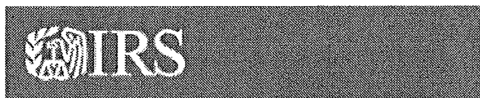

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Regulations Under Section 367(d) Applicable to Certain Outbound Asset Reorganizations

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SECTION 1. OVERVIEW

This notice provides guidance under section 367(d) of the Internal Revenue Code (Code). The guidance addresses transactions that raise significant policy concerns involving certain transfers of intangible property by a domestic corporation to a foreign corporation in an exchange described in section 361(a) or (b) (section 361 exchange). The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) will issue regulations that incorporate the guidance described in this notice. The regulations will apply to transfers occurring on or after July 13, 2012.

SECTION 2. BACKGROUND

Subject to certain exceptions, section 367(a) generally applies to the transfer of property by a United States person to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361. Section 367(d)(1) provides that, except as provided in regulations, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361, section 367(d) (and not section 367(a)) applies to such transfer. Accordingly, income or gain attributable to the transfer of property by a U.S. person to a foreign corporation in an exchange described in section 351 or 361 is taken into account either in accordance with section 367(d)(2)(A)(ii)(I) or (II) (as described below), or in accordance with section 367(a).

Section 367(d)(2)(A) provides that the United States person transferring the intangible property is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of such property. The transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received: (1) annually in the form of such payments over the useful life of such property (section 367(d)(2)(A)(ii)(I)), or (2) in the case of a disposition of the intangible property following such transfer (whether direct or indirect), at the time of the disposition (section 367(d)(2)(A)(ii)(II)). For this purpose, an indirect disposition of the intangible property following the transfer includes a disposition of the transferor's interest in the transferee corporation. S. Rep. No. 169, 98th Cong., 2d Sess., at 367 (1984). The amounts taken into account under section 367(d)(2)(A)(ii) must be commensurate with the income attributable to the intangible. Section 367(d)(2)(A) (flush language).

Section 367(d)(2)(B) provides that for purposes of chapter 1 of the Code the earnings and profits of a foreign corporation to which the intangible property was transferred are reduced by the amount required to be included in the income of the transferor of the intangible property. Section 367(d)(2)(C) provides that for purposes of chapter 1 of the Code any amount included in gross income pursuant to section 367(d) is treated as ordinary income. For purposes of applying section 904(d), any amount included in income under section 367(d) is treated in the same manner as if such amount were a royalty. Section 367(d)(2)(C).

Section 1.367(d)-1T(c)(1) provides that if a U.S. person transfers intangible property that is subject to section 367(d) to a foreign corporation (transferee foreign corporation) in an exchange described in section 351 or 361, then such person is treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property. The regulation further provides that such person shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arm's-length charge for the use of the property. §1.367(d)-1T(c)(1). For this purpose, the appropriate charge is determined under section 482 and the regulations thereunder. *Id.*

Section 1.367(d)-1T(d)(1) provides rules that apply when a U.S. person transfers intangible property that is subject to section 367(d) to a transferee foreign corporation in an exchange described in section 351 or 361 and, within the useful life of the intangible property, that U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a person that is not a related person (within the meaning of §1.367(d)-1T(h)). The rules generally provide that the U.S. transferor is treated as having simultaneously sold the intangible property to the unrelated person acquiring the stock of the transferee foreign corporation. §1.367(d)-1T(d)(1). The U.S. transferor recognizes gain (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property. *Id.*

Section 1.367(d)-1T(e)(1) provides rules that apply when a U.S. person transfers intangible property that is subject to section 367(d) to a transferee foreign corporation in an exchange described in section 351 or 361 and, within the useful life of the transferred intangible property, the U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor (within the meaning of §1.367(d)-1T(h)). These rules generally provide, in part, that the related U.S. persons, over the useful life of the property, annually include in gross income a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor under §1.367(d)-1T(c). §1.367(d)-1T(e)(1).

Section 1.367(d)-1T(g)(1)(i) provides that if a U.S. person is required to recognize income under certain provisions of the regulations under section 367(d), including §1.367(d)-1T(c), and the amount deemed to be received is not actually paid by the transferee foreign corporation, then the U.S. person may establish an account receivable from the transferee foreign corporation equal to the amount deemed paid that was not actually paid. Such account receivable may be established and paid without further U.S. income tax consequences to the U.S. transferor or the transferee foreign corporation. §1.367(d)-1T(g)(1)(i).

