

Revisiting Section 367(d): How Treasury Took the Bite Out of Section 367(d) and What Should Be Done About It

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REVISITING SECTION 367(d): HOW TREASURY TOOK THE BITE OUT OF SECTION 367(d) AND WHAT SHOULD BE DONE ABOUT IT

by

Bret Wells*

Abstract

Section 367(d) seeks to prevent residual profits related to U.S. developed intangible assets from migrating out of the U.S. tax jurisdiction via the outbound contribution or transfer of intangibles to a foreign corporation. There has been a great hue and cry over the outbound migration of intangibles in recent years, which by implication has created significant agitation about whether section 367(d) is effective. For at least a decade, the Treasury Department and IRS have identified section 367(d) as an area in need of regulatory reform, and recent comments by government officials indicate that guidance may be forthcoming in the future. Concurrently, the Obama administration has proposed amendments to section 367(d) and the U.S. subpart F rules to address outbound migration of intangible value.

The debate over the efficacy of section 367(d) to prevent IP migration is being waged along two fronts. As to the first front of this debate, the central question is whether a fatal loophole (a “goodwill loophole”) exists within the architecture of section 367(d) that allows the outbound migration of intangible value under the protective cloak of “goodwill” with the consequence that a substantial portion of the ongoing residual profits related to the transferred goodwill items escape the application of section 367(d)’s super royalty obligation. In Subparts II.A. through II.B., this Article addresses why this “goodwill loophole” that has received so much attention is nonexistent. All that is needed is for the courts to correctly apply section 367(d) as it should be applied, and once this is done the “goodwill loophole” should be defrocked of all of its purported cloaking capabilities.

The second front in this ongoing debate about the efficacy of section 367(d) to prevent IP migration concerns the role that cost sharing

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agreements play in facilitating the outbound migration of residual profits away from the U.S. functions that create the high-profit potential intangibles. Section 367(d) is clear on its face as to what should be the correct outcome in these instances, but the Treasury Department's existing cost sharing regulations create a "cost sharing loophole" that provides the means for substantial profit-shifting. In Subpart II.C., *infra*, this Article sets forth how the Treasury Department should amend its existing Treasury regulations in order to close this inappropriate "costs sharing loophole."

Moreover, as an entirely separate debate, the Treasury Department and IRS have retrofit section 367(a) and (b) as a means to attack the tax-free repatriation of cash from foreign subsidiaries in transactions that utilize the recovery of high stock basis. Part III addresses how section 367(a) and (b) have been substantially altered and how section 367(d) is now being rethought in light of this expanding omnibus strategy that is redefining the contours of all of section 367.

Calm reflection about the contours of section 367(d) is needed because the raging debate about section 367(d) threatens to run it off the road and into a ditch. This Article seeks to provide illumination of the way forward so that section 367(d) achieves its intended purpose.

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I. INTRODUCTION

Section 367(d) seeks to prevent residual profits related to U.S. developed intangible assets from migrating out of the U.S. tax jurisdiction via the outbound tax-free contribution or transfer of intangibles to a foreign corporation. There has been a great hue and cry over the outbound migration of intangibles in recent years,¹ which by implication has created significant agitation about whether section 367(d) is effective. For at least a decade, the Treasury Department and IRS have identified section 367(d) as an area in need of regulatory reform,² and recent comments by government officials indicate that guidance may be forthcoming in the future.³ Concurrently, the Obama administration has proposed amendments to section 367(d) and the

1. See, e.g., STAFF OF THE JOINT COMM. ON TAX'N, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET, JCS-3-11, 197 (2011); STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, JCX-37-10, 75 (2010); U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNING STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (2007).

2. The Treasury Department first issued its temporary regulations in 1986. See T.D. 8087, 1986-1 C.B. 175. These regulations have been amended once in 1998 but remained temporary regulations. See T.D. 8770, 1998-2 C.B. 3. No further amendments have been made to these temporary regulations even though section 367(d) has been identified off-and-on as an area in need of further regulatory guidance in guidance plans issued over the last decade. See DEPARTMENT OF THE TREASURY 2013-2014 PRIORITY GUIDANCE PLAN at 25 (Apr. 21, 2014); DEPARTMENT OF THE TREASURY 2012-2013 PRIORITY GUIDANCE PLAN at 23 (Aug. 9, 2013); DEPARTMENT OF THE TREASURY 2011-2012 PRIORITY GUIDANCE PLAN at 26 (Nov. 19, 2012); DEPARTMENT OF THE TREASURY 2010-2011 PRIORITY GUIDANCE PLAN at 24 (June 30, 2011); DEPARTMENT OF THE TREASURY 2008-2009 PRIORITY GUIDANCE PLAN at 14 (Sept. 10, 2008); DEPARTMENT OF THE TREASURY 2007-2008 PRIORITY GUIDANCE PLAN at 12 (Aug. 13, 2007); DEPARTMENT OF THE TREASURY 2006-2007 PRIORITY GUIDANCE PLAN at 19 (Mar. 12, 2007). It is incredible that the existing temporary regulations have remained in temporary form for almost thirty years and that a significant level of effort has not already been put forward towards improvement of these temporary regulations given the base erosion realities that currently exist.

3. See *International Guidance Update*, 2013 TAX NOTES TODAY 147-1 (July 31, 2013) (quoting source stating that section 367(d) regulatory guidance is forthcoming and the treatment of goodwill will be covered); *IRS Could Update Regs on Transfers of Intangibles to Foreign Corporations*, 2013 TAX NOTES TODAY 109-2 (June 5, 2013) (quoting IRS official who stated that the IRS believes it has authority to deal with intangible migration by closing loopholes under section 367(d) and that the IRS is considering such an update to the existing regulations).

U.S. subpart F rules to address outbound migration of intangible value,⁴ presumably believing that section 367(d) is not up to the task by itself.

The debate over the efficacy of section 367(d) is being waged along two fronts. As to the first front of this debate, the central question is whether a fatal loophole (a “goodwill loophole”) exists within the architecture of section 367(d) that allows the outbound migration of intangible value under the protective cloak of “goodwill” with the consequence that a substantial portion of the ongoing residual profits related to the transferred goodwill items escape the application of section 367(d)’s super royalty obligation. In Subparts II.A. through II.B., this Article addresses why this “goodwill loophole” that has received so much attention is nonexistent. All that is needed is for the courts to correctly apply section 367(d) as it should be applied, and once this is done, the “goodwill loophole” should be defrocked of all of its purported cloaking capabilities.

The second front in this ongoing debate about the efficacy of section 367(d) to prevent intellectual property migration concerns the role that cost sharing agreements play in facilitating the outbound migration of residual profits away from the U.S. functions that create the high-profit potential intangibles. Section 367(d) is clear on its face as to what should be the correct outcome in these instances, but the Treasury Department’s existing cost sharing regulations create a “cost sharing loophole” that provides the means for substantial profit-shifting. In Subpart II.C., this Article sets forth how the Treasury Department should amend its existing Treasury regulations in order to close this inappropriate “costs sharing loophole.”

Moreover, as an entirely separate debate, the Treasury Department and IRS have retrofitted section 367(a) and (b) as a means to attack the tax-free repatriation of cash from foreign subsidiaries in transactions that utilize the recovery of high stock basis. Part III addresses how section 367(a) and (b) have been substantially altered and how section 367(d) is now being rethought in light of this expanding omnibus strategy that is redefining the contours of all of section 367.

Finally, in Part IV, this Article provides concluding comments about the way forward in light of the multi-faceted debates that are currently pummeling section 367(d). Calm reflection about the contours of section 367(d) is needed because the raging debate about section 367(d) threatens to

4. The Obama Administration has proposed legislative changes to section 367(d) that extend its applicability to the outbound transfer of goodwill and also propose to subject the excess intangible returns earned by controlled foreign corporations to taxation under a new category of subpart F income. *See* U.S. TREASURY DEPARTMENT, GENERAL EXPLANATION OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS at 45–47 (Mar. 2014) [hereinafter GENERAL EXPLANATION OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS].

run it off the road and into a ditch. This Article seeks to provide illumination of the way forward so that section 367(d) achieves its intended purpose.

II. THE GOODWILL HUNTING EXERCISE CAUSED US TO LOSE FOCUS ON SECTION 367(d)'S OBJECTIVE

To appropriately frame the context for the debate about the “goodwill loophole” that is raging, it is appropriate to review the legislative policy goals of section 367(d) and to posit a specific “goodwill loophole” transaction that illustrates the potential disconnect before specifically analyzing how current law should be applied, so that is where this Part begins.

Prior to the enactment of section 367(d), taxpayers were regularly able to receive favorable rulings under section 367(a) from the IRS that blessed the tax-free outbound contribution of income-producing intangibles to foreign affiliates as long as the intangible was actively utilized by the transferee foreign corporation in foreign markets and the transferee corporation (i) did not utilize the contributed intangible to make products for distribution back in the United States marketplace⁵ or (ii) paid a royalty for such distribution.⁶ Furthermore, even when the IRS contended that a particular outbound contribution of highly profitable income-producing intangibles was done for tax avoidance reasons, the IRS faced difficulty in sustaining its position in the courts.⁷ Concurrently in time, due to press

5. See Rev. Proc. 68-23, 1968-1 C.B. 821, § 3.02(1)(b)(iii) and (iv) (stating that favorable rulings would not be issued if the intangible was used for U.S.-destined sales) obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388. Taxpayers were regularly able to receive favorable outbound migration of their U.S. intangibles as long as the U.S. affiliate was paid a royalty by the foreign affiliate for the sale of products into the United States. See, e.g., P.L.R. 1984-04-025 (Oct. 21, 1983); P.L.R. 1984-05-004 (Sept. 29 1983); P.L.R. 1984-05-113 (Nov. 4, 1983). Congress has observed this same historical backdrop in its deliberations in its decision to expand the mission of section 367(d). See H.R. REP. NO. 98-432(II), at 1312-15 (1984); COMM. ON FINANCE UNITED STATES SENATE, DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 358-61 (Comm. Print 1984).

6. See *Seagate Tech., Inc. v. Commissioner*, 102 T.C. 149, 248-49 (1994) (where the court stipulates that the U.S. taxpayer received a favorable section 367(a) rulings with respect to the outbound contribution of manufacturing and marketing intangibles to a Singapore affiliate that resulted in high profitability outside the United States).

7. *Dittler Brothers, Inc. v. Commissioner*, 72 T.C. 896, 920 (1979) (IRS asserted that the transfer of the high profit potential intangible to a Netherlands Antilles affiliate had a principal purpose of tax avoidance and thus was taxable under then existing section 367(a); the Tax Court held in favor of the taxpayer, stating that the commercial demands of the joint venture for both parties (the U.S. person and

reports,⁸ Congress had become aware that U.S. pharmaceutical companies claimed research and development deductions for developing pharmaceutical intangibles and then had contributed the developed intangibles to a possession corporation to avail themselves of the then applicable section 936 credit for income earned in the transferee possession corporation.⁹

Congress saw all of these events as creating a common problem: tax deductions were allowed to reduce U.S. taxable income¹⁰ even though these

the non-U.S. investor) to co-contribute intangibles demonstrated that the outbound contribution of the U.S. intangibles did not have a principle purpose of tax avoidance), *aff'd* mem., 642 F.2d 1211 (5th Cir. 1981).

8. See, e.g., Thomas W. Lippman, *Loophole to Puerto Rico Under Fire: Drug Firms Try to Save Puerto Rico Loophole*, THE WASHINGTON POST, Dec. 3, 1981, at C13. This news article was mentioned in the floor debates as one of the factors that galvanized Congressional attention. See 128 CONG. REC. S17,235 (1982) (statement of Sen. Dole).

9. See H.R. REP. NO. 98-432(II), at 1311–12, 1316 (1984); COMM. ON FINANCE UNITED STATES SENATE, DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 366 (Comm. Print 1984); STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 427 (Comm. Print 1984).

10. See I.R.C. §§ 162, 174; Reg. §§ 1.263A-1(e)(3)(iii)(A), (B), and (4)(iv)(N) (allows immediate expensing for marketing, selling, advertising and distribution costs and research and development costs), 1.197-2(k) Ex. (1) (concedes that advertising cost enhances intangible value of a company but even so these costs are not to be capitalized as part of the acquisition cost of an intangible within the meaning of section 197), 1.263A-1(e)(4)(iv)(E) (allows immediate expensing of employee development and training cost even though this can create a valuable workforce in place); Rev. Proc. 2000–50, 2000–2 C.B. 601; Rev. Rul. 92–80, 1992–2 C.B. 57. For criticism of the overly generous expensing under current law, see Calvin H. Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 2013 TAX NOTES TODAY 151-9 (Apr. 15, 2013); Calvin H. Johnson, *Capitalize Costs of Software Development*, 2009 TAX NOTES TODAY 151-9 (Aug. 10, 2009); Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549 (2004); Calvin H. Johnson, *Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations*, 2003 TAX NOTES TODAY 106-32 (June 2, 2003). Interestingly, Chairman Baucus has proposed a discussion draft that would require capitalization of a portion of the ongoing research, development, and advertising cost. See STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT TO REFORM CERTAIN BUSINESS PROVISIONS, JCX-19-13 (Nov. 21, 2013), 2013 TAX NOTES TODAY 226-16. See also SENATE FINANCE COMM., SUMMARY OF STAFF DISCUSSION DRAFT: COST RECOVERY AND ACCOUNTING (Nov. 21, 2013), 2013 TAX NOTES TODAY 226-35. For a review of this proposal, see Calvin H. Johnson, *First Do No Harm: The Senate Staff Discussion Draft on Cost Recovery*, 2014 TAX NOTES TODAY 25-11 (Feb. 6, 2014).

expenses created intangible property which (once developed) was transferred from the intangible developer to a non-U.S. entity that was not subject to full U.S. taxation (either because it was a possession corporation entitled to claim a section 936 credit or because income of the transferee foreign corporation was nonsubpart F income and thus escaped current U.S. taxation). The profit-shifting problem was clear, and in Congress's view the resulting erosion of the U.S. tax base was unacceptable. Cases such as *Dittler Brothers, Inc. v. Commissioner*¹¹ demonstrated that section 367(a), as interpreted by the courts, was insufficient to protect the U.S. tax base from erosion via these intangible migration strategies.¹²

As a result, Congress began systematically addressing the migration of U.S. developed intangibles. In 1982, Congress enacted section 936(h), which required the shareholders of a possession corporation to include in income any income earned by the possession corporation attributable to a contributed intangible that was described in section 936(h)(3)(B),¹³ and the legislative history indicates that the statute was meant to define "intangible assets broadly."¹⁴ Section 936(h)(3)(B) seeks to identify all intangibles that could create future revenue-generating opportunities, and for good order's sake Congress included a "catch-all" category in section 936(h)(3)(B)(vi) including all other "similar items" in section 936(h)(3)(B)'s definition as well.¹⁵ The intent was clear: if an intangible is capable of producing a nonroutine return, then the income of that intangible cannot be assigned to a possession corporation even if the underlying intangible asset is assigned to the possession corporation. Instead, the income derived from the transferred intangible will be allocated back to the U.S. person that transferred the

11. *Dittler Brothers, Inc. v. Commissioner*, 72 T.C. 896 (1979).

12. See H.R. REP. NO. 98-432(II) at 1317 (1984) (so stating and then emphatically stating that this committee has no intention of condoning such a result); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 360 (Comm. Print 1984) (so stating); STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 427 (1984) (same).

13. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 213, 96 Stat. 324 (1982).

14. See S. REP. NO. 97-494(I), at 161 (1982).

15. This term other "similar item" is incorporated in section 482 regulations and states that an intangible is similar if it derives its value not from its physical attributes but from its intellectual content or other intangible properties. See Reg. § 1.482-4(b)(6). Thus, if an item or function has value due to its revenue generating capabilities related to its intangible properties, then it is a "similar item" to all of the other intangibles enumerated in section 936(h)(3)(B) and thus is subject to section 367(d)'s super royalty. Again, this definition is attempting to encompass all contributing factors to nonroutine returns. This analysis is more fully explored in Part II.B., *infra*.

intangible to the possession corporation. Section 936(h) thus represented a statutory expansion of the assignment of income doctrine beyond its historic norm. After the enactment of section 936(h), the possession corporation would be able to earn routine manufacturing returns, but it would not be entitled to earn nonroutine returns because section 936(h) reassigned any intangible returns (“residual profits”) arising from that transferred intangible back to the U.S. transferor.¹⁶

The floor debates at that time indicate that Congress understood that section 936(h)(3)(B) was intended to apply generally to all income-generating intangibles, and legislative amendments that would have curtailed this expansive definition were rebuffed.¹⁷ In the legislative history, Congress was categorical in its concerns, stating that “no legitimate policy is served by permitting tax-free generation of income related to intangibles created, developed or acquired in the United States or elsewhere outside of the possession” and that “ending the availability of the possession credit for income from such intangibles is justified.”¹⁸ Congress simultaneously recognized that some taxpayers had stated that they would transfer intangibles out of their possession corporation and into a foreign corporation incorporated in a low-tax jurisdiction as a means of side-stepping the consequences of the expected enactment of section 936(h).¹⁹ For this reason, Congress concurrently amended section 367 by enacting section 367(d) to provide that any transfer of an intangible enumerated in section 936(h)(3)(B) from a possession corporation to any foreign corporation would be taxable under section 367(d).²⁰

In 1984, the scope of section 367(d) was expanded to apply to outbound contributions of any intangible described in section 936(h)(3)(B) from any U.S. person to any foreign corporation, and the Treasury Department was given broad regulatory authority to adopt regulations that would implement the objectives of this expanded base protection goal of section 367(d).²¹ In addition to expanding the mission of section 367(d), the 1984 amendments made clear that the transfer of intangible property subject to section 367(d) would be treated as a sale of the subject intangible by the U.S. transferor in exchange for ongoing annual contingent payments that are deemed to be received by the U.S. transferor over the useful life of the

16. The implications of the cost sharing arrangements that historically could be employed by possession corporations are beyond the scope of this Article. Similar results are achievable by foreign corporations under the existing cost sharing regulations, and those issues are discussed in Part II.C., *infra*.

17. See 128 CONG. REC. S17,235 (1982) (statement of Sen. Dole).

18. See S. REP. NO. 97-494(I), at 159 (1982).

19. See H.R. REP. NO. 97-760, at 512 (1982) (Conf. Rep.).

20. See H.R. REP. NO. 97-760, at 512 (1982) (Conf. Rep.).

21. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 131(b), 98 Stat. 494 (1984).

transferred intangible (within the nomenclature of section 367(d), these deemed ongoing annual contingent payments came to be known as a section 367(d) “super royalty”).²²

Seen in its historical context, section 367(d) codifies the applicability of the assignment of income doctrine to any section 351 transfer of intangible property to a foreign corporation. Prior to section 367(d), the scope of the judicially created assignment of income doctrine had a limited application. In this regard, the assignment of income doctrine prevented the true earner of income from assigning that income to others.²³ Furthermore, the assignment of income doctrine prevented income from property from being deflected away from the person who maintained ownership control over the underlying property.²⁴ And, the assignment of income doctrine could apply if a property transfer did not have a substantial nontax business purpose.²⁵ The IRS in litigation had argued that the judicially created assignment of income doctrine also should apply to reassign intangible income away from the owner of a contributed intangible and instead should assign such income back to the original developer of the income-generating property.²⁶ But, this argument took the courts further than they were willing to go,²⁷ as the case law prior to section 367(d) generally refused to apply that

22. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

23. See *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Eubank*, 311 U.S. 122 (1940).

24. See *Helvering v. Horst*, 311 U.S. 112 (1940).

25. The Tax Court asserted such a view in *UPS v. Commissioner*, 78 T.C.M. (CCH) 262, 1999 T.C.M. (RIA) ¶ 99268 (holding that the assignment of income doctrine and sham transaction doctrines serve to reallocate income from a foreign subsidiary back to the U.S. affiliate whose income explains those profits). The Eleventh Circuit reversed the Tax Court decision, finding that the UPS restructuring had a business purpose. See *UPS v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001) (finding that UPS restructuring had a business purpose and remanded for determining whether section 482 required a reallocation of income among the related parties). For the view that the UPS case would be decided differently today and that the assignment of income principles would be applicable given the codification of the economic substance doctrine in section 7701(o), see *Caterpillar's Offshore Tax Strategy: Hearing Before the S. Permanent Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs* (2014) (statement of Reuven S. Avi-Yonah) [hereinafter *Caterpillar Hearing*].

