a taxable U.S. corporation, not a pass-through entity, and owns stock in the foreign transferee.

Notice 2012-39 and Pass-Through Successors

The Notice also addresses transactions in which the successor to the U.S. transferor is a partnership. It provides an explicit "look through" rule, so any stock held by a partnership is considered to be owned by its partners. As a result, a U.S. transferor will have to recognize a portion of any built-in gain in section 367(d) property at the time of transfer to the extent that a partnership has foreign partners.

To read a complete copy of the Notice, click here.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

David J. Fischer
Partner – Washington, D.C.
Phone: +1 202.624.2650
Email: dfischer@crowell.com

David B. Blair
Partner – Washington, D.C.
Phone: +1 202.624.2765
Email: dblair@crowell.com