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IRS Strikes Favorable Tax Treatment of Outbound Transfers of Foreign Goodwill and Going Concern Value

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In a significant attempt to stop sophisticated taxpayers from gaming their rules, the Internal Revenue Service struck down longstanding favorable tax treatment for outbound transfers of foreign goodwill and going concern value. Citing taxpayers' increasingly aggressive transfer pricing positions meant to exploit the favorable treatment by allocating artificially increased value to foreign goodwill and going concern in outbound transfers of intangibles, the IRS released proposed regulations eliminating the exceptional treatment for such assets. The IRS also limited the scope of property eligible for the active trade or business exception. This development is in stride with similar actions by tax authorities around the world grappling with tax base erosion and the impact of complicated cross-border tax planning.

Under Section 367(d) of the U.S. Tax Code (the Code), when a U.S. company makes an outbound transfer to a foreign company of an intangible asset (e.g., typically an intellectual property asset like a patent, copyright, or trademark), the U.S. company is treated under the Code as if it sold the asset and is deemed to receive annual payments akin to royalties over the life of the asset, which is capped at 20 years under the existing rules. However, the value of foreign goodwill and going concern value associated with the intangible asset has, until now, been excluded from the rule. As a result, U.S. taxpayers have been incentivized to allocate as much value as possible in an outbound transfer of an intangible asset to the associated foreign goodwill and going concern value since that value transfers tax free.

The proposed regulations, issued on September 14, 2015, effectively wipe out that incentive by treating the outbound transfer of the associated foreign goodwill and going concern value no differently than the outbound transfer of the intangible asset itself. Under the proposed rules, the taxpayer either must recognize the deemed annual income on those values, or elect to recognize gain on the transfer. In addition the proposed rules would strike the 20 year cap on the intangible asset useful life, providing instead that the useful life would be the entire period of reasonably expected use and exploitation of the asset. For this purpose, exploitation would include the use of the property in research and development. It remains unclear exactly how the taxpayer would be expected to anticipate a useful life defined in this manner.

The IRS similarly proposes to limit the scope of property eligible for another tax favorable exception under Section 367(a)(3) which allowed certain outbound transfers of property to be tax free to a foreign corporation for use in its active trade or business. This rule has also been used by taxpayers to transfer foreign goodwill and going concern value on a tax free basis, albeit in a less clear way. The new version of the rule eliminates any debate about whether foreign goodwill and going concern value can qualify since going forward only specifically identified eligible property will benefit from the active trade or business exception.

Although there is a 90 day notice and comment period, the proposes rules are slated to apply to transfers occurring on or after September 14, 2015.

The Kilpatrick Townsend tax team is actively studying the proposed rules and we welcome any discussion or questions on this development. For further information on, please contact the authors of this Legal Alert or any other member of Kilpatrick Townsend's Domestic and International Tax Team.

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