26. See *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1109 (1985) (“Although respondent concedes that Lilly P.R. acquired legal title to the patents and know-how in 1966 in a valid section 351 transfer, he maintains that for purposes of section 482, legal ownership of the intangibles can be disregarded and all income attributable to them reallocated from Lilly P.R. to petitioner.”), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988).

27. See, e.g., *Eli Lilly & Co.*, 84 T.C. at 1123 (“Respondent’s reallocations conflict with a fundamental principle of Federal income tax law: that income from

doctrine in instances where the future income derived from the exploitation of income-producing intangible property was earned by the true owner of the underlying income-producing property.²⁸

With this backdrop in mind, section 367(d) is best seen as an effort to statutorily expand the applicability of the assignment of income doctrine past its historic scope, providing in effect that no transfer of intangible property (whether the fruit, the tree, or the tree with its fruit) will serve to deflect the income from that intangible property away from the U.S. developer. Thus, rightly viewed, section 367(d) is a repudiation of the ability to transfer the ongoing intangible returns generated by U.S. developed income-producing intangibles away from the U.S. developer to a foreign corporation by means of an outbound section 351 transfer of the income-producing intangible as was allowed in cases such as *E.I. Dupont de Nemours & Co. v. United States*,²⁹ *Eli Lilly & Co. v. Commissioner*,³⁰ *G.D. Searle & Co. v. Commissioner*,³¹ and *Bausch & Lomb, Inc. v. Commissioner*.³² Section 367(d) assigns the income derived from the transferred intangible back to the U.S. developer even when ownership of the underlying “tree” (i.e., the income-producing intangible asset) has been transferred to a foreign corporation.

In 1986, concurrent with the addition of the “commensurate with income” standard to section 482, Congress incorporated this same standard into section 367(d), providing that the amount of the ongoing annual section 367(d) super royalty payment must be commensurate with the income generated by the transferred intangible.³³ Said differently, this commensurate with income standard was intended to make clear that where taxpayers

property is earned by the owner of the property. *See Helvering v. Horst*, 311 U.S. 112 (1940); *Blair v. Commissioner*, 300 U.S. 5 (1937)”.

28. *Heim v. Fitzpatrick*, 262 F.2d 887 (2d Cir. 1959). In the context of a section 351 transfer, see *Hempt Bros., Inc. v. U.S.*, 490 F.2d 1172 (3rd Cir. 1974) (held that cash basis taxpayer’s assignment of accounts receivable as part of a transfer of the entire business to a controlled corporation is not assailable under assignment of income principles); *Eli Lilly & Co.*, 84 T.C. at 1116–27 (1985), *aff’d in part and rev’d in part*, 856 F.2d 855 (7th Cir. 1988).

29. *See E.I. Dupont de Nemours & Co. v. United States*, 471 F.2d 1211 (Ct. Cl. 1973) (stating that the grant of a non-exclusive license with respect to a patent constituted a “transfer of property” within the meaning of section 351).

30. *Eli Lilly & Co.*, 84 T.C. 996, 1116–27 (1985), *aff’d in part and rev’d in part*, 856 F.2d 855 (7th Cir. 1988) (manufacturing intangibles transferred to Puerto Rican subsidiary).

31. *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987) (manufacturing intangibles transferred to Puerto Rican subsidiary).

32. *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff’d*, 933 F.2d 1084 (2d Cir. 1991) (manufacturing intangibles transferred to Irish subsidiary).

33. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e), 100 Stat. 2085 (1986).

transfer an enumerated intangible with high-profit potential, the ongoing super royalty cannot be benchmarked with generic industry data. Instead, it must be valued based upon the actual ongoing profit experience of the transferred intangible.³⁴ This commensurate with income standard accomplishes its objective by deeming the foreign transferee corporation as paying a super royalty to the U.S. transferor that is determined in amount by the actual income generated from the exploitation of the transferred intangible.³⁵ Thus, the addition of the commensurate with income standard to section 367(d)(2) in 1986 was an important step towards harmonizing section 367(d)'s super royalty amount with Congress's underlying goal of codifying the assignment of income doctrine because it made clear that all income arising from the contributed intangible would be assigned back to the original U.S. transferor by reason of the fact that the super royalty must always remain commensurate in amount with the amount of the income actually generated by the transferred intangible. Thus, whereas the government had failed to convince the courts to expand their judicially created assignment of income doctrine to assign the income attributable to transferred income-generating intangible property back to the U.S. developer-transferor,³⁶ Congress by 1986 had statutorily codified this doctrine, thus preventing the deflection of intangible returns away from the U.S. developer via the technique of transferring income-generating intangibles to a foreign corporation.

In 1997, Congress modified section 367(d) again to provide that the super royalty would be considered foreign source income to the extent that section 482 would have so sourced an actual ongoing royalty if one had been paid between the parties,³⁷ thus allowing the tax results afforded under

34. See JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1016 (Comm. Print 1987).

35. See Reg. § 1.367(d)-1T(c)(1) (states super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(f)(2)(ii)(C)(4), -4(f)(2)(iii) Ex. (2) (specifies proposition in text and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

36. See, e.g., *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1123 ("Respondent's reallocations conflict with a fundamental principle of Federal income tax law: that income from property is earned by the owner of the property. See *Helvering v. Horst*, 311 U.S. 112 (1940); *Blair v. Commissioner*, 300 U.S. 5 (1937)").

37. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

section 367(d) to better approximate the results achievable under section 482.³⁸

As an important asterisk to this systemic legislative effort, Congress contemplated that a transfer solely categorized as goodwill would not be subjected to section 367(d)'s super royalty obligation,³⁹ and existing

38. H.R. REP. NO. 105-220, at 629 (1997) (Conf. Rep.). Although beyond the scope of this Article, it is worth noting in passing that the change in the sourcing result represents a significant effort to prevent section 367(d)'s deemed super royalty from creating international double taxation. In this regard, consider the facts set forth in the ILLUSTRATION CASE, *infra* but now posit that the income-producing intangible assets of the Target's business owned by the risk-taker entrepreneurial entity includes a Country A trademark and Country A brand names and that Country A imposes its own taxes on the risk-taker entrepreneurial entity for the sale into Country A using those intangible assets. These Country A foreign tax levies in all likelihood would allow the U.S. transferor to claim deemed U.S. foreign tax credit under section 902 when dividends are paid by the risk-taker entrepreneurial entity. *See* Reg. § 1.901-2(b)(1)–(4). The effect of section 367(d)(2)(C)'s sourcing rule is to cause the super royalty attributable to intangibles used outside of the U.S. to generate foreign source income to the U.S. transferor, thus providing the U.S. transferor the foreign tax credit limitation in which to utilize deemed section 902 foreign tax credits from Country A. *See* I.R.C. § 904(a), (d). Thus, the U.S. government has done much to unilaterally address potential double taxation problems arising from section 367(d)'s efforts to assert U.S. taxing jurisdiction over the income generated by foreign-owned intangibles in the ILLUSTRATION CASE, but even so Congress remained committed to preserving the right to tax on a residual basis the U.S. developer on the intangible returns of U.S. developed income-producing intangible assets even when the ownership of those intangible asset are transferred away to a foreign corporation.

39. *See* COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 365 (Comm. Print 1984); H.R. REP. NO. 98-432(II), at 1320 (1984) (stating that the committee contemplates that the transfer of goodwill or going concern value developed by a foreign branch will be treated under this exception [section 367(a)(3)] rather than a separate rule applicable to intangibles [section 367(d)]; a possible explanation for the distinction between goodwill and all other intangibles is indicated in the below excerpt from the Blue Book:

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.

STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 428,

Treasury regulations implement that policy—at least with respect to foreign goodwill.⁴⁰ Does this “goodwill” carve-out represent a fatal “goodwill loophole” to section 367(d) that frustrates Congress’s efforts to statutorily codify the assignment of income doctrine?

The following ILLUSTRATION CASE provides a useful mechanism to clearly frame the relevant policy analysis:

ILLUSTRATION CASE: USP acquires U.S. Target Corporation with a purchase price of \$1,000. The U.S. parent corporation engages an expert to make a purchase price allocation. The expert identifies tangible assets of the Target Corporation and separately values them at \$100. The expert also identifies manufacturing intangibles of the Target Corporation and values them at \$100. The expert identifies marketing-based intangibles, valuable foreign brands, and a workforce-in-place that provides systemic ongoing nonroutine returns, but these assets are not separately valued and are instead included as components of foreign goodwill. The expert report therefore produces the following purchase price allocation:

<i>Purchase Price Allocation</i>	
Tangibles	\$ 100
Manufacturing Intangibles	\$ 100
Foreign Goodwill	\$ <u>800</u>
	\$1,000

The plan is to have the tangible assets acquired by a corporation incorporated in the country where

(Comm. Print 1984). See also H.R. REP. NO. 98-432(II), at 1317 (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.”); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362 (Comm. Print 1984) (same). This policy rationale is nonsensical on its face. As pointed out by Professor Johnson in the debate leading up to the Supreme Court’s decision in *Newark Morning Ledger*, the advertising and marketing costs are immediately deducted even though these costs can have value long into the future and create goodwill. See Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (Aug. 3, 1992). The Congressional statement that foreign goodwill was not the subject of expenditures that reduced the U.S. tax base is factually inaccurate.

40. Temp. Reg. § 1.367(d)-1T(b).

manufacturing is performed. The manufacturing intangibles and foreign goodwill are to be acquired by an offshore entity (a so-called “risk-taker entrepreneur entity”) incorporated in a low-tax jurisdiction. Key personnel of the workforce-in-place are employed by the risk-taker entrepreneur entity so that it can claim to have “real substance.”

In future years, the offshore risk-taker entrepreneur entity earns \$90 of residual profits in excess of the routine profits generated by the routine functions performed by the various affiliates. The taxpayer claims that 1/9th of the residual profits relate to the manufacturing intangible and is subject to section 367(d)’s super royalty but that 8/9ths of the residual profits fall within the protective cloak of the “goodwill loophole” because the \$80 of residual profits relate to the transfer of foreign goodwill and the fantastic entrepreneurship of the risk-taker entrepreneur entity and as such are outside the scope of section 367(d)’s super royalty obligation.

What portion of the intangibles set forth in the ILLUSTRATION CASE are subject to section 367(d)’s super royalty obligation and what amount of super royalty is commensurate with the income generated by those covered intangibles?

Respected tax organizations have urged the Treasury Department to clarify that intangible income assigned to the exploitation of contributed goodwill (\$800 of value in the initial transfer and \$80 of ongoing residual profits in the above example) should not be subjected to section 367(d)’s super royalty provisions.⁴¹ The Obama administration has proposed legislation that would treat all \$900 as subject to section 367(d)’s super

41. See New York State Bar Association, *Report on Section 367(d)*, at 51–58 (Oct. 12, 2010), 2010 TAX NOTES TODAY 198-20; see also Andrew Velarde, *Legislative History Could Prevent U.S. Taxation of Some Intangible Transfers*, 2014 TAX NOTES TODAY 57-9 (Mar. 25, 2014) (quoting James P. Fuller of Fenwick & West for statement that IRS “‘shouldn’t, and under the legislative history maybe couldn’t’ include under section 367(d) guidance things such as workforce in place, going concern value, and goodwill”); Thomas M. Zollo, *Clarification or Modification? The Tax Treatment of the Outbound Transfer of Goodwill, Going Concern Value, and Workforce in Place to a Foreign Corporation*, 39 TAX MGM’T INT’L J. 71 (Feb. 12, 2010); James P. Fuller, *U.S. Tax Review*, 54 TAX NOTES INT’L 773 (June 1, 2009); David N. Bowen, *Full-Value Methods: Has the IRS Finally Hurlled the Holy Hand Grenade? A Critical Analysis of the Scope of §§ 482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place*, 37 TAX MGM’T INT’L J. 3 (Jan. 11, 2008).

royalty obligation as a matter of law.⁴² The staff of the Joint Committee on Taxation has identified the essence of this ILLUSTRATION CASE as a source for profit shifting under current law.⁴³ According to public documents, Caterpillar, Inc. engaged in a supply chain restructuring exercise where sophisticated logistics systems, business methods, foreign goodwill, and the opportunity to sell Caterpillar, Inc. specialty parts (a franchise)⁴⁴ was transferred to a Swiss risk-taker entrepreneur entity that substantively performed no significant function other than as a limited-risk distributor (an internal “commissionaire”). But even so, approximately 85 percent of the residual profits (approximately \$8 billion of profits over a twelve year period) was retained by the Swiss risk-taker entrepreneurial entity notwithstanding that the functions responsible for the generation of these residual profits resided with Caterpillar, Inc. and its independent foreign dealers.⁴⁵ The IRS has identified IP migration strategies premised on the “goodwill loophole” as an area of concern⁴⁶ and is now belatedly contesting these goodwill loophole cases in court.⁴⁷

42. See GENERAL EXPLANATION OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS, *supra* note 4, at 47.

43. SEE STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING (JCX-37-10), at 73–76 (July 20, 2010) (the Charlie Company scenario posits a migration of intangible assets through a strategy where over \$15 billion of intangible value was transferred and almost all of the transferred value was designated as foreign goodwill).

44. *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. 435, 441 (1992) (stating that “we read the word “franchise,” as used in section 1253, broadly to mean ‘franchises’ as that term is commonly understood, including any agreement which gives one party the right to distribute, sell, or provide goods, services, or facilities within a specified area”), *aff’d*, 995 F.2d 530 (4th Cir. 1993); *Int’l Multifoods v. Commissioner*, 108 T.C. 25 (1997) (applies same broad definition found in section 1253 case law to section 865(d)(1)); TAM 2009–070–24 (Nov. 10, 2008) (applies same broad definition to section 936(h)(3)(B)(iv) and thus section 367(d)).

45. See *Caterpillar Hearing*, *supra* note 25 (statement of Bret Wells) (statement of Reuven S. Avi-Yonah). Reuven S. Avi-Yonah, *Just Say No: Corporate Taxation and Social Responsibility* (U. of Michigan Public Law Research Paper No. 402; U. of Michigan Law & Econ. Research Paper No. 14-010), <http://ssrn.com/abstract=2423045>. At the hearing, Caterpillar claimed that the IRS had accepted the company’s position. However, subsequent to this hearing, Caterpillar stated that in fact the IRS was contesting these prior positions. See Filing on Form 10-Q with the Securities and Exchange Commission at 27 (May 2, 2014); Richard Rubin, *IRS Probing Caterpillar Parts Deal Examined by Senators*, BLOOMBERG NEWS (May 3, 2014) <http://www.bloomberg.com/news/2014-05-02/irs-probing-caterpillar-parts-deals-examined-by-senators.html>.

46. See T.A.M. 2009–07–024 (Feb. 13, 2009) (stating that 97 percent of section 351 outbound intangible contribution was designated by the taxpayer as “goodwill” whereas IRS asserted that the transfer represented intangibles such as a

The debate about the correct result in the ILLUSTRATION CASE is fierce. But, seen in its historic context, the correct policy answer to the ILLUSTRATION CASE is straightforward: all \$90 of the residual profits should be assigned back to the original U.S. transferor via section 367(d). That is what Congress intended when it enacted and amended section 367(d), but whether a “goodwill loophole” exists that prevents this result is a critical question that goes to the efficacy of section 367(d).

For the reasons explored in Subparts II.A. and II.B., taxpayers are mistaken when they claim that a “goodwill loophole” exists within section 367(d) that allows residual profits to remain in the risk-taker entrepreneur entity. A correct application of existing law to the facts set forth in the ILLUSTRATION CASE requires that all \$90 of the residual profits be assigned back to the U.S. transferor as a super royalty. There are at least two separate (albeit related) lines of reasoning that lead to this conclusion, and the rationale related to each are set forth below.

A. *The “Goodwill Loophole” Does Not Provide a Protective Cloak Against Section 367(d)’s Super Royalty Obligation for Assets that Generate Residual Profits*

In order to evaluate the ineffectiveness of the “goodwill loophole,” the scope of the term goodwill must be understood as the evolution of the meaning of goodwill provides important insight and context for the current debate. Early case law consistently defined goodwill as the financial benefits

dealer network and network of foreign agents that were subject to section 367(d)’s super royalty obligation); *see, e.g., IRS, Coordinated Issue Paper Addresses Cost-Sharing Arrangement Buy-In Adjustments*, LMSB-04-0907-62 (Sept. 27, 2007), 2007 TAX NOTES TODAY 190-38; IRS Industry Specialization Program Papers, withdrawn in 2012 (see LB&I-04-0812-010 (Aug. 17, 2012)), 2012 TAX NOTES TODAY 161-51; *Audit Guidelines Related to Section 936 Conversion Issues, Attachment to Industry Directive on Section 936 Exit Strategies Audit Guidelines Related to Section 936 Conversion Issues*, LMSB-04-0107-002 (Feb. 2, 2007), 2007 TAX NOTES TODAY 25-39; *LMSB Procedures for Program Action Cases (PACs) on Tax Return Preparers*, LMSB-04-0108-001 (Feb. 13, 2008) (“The definition of foreign goodwill or going concern value requires a business operation conducted outside of the United States.”), 2008 TAX NOTES TODAY 36-42 [hereinafter *LMSB Procedures for Program Action Cases*]; *see also, Coordinated Issue Paper Addresses Cost-sharing Arrangement Buy-In Adjustments*, section III.E.1., LMSB-0400907-62 (Sept. 27, 2007), 2007 TAX NOTES TODAY 190-38; *Coordinated Issue Paper Addressing Transfer of Intangibles Offshore/Section 482 Cost Sharing Buy-In Payment*, LMSB-0400307-027 (Apr. 5, 2007), 2007 TAX NOTES TODAY 67-3.

47. Petition for Redetermination of Deficiency in Tax, *Medtronic v. Commissioner*, No. 6944-11 (2011) 2011 WL 1373498; Petition for Redetermination of Deficiency in Tax, *Amazon v. Commissioner*, No. 31197-12 (2012) 2012 WL 11860896.

attributable to customer patronage that existed for whatever reason.⁴⁸ From the earliest years of the income tax until 1993, Treasury regulations provided that goodwill was not amortizable because it had an indefinite useful life,⁴⁹ and this strict prohibition on the amortization of goodwill had been consistently upheld in the case law.⁵⁰ Faced with the prospect that any purchase price allocated to goodwill would be nonamortizable, taxpayers in the domestic tax context attempted to minimize the amount of purchase price that would be categorized as goodwill by claiming that the purchase price should instead be allocated to separate and distinct customer-based intangible assets that were independent of goodwill, capable of being valued, and had an ascertainable useful life.⁵¹ In response, the government regularly argued

48. See *Boe v. Commissioner*, 307 F.2d 339 (9th Cir. 1962) (denying depreciation or loss deduction for terminable-at-will medical service contracts on mass asset grounds). The notion that goodwill is the “expectancy that old customers will resort to the old place” was first espoused, not in a tax case, but by Lord Eldon in the 1810 British decision of *Cruttwell v. Lye*, 17 Ves. 335, 346 (1810). In *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893), the Court stated that goodwill is the benefit from the general public patronage arising “from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.” Existing regulations continue this definition. See Reg. § 1.197-2(b)(1) (stating that “[g]oodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.”).

