NEW TAX RELIEF OF REPATRIATION OF INTANGIBLE PROPERTY

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In early May, the I.R.S. published proposed regulations affecting transactions in which U.S. corporations bring intangible property back to the U.S.[1]

In this article, we review the legislative background of the proposed regulations and explain their importance. We will then address the key principle of the proposed regulations.

OUTBOUND TRANSFERS OF INTANGIBLE PROPERTY

Background

Certain transactions involving structural changes qualify for nonrecognition treatment under the Code.[2] Such transactions include contributions of property to 80%-owned corporations in exchange for capital[3] and transfers of property as part of corporate reorganizations.[4]

Code §367(a) limits, and in some cases shuts down, the nonrecognition provisions of Subchapter C of the Code where property is transferred by a U.S. person to a foreign corporation. Code §367(d) provides special rules when the outbound transfer involves intangible property.

Section 367(d)

The term “intangible property” is broadly defined for purposes of Code §367(d) and is applicable to a wide range of intangible properties.[5]

Under Code 367(d), the parties to a transfer of intangible property to a foreign corporation (respectively, the “U.S. Transferor” and the “Foreign Subsidiary”) structured as a contribution described in Code §351 or a reorganization described in Code §361 are not eligible for nonrecognition treatment under Code §§351 and 361. Instead, the U.S. Transferor will be treated as having sold the intangible property for

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1 REG-124064-19, RIN 1545-BP55.

2 The Internal Revenue Code of 1986.

3 Code §351.

4 Code §361.

5 See Code 367(d)(4). The definition includes patents, invention, formula, process, design, pattern, know-how, copyright, artistic composition, trademark, tradename, brand name, franchise, license, contract, method, program, system, procedure, survey, study, campaign, forecast, customer list, technical data, goodwill, value of going concern, workforce or other item of value which is not attributable to tangible property or services of an individual.

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payments that are contingent on productivity, use or disposition of the property. Arms-length transfer pricing principles apply in determining whether the payments meet the requirements of Code §367(d).[6] Stated differently, a static amount set forth in the transaction documents likely will be adjusted to meet the deemed contingent consideration requirement.

In general, the payments are deemed received annually over the time of the useful life of the property and are treated as the equivalent of royalties for U.S. Federal tax purposes. In cases where the property is subsequently sold by the Foreign Subsidiary, income is deemed received by the U.S. Transferor at the time of disposition of the property. Similarly, the U.S. transferor is required to recognize gain if the stock of the foreign corporation is sold to an unrelated person.[7]

Any amount included in the taxable income of the U.S. Transferor, either annually or as a lump sum on a disposition, is reduced from the Foreign Subsidiary's earnings and profits.[8] In addition, to avoid double taxation, the royalties imputed by Code 367(d) generally can be paid by the foreign corporation to the U.S. Transferor without further U.S. tax consequences.[9]

SUBSEQUENT TRANSFERS OF I.P. TO RELATED PERSONS – CURRENT LAW

As mentioned above, the U.S. transferor is required to recognize gain on a disposition of the I.P. by the Foreign Subsidiary or on a disposition of the stock of the Foreign Subsidiary to an unrelated person. Immediately after such disposition, the application of Code §367(d) generally terminates.

However, where the I.P. or the stock of the Foreign Subsidiary is transferred to a related person, a different rule applies.[10] In general, Code §367(d) continues to apply following a transfer of the I.P. to a related person.

Three different scenarios of related-person transfers of I.P. are mentioned in the regulations that are currently in effect:

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6 Code §367(d)(2)(D) and Treas. Reg. 1.367(d)-1T(c)(1).

7 Code §367(d)(2)(A)(ii)(II); Reg. §1.367(d)-1T(d)(1), §1.367(d)-1T(f)(1).

8 Code 367(d)(2)(B). Reducing the earnings and profits is expected to weigh heavily in determining the transferor's U.S. federal tax liability if the foreign corporation is a Controlled Foreign Corporation withing its meaning in Code §957.

9 Treas. Reg. 1.367(d)-1T(g)(1)(i). If the imputed amounts are not paid within the taxable year in which they are imputed, the U.S. transferor may establish a non-interest bearing receivable for the amounts imputed but not paid. To the extent payment is not made on the receivable within the following two-year period, the receivable is deemed contributed to the capital of the foreign transferee corporation. The deemed contribution to capital increases the tax basis in the stock of the Foreign Subsidiary, but terminates the ability of the transferor to receive tax-free payments on the receivable account.