SECTION 3. TRANSACTIONS AT ISSUE

The IRS and the Treasury Department are aware that certain taxpayers are engaging in transactions intended to repatriate earnings from foreign corporations without the appropriate recognition of income. In one such transaction, USP, a domestic corporation, owns 100 percent of the stock of UST, a domestic corporation. USP's basis in its UST stock equals its value of $100x. UST's sole asset is a patent with a tax basis of zero. UST has no liabilities. USP also owns 100 percent of the stock of TFC, a foreign corporation. UST transfers the patent to TFC in exchange for $100x of cash and, in connection with the transfer, UST distributes the $100x of cash to USP and liquidates.

The taxpayer takes the position that neither USP nor UST recognizes gain or dividend income on the receipt of the $100x of cash. USP then applies the section 367(d) regulations to include amounts in gross income under §1.367(d)-1T(c)(1) in subsequent years. USP also applies the 367(d) regulations to establish a receivable from TFC in the amount of USP's aggregate income inclusion. USP takes the position that TFC's repayment of the receivable does not give rise to income (notwithstanding the prior receipt of $100x in connection with the reorganization). Accordingly, under these positions, the transactions have resulted in a repatriation in excess of $100x ($100x at the time of the reorganization and then through repayment of the receivable in the amount of USP's income inclusions over time) while only recognizing income in the amount of the inclusions over time.

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

SECTION 4. REGULATIONS TO BE ISSUED

.01 In General

The IRS and the Treasury Department will issue regulations addressing the transfer by a domestic corporation (U.S. transferor) of section 367(d) property in a section 361 exchange to a transferee foreign corporation (outbound section 367(d) transfer) that incorporate the rules described in this notice. The regulations will ensure that, with respect to all outbound section 367(d) transfers, the total income to be taken into account under section 367(d) is either included in income by the U.S. transferor in the year of the reorganization or, where appropriate, over time by one or more qualified successors. Any income taken into account under this notice must be commensurate with the income attributable to the section 367(d) property transferred in the outbound section 367(d) transfer. Section 367(d)(2)(A) (flush language). Except as provided below, the rules described in this notice, rather than §1.367(d)-1T(c), (d), (e), and (g), will govern outbound section 367(d) transfers. For purposes of this notice, references to "stock received" include stock deemed received in a transaction.

.02 U.S. Transferor Takes into Account Income under Section 367(d)(2)(A)(ii)(I)

In an outbound section 367(d) transfer, the U.S. transferor will take into account income under section 367(d)(2)(A)(ii)(I) with respect to each qualified successor, if any, by treating as a prepayment of such income the product of the section 367(d) percentage multiplied by the sum of: (i) the money and fair market value of other property (within the meaning of section 356) received by the qualified successor in exchange for, or with respect to, stock of the U.S. transferor, reduced by the portion of any U.S. transferor distributions received by the qualified successor; and (ii) the product of the qualified successor's ownership interest percentage multiplied by the amount of non-qualifying liabilities that are either assumed (within the meaning of section 357(d)) by the transferee foreign corporation in the reorganization or satisfied by the U.S. transferor with money or other property (within the meaning of section 361) provided by the transferee foreign corporation. As a prepayment of such income, the amount is included in income by the U.S. transferor in the year of the outbound section 367(d) transfer, regardless of the productivity of the transferred section 367(d) property in the year of the transfer or in subsequent years.

.03 U.S. Transferor Takes into Account Income under Section 367(d)(2)(A)(ii)(II)

In an outbound section 367(d) transfer, the U.S. transferor will also take into account income under section 367(d)(2)(A)(ii)(II) in an amount equal to the product of: (i) the sum of the ownership interest percentages of all non-qualified successors, if any, multiplied by (ii) the amount of gain realized on all of the section 367(d) property transferred in the section 361 exchange.