49. The Revenue Act of 1913 allowed taxpayers a reasonable deduction for the exhaustion, wear and tear of property. Tariff Act of 1913, Pub. L. No. 62-16, II(B), 38 Stat. 114, 167 (1913). Regulations were issued in 1914, and those regulations explicitly stated that goodwill was not entitled to a depreciation/amortization deduction. See Reg. 33, art. 162 (1914). Congress, in 1918, enacted legislation that allowed amortization of intangibles. See Revenue Act of 1918, Pub. L. No. 65-254, 234(a)(7), 40 Stat. 1057, 1078 (1919). But, the IRS issued regulations the next year that reconfirmed that no amortization was allowed with respect to goodwill because goodwill had no definite useful life. See Reg. 45, art. 163, (1919). During Prohibition, in order to allow distillers to amortize goodwill made obsolete due to the passage of the Eighteenth Amendment, Treasury regulations were amended to allow amortization of goodwill. See Regs. 45, art. 163 (1920). In 1927, Treasury regulations were amended to state that goodwill is nonamortizable. See Regs. 45, art. 163 (1927). This prohibition on amortization of goodwill has been continued in Reg. § 1.167(a)-3(a) until the enactment of section 197.

50. The Supreme Court upheld the general prohibition of amortization of goodwill in *Haberle Crystal Springs Brewing Co. v. Clarke*, 280 U.S. 384 (1930).

51. See *Report on Proposed Legislation on Amortization of Intangibles* (H.R. 3035), 53 TAX NOTES 943, 944 (Nov. 25, 1991) [hereinafter *Report on*

that the customer-based intangibles identified by the taxpayer were in reality so interrelated with goodwill that the identified intangibles and goodwill were in reality a single, indivisible asset that could not be disaggregated.⁵² The indivisibility of customer-based intangibles from the underlying goodwill of the business came to be known as the “mass asset” rule⁵³ and was summarized as follows:

[The taxpayer seeks] an implausible separation of customer lists from goodwill, one a mirror reflection of the other, for

Proposed Legislation]; Michael J. Douglass, *Tangible Results For Intangible Assets: An Analysis of New Code Section 197*, 47 TAX LAW. 713 (1994).

52. See PHILIP F. POSTLEWATE, DAVID L. CAMERON & THOMAS KITTLE-KAMP, FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES AND INTANGIBLES at ¶ 10.01[2] (Thompson Reuters/WG&L updated Nov. 2013) [hereinafter POSTLEWATE, CAMERON & KITTLE-KAMP]. For authorities that so hold, see *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (purchase of tradename ensured that customers would continue to resort to the same old place of business which is the essence of goodwill); *Vaaler Inc. v. United States*, 68-1 U.S.T.C. ¶ 9183, 21 A.F.T.R. 2d 558 (D.N.D. 1968) (court allowed amortization but only after it was stated that the seller’s tradename was never used by the taxpayer); *but see Donrey, Inc. v. United States*, 809 F.2d 534, 536 (8th Cir. 1987) (court upheld jury verdict that allowed amortization even though taxpayer acquired customer-based intangibles with the seller’s tradename, but the district court judge commented that if it had been the trier of fact it would have found the subscription list to be nondepreciable. and the Eight Circuit affirmed).

53. The mass asset rule appears to have been first applied in *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171, 1172 (1925) (applying mass asset rule to disallow amortization of newspaper customer subscription list because this was inextricably linked to goodwill). The mass asset rule was applied as a rule of law for decades thereafter. See, e.g., *Hillside Dairy Co. v. Commissioner*, 3 T.C.M. 174 (CCH), T.C.M. (RIA) ¶ 44,055 at 193 (1944) (no loss deduction for a customer list acquired as part of the acquisition of a dairy business); *Anchor Cleaning Service, Inc. v. Commissioner*, 22 T.C. 1029 (1954) (disallowed amortization deductions for customer lists acquired as part of the purchase of a cleaning business); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961) (no amortization deduction for spot announcement contracts because they were inseparable from goodwill); *Thoms v. Commissioner*, 50 T.C. 247 (1968) (denying depreciation deduction with respect to list of insurance contracts under mass asset doctrine); *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 56 (1968), *aff’d* 420 F.2d 667 (3d Cir. 1969) (same); *Commissioner v. Seaboard Fin. Co.*, 367 F.2d 646, 652 (9th Cir. 1966) (same); *Richard S. Miller & Sons, Inc. v. Commissioner*, 537 F.2d 446, 45 (Ct. Cl. 1976) (“The rationale and purpose of the mass asset rule is to prevent taxpayers from increasing the value of depreciable property to offset the amount paid in excess of book value of assets purchased. This doctrine makes it possible to strike down depreciation deductions for amounts which should be properly allocated to goodwill” (internal quotation marks omitted)).

goodwill = expectancy of continued patronage = customer lists = goodwill. At least, if goodwill and customer lists are not mutually coextensive, the former includes the latter, and the lesser is inextricable from the greater. In the vernacular, goodwill is a customer list with trimmings. . . . [A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.⁵⁴

Based on the mass asset rule, if a customer-based or marketing-based intangible was identifiable but it was acquired as part of the acquisition of the seller's entire operating business, taxpayers could expect that the government would argue that the customer-based intangible was subsumed within the definition of goodwill as a matter of law because any effort to separately identify an intangible was merely an effort to disaggregate what was better viewed as a mass asset (goodwill). Accordingly, instead of goodwill representing a residual category, prior to 1973, goodwill represented a substantively pre-defined category that trumped the ability to separately identify income-producing customer-based intangibles. Thus, returning to the ILLUSTRATION CASE, the import of the mass asset rule would be to prevent the separate classification of marketing-based or customer-based intangibles, thus allowing the foreign goodwill classification to trump all other possible classifications for income-producing intangibles linked to goodwill. If our understanding of goodwill had stopped at this juncture, the "goodwill loophole" would have had the capability to cloak substantial income-producing intangible assets within its scope.

54. *Golden State Towel and Linen Services, Ltd. v. United States*, 373 F.2d 938, 942–44 (Ct. Cl. 1967) (citations omitted).

However, this expansive view of goodwill was significantly undercut in 1973 by the Fifth Circuit's decision in *Houston Chronicle Publishing Company v. United States*⁵⁵ in which the taxpayer acquired newspaper subscription lists as part of the acquisition of a newspaper publishing company. The taxpayer had no intention of continuing to operate the acquired newspaper and maintained that the acquired subscription lists represented separate and distinct assets with a limited and ascertainable life.⁵⁶ The government argued that while the subscription list may have a limited useful life that was ascertainable, the acquired subscription lists nevertheless were nonamortizable as a matter of law since they were in the nature of goodwill.⁵⁷

The Fifth Circuit observed that goodwill was nonamortizable as a matter of law, but even so, neither the prohibition against its amortization nor the mass asset rule prevented the taxpayer from properly claiming amortization deductions when the taxpayer could factually prove that: (1) an intangible had an ascertainable value separate and distinct from goodwill, and (2) the separately identified customer-based intangible had a limited useful life.⁵⁸ The Fifth Circuit then reconciled its decision to prior case law by stating that "most of the cases purporting to apply the 'mass asset' rule involved evidentiary failures on the part of the taxpayer to meet the dual burden of proof."⁵⁹ In the view of the Fifth Circuit, the determination of whether a customer-based intangible asset was separately identifiable and had an ascertainable useful life were simply factual questions, the resolution of which depended on whether the taxpayer could carry its burden of proof.⁶⁰ If so, then the identified intangible would be defrocked from the cloak of "goodwill."

In the following year, the IRS issued Revenue Ruling 74-456 where it reconsidered two earlier revenue rulings⁶¹ that had asserted that the "mass asset" rule was a rule of law and instead now asserted that whether customer-based intangibles were separate and distinct intangibles that existed apart

55. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). For an excellent discussion of this case law evolution, see POSTLEWAITE, CAMERON & KITTLE-KAMP, *supra* note 52, ¶ 10.01[2].

56. *See Houston Chronicle Publishing Co.*, 481 F.2d at 1244-45.

57. *See id.* at 1245.

58. *See id.* at 1250.

59. *See id.* at 1249.

60. *See id.* at 1247-53. The Eighth Circuit followed the rejection of the mass asset rule announced in *Houston Chronicle* by asserting that the burden to prove that an asset qualified for tax amortization is cast upon the taxpayer. *See Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987).

61. Rev. Rul. 74-456, 1974-2 C.B. 65, modifying Rev. Rul. 65-175, 1965-2 C.B. 41, and Rev. Rul. 65-180, 1965-2 C.B. 279.

from goodwill was a factual inquiry.⁶² Although the IRS asserted that the taxpayer's burden of proof was likely to be met only in the "unusual situation,"⁶³ it clearly contemplated that the mass asset rule was no longer a rule of law that barred such a factual inquiry. After *Houston Chronicle Publishing* and Revenue Ruling 74-456, commentators asserted that the mass asset rule, as a rule of law, was dead.⁶⁴ Emboldened by the inherently factual nature of the inquiry contemplated by these authorities, taxpayers aggressively sought to identify amortizable nongoodwill intangibles (such as marketing-based intangibles, workforce-in-place, and customer-based intangibles), and the efficacy of such efforts rested on the sophistication of the taxpayer's proof; as a result, even if one taxpayer lost a case, another taxpayer was motivated to try again with better proof.⁶⁵

In 1989, the General Accounting Office gathered data with respect to unresolved tax cases from 1979 to 1987 that had arisen in the wake of *Houston Chronicle Publishing* and found that taxpayers had identified 175 different types of customer-based intangible assets that were separate and distinct from goodwill, and these identified assets had a cumulative value (according to taxpayers) of \$23.5 billion.⁶⁶ In 70 percent of the contested

62. In Revenue Ruling 74-456, the Service modified two previous Revenue Rulings to reflect the Fifth Circuit's *Houston Chronicle* decision. Under Revenue Ruling 74-456, customer-related intangibles were no longer automatically characterized as a mass asset and "indistinguishable from goodwill." See Rev. Rul. 74-465, 1974-2 C.B. 65.

63. See Rev. Rul. 74-456, 1974-2 C.B. 65 ("Generally, customer and subscription lists, location contracts, insurance expirations, etc., represent the customer structure of a business, their value lasting until an indeterminate time in the future. These lists, contracts, insurance expirations, etc., are in the nature of goodwill or otherwise have indeterminable lives and, therefore, are not subject to depreciation. . . . However, if in an unusual case the asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable.").

64. See Gregory M. Beil, *Internal Revenue Code Section 197: A Cure for the Controversy over the Amortization of Acquired Intangible Assets*, 49 U. MIAMI L. REV. 731, 749-51 (1995); Amy J. Bokinsky, *Note: Section 197: Taxpayer Relief and Questions of Asymmetry*, 14 VA. TAX REV. 211, 220-22 (1994).

65. See *Report on Proposed Legislation*, *supra* note 51, at 946; Allen Walburn, *Depreciation of Intangibles: An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453, 466 (1993).

66. See GENERAL ACCOUNTING OFFICE, REPORT TO THE JOINT COMMITTEE ON TAXATION: ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS at 3 (Aug. 1991) [hereinafter ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS]. The GAO report further indicated that the identified intangibles fell into the following categories:

cases of this period, the government asserted that the taxpayer had not met its burden of proof to demonstrate that the identified intangible was independent of goodwill.⁶⁷ As a further complication, the Tax Court appeared to hold onto the belief that the mass asset rule had continued vitality,⁶⁸ and so in 1991 the IRS again resurrected the mass asset rule as a rule of law in its audit strategy.⁶⁹

Category #1	Customer- or Market-based Assets (\$10.5 billion)
Category #2	Contract-based assets (\$3.7 billion)
Category #3	Technology-based assets (\$2.2 billion)
Category #4	Statutory-based assets (\$3.5 billion)
Category #5	Workforce-based intangibles (\$1.1 billion)
Category #6	Corporation organization/financial intangibles (\$1.3 billion)
Category #7	Unidentified assets (\$1.2 billion)

67. See ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS, *supra* note 66, at 4.

68. See *Ithaca Industries v. Commissioner*, 97 T.C. 253 (1991) (utilizing the mass asset rule as a basis to conclude that the assembled workforce in place was not amortizable), *aff'd in result*, 17 F.3d 684, 687 (4th Cir. 1994) (Although the Fourth Circuit affirmed the Tax Court decision on the grounds that the factual record did not demonstrate that the workforce-in-place had an ascertainable life in this particular case, the Fourth Circuit rejected the Tax Court's reliance on the "mass asset rule" and the inability of workforce-in-place to have a separate and distinct intangible asset, stating that after the decision in *Newark Morning Ledger*, "it is no longer appropriate to classify an intangible asset based on its resemblance to the classic conception of goodwill or going-concern value, and *Ithaca's* deduction cannot be denied on that basis.").

69. *IRS Media/Communications Industry Specialization Program, Coordinated Issue Paper, Customer Subscription List* (Oct. 31, 1991), reprinted in *Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 705, 706 (June 8, 1992). See also *IRS Retail Industry Specialization Program, Coordinated Issue Paper, Customer-Based Intangibles* (Oct. 31, 1991), reprinted in *Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 746 (June 8, 1992) (IRS position is that when an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps into the shoes of the seller; the two-prong factual test announced in *Houston Chronicle* and followed in Revenue Ruling 74-456 cannot be met.); *IRS LBO Industry Specialization Program, Coordinated Issue Paper, Amortization of Market Based Intangibles* (Oct. 31, 1991), reprinted in *Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 687 (June 8, 1992) (an intangible asset based on the benefit derived from a competitive market position is nonamortizable). As *Newark Morning Ledger* was making its way through the

Another front in this ongoing battle of how much intangible value should be assigned to the category called goodwill involved whether the use of the capitalization of excess earnings method was an appropriate purchase price allocation methodology. This method was supported by the Ninth Circuit decision in *Commissioner v. Seaboard Financial Co.*⁷⁰ and by Revenue Ruling 68-609.⁷¹ Under this method, goodwill was not considered a residual category; instead, taxpayers separately identified an initial value for all assets (including goodwill) and then allocated any “excess purchase price” pro rata among all of the identified assets (including goodwill). Thus, under the capitalization of excess earnings methodology, depreciable assets could receive an allocation of purchase price in an amount in excess of their fair market value. In contrast to the capitalization of excess earnings methodology, the residual allocation methodology sought to allocate purchase price to all identified assets up to their fair market value and then any remaining difference was simply allocated entirely to goodwill.⁷² To resolve this split in the circuits and create conformity, Congress enacted section 1060 in 1986 to require the residual allocation methodology be employed for acquisitions.⁷³ Thus, after the enactment of section 1060, goodwill was considered a *residual category*.⁷⁴ While the residual allocation methodology became the means to determine value assigned to goodwill, Congress again left unaddressed the question of whether “goodwill” included

courts and the IRS’s audit position became well known, a spirited debate about the continued viability of the mass asset rule was had in Tax Notes. See Reuven S. Avi-Yonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles*, 55 TAX NOTES 981, 983 (May 18, 1992); Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (Aug. 3, 1992); Reuven S. Avi-Yonah, *Getting Out of the ‘Silly Quagmire,’* 57 TAX NOTES 427 (Oct. 19, 1992); Calvin H. Johnson, *Newark Morning Ledger: Intangibles Are Not Amortizable*, 57 TAX NOTES 691 (Nov. 2, 1992); Reuven S. Avi-Yonah, *Newark Morning Ledger: Striking a Blow for Tax Equity*, 57 TAX NOTES 819 (Nov. 9, 1992); Calvin H. Johnson, *The Argument over Newark Morning Ledger*, 57 TAX NOTES 1090, 1091 (Nov. 16, 1992); Calvin H. Johnson, *Sowing Mass Confusion*, 57 Tax Notes 1087 (Nov. 16, 1992); Calvin H. Johnson, *The Mass Asset Rule Is Not the Blob That Ate Los Angeles*, 57 TAX NOTES 1603 (Dec. 14, 1992); Calvin H. Johnson, *Once More into the Mass Assets*, 58 TAX NOTES 369 (Jan. 18, 1993); Reuven S. Avi-Yonah, *Newark Morning Ledger: A Post-Litem and Some Implications*, 59 TAX NOTES 813, 816 (May 10, 1993).

70. *Commissioner v. Seaboard Fin. Co.*, 367 F.2d 646 (9th Cir. 1966).

71. Rev. Rul. 68-609, 1968-2 C.B. 327.

72. See *R.M. Smith, Inc. v. Commissioner*, 591 F.2d 248, 252 (3d Cir. 1979); *cert. denied*, 444 U.S. 828 (1979); *Banc One Corp. v. Commissioner*, 84 T.C. 476, 506 (1985).

73. See Tax Reform Act of 1986, P.L. 99-514, § 641; H.R. REP. NO. 99-841(II), at 209 (Conf. Rep. 1986).

74. See S. REP. NO. 99-313, at 252-55 (1986).

all customer-based and marketing-based intangibles as a matter of law (under the mass asset rule) or whether goodwill excluded all intangibles that were capable of separate identification.

Thus, in the 1980s, it is fair to say that significant controversy existed over the separate and distinct identity of marketing-based and customer-based intangibles. In the midst of this raging debate, Congress defined intangibles in broad terms in section 936(h)(3)(B) but omitted “goodwill” from the list of intangibles, and the legislative history provides support for excluding goodwill from section 367(d)’s super royalty obligation. But, Congress did not legislatively resolve the debate about the contours of the term “goodwill.”

Ambiguity over the scope of what was meant by the term goodwill eventually was definitively resolved by the Supreme Court in 1993 in its landmark decision in *Newark Morning Ledger v. United States*.⁷⁵ In *Newark Morning Ledger*, the Supreme Court subordinated the category of “goodwill and going concern value” to all other separately identifiable intangible assets that are capable of separate identification, thus making “goodwill” an ephemeral category that deferred to other separately identifiable categories of intangibles.⁷⁶ Specifically, in *Newark Morning Ledger*, the taxpayer was the successor to The Herald Company (Herald).⁷⁷ In a prior year, Herald had purchased Booth Newspapers (Booth) and was required to determine its basis for the Booth assets by allocating its stock purchase price to the various Booth assets. After allocating \$234 million to financial and tangible assets,

75. *Newark Morning Ledger v. United States*, 507 U.S. 546 (1993). After the Supreme Court opinion was issued on April 20, 1993, Congress understood that the effort to separately identify intangibles would continue in light of the Supreme Court’s decision in *Newark Morning Ledger* and that a significant backlog of cases existed. See H.R. REP. NO. 103-213, at 690 (Conf. Rep. 1993). So, Congress enacted section 197 within four months of the Supreme Court’s decision in *Newark Morning Ledger* as a means to simplify the law. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-166, 107 Stat 312 (Aug. 10, 1993). Under section 197, taxpayers generally are allowed to amortize all purchased intangible property, including goodwill, over a fifteen year period. Final regulations under section 197 were issued shortly thereafter. T.D. 8865, 2000-1 C.B. 589. For purposes of section 197, the regulations provide that goodwill means “the value of a trade or business attributable to the expectancy of continued customer patronage” and “may be due to the name or reputation of a trade or business or any other factor.” Reg. § 1.197-2(b)(1). The regulations go on to distinguish goodwill from other intangible property including going concern value, customer based intangibles, trademarks and trade names, and workforce in place. Reg. § 1.197-2(b)(2)–(12). See I.R.C. § 197(d)(1)–(3). However, for purposes of amortization, section 197 makes no significant distinction between these various intangible assets. I.R.C. § 197(d)(1). See Reg. § 1.197-2(d)(1).

