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By Ken Brewer and Philip Antoon

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In this article, Brewer and Antoon discuss recently proposed regulations under section 367 that would dramatically change the treatment of goodwill and going concern value transferred by a U.S. person to a foreign corporation.

On September 14, 2015, Treasury and the IRS released proposed regulations under section 367 that would dramatically change the treatment of goodwill and going concern value transferred by a U.S. person to a foreign corporation in what, in a purely domestic context, would otherwise be a tax-free transaction.[1] If finalized as proposed, the regulations would be effective retroactively for transfers occurring on or after September 14, 2015. Several commentators, including two of the Big Four public accounting firms, submitted comments before the December 15, 2015, deadline.

The following summarizes the proposed regulations and notes some potential changes in the way companies might approach the allocation of value among the transferred assets.

Under existing section 367 regulations, the transfer of goodwill and going concern value to a foreign corporation can qualify for nonrecognition of gain or loss if they are transferred for use in the active conduct of a trade or business outside the United States. Under the proposed regulations, these transfers would no longer qualify for nonrecognition of gain.

The proposed change reflects the Obama administration's views on the proper policies for section 367 but is contrary to the policy views of Congress, as expressed in the section's legislative history. Because of this conflict with legislative intent, there is reason to believe that if the regulations are finalized as proposed, they may be found invalid if challenged in court (that is, under a *Chevron* analysis). Several of the comment letters, including those submitted by Deloitte Tax LLP and PwC, reflect that view and strongly recommend that the proposed regulations be revised, or withdrawn and reissued, to include rules consistent with the legislative intent.

The proposed regulations present difficult choices for taxpayers currently considering the incorporation of foreign operations that are now conducted in passthrough (that is, branch or partnership) format, and they may change the calculus for taxpayers contemplating the choice of entity for start-up operations outside the United States. Taxpayers making business, tax, and valuation decisions now in reliance on the proposed regulations may eventually find that the regulations, including their proposed effective date, have substantially changed by the time they are issued in final form — in ways that might have led to different decisions. Hopefully the final regulations will permit taxpayers to retroactively change any of these decisions, when appropriate. However, it is unlikely that the final regulations would permit a retroactive change in appraised values arrived at by taxpayers that acted in reliance on the proposed regulations.

By way of background, U.S. tax law contains nonrecognition rules that generally permit the tax-free transfer of property to a corporation in connection with the corporation's formation or reorganization. Section 367 provides a set of rules that override nonrecognition treatment, to some extent, when the transferor is a U.S. person and the transferee is a foreign corporation (so-called outbound transfers).

Ever since its enactment in 1976, section 367 has been interpreted to permit the tax-free transfer of goodwill and going concern value to a foreign corporation for use in the active conduct of a trade

[1] REG-139483-13.

or business outside the United States. The Obama administration has made it known that it disagrees with the policy views of Congress, as expressed in the legislative history to section 367, regarding the favorable treatment of goodwill and going concern value. The administration's budget proposals have consistently called for the elimination of that favorable treatment, citing it as a source of abuse of the U.S. tax system. Apparently unwilling to wait any longer for Congress to act, the administration has taken it upon itself to make this change by means of a regulation.

Under the proposed regulations, taxpayers would have two options for the treatment of outbound transfers of goodwill and going concern value. The following is a discussion of those options and the potential valuation implications:

> The first alternative is to opt for immediate recognition of gain under section 367(a).
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> Under this option, any gain inherent in goodwill and going concern value would be recognized at the time of the transfer. The transfer of any other types of intangibles would remain taxable under the deferred, contingent sale treatment provided by section 367(d). Given the resulting difference in the treatment of goodwill and going concern value, as compared with the treatment of other intangibles, option one would require a separate valuation of each element of intangible value and separate determinations of the useful lives of each element. To the extent that value is allocated to goodwill and going concern value, income recognition would be accelerated to the year of the transfer. This may be undesirable in most instances, but it may be desirable for taxpayers that wish to accelerate income (for example, to avoid the expiration of net operating losses or tax credit carryovers).
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> Because goodwill is a residual asset — that is, it reflects the difference between the overall value of the company less the value of the tangible and identifiable intangible assets — it is not valued discretely. The first step in valuing goodwill is to estimate the value of the overall entity. Once the overall entity value is determined, the values of the tangible and identifiable intangible assets are then deducted to derive the residual value consisting of goodwill.
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> In valuing the overall entity, it is important to proceed cautiously because there are many subtleties associated with conducting a valuation for U.S. tax purposes relative to other purposes (such as financial reporting purposes). Rather than providing a tutorial on valuing a business, we instead highlight the key issues that — unlike many other types of valuations — must be considered in a valuation conducted for tax purposes. These are:
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> - treatment of intercompany transactions;
> - nature of the entity;
> - transfer pricing and profit margin;
> - entity risk;
> - intellectual property ownership; and
> - repatriation position and tax rates.
>
> Each of the above factors can have a significant effect on the appraised value of an entity. Failure to properly address any of them can adversely affect the validity of the appraisal. It is worth noting that we are often asked if using the net book value of the entity as a proxy for the fair market value is a reasonable assumption. The answer is typically no, because the net book value provides an accounting figure and thus in most cases understates the value of the entity, given that it does not capture the full (or in some cases any of the) value of intangible assets, including goodwill and going concern.
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> The values of the so-called identifiable intangible assets that were previously derived for the calculation of the goodwill value could also potentially be used to compute earnings and profits of the transferee corporation for periods after the outbound transfer. In this scenario, the approach to ascribing an arm's-length value to the intangibles could vary depending on the circumstances. Given that goodwill and going concern will typically carry different lives than the identifiable intangible assets and considering (as detailed below) that the proposed regulations would also eliminate a rule in the existing regulations that limits the useful life of intangible property to 20 years for purposes of section 367(d), regardless of the approach taken, the valuation of the individual assets is likely to create additional complexity.
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> A second alternative is to treat goodwill and going concern value as being subject to the rules for intangible property covered in section 367(d). Under section 367(d), a U.S. taxpayer that contributes intangible property to a foreign corporation is treated as though it sold the intangible to the foreign corporation for a stream of contingent payments over the useful life of the intangible, with the hypothetical contingent amounts being "commensurate with the income attributable to the intangible."

"Commensurate with income" determinations may involve varying methods, one of which could be FMV. There are numerous variables and outcomes that affect the commensurate with income measurement, a key question being the most appropriate method for ascribing value to goodwill, given its unique characteristics relative to identifiable intangible assets (that is, the inability to discretely value goodwill, the potential for an indefinite life, and so on). Other considerations include the life ascribed to each transferred asset, the method applied to ascribe value, etc.

In addition to requiring gain recognition on outbound transfers of goodwill and going concern value, the proposed regulations would eliminate a rule in the existing regulations that limits the useful life of intangible property to 20 years for purposes of section 367(d). As a result of that change, the hypothetical contingent payments created by section 367(d) would continue for the entire period during which the exploitation of the intangible property was reasonably anticipated to occur, as of the time of the outbound transfer (which could be far longer than 20 years).

These proposed regulations came shortly after Notice 2015-54,[2] issued on August 6, 2015, indicating that Treasury and the IRS will be issuing regulations, based on similar policy concerns, that will reduce the possibilities for nonrecognition treatment of transfers of property to partnerships that have foreign partners.[3]

[2]Notice 2015-54, 2015-34 IRB 210.

[3]*See* Jill-Marie Harding, "And Then There Were Two . . . One Less Way to Efficiently Migrate IP Offshore — the Impact of Notice 2015-54 on IP Partnerships," Alvarez & Marsal Taxand Tax Advisor Weekly (Sept. 29, 2015).

Taxpayers contemplating a transfer of business operations to a foreign corporation (either an actual transfer or a deemed transfer resulting from an entity classification election) will need to make a decision as to the likelihood that the proposed regulations will be finalized in their present form and, if so, whether they are likely to withstand a court challenge. For public companies, this may be a particularly difficult issue to address for purposes of Financial Accounting Standards Board Interpretation No. 48 and any required disclosures in the Schedules UTP.

Assuming that the proposed regulations are finalized in their present form (and remain in effect), they may make it undesirable to transfer operations to a foreign corporation. Alternatively, if the taxpayer decides to proceed with an outbound transfer, it will need to decide whether to elect immediate gain recognition under section 367(a) or deferred/periodic gain recognition under section 367(d) for goodwill and going concern value. For many taxpayers, the latter choice is likely to be more desirable. But for some, (for example, those that may have expiring tax credits), the alternative of immediate gain recognition may represent a tax planning opportunity.

To make an informed decision whether to transfer operations to a foreign corporation and whether to elect immediate or deferred/periodic gain recognition for goodwill and going concern value, it would be prudent to model out the projected after-tax consequences of those decisions. A key aspect in making an informed decision will be the value ascribed to goodwill, which will carry significant complexity.

For new foreign operations, the proposed regulations will tend to make it more desirable to operate through a foreign corporation from inception, rather than operating through a branch of a U.S. corporation for some period with the possibility of incorporating a foreign subsidiary later.