.04 Treatment of Qualified Successors

Consistent with the principles of §1.367(d)-1T(e)(1)(ii) and (iii), except as provided in this paragraph 4.04, each qualified successor will take into account the income attributable to a proportionate share of the contingent annual payments that the U.S. transferor would have been treated as receiving under section 367(d)(2)(A)(ii)(I) and §1.367(d)-1T(c) had the U.S. transferor remained in existence and retained the qualified stock (or, in the case of certain distributions under section 355, had the U.S. transferor retained the qualified stock) received in the reorganization (assuming for this purpose that the transfer continues to qualify as an exchange described in section 361), and had the U.S. transferor not recognized any income under section 4 of this notice. A qualified successor's proportionate share of such contingent annual payments is the product of the contingent annual payments multiplied by the qualified successor's ownership interest percentage. The income attributable to a qualified successor's proportionate share of the contingent annual payments is excluded from gross income to the extent of the income included by the U.S. transferor under section 4.02 of this notice that is attributable to the qualified successor (credit amount).

A qualified successor may, in accordance with §1.367(d)-1T(g)(1), establish an account receivable for any contingent annual payments included in gross income by the qualified successor under this notice.

Qualified successors are subject to the rules of §1.367(d)-1T, as modified by this paragraph 4.04. Thus, for example, if a qualified successor subsequently transfers qualified stock received in the reorganization to a U.S. person that is related (within the meaning of §1.367(d)-1T(h)) to the qualified successor, §1.367(d)-1T(e) will apply to such transfer. In this case, a proportionate amount of any remaining credit amount attributable to the qualified successor can be taken into account by such related U.S. person in the same manner as it could have been taken into account by the qualified successor. Alternatively, for example, if a qualified successor subsequently transfers qualified stock to a U.S. person that is unrelated to the qualified successor or to a person that is not a U.S. person, §1.367(d)-1T(d) will apply to such transfer. In this case, a proportionate amount of any remaining credit amount attributable to the qualified successor can be taken into account to reduce the amount of gain recognized under §1.367(d)-1T(d).

.05 Definitions

The following definitions apply for purposes of this notice:

(1) *Non-qualifying liabilities*—(i) *In general.* Except as provided in paragraph (1)(ii) of this section 5, non-qualifying liabilities include all liabilities of the U.S. transferor other than a liability:

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

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

(C) That is owed to an unrelated person. For this purpose, an unrelated person is any person that does not have a relationship to the U.S. transferor described in section 267(b) or 707(b) immediately before the reorganization.

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

(2) *Ownership interest percentage* is the ratio of the value of the stock in the U.S. transferor owned by a shareholder to the value of all of the outstanding stock of the U.S. transferor. Except as provided in this paragraph, the ownership interest percentage of a shareholder is determined immediately before the reorganization. For purposes of determining the ownership interest percentage with respect to each shareholder, however, the numerator of the fraction is first reduced (but not below zero) by U.S. transferor distributions made to such shareholder, and the denominator is reduced by the total amount of U.S transferor distributions.

(3) *Property* is defined in §1.367(a)-1T(d)(4). *Section 367(d) property* is any property described in section 936(h)(3)(B). *Section 367(a) property* is any property other than section 367(d) property.

(4) *Qualified stock* means stock in the transferee foreign corporation, including stock received in the transferee foreign corporation under section 354, 355, or 356 in exchange for, or with respect to, stock of the U.S. transferor.

(5) *Qualified successor* means a shareholder of the U.S. transferor that is a domestic corporation, other than a regulated investment company (as defined in section 851(a)), a real estate investment trust (as defined in section 856(a)), or an S corporation (as defined in section 1361(a)), provided such shareholder receives qualified stock in the reorganization or immediately after the reorganization owns qualified stock other than qualified stock received in the reorganization. A *non-qualified successor* means a shareholder of the U.S. transferor other than a qualified successor.

(6) *Section 367(d) percentage* is the ratio of the aggregate value of the section 367(d) property transferred by the U.S. transferor to the transferee foreign corporation in the section 361 exchange to the aggregate value of all property (in other words, all section 367(a) property and section 367(d) property) transferred by the U.S. transferor to the transferee foreign corporation in the section 361 exchange.

(7) *U.S. transferor distributions* are any distributions by the U.S. transferor of money or other property (within the meaning of section 356) to shareholders pursuant to the plan of reorganization, but only to the extent such money or other property is not provided by the transferee foreign corporation in exchange for property of the U.S. transferor acquired in the section 361 exchange.