76. *Newark Morning Ledger*, 507 U.S. at 546.

77. *Id.*

Herald allocated approximately \$68 million of its purchase price to “paid subscribers lists” and then determined the ascertainable life for each of them.⁷⁸ Herald allocated the \$26 million remaining balance to goodwill and going concern value.⁷⁹

The Supreme Court stated that goodwill can be defined as the expectancy of continued patronage⁸⁰ and that goodwill is nonamortizable,⁸¹ but the Court pointed out that the regulatory test for whether an asset is amortizable depends upon whether the asset is separately identifiable, has a limited useful life, and has a reasonably ascertainable value.⁸² If such an asset exists, then by definition such an intangible is *no longer part of goodwill because goodwill is what is left-over after all other intangible assets have been identified*.⁸³ The effect of the Supreme Court’s holding was to dismember goodwill and require that all separately identifiable aspects of customer patronage be segregated from goodwill.⁸⁴ Consequently, even if customer-based or marketing-based intangibles were inextricably linked to the common understanding of what goodwill is (i.e., the expectancy of continued patronage), the value assigned to that customer patronage would

78. *Id.*

79. *Id.* at 550.

80. *Id.* at 556.

81. *Id.* at 565 n.13.

82. *Newark Morning Ledger*, 507 U.S. at 565–66 n.13.

83. The Court stated as follows:

The dissent’s mistake is to assume that because the “paid subscribers” asset looks and smells like the “expectancy of continued patronage,” it is, ipso facto, nondepreciable. In our view, however, whether or not an asset is depreciable is not a question to be settled by definition. “Goodwill” remains nondepreciable under applicable regulations, and we do not purport to change that fact. In interpreting those regulations, however, we have concluded that because the “paid subscribers” is an asset found to have a limited useful life and an ascertainable value which may be determined with reasonable accuracy, it is depreciable. *By definition, therefore, it is not “goodwill.”*

Id. at 565 n.13 (emphasis added).

84. The dissenting opinion in *Newark Morning Ledger* seems particularly prescient on this point when its stated:

[The taxpayer] would have us scrap the accepted and substantive definition of “goodwill” as an expectation of continued patronage, in favor of a concept of goodwill as a residual asset of ineffable quality, whose existence and value would be represented by any portion of a business’s purchase price not attributable to identifiable assets with determinate lives. Goodwill would shrink to an accounting leftover.

Id. at 574. The dissent’s prophecy has come true.

be allocated to a separate and distinct asset that was not part of goodwill if the asset could be shown to have an ascertainable useful life and was able to be separately identified and valued.⁸⁵

In view of section 1060's and *Newark Morning Ledger's* endorsement of the residual allocation methodology, goodwill has no preset definition and is displaced whenever income-producing intangibles are capable of separate identification,⁸⁶ and so any allocation to goodwill is at best provisional. In the context of the ILLUSTRATION CASE, an effort to use the "goodwill loophole" as a cloak to cover income-producing intangibles is ineffective. The case law indicates that all intangibles that can be identified are no longer "goodwill" for tax purposes. In the context of the ILLUSTRATION CASE, the allocation of \$800 to goodwill would be unsupported after *Newark Morning Ledger* if the value assigned to goodwill included income-producing intangible assets. Any value that remains as residual goodwill is only the left-over residual value that remains after all income-producing intangibles have been valued. Said differently, any allocation of intangible value to goodwill remains in goodwill only if that value has no discrete income-generating capability; otherwise the value should be segregated out of goodwill whenever it does have income-producing potential and assigned to the identifiable income-producing asset that generates the annual residual profits.⁸⁷

In the context of the ILLUSTRATION CASE, taxpayers have argued that only the residual profits attributable to the \$100 of manufacturing intangibles are subject to section 367(d) and that the residual profits of \$80 that are attributable to the \$800 of foreign goodwill are not.⁸⁸ The legislative

85. See Brian R. Greenstein, *The Depreciation of Customer-Based Intangible Assets After Newark Morning Ledger*, 20 J. CORP. TAX'N 315, 324-25 (1994).

86. See Christian M. McBurney, *Goodwill in Like-Kind Exchanges of Newspapers—IRS is Inconsistent With Other Areas*, 108 J. TAX'N 147 (Mar. 2008).

87. See authorities cited *supra* note 35.

88. The IRS has stated as follows:

The existence of this [foreign goodwill exception to section 367(d)] exception often leads US transferors to contend that a significant portion of the intangibles transferred in a section 351 or 361 exchange, particularly marketing intangibles and workforce in place, should be treated as foreign goodwill and going concern value. Such claims should be carefully scrutinized, and the nature of all transferred intangibles should be examined to determine whether it would be more appropriate to treat the claimed foreign goodwill and going concern value as intangibles subject to section 367(d). Likewise, in the case of section 936 conversions, it may be appropriate to consider whether claimed foreign goodwill and going concern value is really foreign. It may be that these

history to section 367(d) indicates that Congress did not intend for section 367(d) to apply to an outbound contribution of solely goodwill,⁸⁹ and several practitioners have argued that “goodwill” should have some static meaning and should not be eroded by the opportunity to separately identify specific marketing-based or customer-based intangibles,⁹⁰ thus harkening back to the mass asset rule that was the subject of the litigation in *Newark Morning Ledger*. However, the legislative history indicates that this goodwill exception should not allow separate and distinct intangibles to escape section 367(d)’s super royalty obligation.⁹¹

Arguments based on the legislative history that claim that “goodwill” provides a safe haven categorization for significant income-producing intangibles that are marketing-based or based on a workforce-in-place are overdone.⁹² Nowhere did Congress evidence an intent to affirmatively define

intangibles are goodwill and going concern value, but are not foreign and thus are subject to tax.

See IRS Directive LMSB-04-0107-002, transmitted by memorandum dated Feb. 2, 2007, from John Risacher, Industry Director for Retailers, Food, Pharmaceuticals and Healthcare Division.

89. See authorities cited *supra* note 39.

90. See authorities cited *supra* note 41.

91. The conference report indicates that all intangibles, whether or not otherwise subject to a nonrecognition transaction, are intended to be subject to section 367(d)’s super royalty provision. See H.R. REP. NO. 98-861, at 953–55 (Conf. Rep. 1984). The House Ways and Means Committee report indicates that section 367(d) should apply to intangibles regardless of whether an otherwise applicable nonrecognition exception existed. See H.R. REP. NO. 98-432(II), at 1323 (1984); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 367–68 (Comm. Print 1984) (same); H.R. REP. NO. 98-861, at 953 (Conf. Rep. 1984) (same); see also STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, at 432–35, (Comm. Print 1984) (stating that the special rule for transfers of intangibles preempts the rule for tainted assets where property is described in both provisions).

92. Those who attempt to provide a carve-out point to the discussion of marketing intangibles that occurred within the context of section 367(a)(3)’s exception, which provided that:

It is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names) in appropriate cases.

COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 365 (Comm. Print 1984); see also STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, at 435, (Comm. Print 1984) (same). Trade names and trademarks are explicitly enumerated in section 936(h)(3)(B), so

goodwill in any way other than in its generally understood meaning, and that generally understood meaning was significantly clarified by the Supreme Court in 1993. As the Supreme Court stated in *Newark Morning Ledger*, if an intangible asset is separately identifiable and valuable, then it is by definition no longer goodwill even though one might recognize that it represents aspects of customer patronage.

Thus, in the context of the ILLUSTRATION CASE, a court should understand that if an intangible (individually or collectively) actually creates ongoing annual residual profits, then the underlying asset that generates those residual profits is no longer part of goodwill and should be separately identified. The existence of the full \$90 of annual intangible profits requires a court to engage in a fact-finding exercise to determine the underlying intangibles that generated those intangible returns, and once this is done then the identified intangibles that generated the intangible returns (the full \$90 of residual profits in the ILLUSTRATION CASE) are no longer goodwill but in fact are attributable to separate and distinct intangibles. Once those identified intangibles are excluded from goodwill, then section 367(d) causes the full \$90 of residual profits attributable to those identified intangibles to be assigned back to the U.S. transferor if the U.S. transferor is the one that contributed those income-generating intangible assets to the foreign corporation. A court that allows residual profits to remain in goodwill without associating them to the specific intangible that created them fails to apply section 367(d) in a manner that achieves Congress's goals. The system is watertight, and purposefully so because Congress intended to statutorily codify the judicially created assignment of income doctrine so that residual profits would stay with the developer of the intangible and would not follow the transferred income-producing intangible to the risk-taker entrepreneurial entity in the facts set forth in the ILLUSTRATION CASE.

Regardless of how one reads the legislative history and common law on these points, it is clear that the Treasury Department was given broad

this legislative history needs to be read as solely describing the applicability of section 367(a)(3) and not a broad articulation that these intangibles can be transferred in avoidance of section 367(d). In addition, as mentioned in *supra* note 91, the legislative history goes on to state that section 367(d)'s super royalty provision preempts other results including otherwise nontaxable results achieved under section 367(a). Furthermore, other statements in the legislative history make clear that section 367(d) applies to both marketing and manufacturing exceptions. See H.R. REP. NO. 98-432(II), at 1316 (1984) (referring to both marketing and manufacturing intangibles as transactions that motivated the enactment of section 367(d)). The conference report summarily states that an outbound transfer of an intangible is subject to section 367(d) and then states that certain marketing intangibles may simultaneously be taxable under section 367(a). See H.R. REP. NO. 98-861, at 955 (Conf. Rep. 1984).

regulatory authority to define the scope of section 367(d),⁹³ and it is also clear that Congress wanted to stop the migration of residual profits away from the U.S. developer via the contribution of income-producing intangibles to a foreign corporation.⁹⁴ The Treasury Department exercised its regulatory authority to provide that section 367(d)'s super royalty provisions apply equally to both manufacturing intangibles and to marketing intangibles,⁹⁵ and these regulations distinguish and define goodwill as “*the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued.*”⁹⁶ This definition of goodwill in the section 367(d) regulations incorporates the approach articulated in *Newark Morning Ledger*. If the intangible assets that

93. In this regard, section 367(d) includes the lead-in clause, “[e]xcept as provided in regulations,” thus leaving Treasury and the IRS with abundant authority to carry out the congressional intent to interpret scope of section 367(d) in a manner that prevents the migration of residual profits out of the U.S. tax base.

94. See legislative history discussed *supra* note 91.

95. See Temp. Reg. § 1.367(a)-1T(d)(5)(i) (second sentence), cross-referenced by Temp. Reg. § 1.367(d)-1T(b) (first sentence). Others have attempted to infer that the Treasury and the IRS clearly understood that they were not acting consistently with the intent of Congress because the section 367 regulations include a special transition rule under which foreign trademarks, trade names, brand names, and similar marketing intangibles developed by a foreign branch are treated as foreign goodwill or going concern value. See Temp. Reg. § 1.367(a)-1T(d)(5)(iv). Note, however, that this provision is not cross-referenced by Temporary Regulation section 1.367(d)-1T(b). Such treatment effectively allowed such transfers to be excluded from the scope of section 367(d). This special rule is effective, however, only for transfers occurring after December 31, 1984 (the effective date of section 367(d)), and before May 16, 1986 (the date of publication of the regulations). No explanation is given as to why certain marketing intangibles developed by a foreign branch are effectively excluded from the scope of section 367(d) (by their treatment as foreign goodwill or going concern value) only on a transitional basis. See Davis, 920-3rd T.M., *Other Transfers Subject to Section 367* at III.B.1.a(3).

96. Temp. Reg. § 1.367(d)-1T(b) (second sentence) (emphasis added). The section 482 White Paper states:

A particularly difficult aspect of valuing intangibles has been determining what part of an intangible profit is due to manufacturing intangibles and what part is due to marketing intangibles. This problem has particular significance in section 936, since the possessions corporation is generally entitled to a return only on manufacturing intangibles when it elects the cost sharing method under section 936(h).

See Notice 88-123, 1988-2 C.B. 458, 463 (TREASURY DEP'T & INTERNAL REVENUE SERVICE, A STUDY OF INTERCOMPANY PRICING 20-21 (1988)) [hereinafter 1988 White Paper]. The inclusion of both marketing intangibles and manufacturing intangibles within the scope of section 367(d) avoids difficult allocations of value between these types of identified intangibles.

generated the \$90 of residual profits have not been identified, then they must be identified and doing so requires that the identified items be removed from goodwill, thus defrocking them of the “goodwill loophole.”

Furthermore, it is equally clear under the section 367 regulations that section 367(d)’s super royalty provisions apply to intangibles that are owned by a U.S. person without regard to whether those items are used or developed in the United States or in a foreign country.⁹⁷ A taxpayer attempting to assign significant value to a residual category called “goodwill” with an eye towards resisting efforts to separately identify the underlying intangibles that generate annual residual profits frustrates the policy goals that are behind section 367(d) and ignores *Newark Morning Ledger*. If significant ongoing residual profits exist in an enterprise, then the ongoing residual profits must be explained in terms of the specific income-producing intangibles that generate those nonroutine returns.⁹⁸ Congress made it clear that annual and ongoing residual profits cannot be transferred away from the U.S. developer via the transfer of the underlying income-producing intangible asset in an outbound section 351 transfer, and Congress made this air tight by stating that intangibles that generate intangible returns are subject to section 367(d)’s super royalty and that the amount of the section 367(d) super royalty must be commensurate in amount to the actual residual income that is generated by those transferred income-producing intangibles.⁹⁹ A section 351 transfer that is designated as goodwill is not an effective loophole for migrating residual profits to a foreign corporation because the goodwill cloak is defrocked of all income-producing intangibles that generate residual profits. When faced with the “goodwill loophole” cases, courts should decide those cases in a manner that achieves section 367(d)’s fundamental goals, and the common law along with existing Treasury regulations provide the courts with ample means to do so.

97. See Reg. § 1.367(a)-1T(d)(5)(i); Reg. § 1.367(a)-7(f)(11).

98. See Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(b)(6) (defines “intangible” to include an item that exhibits intangible property characteristics which presumably is met if the asset is capable of generating intangible returns).

99. See authorities cited *supra* note 35.

B. Section 936(h)(3)(B) Uses a Purposefully Circular Definition to Ensure that Residual Profits Arising from a Contributed Business are Always Subject to Section 367(d)'s Super Royalty Obligation

An objector may claim that intangible property must be described in section 936(h)(3)(B) before that intangible asset is subjected to section 367(d)'s super royalty obligation and that important intangibles, such as workforce-in-place or marketing intangibles, were not enumerated within section 936(h)(3)(B). The proponent of that argument would then say that failing to be specified in section 936(h)(3)(B) prevents the application of section 367(d)'s super royalty obligation.¹⁰⁰ Thus, even if the \$90 of residual profits are all associated with income-producing intangibles that are not goodwill, the objector would still argue that the income-producing intangibles must still be described in section 936(h)(3)(B) before the income from the contributed income-producing intangibles is subjected to section 367(d)'s super royalty obligation. As facially plausible as this argument may seem based on the statutory language, it is patently erroneous.

Section 936(h)(3)(B) contains an extensive list of twenty-eight specifically enumerated items¹⁰¹ that are explicitly enumerated as "intangibles." This list is extremely broad in its scope in that it utilizes traditional indicia of customer patronage (such as trademarks, trade names, brand names) but then the statute provides in section 936(h)(3)(B) (iv) and (v) that an intangible also includes any "franchise, license, contract, method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data." These categories are extremely broad and would capture almost any aspect of an intangible business asset that generates residual profits.

100. *See* I.R.C. § 367(d)(1) (cross-references section 936(h)(3)(B)'s definition of intangibles for the list of intangibles that are subject to section 367(d)'s super royalty).

101. Section 936(h)(3)(B) states that the term "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.

However, assume for the sake of argument that some aspect of workforce-in-place or of a marketing intangible defies ready categorization within the twenty-eight enumerated terms set forth under section 936(h)(3)(B)(i) through (v) and yet represents an intangible that generates ongoing intangible returns. If this were the procedural posture of the case before a court, would this cause a court to conclude that the intangible profits associated with this unspecified transferred intangible escapes section 367(d)'s super royalty obligation? The answer is a categorical "no" because of the purposeful circularity employed for the definition of a "similar item" in section 936(h)(3)(B)(vi).

In this regard, section 936(h)(3)(B)(vi) provides a final "catch-all category," stating that an intangible within the meaning of section 936(h)(3)(B) also includes any "similar item." For this purpose, the section 367(d) regulations incorporate the regulations under section 482,¹⁰² and those section 482 regulations state that an intangible is a "similar item" if it derives value from its "other intangible properties."¹⁰³ What is a characteristic of an intangible property? The answer a court should reach is that a characteristic of an intangible property is that it generates intangible returns. Thus, if an internal function has the characteristic that it creates intangible returns (i.e., creates residual profits), then it is a "similar item." If a particular workforce-in-place creates intangible returns (i.e., residual profits), then that particular workforce-in-place has properties that are characteristic of an intangible and is therefore a "similar item" under section 936(h)(3)(B)(vi). If another workforce-in-place makes no contribution towards creating residual profits, then that other workforce-in-place does not exhibit the characteristic of an intangible asset in this alternative scenario.

One should not miss the results-oriented, purposeful circularity of this definition: if residual profits exist as a result of a transferred asset, then that transferred asset exhibits properties that are characteristic of an intangible asset, and it is that fact alone that causes the asset to be included within the definition of section 936(h)(3)(B)(vi). The circularity is purposeful: ongoing residual profits must be grounded to some "item," and once that item is identified then it is covered under section 936(h)(3)(B)(vi) exactly because it generates intangible returns. The circularity is inexplicable until one remembers the rationale for section 367(d): Congress wanted to codify the assignment of income doctrine so that residual profits from contributed businesses are assigned back to the U.S. transferor who developed the transferred assets that generate intangible returns. Furthermore, the addition of the commensurate with income requirement now means that the super royalty is determined by looking to the actual

102. See Temp. Reg. § 1.367(d)-1T(c)(1).

103. See Reg. § 1.482-4(b)(6); see also T.D. 8552, 1994-2 C.B. 93 (stating that this definition of a "similar item" was merely a clarification of existing law).

annual residual profits that are generated so that the amount assigned back to the U.S. transferor as a super royalty is the full amount of the residual profits attributable to the underlying business that was transferred away.¹⁰⁴ The circularity achieves the fundamental goal of the statutorily codified assignment of income doctrine.

Interestingly, the government has already adopted in its audit and litigating positions that those things that create residual profits represent separate and distinct customer-based and marketing-based intangibles (such as workforce-in-place,¹⁰⁵ long-term supply agreements,¹⁰⁶ and foreign marketing and distribution networks)¹⁰⁷ and as such are described within the defined categories enumerated in section 936(h)(3)(B), thus excluding them from the definition of goodwill.¹⁰⁸ Conceptually, the IRS position is that

104. See Temp. Reg. § 1.367(d)-1T(c)(1) (states super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(f)(2)(ii)(C)(4) and -4(f)(2)(iii) Ex. (2) (specifies and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

105. The IRS has stated as follows with respect to taxpayer efforts to categorize intangible value associated with workforce-in-place as part of foreign goodwill:

Workforce-in-place is properly treated as an intangible under § 936(h)(3)(B), and is therefore taxable under § 367(d). Some taxpayers have argued that the workforce-in-place is a part of going concern value that transfers tax free to the foreign corporation. However, to the extent that workforce-in-place can be identified and valued as a distinct asset, workforce-in-place should not be viewed as part of foreign goodwill or going concern value.