10 "Related person" is defined in 1.367(d)-1T(h), and includes persons that are considered related under Code §267(b), (c) and (f) with certain modifications, as well as partners or partnerships described in Code §707(b)(1).

- The first scenario involves the transfer of the I.P. by the foreign corporation to a related person. In this scenario, the U.S. transferor is required to continue including the annual payments as if the subsequent transfer never happened.[11] For purposes of this scenario, there is no *distinction* between a related foreign person and a related U.S. person.

- The second scenario involves the transfer of the stock of the Foreign Subsidiary by the U.S. Transferor to a related foreign person. Here, again, the U.S. transferor is required to continue including the annual payments as if the subsequent transfer never happened.[12]

- The third scenario involves the transfer of the stock of the Foreign Subsidiary by the U.S. Transferor to a related domestic person. Here, the related transferee succeeds to the U.S. transferor's annual payments. Hence, it is referred to as the "U.S. Successor."[13]

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SUBSEQUENT INBOUND TRANSFERS OF I.P. TO RELATED U.S. PERSONS – NEW REGULATIONS

Terminating the Application of Code §367(d)

As explained above with respect to the first scenario, the existing rules provide that Code §367(d) continues to apply and the U.S. Transferor must continue to include the annual payments that are commensurate with the income attributable to the I.P. The existing rule applies even if the I.P. is transferred by the Foreign Subsidiary to a related U.S. transferee.

At the same time, income related to the I.P. is also expected to be included in the U.S. Transferee's taxable income, since the U.S. Transferee is subject to tax on its worldwide income from all sources under the general U.S. Federal tax rules.

Since both the U.S. transferor and the U.S. Related Transferee are required to include in taxable income the payments related to the I.P., the existing rules may lead to excessive U.S. taxation on income related to the I.P.

To prevent this result, which could dissuade some companies from repatriating their intangible property, the I.R.S. published proposed regulations in early May 2023 that terminate the application of Code §367(d) where the I.P. is repatriated to certain U.S. persons that are subject to U.S. taxation with respect to the income derived from the I.P.[14]

Below are the key principles of the proposed regulations.[15]

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11 Treas. Reg. §1.367(d)-1T(f)(3),

12 Treas. Reg. §1.367(d)-1T(e)(3).

13 Reg. §1.367(d)-1T(e)(1).

14 REG-124064-19, RIN 1545-BP55.

15 For a more detailed review, see, REG-124064-19, Explanation of Provisions of the proposed regulations.

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Requirements

Qualified Domestic Person

The proposed new regulations are subject to two conditions. The first condition is that the foreign transferee corporation transfers the I.P. to a Qualified Domestic Person.[16]

- A Qualified Domestic Person includes, first and foremost, the U.S. transferor that initially transferred the intangible property that is subject to section 367(d) which is being repatriated.
- A Qualified Domestic Person also includes any Successor U.S. Transferor to the I.P., provided that such U.S. Transferor is not exempt from U.S. Federal income tax under any of the Code provisions specified in the proposed regulations.[17]
- Finally, a Qualified Domestic Person includes any U.S. person that is related to the initial U.S. Transferor or the Successor U.S. Transferor, provided that if the related person is a U.S. corporation, it is not exempt from U.S. Federal income tax under any of the Code provisions specified in the proposed regulations as described in n. 17.

New Reporting Requirements

The second requirement for terminating the application of Code §367(d) under the proposed regulations is that certain reporting requirements must be satisfied.

While reporting requirements for subsequent transfers of I.P. that are subject to Code §367(d) are already in place under existing rules,[18] the proposed regulations make conforming changes to the reporting requirements, and add information reporting requirements for subsequent transfers to a Qualified Domestic Person.[19]

Tax Consequences

Gain Recognition as to the U.S. Transferor

The proposed regulations require the U.S. Transferor to recognize gain in some cases as a result of the repatriation transaction. Whether the U.S. transferor actually recognizes gain under the proposed regulations, and the amount of such gain, depends on the form of the repatriation transaction.[20]

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[16] Defined under Prop. Reg. §1.367(d)-1(f)(4)(iii).

[17] Under Prop. Reg. §1.367(d)-1(f)(4)(iii)(B), the following are considered to be persons exempt from tax: (i) a corporation exempt from tax under Code §501(a), (ii) a regulated investment company as defined in Code §851(a), (iii) a real estate investment trust as defined in Code §856(a), (iv) a domestic international sales corporation as defined in Code §992(a)(1)), and (v) an S-corporation as defined in Code §1361(a).

