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367 (d) - TRANSFER OF INTANGIBLES TO FOREIGN CORPORATION - PROPOSED CHANGES.



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Introduction

In general when a U.S. individual or corporation transfers an intangible asset to a foreign corporation, income is to be recognized by the U.S. person. According to Section 367(d)(2), the United States person transferring the intangible property is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of such property. The transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received either (1) annually in the form of such payments over the useful life of such property, or (2) in the case of a disposition of the intangible property following such transfer (whether direct or indirect), at the time of the disposition.

Transactions of Concern Under The Existing Rules

The IRS and the Treasury Department are aware that certain taxpayers are engaging in transactions intended to repatriate earnings to foreign corporations without the appropriate recognition of income. The general rule under IRC Section 361(a) states that no gain or loss needs to be recognized by a U.S. corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation which is a party to the reorganization. However, the exception to this rule is provided under IRC Section 361(b)(1). It provides that when the corporation receives other property or money for the intangible property instead of stock or security, and this property or money is distributed in pursuance of the plan of reorganization, then no gain is recognized in the transaction.

For example, a U.S. Corporation owned 100% of another U.S. Corporation. The subsidiary corporation's only asset was an intangible. This intangible was transferred to a foreign corporation, also a 100% subsidiary of the U.S. parent entity, and subsequently the subsidiary liquidated. In this case, the U.S. parent does not need to recognize any gain on the original transfer on the intangible property, but must recognize income for subsequent receipts from the foreign subsidiary for the use of the intangible.

There were two transactions, the first was the repatriation of the cash at the time of transfer, and second was the subsequent repayments of the receivable. However income for only the second transaction was being recognized, i.e. for the subsequent payments. The IRS and the Treasury Department intend to address these types of transactions that are set-up to avoid income or gain recognized on these earnings, and accordingly to revise the regulations through this notice.

Proposed Changes to IRC Section 367(d)

The regulations are intended to include the total income to be taken into account under section 367(d) during a reorganization by either including in income of the U.S. transferor in the year of the reorganization or, where appropriate, over time by one or more qualified successors.

In the same example mentioned above, the U.S. parent becomes a qualified successor to the subsidiary that got liquidated. So when the subsidiary transfers the cash to the U.S. parent and liquidates, the parent corporation steps into the shoes of the U.S. subsidiary and is required to recognize income just as the subsidiary would have had to if the reorganization did not take place. There are two transactions once again, the first was the repatriation of the cash at the time of transfer, and second was the subsequent repayments of the receivable. But after the implementation of the proposed regulations, the U.S. parent will have to recognize income for the first transaction as well because it steps into the shoes of the liquidated subsidiary.

The amount of gain to be recognized for the first transaction will be the

product of the qualified successor's (i.e. a shareholder of the transferor that is a domestic corporation, and owns qualified stock in the transferee foreign corporation) share of ownership after the reorganization, with the amount of gain that would have been recognized by the transferor organization. However, if there are any non-qualified successors, then the transferor will have to recognize the income which is equal to the product of the non-qualified successors' share of ownership after the reorganization, with the amount of gain that would have been recognized by the transferor organization.

The IRS intends to address their policy concerns regarding the corporations conducting transactions involving transfer of intangibles during reorganization, and thereby avoiding the tax on the repatriation of intangibles to foreign corporations. Accordingly, through these proposed measures, the IRS wants to ensure that the income is recognized by the transferor or the transferee.

The income taken into account is treated as ordinary income and is treated, for purposes of applying section 904(d), (i.e. classification of passive category or general category of income) in the same manner as if such amount were a royalty.

The revised regulations will apply to transactions occurring on or after July 13th, 2012.

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