See IRS, LMSB-04-0108-001 (Feb. 13, 2008). The issue of whether workforce in place is a section 936(h)(3)(B) intangible that is subject to section 367(d)'s super royalty is an issue in controversy in *Petition for Redetermination of Deficiency in Tax, Medtronic v. Commissioner*, (2011) (No. 6944-11), 2011 WL 1373498.

106. See F.S.A. 2001-28-040 (Apr. 16, 2001) (wherein the Chief Counsel's Office treated a long-term supply agreement as a section 367(d) intangible property that was separate and distinct from foreign goodwill).

107. See authorities cited *supra* notes 46 and 47. A fact pattern substantially similar to the one posited in T.A.M. 2009-07-024 was presented in the docketed case of *First Data Corp. v. Commissioner*, but the taxpayer conceded this issue in its entirety prior to trial. See *Fourth Stipulation of Settled Issues, First Data Corp. v. Commissioner*, (2011) (No. 7042-09), 2011 WL 9160637.

108. The staff of the Joint Committee on Taxation has a different view, believing that the IRS is arguing that outright goodwill is a "similar item" to those set forth in section 936(h)(3)(B)(i) through (v). See STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSALS, JCS-2-12, at 364 (2012). However, that is

identified intangibles are either intangibles that are contained within the explicitly enumerated twenty-eight identified intangibles¹⁰⁹ or such intangibles represent an unspecified intangible that is a “similar item” within the meaning of section 936(h)(3)(B)(vi) because the item has ongoing income-generating intangible property value. In the context of section 482, the case law has recognized that marketing intangibles exist as a separate and distinct asset,¹¹⁰ and cases where the government has failed in its arguments to find a marketing intangible can be viewed as failures to sustain a factual finding and not as articulating a rule of law.¹¹¹ Thus, the government’s

not what the IRS has been saying in the publicly available audit guidelines. *See, e.g., LMSB Procedures for Program Action Cases*, *supra* note 46. In any event, if aspects of customer patronage or workforce-in-place provide significant value, then a separately identified and valuable intangible asset exists apart from goodwill and as such workforce-in-place is simply no longer goodwill but is instead an intangible asset that is similar within the meaning of section 936(h)(3)(B)(vi) to the enumerated intangibles set forth in section 936(h)(3)(B)(i) through (v).

109. Either the intangible is explicitly so named or it is an intangible that is functionally the same as an intangible that is explicitly named in section 936(h)(3)(B)(i) through (v).

110. *See, e.g., Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930) (goodwill in the nature of trademarks, trade names, and trade brands); *J.C. Cornillie Co. v. United States*, 298 F. Supp. 887 (E.D. Mich. 1968) (goodwill in the form of customer lists); *F.W. Drybrough v. Commissioner*, 45 T.C. 424 (1966), *aff’d*, 384 F.2d 715 (6th Cir. 1967) (goodwill consisting of agency’s file of uncollected claims). *See also* P.L. R. 1981-34-193 (May 29, 1981) (“marketing intangibles” defined as the right to use tradename, trademark, and related goodwill).

111. In *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009) (nonacq.), A.O.D. 2010-5, 2010 WL 4531284, the Tax Court primarily addressed a cost sharing buy-in payment in the context where the court found that there was no evidence to support a finding that the transfer of access to U.S.-based R&D and marketing teams was the transfer of an intangible. As part of this discussion, the court included the following footnote 31:

Even if such evidence existed, these items would not be taken into account in calculating the requisite buy-in payment because they do not have “substantial value independent of the services of any individual” and thus do not meet the requirements of sec. 936(h)(3)(B) or sec. 1.482-4(b), Income Tax Regs. “Access to research and development team” and “access to marketing team” are not set forth in sec. 936(h)(3)(B) or sec. 1.482-4(b), Income Tax Regs. Therefore, to be considered intangible property for sec. 482 purposes, each item must meet the definition of a “similar item” and have “substantial value independent of the services of any individual.” Sec. 936(h)(3)(B); sec. 1.482-4(b), Income Tax Regs. The value, if any, of access to VERITAS US’ R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members).

arguments are laudable, but they are incomplete and are making the “goodwill loophole” case more difficult for the court than need be.

The government, courts, and taxpayers need to recognize that if a business is transferred to a foreign corporation and residual profits are generated annually thereafter from the contributed business, then the underlying assets that generate those annual residual profits exhibit properties that are characteristic of an intangible and as such are included within the scope of section 936(h)(3)(B)(vi) due to that fact alone. The mere existence of residual profits arising from an outbound transfer of assets implicates section 367(d). The underlying assets that explain those residual profits are either explicitly enumerated, or the residual profits relate to an unspecified intangible that from this fact alone causes them to be a “similar item” under the “catch-all category” of section 936(h)(3)(B)(vi) due to the sole fact that it generates residual profits. The existence of residual profits creates the definition. Thus, in the end, the government is not required to demonstrate what business asset created the residual profits. It need only show that annual residual profits exist with respect to a business that was the subject of an outbound transfer and so *a priori* those residual profits relate to intangibles that fall within the scope of section 367(d)’s super royalty obligation. There is no space in this rubric for a “goodwill loophole.” Furthermore, the addition of the commensurate with income requirement

Nevertheless, respondent in support of his contention cites Newark Morning Ledger Co. v. United States, 507 U.S. 546 [71 AFTR 2d 93-1380] (1993), and Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991), *affd.* 17 F.3d 684 [73 AFTR 2d 94-1323] (4th Cir. 1994). These cases, however, do not suggest that access to an R & D or marketing team has substantial value independent of the services of an individual, do not define intangibles for sec. 482 purposes, and do not even reference sec. 482. We note that in December 2008, the Secretary promulgated temporary regulations (i.e., secs. 1.482-1T through 1.482-9T, Temporary Income Tax Regs., *supra*) which reference “assembled workforce.” In addition, the Administration, in 2009, proposed to change the law to include “workforce in place” in the sec. 482 definition of intangible.

The author harmonizes this dicta with the synthesis of the law set forth in this article by simply noting that the Tax Court did not find a separate and distinct intangible in *Veritas* as a factual matter and as a factual matter believed solely goodwill existed. Under that finding of fact, it is entirely consistent to say that any remaining value was therefore allocable to residual goodwill. However, if the taxpayer asserts that workforce-in-place possesses nonroutine functions that contribute towards the generation of nonroutine profits, then that workforce-in-place represents an intangible that is subject to section 367(d)’s super royalty because it is a “similar item” within the meaning of section 936(h)(3)(B)(vi). *See* Reg. § 1.482-4(b)(6) (defines “similar item” as an intangible that has value due to its intangible property characteristics).

ensures that all of the \$90 of residual profits in the ILLUSTRATION CASE must be assigned as a super royalty to the U.S. person who transferred the nonroutine intangible that generated those residual profits.¹¹²

The breadth of section 936(h)(3)(B) places the taxpayer in the ILLUSTRATION CASE on the horns of a dilemma. If the taxpayer says that the \$800 of value assigned to goodwill actually creates future intangible property returns, then to that extent the value so designated represents an other “similar item” and thus is carved-out of goodwill and is subject to section 367(d)’s super royalty obligation. Alternatively, the taxpayer could claim that none of the \$800 assigned to goodwill has any ongoing income-producing value to the controlled foreign corporation and thus is not an intangible that is valuable due to its intangible property characteristics. However, having made that argument, the taxpayer cannot then claim that any of the \$90 of residual profits in the ILLUSTRATION CASE remain with the risk-taker entrepreneur entity, because the amount of the section 367(d) super royalty (in order to be commensurate in amount to the residual profits actually generated) must be \$90 as the residual profits are to be allocated only to the income-producing intangibles that generate those residual profits¹¹³ and then assigned back to the U.S. transferor under section 367(d). What cannot be true is that goodwill cloaks some intangible that creates ongoing residual profits. Section 936(h)(3)(B) is drafted to defrock goodwill of all intangibles that create ongoing intangible property returns and leaves it as a hollow shell. If there is any value left-over in the residual category called goodwill, it has no claim to share in the ongoing future residual profits.

The only pathway out of section 367(d)’s super royalty obligation for the full \$90 of residual profits is for the risk-taker entrepreneur entity to show that the annual residual profits arise from a function that was not part of the outbound contribution. However, now the taxpayer is required to prove what function made a nonroutine contribution towards the creation of those residual profits¹¹⁴ and must also show that the identified function was not part of the outbound section 351 transfer. As has been argued elsewhere, risk-taking by itself is not a “nonroutine function” that affords an entity the right to share in residual profits.¹¹⁵

Seen in this light, the decision by the Tax Court in *International Multifoods v. Commissioner*¹¹⁶ is in harmony with this evolution in the law.

112. See authorities cited *supra* note 35.

113. See Reg. §§ 1.482-6(c)(3), 1.482-4(b)(6).

114. See Reg. § 1.482-6(c)(3)(i)(B).

115. See Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482’s Arm’s Length Standard*, 15 FLA. TAX REV. 737 (2014) [hereinafter Wells & Lowell, *Tax Base Erosion*].

116. *Int’l Multifoods v. Commissioner*, 108 T.C. 25 (1997).

In *International Multifoods*, the Tax Court held that a U.S. corporate seller's goodwill inherent in its doughnut business in Asia and the Pacific was embodied in, and not severable from, its franchisor's interest and trademark that were conveyed to the buyer. Accordingly, the court held that the gain from the sale of the taxpayer's franchisor's interest and trademarks (including any goodwill inherent therein) was U.S.-source income for foreign tax credit limit purposes under the residence-of-the seller rule in section 865(a) and (d)(1) since the subject matter of the sale was a trademark. In the court's view, the special source rule in section 865(d)(3) for gain from the sale of goodwill applies only where goodwill is separate from the other intangible assets that are specifically listed in section 865(d)(1). Since an identified asset (namely a tradename) apart from goodwill was identified that coterminously explained the intangible value of the doughnut business, the allocation of that intangible value to the identified trademark supplanted any opportunity to source the gain under the specialized sourcing rule of section 865(d)(3). Thus, the Tax Court in *International Multifoods* rejected prior case law that goodwill, trademarks, and tradenames were inextricably linked and were thus sourced as goodwill under section 865(d)(3).¹¹⁷ These earlier decisions harken back to the now defunct mass asset rule, but since 1993 goodwill is considered a left-over or residual allocation that only receives an allocation for sourcing purposes after the other identifiable intangibles specified in section 865(d)(1) are valued, thus causing goodwill to have an ephemeral and contingent status.

C. *Section 367(d)'s Purpose is Frustrated by the Existing Cost Sharing Regulations*

The ability to assign residual profits to a risk-taker entrepreneur entity and away from the affiliate whose functions created the income-producing intangible is a theme that has been clearly played out through the use of cost sharing arrangements (CSAs) entered into among MNE affiliates.¹¹⁸ Essentially, CSAs allow two or more controlled parties to share the costs and risks of a research and development project for an agreed upon scope in exchange for a specified interest in the results of the project. As the participants jointly own the developed technology, there is typically no royalty obligation with respect to the use of the technology by any participant. Consideration for use of intangibles developed in a CSA is paid

117. For cases articulating that trademarks and tradenames are the embodiment of goodwill, see *Canterbury v. Commissioner*, 99 T.C. 223, 252 (1992); *Philip Morris, Inc.*, 96 T.C. 606, 634 (1991).

118. The views expressed by the author with respect to cost sharing agreements was originally set forth in Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

in advance during the course of development as opposed to after the development (typically as royalties) where the intangibles are developed by another person. In effect, a CSA involves multiple developers.

The IRS has struggled with the cost sharing regulations from a U.S. tax base defense standpoint since the mid-1960s.¹¹⁹ In the pre-1986 cases, courts typically sided with taxpayers.¹²⁰ While the Tax Reform Act of 1986 Act did not specifically address CSAs, the legislative history indicates that the commensurate-with-income provisions of sections 367(d) and 482 were not intended to prevent appropriate use of such arrangements.¹²¹ The

119. Administrative guidance was initially provided in the 1966 proposed regulations. Prop. Reg. § 1.482-2(d)(4)(i), 31 Fed. Reg. 10,394, 10,398 (1966). When the section 482 regulations were finalized in 1968, the provisions applicable to cost sharing were considerably reduced and simplified, with the content compressed from several pages to only one paragraph. T.D. 6952, 1968-1 C.B. 218.

120. The first significant cost-sharing case was *Seagate Technology, Inc. v. Commissioner*, 102 T.C. 149 (1994), *acq.* 1995-2 C.B. 1. A U.S. MNE, “S,” established a Singapore subsidiary (SSing) to manufacture disk drives. The IRS asserted that the cost share of SSing should be increased to reflect relative production. The evidence indicated that by 1987 the preponderance of manufacturing in SSing suggested that a sharing ratio of 75 percent and 25 percent as between SSing and S was reasonable. Experts testifying for the IRS stated that shares should be based on the relative production of disks, which over the three years in question would have resulted in an 84 percent and 16 percent split. The court found that the record did not contain any uncontrolled cost-sharing arrangements that could be consulted for guidance and used its “best judgment” to conclude that 75 percent of the costs should be allocated to SSing and 25 percent to S. *See also* *Altama Delta Corp. v. Commissioner*, 104 T.C. 424, 463-72 (1995) (applying the cost-sharing method in the context of the possession corporation cost-sharing provisions); *Ciba-Geigy Corp. v. Commissioner* 85 T.C. 172, 222 (1985) (rejecting IRS’s position that a generalized facts and circumstances approach should be applied to an arrangement similar to a CSA in favor of the provisions of the intangibles section 482 regulations).

121. Specifically, the legislative history to the Tax Reform Act of 1986 indicated that Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent that the income allocated among the parties reasonably reflects the actual economic activity undertaken by each. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1017 (Comm. Print 1987). In order for cost-sharing arrangements to produce results consistent with the commensurate with income provisions of the 1986 Act, it was envisioned that cost allocations should generally be proportionate to profits determined before deduction for research and development costs. In addition, to the extent that one party actually contributes funds at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be

regulatory experience of the succeeding decades has been that the cost sharing regulations have become more and more complicated.¹²²

For the purposes of this Article, the fundamental principle behind the existing and previous cost sharing regulations is that they explicitly allocate residual profits based on anticipated future benefits,¹²³ whereas the profit-split methodologies of section 482 seek to allocate residual profits based on the relative functional contribution towards the creation of the nonroutine intangible generating those residual profits.¹²⁴

Where a CSA is put into place among parties that both contribute nonroutine intangibles and where their cost shares (i.e., their expected future benefits) are equivalent to their relative contribution of the nonroutine functions creating the developed intangible, then those results achieved under the cost sharing regulations should mirror the results provided by a two-sided transfer pricing methodology conducted under the rubric of Regulation section 1.482-6. Thus, in such a fact pattern, the CSA formalizes an arrangement that harmonizes with the results achieved under the profit-split approaches. On the other hand, when a CSA allows an MNE to choose a risk-taker entrepreneurial affiliate to fund the intangible development for an amount in excess of its functional contribution towards the creation of that developed intangible, then the cost sharing regulations allow the residual profits to be stripped away from the functions that created those residual

expected that an appropriate return would be provided to such party to reflect the time value of this investment.

122. See 1988 White Paper, *supra* note 96. The 1988 White Paper provided a detailed analysis of how those provisions of the 1986 Act should be applied to CSAs. The 1988 White Paper seemed generally to take a rather restrictive approach. *Id.* at 495. The stringent requirements of the 1988 White Paper were roundly criticized by commentators, and a more lenient set of provisions was proposed in 1992. Prop. Reg. § 1.482-2(g)(1)(i), 57 Fed. Reg. 3571, 3575 (1992). The IRS issued final cost-sharing regulations on December 20, 1995. T.D. 8632, 1996-1 C.B. 85. The final regulations largely followed the 1992 proposed regulations, but made several important alterations. *Id.* The IRS issued proposed regulations restating the CSA regulations in August 2005. See 70 Fed. Reg. 51,116 (2005). On December 31, 2008, final and temporary regulations were issued. T.D. 9441, 2009-7 I.R.B. 460. These regulations had been proposed in 2005 to replace the 1995 regulations. The 1995 regulations were controversial, reflecting the conflicting interests of MNEs and the public fisc with respect to the cross-border use or transfer of intangible property. In 2011, final, temporary, and proposed regulations were released. T.D. 9569, 76 Fed. Reg. 80,249 (Dec. 23, 2011), finalizing the 2009 version with relatively modest substantive change.

123. See Reg. § 1.482-7(a)(1).

124. Compare Reg. § 1.482-6(a), with Reg. § 1.482-7(b)(1)(i), and (e)(1). The appropriate transfer pricing results under section 482 are dealt with extensively by the authors in a separate work. See Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

profits and given to the offshore “risk-taker.”¹²⁵ From the standpoint of devising a solution to this profit shifting problem, Regulation section 1.482-7 should be amended to provide that all allocations of residual profits via a CSA (whether a pre-existing CSA or a new CSA) will be respected in future years only to the extent that the CSA allocates residual profits in the same manner as would occur under a straightforward application of a two-sided transfer pricing methodology set forth in Regulation section 1.482-6. To the extent that a foreign corporation is able to fund a cost sharing arrangement to develop intangibles above their functional contribution (apart from funding), section 367(d) should treat the transfer of this excess ownership interest in the developed intangible as an outbound contribution of an intangible to a foreign corporation that is subject to section 367(d)’s super royalty provisions. Stated differently, the excess funding should be viewed as a prepayment of the ongoing section 367(d) super royalty obligation.

Section 367(d) provides the IRS with authority to require all transfer pricing arrangements, including CSAs, to comply with the commensurate with income requirements regardless of which entity owns the intangible. Some have argued that the Treasury Department should explicitly state that section 367(d) has no application to value transfers that occur via qualified

125. See Reg. § 1.482-7(a)(1), (b)(1)(i), and (e)(1). The problem of how to source intangible income has been explored by others without academic agreement. See Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013) (discussing and cataloging several possible policy options); Ilan Benschalom, *Sourcing the “Unsourceable:” The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631 (2007) (proposing that manufacturing intangibles be sourced according to where their value was created whereas marketing intangibles should be sourced to where they were created based on sales); Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 235 (1981) (discussing sourcing intangible income to the place where the intangible value is sold or where manufactured); Erin L. Guruli, *International Taxation: Application of Source Rules to Income From Intangible Property*, 5 HOUS. BUS. & TAX L.J. 204 (2005) (sourcing intangible income to where intangible value is sold); David G. Noren, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337 (2001) (sourcing intangible income to where sale is made). The OECD released a draft proposing that intangibles should be sourced to the functions that created them. See OECD, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 2012 TAX NOTES TODAY 110-37 (June 6, 2012). The view taken by the OECD is that to solve the base erosion and profit shifting phenomenon the residual profits must be sourced to the functions that contributed to their creation, not based on the entity that will benefit from them.

cost sharing arrangements,¹²⁶ so in response the Treasury Department should clarify in forthcoming section 367(d) regulations that a CSA's assignment of residual profits to a risk-taker satisfies the commensurate-with-income requirements only if the results are in accord with the results achieved with a two-sided transfer pricing methodology.¹²⁷ The IRS is on record as having asserted authority under section 367(d) to require pre-existing CSAs to comply with the commensurate-with-income standard, and it should now follow-through on that authority.¹²⁸ Instead of exercising that authority to

126. See NEW YORK STATE BAR ASSOCIATION, REPORT ON SECTION 367(D) 62-64 (Oct. 12, 2010) 2010 TAX NOTES TODAY 198-20.

127. See Reg. § 1.482-6(c). For a detailed analysis of how the profit-split methodologies better align the residual profits with the substantive functions that create those residual profits, see Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

128. See 1988 White Paper, *supra* note 96, at Chapter 13(J). The White Paper states as follows:

It is unlikely that there will be preexisting cost sharing agreements that will meet all of the standards described above. If such agreements are not recognized, the Service and taxpayers will encounter significant problems in determining ownership of preexisting intangibles and the treatment of the payments that have been made pursuant to the preexisting agreements. Some type of grandfather treatment would therefore appear to be appropriate. One possibility would be to permit any cost sharing agreement that conforms to the requirements of the existing regulations, and that has been in existence for more than 5 years prior to 1987, to be recognized fully if conformed within a certain period after the promulgation of the new rules with respect to matters other than the buy-ins that occurred prior to June 6, 1984 (the effective date of section 367(d)). If the cost sharing agreement has been in effect for less than 5 years and the agreement does not conform substantially to the new rules, then the old agreement would not be recognized. If a new agreement that conforms to the new rules is adopted, then all payments pursuant to the old agreement would be taken into account as an adjustment to any required buy-in payments relating to the new agreement.

