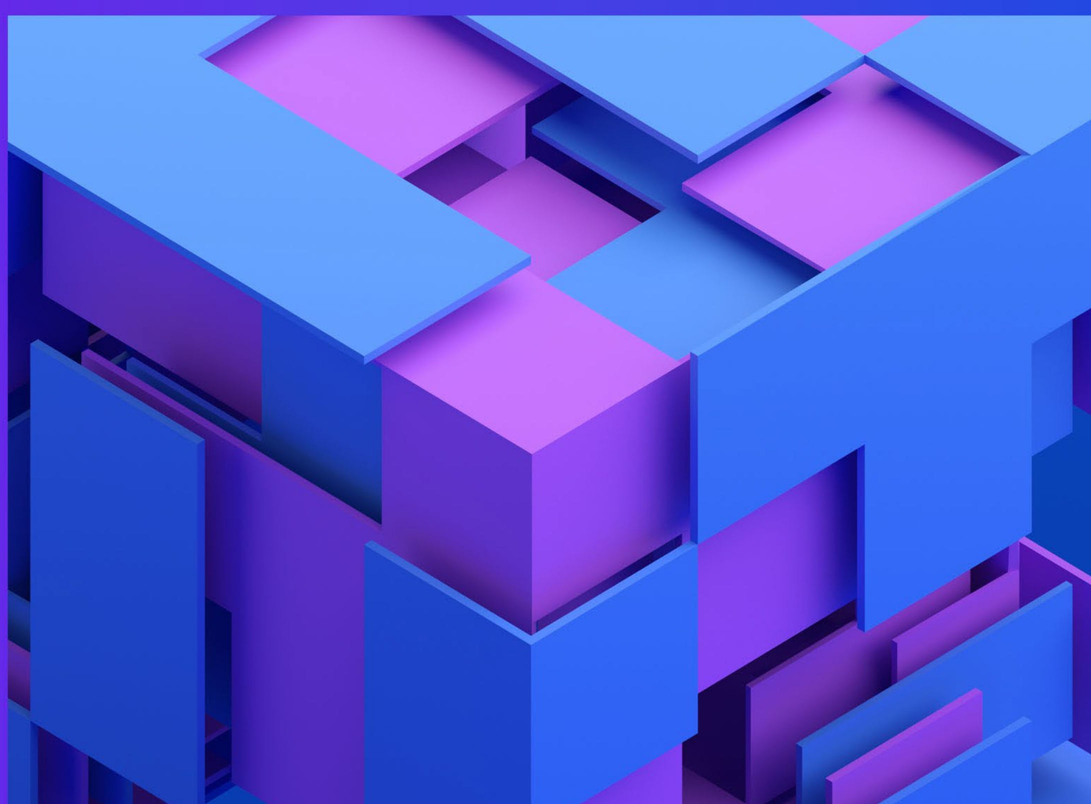
Proposed section 367(d) regulations addressing certain intangible property repatriations

KPMG analysis and observations



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Introduction

The U.S. Treasury Department and IRS on May 2, 2023, released **proposed regulations** [PDF 273 KB] (REG-124064-19) (the "Proposed Regulations") that would terminate the application of section 367(d) arising from an outbound transfer of intangible property described in section 367(d)(4) ("offshored IP") when such IP is subsequently repatriated to certain U.S. persons. By terminating the application of section 367(d) upon the repatriation of offshored IP, the Proposed Regulations alleviate the excessive taxation that can result under current law. As expected, the Proposed Regulations are narrow in scope and do not address many long-standing questions regarding the operation of section 367(d).

The Proposed Regulations are proposed to apply prospectively for repatriations of offshored IP occurring on or after the date of publication of the final regulations. As a result, if Treasury and the IRS retain this applicability date in the final regulations, repatriations of offshored IP prior to finalization would be ineligible for the relief afforded by the Proposed Regulations. Therefore, taxpayers that would like to repatriate offshored IP before the Proposed Regulations are finalized, need to consider obtaining from the IRS a private letter ruling (PLR) as regards the application of section 367(d) to the offshored IP after repatriation.

KPMG observation

The continued application of section 367(d) to offshored IP after repatriation is an issue of increasing importance after the enactment of the so-called Tax Cuts and Jobs Act (**TCJA**), which created certain "carrots and sticks" that generally incentivize U.S. ownership of IP over foreign ownership. As a "carrot," income received by domestic corporations from the exploitation of U.S.-owned IP in foreign markets is potentially subject to a lower rate (through a deduction under section 250) under the foreign-derived intangible income (FDII) rules. As a "stick," royalties paid by domestic corporations to related foreign persons with respect to foreign-owned U.S. IP are potentially subject to the base erosion anti-abuse tax (BEAT).[1] Further, the global intangible low-taxed income (**GILTI**) rules result in immediate taxation of IP owned by controlled foreign corporations (**CFCs**), thus eliminating the benefit of tax deferral with respect to income from such IP that existed before the TCJA.

Whereas the TCJA has generally equalized the tax benefits of foreign-owned versus U.S.-owned IP, changes to foreign tax regimes are increasing the costs of owning IP offshore. Specifically, multinational companies are experiencing increased pressure to locate the ownership of their IP where they have development, enhancement, maintenance, protection, and exploitation (DEMPE) functions to minimize tax disputes among jurisdictions and reduce the potential for excess taxation. For many U.S. multinationals, DEMPE functions exist primarily in the United States.

Although these developments have made multinational enterprises consider moving ownership of their IP to the United States, the tax landscape with respect to the location of IP ownership continues to evolve. First, the corporate alternative minimum tax (CAMT) regime could have the effect of recapturing much of the FDII benefit for U.S.-owned IP for very large corporations, while incentivizing CFC-ownership of such IP due to the tax blending permitted across all CFCs (without the application of section 904 expense allocation rules). Further, the imminent widespread adoption of the Pillar 2 global anti-base erosion (GloBE) rules may also curtail U.S. tax benefits from FDII, in addition to subjecting U.S. companies to foreign tax by reason of their nonrefundable R&D credits.