.06 Other Rules

Income taken into account under section 4.02 or 4.03 of this notice is treated as ordinary income and is treated, for purposes of applying section 904 (d), in the same manner as if such amount were a royalty.

For purposes of this notice, stock of the U.S. transferor held by a partnership (domestic or foreign) is treated as held proportionately by its partners. Thus, for example, if a partnership is a shareholder of the U.S. transferor and receives qualified stock in the reorganization, the partners in the partnership are treated as receiving the qualified stock for purposes of this notice, including for purposes of identifying a qualified successor.

.07 Example

The following example illustrates the rules and guidance provided in this notice.

Example. (i) *Facts.* USP, a domestic corporation (that is not a regulated investment company, a real estate investment trust, or an S corporation), owns 100% of the outstanding stock of UST, a domestic corporation, and 100% of the outstanding stock of TFC, a foreign corporation. UST owns a patent with a tax basis of $0x and a value of $60x. UST also owns Asset A, which is section 367(a) property, with a value of $40x. UST has no liabilities. In a reorganization described in section 368(a)(1)(D), UST transfers the patent and Asset A to TFC in exchange for $70x of TFC stock and $30x of cash. In connection with the transfer, UST distributes the $70x of TFC stock and $30x of cash to USP and liquidates. UST's transfer of the patent and Asset A to TFC qualifies as a section 361 exchange. USP is treated as exchanging its UST stock for $70x of TFC stock and $30x of cash pursuant to section 356.

(ii) *Analysis.* UST's transfer of the patent to TFC in the section 361 exchange is an outbound section 367(d) transfer subject to section 367(d) and the regulations thereunder, as modified by this notice. Under section 4.02 of this notice, the income that UST will take into account as a prepayment is $18x, the product of the section 367(d) percentage (60%) multiplied by the amount of cash ($30x) received by USP, a qualified successor. UST must include this amount in income regardless of whether income is being generated by the patent at the time of the outbound section 367(d) transfer. USP is a qualified successor because USP (a domestic corporation) is a shareholder of UST that receives qualified stock (newly issued stock of TFC) under section 356 in exchange for stock of UST. USP is also a qualified successor because USP (a domestic corporation) is a shareholder of UST that owns qualified stock (existing stock in TFC) other than the qualified stock received in the reorganization. Under section 4.05 of this notice, the section 367(d) percentage of 60% is computed as the $60x aggregate value of the section 367(d) property transferred in the section 361 exchange, divided by $100x aggregate value of all property transferred in the section 361 exchange. USP, as a qualified successor to UST, will take into account the income attributable to the contingent annual payments that UST would have received under §1.367(d)-1T(c) over the remaining useful life of the intangible property, determined as if UST had remained in existence and not taken into account the $18x of income. Under §1.367 (d)-1T(c)(1), such contingent annual payments must be determined in accordance with section 482 and the regulations thereunder, and therefore must be consistent with the arm's-length standard. The first $18x of contingent annual payments (if otherwise taken into account by USP under section 4.04 of this notice) are excluded from USP's gross income under section 4.04 of this notice, and any additional contingent annual payments are included in USP's gross income. In accordance with §1.367(d)-1T(g)(1), USP may establish an account receivable with respect to any contingent annual payments included in gross income by USP under this notice. For rules applicable to the transfer of Asset A, see section 367(a) and any regulations thereunder.

SECTION 5. EFFECTIVE DATE

The regulations described in this notice will apply to outbound section 367(d) transfers occurring on or after July 13, 2012. No inference is intended as to the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

SECTION 6. COMMENTS

The IRS and the Treasury Department request comments on the regulations to be issued under this notice. Specifically, comments are requested regarding whether certain domestic corporations that are related to the U.S. transferor but not subject to section 4.04 of this notice (relating to qualifying successors) should nevertheless be subject to section 4.04. For example, the IRS and the Treasury Department are considering whether the rules described in section 4.04 of this notice should apply to transactions in which a domestic corporation is not a qualified successor because it indirectly owns the U.S. transferor through a controlled foreign corporation. In addition, comments are requested as to the proper recovery of basis in the section 367(d) property transferred.

SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Robert B. Williams, Jr. of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Robert B. Williams, Jr. at (202) 622-3860 (not a toll-free call).

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