Id.

Consistent with the above methodology, the IRS could require that all CSAs conform their tax results to those resulting from two-sided transfer pricing methodologies of Regulations section 1.482-6 regardless of which affiliate is the tax owner of the nonroutine intangible if the ownership was acquired by a CSA entered into after the effective date of section 367(d). This regulatory requirement would ensure that the affiliate that created the nonroutine intangible was in fact allocated the residual profits commensurate with that residual income under the principles of section 367(d). The IRS could provide a short transition rule (two years or less) for having taxpayers subject their existing CSAs to a two-sided transfer pricing

harmonize the residual profit allocations afforded under the cost sharing regulations to the residual profit allocations afforded under Regulation section 1.482-6, the IRS has instead limited its policing of CSAs to contesting (1) the buy-in payment amount for pre-existing intangibles¹²⁹ and (2) whether the MNE had included all of the intangible development costs as part of the cost shares.¹³⁰ But in each of these factual settings, the IRS has faced a significant factual determination challenge. Furthermore, the existing cost sharing regulations grandfathered even more lenient CSAs entered before the issuance of the current regulations.¹³¹ Thus, existing Regulation section 1.482-7 provides significant opportunities for an MNE to utilize a CSA to assign a foreign risk-taker entrepreneur affiliate the right to residual profits for intangible property created by other affiliates without the need to provide any further significant contribution towards their creation other than internal funding.

In the legislative hearings relating to profit shifting, CSAs have played a prominent role.¹³² If public statements are to be believed, in the case of Apple, Inc.,¹³³ its tax-haven affiliate funded \$5 billion of its research and

methodology as a confirming check to the results achieved under Regulation section 1.482-7.

129. See *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009) (where the IRS unsuccessfully argued that the buy-in payment should have been 1000 percent higher than the one utilized by the taxpayer, and the Tax Court sustained the taxpayer's valuation of the buy-in payment); A.O.D. 2010-005, 2010-49 I.R.B. 803.

130. See *Xilinx, Inc. v. Commissioner*, 567 F.3d 482 (9th Cir. 2009) (rejecting IRS position that stock option costs should be included in the cost to be shared among the parties), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010).

131. See Reg. § 1.482-7(m)(1).

132. See *Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 6 (2013), http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2 [hereinafter *Offshore Profit Shifting Hearing (Apple, Inc.)*]; *Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft & Hewlett Packard): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 2 (2012), (Ex. 1.a. Memorandum from Permanent Subcommittee on Investigations (May 21, 2013)) [hereinafter *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*].

133. The author has no personal knowledge of the Apple tax situation, and as a general rule would not comment on a particular taxpayer situation in my writings outside the context of decided cases. However, Apple has explicitly invited the public to consider its tax structure as part of the ongoing comprehensive tax reform debate. See *Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 132, (statement of Tim Cook, Chief Executive Office of Apple, Inc.). Mr. Cook stated that Apple welcomes an objective evaluation of the U.S. corporate tax system, that

development expenditures and in return was allocated \$79 billion of income or \$74 billion in residual profits (net of the research expenditures).¹³⁴ If section 367(d) were faithfully implemented, Apple's tax-haven subsidiary would not be entitled to share in the residual profits unless it met the functional standard. As a general rule, an entity whose sole function is that of a risk-taker funding party is not providing a "function" that creates residual profits.¹³⁵ Instead, the Treasury Department should amend its cost sharing regulations to make clear that the residual profits would be allocated to the affiliate whose functions contributed to the creation of the valuable intangible. If all functions that contributed to the creation of the developed intangible were located in the United States, then all of Apple's residual profits should be allocated to the United States. If, however, a significant nonroutine European marketing intangible existed in the Apple fact pattern and that European marketing intangible contributed towards the generation of the combined residual profits, then the residual profits should be split based on the relative contribution of the offshore marketing intangible's contribution versus the contribution of the other intangibles that contributed to Apple's combined residual profits. If the Irish risk-taker subsidiary is receiving a share of nonroutine intangibles that is in excess of its functional contribution towards their creation (apart from funding),¹³⁶ then this arrangement represents an outbound contribution of an intangible that ought

Apple provided its information as a means to provide information "critical to any objective evaluation of its tax practices," and that Apple supports comprehensive U.S. corporate tax reform "even though it would result in Apple paying more U.S. corporate tax." *Id.* This article comments on the publicly-disclosed facts for the purpose of answering the question of whether section 367(d) can be reformed to prevent inappropriate shifting of profits to tax havens via CSAs.

134. See *Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 132, at 4, n.6 (Statement of Richard Harvey, Jr., Villanova University School of Law).

135. See *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 611 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991). In fact, in this case, the party funding the research was entitled to receive a 27 percent return on its funding investment and then residual profits were split based on the relative contribution of the functions. The Tax Court stated as follows as to the return that the risk-taker should take: "[w]e can assume that the 12-percent rate used to discount future cash-flows in the SEA projections constituted petitioner's estimate of the acceptable rate of return on a relatively riskless venture. The additional 15 percentage points earned by the investor can thus be viewed as compensation for assuming the risks involved in the venture." *Id.* This aspect of the Tax Court's holding in *Bausch & Lomb* recognizes that the funding function was a routine function that did not deserve to share in residual profits, and this aspect of the court's holding could be adopted in regulations.

136. See *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 132, (Staff Memorandum to the Members of the Senate Permanent Subcommittee on Investigations (May 21, 2013)).

to be subject to section 367(d)'s super royalty obligation, and existing Treasury regulations should be amended to require this result.

D. Specific Reform Proposals to Prevent Intangible Migration Are Administratively Available

The discussion throughout this Part II leads to a consistent conclusion, namely that if significant intangible profits can be transferred via the transfer of the underlying intangible property, then the U.S. tax base is left unprotected and base erosion and profit shifting will be the result. Courts were unwilling to extend their own judicially created assignment of income doctrine to prevent the profit shifting occasioned by the transfer of intangibles away from the U.S. developer, but Congress statutorily did so. When one considers the evolution of the U.S. case law definition of goodwill, the adoption of section 367(d), the expansive definition contained in section 936(h)(3)(B), and the commensurate with income standard, the clear statutory purpose of section 367(d) is expressed, and it is the following: whenever significant annual residual profits exist in a risk-taker entrepreneur entity that obtained its business in a supply chain restructuring, an outbound transfer of an active foreign business, or via a cost sharing agreement, the specific and distinct intangibles that generate those intangible returns must be identified and if those income-generating intangibles originated from a U.S. person then section 367(d) requires the profits from those income-generating items to be reassigned back to the U.S. developer whose functions created those income-producing items.

The legislative goals for section 367(d) dictate that significant residual value generated by U.S. developed intangibles should not migrate out of the U.S. tax base, and Congress carefully crafted a statute that effectively codified the judicially created assignment of income doctrine to achieve that purpose. Thus, if the Treasury Department and IRS want to ensure that it faithfully implements the legislative intent that Congress had in mind when it enacted section 367(d), then it needs to do two things:

Action #1: Clearly assert in litigation of these so-called “goodwill loophole” cases that Section 367(d) does not allow the annual residual profits to remain in the foreign risk-taker entrepreneur when those residual profits are attributable to items contributed as goodwill. If there are aspects of goodwill that are capable of providing intangible property returns, then those aspects of goodwill are described in section 936(h)(3)(B) to that extent and thus are to that extent subject to section 367(d)'s super royalty obligation. All income-producing intangibles that contribute towards the generation of annual residual profits should be

separately identified, and under today's modern valuation techniques it should be possible to determine the business functions, processes, methods, and systems that comprise the items that contribute towards the creation of an enterprise's ongoing residual profits. Those identified intangibles then should be subjected to section 367(d)'s super royalty provisions if they are the subject of an outbound section 351 transfer to a foreign corporation, and the amount of the super royalty obligation should be determined so that all the residual profits arising from the transferred income-producing intangibles are assigned back as a super royalty to the U.S. person who transferred the income-producing intangible property.

Action #2: Amend the existing cost sharing regulations to not allow a party to share in residual profits from a developed intangible simply because they funded the development of the intangible. Tax base erosion occurs as a result of the transparent "assignment of residual income" planning that is achievable under the cost sharing regulations. CSAs, under current law, allow residual profits to be migrated to a risk-taker entrepreneur entity in an amount above its functional contribution, and thus the current regulations allow annual residual profits to be segregated away from the functions that created the residual income. CSAs should not be sanctioned except to the extent that they provide allocations of residual profits in accordance with the functional contribution of the contributing entities towards the creation of the income-producing intangible. The Treasury Department has evolved the cost sharing regulations over time, but the fundamental mistake of allowing a taxpayer to simply assign residual profits away from the affiliates that create the nonroutine intangible remains an important avenue for accomplishing IP migration strategies under current law. The Treasury Department's regulations that implement section 367(d) should be amended to say that any assignment of residual rights under a qualified CSA to a funding party in excess of its functional contribution represents an outbound contribution of intangibles subject to section 367(d)'s super royalty provisions.

In combination, the above recommendations address much of the mischief currently in play under section 367(d) and would serve to fulfill Congress's

goal of assigning intangible income back to the U.S. developer whose nonroutine functions created the income-producing intangible.

III. SYNTHESIS OF SECTION 367(d) WITH § 367'S NEVER-ENDING STORY OF POLICING TAX-FREE CASH REPATRIATION STRATEGIES

Although Part II dealt with the historical objectives of section 367(d) and how section 367(d) should be interpreted in terms of the challenges posed by the ILLUSTRATION CASE, the reality is that the Treasury Department has enlisted section 367 to achieve a variety of other tax policy objectives, and section 367(d) is now being impacted by those other objectives. Thus, in Part III, this Article addresses how section 367(d) needs to be reformed in light of the other policy goals that are reformulating section 367 generally.

Before commencing this analysis, however, it is important to recognize that the historical goals of section 367(a) and (b) were premised on preserving the U.S. tax jurisdiction over the built-in gain inherent in assets that are contributed to a foreign subsidiary (section 367(a)'s historic concern) and subjecting any unrepatriated section 1248 earnings of a controlled foreign corporation to immediate taxation if a corporate adjustment causes those earnings and profits to move into a non-CFC environment (section 367(b)'s historic concern).¹³⁷ However, although the above twin goals provide a framework for understanding the original goals of section 367(a) and (b), they are not sufficient in and of themselves to understand section 367 as it has been implemented because Congress granted broad regulatory authority to the Treasury Department, and the Treasury Department in recent years has utilized that authority to achieve other goals. It is these other goals to which the existing section 367(d) regulations are in conflict and where reform is thus needed. In Subpart III.A., this Article explores the additional goals that have been grafted into section 367(a) and (b). In Subpart III.B., this Article discusses how these changes to section 367(a) and (b) now require changes to the existing Treasury regulations under section 367(d).

A. *Policing Cash Repatriation Section 367(a) and Section 367(b)*

The starting point for analysis is with the Treasury Department's efforts to utilize its regulatory authority under section 367(a) to attack corporate inversion transactions prior to the enactment of section 7874.¹³⁸ In

137. See JOSEPH ISENBERG, INTERNATIONAL TAXATION at 208 (Foundation Press 3d Ed. 2010).

138. In the well-known outbound transfer of Helen of Troy's stock in 1994, shares of Helen of Troy (U.S.) were exchanged for shares of Helen of Troy

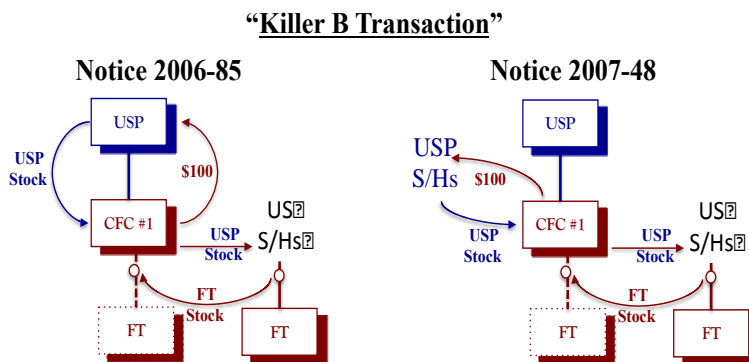
general, under the anti-inversion regulations enacted under section 367(a), U.S. shareholders that transfer stock in a U.S. corporation to a foreign transferee corporation and receive 50 percent or more of the transferee foreign corporation stock are immediately taxable on their stock gain.¹³⁹ Through its adoption of these anti-inversion regulations, the Treasury Department signaled that other goals apart from the historic goals of section 367(a) and (b) would guide future regulatory reform.

After its anti-inversion foray, the Treasury Department again signaled that it would use its regulatory authority under section 367 to prevent nontaxable repatriations of cash from foreign subsidiaries even though the built-in gain in foreign subsidiary stock was preserved and the

(Bermuda), and the U.S. company became a wholly owned subsidiary of the Bermuda corporation. The nuances of how this form of expatriating transaction was accomplished under the old section 367 regulations have been adequately addressed by other commentators. *See generally* David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions, and Restructurings*, 72 TAXES 1061, 1063–68 (1994); *see also* Benjamin G. Wells, *Section 367(a) Revisited*, 71 TAX NOTES 1511 (June 10, 1996). The purpose of the transaction was to rearrange the ownership of the companies so that Helen of Troy (Bermuda) could make further international investments outside the reach of the U.S. extra-territorial tax regime. The IRS responded to this expatriation transaction by issuing Notice 94–46, 1994–1 C.B. 356, which announced that such inversion transactions would be attacked under the government’s authority in section 367. The Treasury Department then issued regulations in 1996 that required the transfer of stock in a U.S. corporation to a foreign corporation to be taxable unless the premerger foreign corporation was more valuable than the U.S. corporation and other requirements were met. *See* Reg. § 1.367(a)-3(c)(1). The stated purpose for the rule was to address Treasury’s concern that outbound reorganizations could provide corporations an opportunity to avoid the U.S. extraterritorial taxation regime, so the government amended its regulations under § 367(a) to require immediate recognition of all built-in gain when the outbound reorganization was being used as a means to effectuate a corporate inversion. *See, e.g.*, T.D. 8770, 1998–2 C.B. 3. (explaining purpose of the anti-inversion regulations and the government’s desire to update them to stop inversions). However, these regulations did not stop inversion transactions. For a thorough review of expatriations from 1996 through 2002, *see* Willard B. Taylor, *Corporate Expatriations—Why Not?*, 78 TAXES 146 (2002). Congress would later respond by adopting section 7874 in an effort to further attack the corporate inversion phenomenon, but section 7874 has also not stopped inversions. *See* Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429 (July 23, 2012) [hereinafter Wells, *Cant and the Inconvenient Truth*]. Nevertheless, Regulation section 1.367(a)-3(c) has remained a permanent fixture of the section 367(a) regulations and as such has fundamentally modified the application of section 367(a).

139. *See* Reg. § 1.367(a)-3(c). An important exception to this general taxable result is provided for certain triangular reorganizations, and this exception is more fully discussed *infra* text accompanying notes 152–68.

U.S. parent company had not altered its position with respect to unrepatriated section 1248 earnings and profits of its controlled foreign corporations. The first expression of this emerging anti-repatriation goal was in 2006 when the Treasury Department stated that it had become concerned about transactions where a controlled foreign corporation purchased the stock of its U.S. parent and then used the U.S. parent stock to acquire a foreign target corporation in a transaction that was intended to qualify as a tax-free reorganization under section 368(a)(1)(B). If successful, the U.S. parent corporation's receipt of cash in exchange for its own shares would be nontaxable by reason of section 1032,¹⁴⁰ and the controlled foreign corporation obtained a cost basis in the parent shares by reason of section 1012. The transaction, under this construct, did not require the U.S. parent to incur an income inclusion with respect to the foreign subsidiary's unrepatriated section 1248 earnings and profits.¹⁴¹ These repatriation techniques came to be known as "Killer B Transactions," and two common variations of these Killer B Transactions are graphically depicted in the below diagram.



In two notices, the Treasury Department announced that these Killer B Transactions raise significant policy concerns because they allow the U.S. parent corporation to repatriate or access foreign subsidiary cash (\$100 in the above diagrams) or both while avoiding any income inclusion with respect to the unrepatriated section 1248 earnings and profits of the controlled foreign corporation. In Notice 2006-85,¹⁴² the Treasury Department stated that it intended to issue regulations under section 367(b) that would treat the \$100

140. See Reg. § 1.1032-1(a).

141. See Reg. § 1.367(b)-4(b)(1)(ii). The U.S. parent stock was disposed of before the close of a quarter-end in order to avoid an income inclusion by reason of having an investment in U.S. property. See I.R.C. § 956(a).

142. Notice 2006-85, 2006-2 C.B. 677, *obsoleted* by T.D. 9400, 2008-1 C.B. 1139, *adopted with modification* by T.D. 9626, 76 Fed. Reg. 28,890 (May 19, 2011).

payment from CFC #1 to USP in the above left diagram as a separate transaction that for tax purposes is bifurcated from the overall exchange, thus in effect treating CFC #1's payment of the \$100 of cash in the Notice 2006-85 diagram as a stand-alone taxable section 301 dividend in much the same manner as section 304 would have done if it had been applicable.¹⁴³ In Notice 2007-48,¹⁴⁴ the Treasury Department expanded the deemed section 301 dividend treatment of Notice 2006-85 to include transactions where a subsidiary acquires stock of its U.S. parent from the open market in order to use such stock as part of a larger acquisitive reorganization.¹⁴⁵ Subsequently, the Treasury Department issued temporary¹⁴⁶ and eventually final regulations¹⁴⁷ to implement this reform.

No built-in gain property was transferred in these Killer B Transactions, and the section 1248 earnings of CFC #1 remain within a controlled foreign corporation environment.¹⁴⁸ Yet, section 367(b) was amended to create an immediate income inclusion to the U.S. parent in the context of Killer B Transactions. Why? The reason is that the use of the CFC #1 cash to purchase U.S. parent stock was seen as a de facto repatriation event and thus represented an appropriate occasion to subject to U.S. taxation a corresponding amount of unrepatriated section 1248 earnings of CFC #1. Thus, seen in its larger context, the IRS and Treasury Department utilized its

143. The IRS agrees that "section 304, by its terms, does not apply to the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical," but then the IRS went on to state that "a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein" and that it was "on this basis that regulations will be issued to address the triangular reorganizations covered by this notice." See Notice 2006-85, 2006-2 C.B. 677, § 3.03 & § 4.

144. Notice 2007-48, 2007-1 C.B. 1428, *obsoleted* by T.D. 9400, 2008-1 C.B. 1139, *adopted with modification* by T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011).