[18] Treas. Reg. §1.6038B-1T(d)(2).

[19] Prop. Reg. §1.6038-1(d)(2)(iv).

[20] See, Prop. Reg. §1.367(d)-1(f)(4)(i) & (ii).

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At a high level, if the repatriation is structured as a nonrecognition transaction, such that the transferee (the Qualified Domestic Person) will have a transferred basis[21] in the transferred I.P.,[22] the U.S. transferor will generally not be required to recognize gain.[23]

If the repatriation is structured other than as described above, the U.S. Transferor will generally recognize gain on the disposition of the I.P., equal to the excess of the fair market value of the I.P. on the date of the transfer over the U.S. Transferor's former adjusted basis in the I.P.[24]

In addition, the proposed regulations require the U.S. Transferor to include in gross income a partial annual inclusion attributable to the part of its taxable year in which the Foreign Subsidiary held the I.P. (*i.e.*, prior to the transfer to the Qualified Domestic Person).[25]

Adjustments Related to the Annual Inclusions

To prevent the Foreign Subsidiary from recognizing gain that is also recognized by the U.S. Transferor by reason of the repatriation transaction, the proposed regulations allow the Foreign Subsidiary to reduce any income arising from the repatriation transaction, to take into account the gain recognized by the U.S. Transferor.[26] This amount can be paid to the U.S. Transferor without further U.S. tax consequences.[27]

Adjusted Basis in the Repatriated I.P.

The proposed regulations are meant to ensure that a Qualified Domestic Person does not receive a tax-free step-up in the adjusted basis in the repatriated I.P.[28]

To achieve that result, the proposed regulations provide for a special rule wherever the repatriation transaction is structured in a way that complies with a nonrecognition provision in the Code and the I.P. qualifies as Transferred Basis Property.

Under the proposed regulations, the Qualified Domestic Person's adjusted basis in the I.P. will be equal to the Foreign Subsidiary's adjusted basis in the I.P. immediately before the repatriations or the U.S. Transferor's former adjusted basis in the I.P., whichever is lower. The adjusted basis is then increased by the greater of the gain recognized by the U.S. Transferor upon the repatriation under the proposed

[21] Within its meaning in Code §7701(a)(43). See reference in Prop. Reg. §1.367(d)-1(f)(4)(ii)(A).

[22] Determined without regards to Code §367(d). Prop. Reg. §1.367(d)-1(f)(4)(ii).

[23] However, gain might be recognized under certain circumstances. For example, a contribution of property to an 80%-owned corporation in exchange for stock is generally subject to nonrecognition treatment under Code §351(a). Nevertheless, gain must be recognized to the extent a taxpayer received money or other property in exchange for the contributed property under Code §351(b).

[24] Prop. Reg. §1.367(d)-1(f)(4)(ii)(B).

[25] Prop. Reg. §1.367(d)-1(f)(4)(i).

[26] Prop. Reg. §1.367(d)-1(f)(2)(i).

[27] Prop. Reg. §1.367(d)-1(f)(2)(ii). The tax-free transfer of gain is based on the account receivable mechanism provided in §1.367(d)-1T(g)(1).

[28] RIN 1545-BP55, Explanation to Provisions, I.B.2.

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regulations, if any, or the amount of gain recognized by the Foreign Subsidiary, if any.[29]

Alternatively, if the intangible property does not qualify as Transferred Basis Property, a Qualified Domestic Person's adjusted basis in the I.P. will be equal to the fair market value of the I.P. as of the date of the repatriation transaction.[30]

Other Modifications

In addition to the key principles explained above, the proposed regulations provide for some other modifications and fix some longstanding errors.

Effective Dates

The new regulations are not yet final. They will apply to dispositions of I.P. occurring on or after the date of publication of the Treasury decision adopting the proposed rules as final regulations in the Federal Register.

CONCLUSIONS

For several years, the regulations issued under Code §367(d) have created excessive U.S. Federal tax liability on repatriation of intangible property. The newly proposed regulations will put an end to such excessive taxation.

The timing of the publication is not surprising. The proposed regulations are aligned with other measures taken by the Treasury Department in recent years to incentivize U.S. corporations to keep their intellectual property onshore.

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[29] Prop. Reg. §1.367(d)-1(f)(4)(iv)(A).

[30] Prop. Reg. §1.367(d)-1(f)(4)(iv)(B).