145. This result reversed longstanding case law and IRS administrative guidance that had concluded in the non-section 367 context that a subsidiary's acquisition of its parent stock in the open market for cash was not a deemed dividend to the shareholder. See *Broadview Lumber Co. v. U.S.*, 561 F.2d 698 (7th Cir. 1977); *Virginia Materials Corp. v. Commissioner*, 67 T.C. 372 (1976), *aff'd* 577 F.2d 739 (4th Cir. 1978); *Webb v. Commissioner*, 67 T.C. 293 (1976), *aff'd* 572 F.2d 135 (5th Cir. 1978); Rev. Rul. 80-189, 1980-2 C.B. 106.

146. See Temp. Reg. § 1.367(b)-14T, 73 Fed. Reg. 30,301 (May 27, 2008).

147. Reg. § 1.367(b)-10.

148. See Joseph Calianno & Kagney Petersen, *IRS Issues Notice on 'Killer B' Transactions: Curbing Repatriation or Overreaching?*, 18 J. INT'L TAX'N 52, 55 (Jan. 2007) (making this observation) [hereinafter Calianno & Petersen, *Curbing Repatriation or Overreaching?*].

authority under section 367(b) to create tax results that were analogous to the results afforded under section 304 without the benefit of section 304's direct applicability.¹⁴⁹ Respected practitioners questioned whether the Treasury Department had exceeded its authority,¹⁵⁰ but the government ignored these concerns¹⁵¹ and finalized its regulations,¹⁵² thus utilizing its section 367(b) regulatory authority to attack repatriation strategies even when the section 1248 amount had been preserved in the transaction.

Although the government's goal was to stop Killer B Transactions, the amendments made to section 367 that effectuated the anti-repatriation goals unexpectedly provided taxpayers with the means to implement an inversion that avoided the anti-inversion regulations contained in Regulation section 1.367(a)-3(c). The relevant planning opportunity is set forth in the

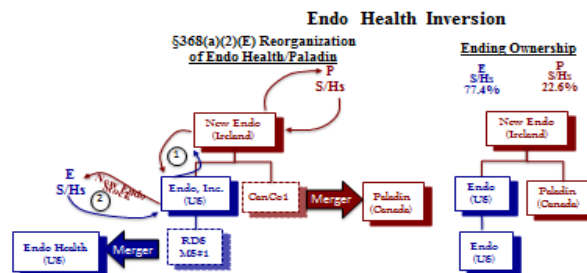
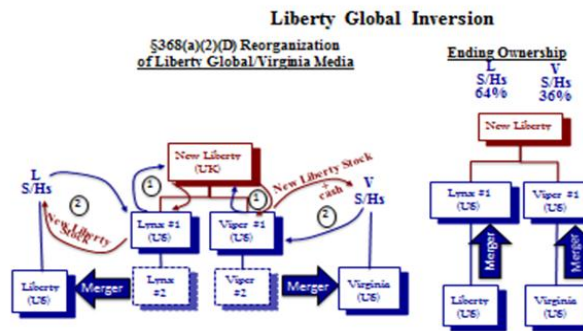
149. Section 304 on its face is inapplicable to this transaction because section 304(a)(2) applies to a subsidiary's purchase of its parent's stock from an entity other than the parent corporation. *See* Reg. § 1.1032-1(a) (disposal of parent stock for cash is not taxable to parent); Rev. Rul. 80-189, 1980-2 C.B. 106 (subsidiary purchases parent stock from sole parent shareholder not a section 304 transaction); Rev. Rul. 69-261, 1961-1 C.B. 94 (subsidiary's purchase of parent stock from open market is not a section 304 transaction); Joseph Calianno & Kagney Petersen, *Have the IRS and Treasury Overextended Their Reach?*, 34 J. CORP. TAX'N 11 (Sept.-Oct. 2007) [hereinafter Calianno & Petersen, *Have the IRS and Treasury Overextended Their Reach?*].

150. *See* Robert Willens, *Service Rejects 'Killer Bees' Technique for Repatriating Earnings of Foreign Subsidiary but Courts May Reject Move for Lack of Authority*, Daily Tax Rep. (BNA) No. 193, at J-1 (Oct. 5, 2006); Calianno & Petersen, *Curbing Repatriation or Overreaching?*, *supra* note 148; Calianno & Petersen, *Have the IRS and Treasury Overextended Their Reach?*, *supra* note 149; Joseph M. Calianno & Kagney Petersen, *Notice 2007-48: A Further Attack on the 'Killer B' and Similar Transactions*, 18 J. INT'L TAX'N 18 (Aug. 2007); Joseph M. Calianno & Kagney Petersen, *The 'Killer B' Saga Continues—IRS Issues New Regulations*, 19 J. INT'L TAX'N 34 (Sept. 2008); Jeffrey L. Rubinger, *Final 'Killer B' Regulations Further Expand Likelihood of Gain Recognition by Taxpayers*, 114 J. TAX'N 365 (June 2011); William R. Pauls & H. Carl Zeswitz, Jr., *A Gambit Vanquished: The Rise and Fall of the "Killer B,"* 52 TAX MGM'T MEM. (BNA) 419 (Oct. 2011).

151. *See* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008) (to justify its regulatory attack on the Killer B Transaction, the preamble to the temporary regulations stated that Congress granted the Secretary authority to provide regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" and identified "transfers constituting a repatriation of foreign earnings" as a type of transfer to be covered in regulations to be promulgated by the Secretary); *See* T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011) (stating that the government was not adopting comments that section 304 concepts should not apply to a subsidiary's use of cash to purchase parent stock in the open market).

152. *See* Reg. § 1.367(b)-10.

below two diagrams that are based on two recently announced inversion transactions:¹⁵³



In both the Endo Health diagram (top) and the Liberty Global diagram (bottom), a U.S. subsidiary (Endo, Inc. (U.S.) in the top diagram and

153. The below diagrams are based on two recent high profile deals where respected tax counsel advised shareholders that the legacy U.S. shareholders potentially would receive tax-free treatment on their exchange of U.S. target stock for the foreign acquirer stock even though the legacy U.S. target shareholders owned more than 50 percent of the vote and value of the combined entity. See Proxy Statement of Endo Health Solutions, Inc. filed on Schedule 14A at 108–09 (Jan. 24, 2014) [hereinafter Proxy Statement of Endo Health Solutions, Inc.]; Proxy Statement of Liberty Global, Inc. filed on Schedule 14A at 170–72 (May 1, 2013) [hereinafter Proxy Statement of Liberty Global, Inc.].

Lynx #1 and Viper #1 in the bottom diagram) purchased stock of a newly created inverted parent entity by issuing its own promissory note and stock to the inverted parent entity (New Endo in the top diagram and New Liberty in the bottom diagram). Under general corporate tax principles, this transaction would have been treated as a purchase transaction, but the changes to the section 367(b) regulations designed to attack the “Killer B Transactions” supplant this result and treat the transfer of the subsidiary’s promissory note as a section 301 distribution in an amount equal to the full value of the note.¹⁵⁴ The transfer of the parent stock is treated as a separate transaction that occurs after the distribution of the subsidiary’s promissory note and is treated as a contribution in an amount equal to the fair market value of the contributed parent stock.¹⁵⁵ Because the subsidiary that issued its promissory note was also newly created, the amount of its earnings and profits and the basis in its stock (apart from the later-in-time basis increase occasioned by the subsequent contribution of the parent stock) was insignificant, and so the distribution of the subsidiary’s promissory note created a substantial amount of section 301(c)(3) gain in the hands of the inverted parent company.¹⁵⁶ However, this section 301(c)(3) gain escapes any actual U.S. taxation by reason of the applicable U.S. tax treaty.¹⁵⁷ In addition, even though this section 301(c)(3) gain was not subject to any actual U.S. taxation, its existence causes section 367(a) to become inapplicable. In this regard, under a coordination rule contained in Regulation section 1.367(a)-3(a)(2)(iv), the Treasury regulations provide that section 367(a) is inapplicable to any triangular reorganization where the total amount of the income recognized by the inverted parent under section 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.¹⁵⁸ Furthermore, section 367(b) provides a similar rule, stating that

154. *See* Reg. § 1.367(b)-10(b)(1).

155. This result was explicitly clear in the temporary regulations that contained an example. *See* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008). The final regulations modified this example but state that the distribution and contribution are separate transactions and the distribution is listed first, so presumably it occurs first-in-time consistent with the temporary regulations. *See* Reg. § 1.367(b)-10(b)(1)–(3).

156. *See* I.R.C. §§ 301, 316; Prop. Reg. § 1.301-2. The later-in-time contribution then provided the inverted parent with a basis increase in its subsidiary stock in an amount equal to the fair market value of the parent stock that was transferred to the subsidiary. *See* Reg. § 1.367(b)-10(b)(2).

157. Taxpayers claimed that the minor dividend amount would be entitled to reduced withholding taxes under U.S. tax treaties and that the section 301(c)(3) gain would be exempt from all U.S. taxation pursuant to treaty. *See* Proxy Statement of Endo Health Solutions, Inc., *supra* note 153, at 37, 106–10.

158. In this regard, Regulation section 1.367(a)-3(a)(2)(iv) provides that neither section 367(a) generally nor the anti-inversion provisions of Regulation

section 367(b) is inapplicable to any triangular reorganization if the total amount of the income recognized by the inverted parent under section 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.¹⁵⁹

The irony of this result is striking: the U.S. subsidiary issues a promissory note, and this promissory note along with the acquisitive reorganization accomplishes a leveraged corporate inversion that affords significant earnings stripping advantages (a flashpoint for Congress and the Treasury Department),¹⁶⁰ and yet it is the addition of this promissory note into the triangular reorganization rubric that affords the opportunity to avoid the applicability of the anti-inversion regulations of Regulation section 1.367(a)-3(c). From a policy perspective, one would have thought that an inversion that is combined with earnings stripping attributes would be the poster child for when the anti-inversion regulations of section 367(a) should apply, and yet it is this transaction that is excluded from their application as a result of the amendments to the section 367 regulations that were made in order to stop the Killer B Transactions.

What is more, inversion benefits arising from these transactions are not assailable under section 7874.¹⁶¹ In the Endo Health inversion, the

section 1.367-3(a) apply to triangular reorganization if the requirements of Regulation section 1.367(b)-10(a)(2)(iv) are met. Regulation section 1.367(b)-10(a)(2)(iv) provides that this provision is met if the amount of gain in the U.S. target corporation's stock or securities that would otherwise be recognized under section 367(a)(1) is less than the sum of the amount of the deemed distribution under section 301(c)(1) and the amount of such deemed distribution treated as gain from the sale or exchange of property under section 301(c)(3).

159. See Reg. § 1.367(b)-10(a)(2)(iii).

160. The earnings stripping opportunities afforded by inversion debt has been well documented. See S. REP. NO. 108-192, at 142 (Nov. 7, 2003); see also STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, at 343 (Comm. Print 2005), 2005 TAX NOTES TODAY 108-16; TREASURY DEPARTMENT OFFICE OF TAX POLICY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING, AND U.S. TAX TREATIES, at 8 (Nov. 2007), 2007 TAX NOTES TODAY 230-17.

161. The recent round of inversions has spurred further Congressional calls for further tightening section 7874. See Stop Corporate Inversions Act of 2014 (draft released May 20, 2014), H.R. 4679, 113th Cong. 2nd Sess., 2014 TAX NOTES TODAY 98-25; Andrew Velarde & Lindsey McPherson, *Inversion Rule Tightening to Wait for Tax Reform, Wyden Says*, 2014 TAX NOTES TODAY 98-1 (May 21, 2014). The author has stated elsewhere that such efforts, although commendable, are unlikely to be effective because what is needed is to address the base erosion opportunities afforded to all foreign-owned multinational corporations; simply attacking inversion transactions without addressing the underlying financial incentives that make inversion transactions financially attractive ensures that efforts to effectuate inversions will continue. See Wells, *Cant and the Inconvenient Truth*, *supra* note

foreign parent is not treated as a surrogate foreign parent under section 7874 because the legacy U.S. shareholders of the U.S. target corporation own less than 80 percent of the foreign parent.¹⁶² Likewise, in the Liberty Global inversion, the foreign parent is not a surrogate foreign parent under section 7874 because the foreign parent possesses a substantial foreign business presence conducted in the country of the inverted parent's incorporation.¹⁶³

In what can be understood as an “uh-oh moment” for the government, the IRS issued Notice 2014–32.¹⁶⁴ In this notice, the IRS stated that forthcoming amendments to its existing regulations will provide that only dividend income and section 301(c)(3) gain that is actually subject to U.S. taxation should be considered for purposes of applying the coordination rule of Regulation section 1.367(a)-3(a)(2)(iv). This change effectively means that section 301(c)(3) gain that escapes any U.S. taxation will be excluded for purposes of determining whether the inverted parent receives a taxable section 301 distribution in an amount that exceeds the aggregate built-in gain of the U.S. shareholders.¹⁶⁵ Once that section 301(c)(3) gain is excluded from the analysis, the inversion transactions depicted in the above diagram will not be able to meet the exception to the anti-inversion regulations that is contained in Regulation section 1.367(a)-3(a)(2)(iv) because the inverted parent's gain is likely to be less than the aggregate built-in gain of the U.S. shareholders of the U.S. target corporation. Notice 2014-32 further provides that section 367(a) and (b) will apply to triangular reorganizations even if the inverted parent's total income exceeds the aggregate built-in gain of the U.S. shareholders in the scenario where the inverted parent receives a dividend from a U.S. subsidiary that is not subject to any actual U.S. taxation or where no actual dividend exists in the transaction.¹⁶⁶ The above regulatory modifications, once effective, will cause

138; Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345 (June 21, 2010).

162. See I.R.C. § 7874(b); *see also* Proxy Statement of Endo Health Solutions, Inc., *supra* note 153, at 105.

163. See I.R.C. § 7874(a)(2); Temp. Reg. § 1.7874-3T; *see also* Proxy Statement of Liberty Global, Inc., *supra* note 153, at 167–68.

164. See Notice 2014–32, 2014–20 I.R.B. 1006.

165. Notice 2014–32, 2014–20 I.R.B. 1006, § 4.01.

166. See Notice 2014–32, 2014–20 I.R.B. 1006, § 4.02 (stating that “the regulations will clarify that the no-U.S.-tax exception [in Reg. § 1.367(b)-10(a)(2)(ii)] will apply if the deemed distribution that would result from application of § 1.367(b)-10 to the triangular reorganization would not be treated as a dividend under section 301(c)(1) that would be subject to U.S. tax (for example, by reason of an applicable treaty or by reason of an absence of earnings and profits)”). Furthermore, for good order's sake, this notice states that Regulation section 1.367(b)-10(b)(4) will be modified to provide that the parent corporation (New Endo in the topt diagram and New Liberty in the bottom diagram) must treat the transfer of

the U.S. shareholders in the above diagrams to recognize their built-in gain in their U.S. target stock by reason of Regulation section 1.367(a)-3(c) because the exception to that result afforded by Regulation section 1.367(a)-3(a)(2)(iv) is no longer available. With this said, these proposed amendments to the existing regulations would only apply prospectively.¹⁶⁷ Thus, the transactions contemplated for Liberty Global and Endo Health appear to be grandfathered.¹⁶⁸ This episode has caused many to believe that the Treasury Department has experienced significant growing pains in its efforts to implement its new anti-repatriation goals under section 367 alongside its already existing anti-inversion goals.¹⁶⁹

Nevertheless, notwithstanding these growing pains, the Treasury Department remains committed to expanding its anti-repatriation goals to more and more analogous fact patterns. In this regard, shortly after the first two Killer B notices were issued, the Treasury Department identified another technique to repatriate cash from a controlled foreign corporation without triggering an income inclusion—this time with reorganizations described in section 368(a)(1)(D). Two variations of the “all-cash D reorganizations” or

the parent stock to its subsidiary as being part of the later-in-time triangular reorganization with the consequence that the inverted parent company’s basis in its subsidiary stock is increased in an amount equal to the exchanging U.S. shareholders’ aggregate basis in their stock, which could well be less than the fair market value of the parent stock used in the exchange. *See* Reg. § 1.358-6. Finally, the anti-abuse rules in the regulations will be clarified to take into account the earnings and profits of other corporations (even if unrelated) for purposes of determining the application of these rules. *See* Notice 2014–32, 2014–20 I.R.B. 1006, § 4.03.

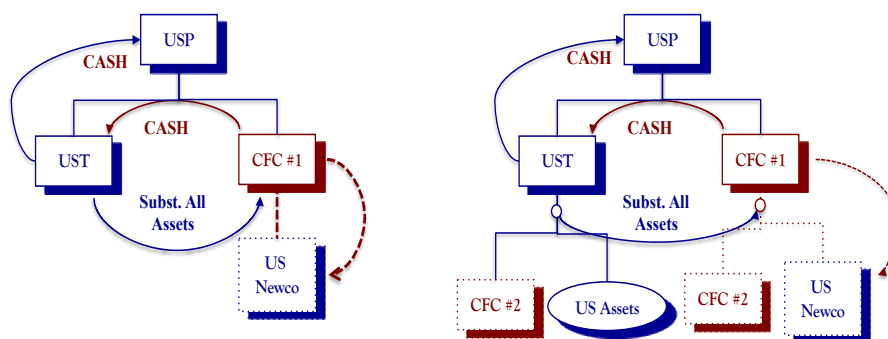
167. Notice 2014–32, 2014–20 I.R.B. 1006, § 5, states that the proposed changes to the regulations described in the notice will apply to a triangular reorganization that is completed on or after April 25, 2014. “The regulations described in this notice will not apply if (i) T was not related to P or S (within the meaning of section 267(b)) immediately before the triangular reorganization; (ii) the triangular reorganization was entered into either pursuant to a written agreement that was (subject to customary conditions) binding before April 25, 2014 and all times afterward, or pursuant to a tender offer announced before April 25, 2014 or that is subject to . . . comparable foreign laws; and (iii) to the extent the P acquisition that occurs pursuant to the plan of reorganization is not completed before April 25, 2014, the P acquisition was included as part of the plan before April 25, 2014.” *Id.*

168. *See* Notice 2014–32, 2014–20 I.R.B. 1006, § 5. The IRS did make a statement that it believed that the anti-abuse rules of Reg. § 1.367(b)-10(d) have been too narrowly construed by taxpayers. *See* Notice 2104–32, 2014–20 I.R.B. 1006, § 2.04. So, it will be interesting to see if the IRS proceeds to attack these transactions on that basis.

169. Mindy Herzfeld, *News Analysis: The IRS Shuts Down the Serial ‘Killer B,’* 2014 TAX NOTES TODAY 86-3 (May 5, 2014).

“Deadly D reorganizations” that were of concern to the government are set forth in the below diagrams.

“Deadly D” Reorganizations / All Cash D Reorganization



In these reorganizations, cash boot is paid to the transferor corporation for substantially all of the transferor’s assets at a time when both are under common control, and thereafter the transferor corporation is immediately liquidated as part of the reorganization. Under subchapter C of the Code, the cash boot paid by CFC #1 in both of the above diagrams is not taxable to the transferor corporation (i.e., the company designated as “UST” in the above two diagrams) if the transferor corporation (UST) distributes that cash boot to its shareholder,¹⁷⁰ and in this scenario the transferor shareholder (USP) is taxable on the receipt of the cash boot only to the extent that the cash boot exceeds the shareholder’s (i.e., USP’s) basis in its UST stock.¹⁷¹ Furthermore, taxpayers had concluded that UST’s and USP’s receipt of cash should not create an independent tax recognition event under section 367(a) as long as appropriate basis adjustments contemplated by section 367(a)(5) were made in USP’s “old and cold” basis in the CFC #1 shares to preserve the historic built-in gain in those CFC #1 shares, or at least so thought taxpayers. As a result of this analysis, “all cash D reorganization” strategies came to be employed as a means to repatriate cash from foreign subsidiaries without triggering an income inclusion of CFC #1’s unrepatriated section 1248 earnings and profits.

In Notice 2008–10,¹⁷² the IRS surprised many in the tax community by stating that the necessary basis adjustments required by section 367(a)(5) could only be made with respect to the newly-issued CFC #1 shares and that

170. See I.R.C. § 361(b)(1)(A).

171. See I.R.C. § 356(a)(1), (2).

172. Notice 2008–10, 2008–1 C.B. 277.

any basis in the old and cold CFC #1 shares must be excluded in this analysis. Thus, in the above diagrams, since no new CFC #1 shares were issued in the all-cash D reorganization, the U.S. parent did not receive new shares in CFC #1 in an amount equal to the inside gain inherent in the assets transferred in the reorganization. Consequently, the Treasury Department said that the built-in gain that exists in the U.S. target's assets could not be appropriately preserved in the new shares received. Because appropriate basis adjustments could not be made in the new shares received to preserve the inside gain inherent in the UST assets, the basis adjustments required by section 367(a)(5) could not be made. Based on this analysis, the government stated that the built-in gain in the assets that were transferred as part of the valid section 368(a)(1)(D) reorganization was taxable by reason of section 367(a)(1) because appropriate basis adjustments as required by section 367(a)(5) could not be made. Proposed regulations consistent with this notice were issued later that same year,¹⁷³ and final regulations were issued in 2013.¹⁷⁴ Under the final regulations, as long as newly-issued shares in CFC #1 were issued in the reorganization and those newly-issued shares had a fair market value equal to or in excess of the inside gain in the assets that were being transferred by UST to CFC #1, then and only then would an appropriate basis adjustment be possible within the meaning of section 367(a)(5) such that the outbound transfer would not be taxable to any extent under section 367(a)(1).¹⁷⁵ The effect of this redefinition of section 367(a) was to prevent U.S. corporations from being able to effectively avail themselves of the boot-within-gain rule of section 356(a) with respect to old and cold high basis shares in UST.

Another area evidencing the Treasury Department's and IRS's evolving concern with respect to the ability to repatriate cash in a tax-free manner concerns the interplay of section 304 and section 367. Prior to 2005, the IRS apparently believed that both section 367(a) and section 367(b) applied to any cross-border section 304 transaction.¹⁷⁶ In 2005, the Treasury Department and IRS proposed to exempt the deemed section 351 transfer that occurs as part of a section 304(a)(1) exchange from a section 367

173. See Prop. Reg. § 1.367(a)-7 (2008). In general, these proposed regulations retained Notice 2008-10's pronouncement that basis adjustments required by § 367(a)(5) can only be made to the newly-issued CFC #1 stock received as part of the reorganization exchange and could not be made to the basis in the "old and cold" CFC #1 stock.

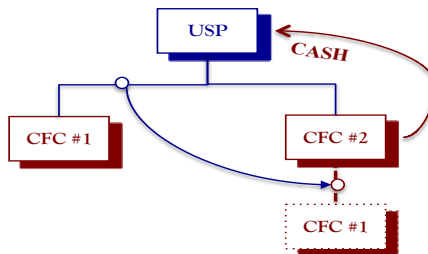
174. See T.D. 9614, 78 Fed. Reg. 23,487 (Apr. 18, 2013).

175. See Reg. § 1.367(a)-7(c)(3). For an illustration of this nuance, see Regulation section 1.367(a)-7(g) Ex. (1).

176. See, e.g., Rev. Rul. 92-86, 1992-2 C.B. 1999; Rev. Rul. 91-5, 1991-1 C.B. 114.

analysis entirely.¹⁷⁷ This section 351 exchange is graphically depicted in the below diagram by the transfer of the CFC #1 shares from USP to CFC #2.

§304 Transaction
(Gain Greater Than E&P)



The government finalized these regulations in 2006, and the final regulations continued the government's belief that the policies of sections 367(a) and (b) would be preserved if section 304 solely applied because the income inclusion required by the transferor in a section 304 transaction would generally exceed the transferor's built-in gain in the assets that were being transferred.¹⁷⁸ Thus, allowing the transaction to be controlled entirely by

177. See Notice of Proposed Rulemaking, 70 Fed. Reg. 30,036 (May 25, 2005). In this notice of proposed rulemaking, the government stated as follows:

In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares. The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1), (3).

Id. at 30,038.

178. See T.D. 9250, 71 Fed. Reg. 8,802 (Feb. 21, 2006) which states as follows:

The IRS and Treasury believe that, in most or all cases, the income recognized in a section 304 transaction will equal or exceed the transferor's inherent gain in the stock of the issuing corporation transferred to the foreign acquiring corporation. Elimination of the application of section 367(a) and (b) in this context will also serve the interests of sound tax administration by creating greater certainty and simplicity in these transactions, and by avoiding the over-inclusion of income that could result when section 367 and section 304 both apply to such transactions. As a result, this

section 304 meant that the distribution would first be treated as a dividend to the extent of earnings and profits of CFC #1 and CFC #2 and then secondarily as a return of capital and then thirdly as gain. Consequently, in situations where CFC #1 and CFC #2 did not have significant earnings and profits, the distribution would be treated as a tax-free return of capital by reason of section 301(c)(2). The downward basis adjustment in the case of a tax-free repatriation would ensure that the built-in gain in the property transferred in the section 304 transaction would be preserved, which again was the historic concern of section 367(a). The IRS repeated this belief that the framework of section 304 appropriately handled section 367(a) concerns in proposed regulations issued in 2009.¹⁷⁹

However, later in 2009, the Treasury Department reversed course and stated that although section 367(a) and (b) generally would not apply to an outbound transaction subject to section 304, section 367(a) would nevertheless apply where a taxpayer recovered basis in the old and cold shares and not solely from the stock deemed issued and redeemed under

Treasury decision finalizes the proposed regulations and makes section 367(a) and (b) inapplicable to deemed section 351 exchanges pursuant to section 304(a)(1) transactions.

Id. at 8,803. However, the preamble to the final regulations did caution that instances where the income inclusion under section 304 was less than what would otherwise be required under section 367(a) and (b) may be problematic in the following statement:

[C]ommentators posit that P in the above example may not recognize income or gain because the adjusted basis of both the F2 stock that is treated as being issued in the deemed section 351 exchange, and the adjusted basis of the F2 stock already held by P prior to the transaction, is available for reduction under section 301(c)(2). On these particular facts (i.e., no earnings and profits in either the acquiring corporation or the issuing corporation), this basis position would mean that income or gain is not recognized as a result of the transaction. The IRS and the Treasury believe, however, that current law does not provide for the recovery of the basis of any shares other than the basis of the F2 stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock). Thus, in the case described, P would recognize \$ 100x of gain under section 301(c)(3) (the built-in gain on the F1 stock), and P would continue to have a \$ 100x basis in its F2 stock that it holds after the transaction. This issue will be addressed as part of a larger project regarding the recovery of basis in all redemptions treated as section 301 distributions. This larger project will be the subject of future guidance.

Id. at 8,803.

179. *See* Prop. Reg. § 1.304-2(a)(4), 74 Fed. Reg. 3,509 (2009).

section 304.¹⁸⁰ In Notice 2012–15, the Treasury Department finished its course reversal by stating that all outbound section 304(a)(1) transactions would be subject to both section 367(a) and (b). Thus, again, the effect of this notice is to prevent taxpayers from claiming that they are not taxable on the receipt of cash from their controlled foreign corporations in a transaction that represents a return of basis with respect to the high old and cold share basis.

B. Section 367(d)'s Entrance Into the Policing of Tax-Free Cash Repatriations

With the above background in mind, this Article can now address the cash repatriation concerns raised in the context of an outbound contribution of intangibles subject to section 367(d) that occurs as part of a larger transaction controlled by either section 351(a) or section 368(a) where boot is received by the U.S. transferor. In this context, should the cash payment received by the U.S. transferor be treated as a prepayment of the section 367(d) super royalty obligation or should the cash be considered as boot received in a transaction described under section 351(a) or section 368(a)?

In a 1990 administrative ruling¹⁸¹ and in a more thorough memorandum issued by the IRS chief counsel in 2005,¹⁸² the IRS concluded that the cash should be treated as a prepayment of the section 367(d) super royalty and should not be treated as boot received as part of the section 351 transaction. The essential facts in Chief Counsel Advice 2006-100-19 were that a U.S. subsidiary acquired intangible property from its U.S. parent corporation and then re-contributed the intangible property to a wholly-owned controlled foreign corporation in exchange for both common stock and nonqualified preferred stock.¹⁸³ The taxpayer took the position that section 351(b) applied with respect to the boot received (i.e., the nonqualified preferred stock) and that section 367(d) applied only with respect to the common stock. In the ruling, the IRS concluded that the cash should be treated as having been received as part of the section 367(d) transaction, thus in effect causing section 367(d) to override section 351. Thus, the effect of the ruling was that the entire cash transfer was bifurcated and treated as part of a separate section 367(d) outbound intangible transfer that was independent of the section 351 transfer. By bifurcating the cash

180. See Temp. Reg. § 1.367(a)-9T; Temp. Reg. § 1.367(b)-4T(e); Temp. Reg. § 1.1248-1T(b) (effective Feb. 11, 2009 to Apr. 23, 2012) in T.D. 9444, 74 Fed. Reg. 6824 (2009).

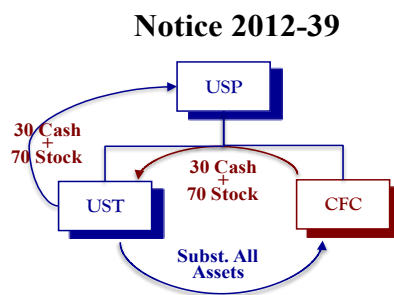
181. See 1990 IRS NSAR 8126, 1990 WL 10072532.

182. C.C.A. 2006–10–019 (Nov. 23, 2005); see also P.L.R. 2008–45–044, Ruling 11 (Aug. 4, 2008).

183. C.C.A. 2006–10–019 (Nov. 23, 2005); see I.R.C. § 351(g).

payment away from the overall section 351 transaction, the cash was treated as solely a prepayment of the section 367(d) super royalty and was immediately taxable under Regulation section 1.451-5.

In Notice 2012-39,¹⁸⁴ the IRS issued guidance concerning the interaction of section 367(d) with the reorganization provisions of section 368(a). The essential facts of Notice 2012-39 are set forth in the below diagram.



As set forth in the above diagram, UST transfers substantially all of its assets (consisting of \$40 of non-IP assets and a patent worth \$60) in exchange for CFC #1 stock of \$70 and cash of \$30. Under subchapter C of the Code, the cash boot paid by the transferee corporation (i.e., CFC #1) to the transferor corporation (UST) is not taxable to the transferor corporation if the transferor corporation distributes that cash to its shareholder (USP),¹⁸⁵ and the transferor shareholder (USP) is taxable upon the receipt of this cash boot only to the extent that the cash exceeds USP's basis in its UST stock.¹⁸⁶ In the notice, the government indicated that taxpayers had taken the position that the receipt of \$30 of cash was not taxable to the UST (presumably because the cash was distributed to USP)¹⁸⁷ or to the USP (presumably because USP had a high stock basis in its UST shares such that there was no taxable boot).¹⁸⁸ Furthermore, in Notice 2012-39, the government asserted that taxpayers then claimed that the U.S. parent corporation could then include annual royalty income each year¹⁸⁹ under the commensurate-with-income standards of section 367(d) and then establish a receivable from the controlled foreign corporation in the aggregate amount of the annual royalty

184. Notice 2012-39, 2012-2 C.B. 95.

185. See I.R.C. § 361(b)(1)(A).

186. See I.R.C. § 356(a)(1) and (2).

187. Notice 2012-39, 2012-2 C.B. 95; see I.R.C. § 361(b).

188. Notice 2012-39, 2012-2 C.B. 95; see I.R.C. § 356(a).

189. Notice 2012-39, 2012-2 C.B. 95; see Temp. Reg. § 1.367(d)-1T(c)(1).

income inclusion.¹⁹⁰ Furthermore, practitioners had urged the Treasury Department to confirm that section 361(b) would control the treatment of boot in this outbound asset reorganization that is described in section 368(a).¹⁹¹

In Notice 2012-39, the government asserted that the U.S. parent in effect is paid twice for the same intangible: once upfront in the form of cash boot in the reorganization that was not taxable to USP due to its high “old and cold” basis in its UST stock and then over time in the form of a taxable royalty imputed by reason of section 367(d). Even though cash is paid twice for the same outbound intangible, only one income inclusion occurred.

In response to this planning technique, the government asserted that the U.S. target must include \$18 in income¹⁹² immediately as a prepayment of the section 367(d) super royalty obligation and will be able to exclude the first \$18 of deemed super royalty in later years and will not be able to establish a receivable to the extent that the deemed super royalty has been prepaid. Thus, in effect, the portion of the cash received that is attributable to the patent is taxable immediately upfront without any benefit of a basis offset in the old and cold basis that USP has in its UST shares. The amount of the future section 367(d) super royalty imputed in future years is reduced to the extent of the prepayment, but so to is the amount of the receivable that can be established. Thus, the taxpayer loses the ability to recover its high “old and cold” basis in UST in this transaction. The ruling is ambiguous (seemingly intentionally ambiguous) on what basis UST has in its non-intellectual property assets that are worth \$40. If those assets have \$40 of basis, then no separate section 367(a)(5) issues would be present since appropriate basis adjustments are possible in the stock received since the stock received (\$70 value) exceeds the amount of the inside gain in the UST assets of \$60 (i.e., \$100 value less \$40 basis). However, if UST’s basis in the non-intellectual property assets is less than \$30, then the inside gain in the UST assets (\$70+) would exceed the fair market value of the stock received (\$70), and the ruling leaves unaddressed how to handle this result. Conceptually, if \$18 of the boot is taxable as a prepayment of future royalty, then one would think that the maximum that should be taxed under section 367(a)(1) should be no more than the remaining \$12 of cash boot, but again this issue is not addressed in the notice and existing regulations would need to be revised to avoid a double-inclusion of gain.¹⁹³

190. Notice 2012-39, 2012-2 C.B. 95; *see* Temp. Reg. § 1.367(d)-1T(g).

191. *See* Letter from PricewaterhouseCoopers LLP to Michael Mundaca, Assistant Secretary (Tax Policy) at 15-18 and 22-23 (Apr. 29, 2011), 2011 WTD 85-21, Doc. 2011-9374.

192. Calculated as 60 percent of assets were intangibles subject to section 367(d) multiplied by \$30 of cash boot in the reorganization.

193. Again, as currently envisions, the Treasury regulations that implement the basis adjustments required by section 367(a)(5) require the built-in gain on the

Thus, forthcoming regulations should clarify the outcomes set forth in asset transfers covered by section 351 and outbound asset reorganizations described by section 368(a). In both cases, the Treasury Department has given priority to treating cash payments made in the context of an outbound transfer of an intangible as a separate transaction from the overall transaction that is otherwise subject to either section 351 or section 368(a). This bifurcation of the transaction causes the cash that is paid in exchange for the outbound transfer of the intangible to represent a prepayment of the section 367(d) super royalty and as such is fully taxable upon receipt without any basis offset. However, if boot is paid to the U.S. transferor in excess of the value of the transferred intangible, then that excess cash should be treated as boot in the transaction that is governed by section 351 or section 368(a) and as such should be taxable (or not) in accordance with the boot-within-gain rules of section 356(a)(2) and the basis adjustment rules as set forth in the revised regulations that implement the goals of section 367(a)(5).

IV. CONCLUDING THOUGHTS ON THE WAY FORWARD

As a country, we have been here before. In the 1980s, Congress was agitated about the erosion of the U.S. tax base that occurred due to the outbound migration of intangible property. In response, by enacting section 367(d), Congress expressed a strong desire to systemically address profit-shifting by in effect codifying the assignment of income doctrine so that the residual profits generated from transferred intangible assets would be assigned back to the U.S. developer whose nonroutine U.S. functions created the income-generating intangible asset in the first place. The addition of the commensurate with income standard within section 367(d)(2) finalized the objective as that standard ensures that all actual intangible profits would be considered for purposes of determining section 367(d)'s super royalty rate so that all of the actual ongoing residual income would be assigned back to the U.S. transferor.¹⁹⁴ Concurrently, Congress gave the Treasury Department

assets to be triggered to the extent that the inside gain of \$100 (if UST had no basis in any of its assets) exceeds the fair market value of the stock received of \$70. *See* Reg. § 1.367(a)-7(c)(3), (g) Ex. (1). However, if \$18 of boot has already been taxable as a prepaid royalty by reason of section 367(d), then somehow only a maximum amount of \$12 of gain should be triggered under section 367(a)(1) or else the boot is creating a double income inclusion.

194. *See* Temp. Reg. § 1.367(d)-1T(c)(1) (super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. §§ 1.482-4(f)(2)(ii)(C)(4), -4(f)(2)(iii), Ex. (2) (specifies and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

broad regulatory authority to implement the policy objectives of section 367(d).

Inexplicably, the Treasury Department has not aggressively shut-down the “goodwill loophole” tax planning as it should have done, and the Treasury Department’s own cost sharing regulations create an inappropriate “cost sharing loophole” to section 367(d). Instead of fixing these problems through its regulatory authority or through its litigation of cases where taxpayers assert positions that frustrate the goals of section 367(d), the Treasury Department has proposed that Congress again consider further amendments to section 367(d),¹⁹⁵ thus distracting attention away from the real path forward. In a separate arena, the Treasury Department has also been active in amending its regulations under section 367(a) and (b) as a means to prevent tax-free repatriations of cash from foreign subsidiaries, but the Treasury Department has not made corresponding changes to its long-standing temporary section 367(d) regulations to harmonize them with the government’s omnibus anti-repatriation goals.

It is now time for the Treasury Department to re-focus its attention on the task at hand. As to the “goodwill loophole” cases, the Treasury Department should forcefully argue along the lines set forth in this Article that section 367(d) does not allow income-generating intangibles to be cloaked under the guise of a “goodwill loophole.”¹⁹⁶ As to the “cost sharing loophole” that the Treasury Department itself created, it is past time for the Treasury Department to amend its existing cost sharing regulations in Regulation section 1.482-7 to remove the “cost sharing loophole” so that these regulations do not become the means to migrate high-profit potential intangibles to an offshore risk-taker entrepreneur entity through the use of a CSA.¹⁹⁷ And, with respect to the Treasury Department’s goal of preventing tax-free cash repatriations from foreign subsidiaries, the Treasury Department should amend its section 367(d) regulations to provide an explicit coordination rule in situations where a section 367(d) transfer occurs within the context of a transaction that is also described in either section 351(a) or section 368(a) and cash is received by the U.S. transferor.¹⁹⁸ The path forward is clear and unmistakable to those who want to see it. Hopefully, the Treasury Department will get to work on enforcing section 367(d) in a manner that fulfills its already-existing legislative directive. The

195. The Administration has proposed legislative changes to section 367(d) and for taxing excess intangible returns earned by controlled foreign corporations. See GENERAL EXPLANATION OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS, *supra* note 4, at 45–47.

196. See *supra* Reform Recommendation #1 in Part II.D., along with the discussion in Part II.A. & B.

197. See *supra* Reform Recommendation #2 in Part II.D., along with the discussion in Part II.C.

198. See *supra* discussion in Part III.

Treasury Department has been given the authority it needs to address all of these issues, and it is past time for it to do so.