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[1] However, the BEAT can also disincentive U.S.-owned IP to the extent R&D with respect to such IP is performed by foreign related persons, because in that case R&D payments to such persons are potentially subject to BEAT.

Section 367(d) proposed regulations

Background

Outbound transfers of IP

Section 367(d) provides rules governing the outbound transfer of IP by a U.S. person to a foreign corporation in certain nonrecognition transactions. Specifically, if a U.S. person ("U.S. transferor") transfers IP to a foreign corporation (the "transferee foreign corporation") in a transaction described in section 351 or 361, the U.S. transferor is treated as:

- Having sold the IP in exchange for payments contingent upon the productivity, use, or disposition of the IP, and
- Receiving amounts that reasonably reflect the amounts that would have been received (1) annually over the useful life of the IP (the "deemed payment"), or (2) upon a direct or indirect disposition following the transfer.[2]

Deemed payments

The deemed payment must be commensurate with the income attributable to the IP.[3] In addition, the deemed payment is treated as ordinary income to the U.S. transferor and as a royalty for purposes of the foreign tax credit limitation.[4] The transferee foreign corporation reduces its earnings and profits (E&P) by the amount of the deemed payment.[5] The transferee foreign corporation also treats the deemed payment as a deductible expense for purposes of determining its subpart F income, tested income, and tested loss.[6] Aside from these limited adjustments, the regulations under section 367(d) (the "section 367(d) regulations") generally preclude any other adjustments to E&P, basis, or gross income by reason of the deemed payment.[7] Thus, a deemed payment does not result in a deduction for all U.S. federal income tax purposes.

In general, if a U.S. transferor recognizes income from a deemed payment, and the transferee foreign corporation does not actually pay the deemed payment amount, then the U.S. transferor can establish an account receivable from the transferee foreign corporation equal to the unpaid amount.[8] The U.S. transferor must establish a separate account receivable for each tax year in which it is treated as receiving a deemed payment but does not receive an actual payment from the transferee foreign corporation. If the U.S. transferor establishes an account receivable, the transferee foreign corporation can repay the account receivable without any additional U.S. federal income tax consequences to itself or the U.S. transferor. If a portion of an account receivable remains unpaid as of the last day of the third tax year following the tax year to which the account relates, then the unpaid portion is deemed paid, and the U.S. transferor is deemed

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[2] Section 367(d)(2)(A); Treas. Reg. § 1.367(d)-1T(c), (d), and (f).
[3] Section 367(d)(2)(A) (flush language). The amount of the deemed payment is determined generally by reference to section 482. *See* Treas. Reg. § 1.367(d)-1T(c)(1).
[4] Section 367(d)(2)(C); Treas. Reg. § 1.367(d)-1T(c)(1). The section 367(d) regulations also provide that the deemed payment "shall be treated as ordinary income *from sources within the United States*." Treas. Reg. § 1.367(d)-1T(c)(1) (emphasis added); *see also* Treas. Reg. § 1.367(d)-1T(d)(1) and (e)(1)(ii) (for gain from the disposition rule). However, this sourcing rule in the section 367(d) regulations is deadwood. The regulations reflect a prior version of section 367(d)(2)(c), which provided that a deemed payment would be "treated as ordinary income *from sources within the United States*" (emphasis added). However, effective December 17, 1999, this rule prescribing U.S. source was replaced with the rule treating the deemed payment as a royalty for purpose of section 904, including for purposes of determining source. *See* Pub. L. 106-170, Title V, § 532(c)(1)(C), 113 Stat. 1930. The regulations have not yet been updated to reflect this statutory change.
[5] Treas. Reg. § 1.367(d)-1T(c)(2)(i); *see also* section 367(d)(2)(B).
[6] Treas. Reg. § 1.367(d)-1T(c)(2)(i), (ii); Treas. Reg. § 1.951A-2(c)(2)(ii).
[7] Treas. Reg. § 1.367(d)-1T(c)(2) (flush language).
[8] Treas. Reg. § 1.367(d)-1T(g)(1).

to contribute an equivalent amount to the capital of the transferee foreign corporation and increase its adjusted basis in the stock of the transferee foreign corporation commensurately.[9]

Subsequent transfers of offshored IP

The section 367(d) regulations provide specific rules addressing the consequences of a subsequent direct disposition (*i.e.*, through a disposition of the IP) or indirect disposition (*e.g.*, through a disposition of the stock of the transferee foreign corporation) of offshored IP. With respect to a direct disposition, if, within the useful life of the offshored IP, the transferee foreign corporation subsequently transfers the IP to an unrelated person, the U.S. transferor recognizes gain, but not loss, based on the U.S. transferor's adjusted basis in the IP immediately before the section 367(d) exchange ("original basis") and the fair market value of the IP at the time of the subsequent transfer (the "unrelated party transfer rule").[10] The U.S. transferor also recognizes a partial deemed payment for the part of the tax year preceding the transfer of the offshored IP to an unrelated person, but is not required to recognize any further deemed payments with respect to the offshored IP.[11]

The E&P of the transferee foreign corporation is reduced by the amount of gain recognized by the U.S. transferor under the unrelated party transfer rule and the U.S. transferor can establish an account receivable from the transferee foreign corporation equal to the amount of such gain.[12] The transferee foreign corporation's gross income, however, is not reduced by the amount of gain recognized by the U.S. transferor under the unrelated party transfer rule.[13]

If, instead, the transferee foreign corporation subsequently transfers the offshored IP to a related person within the useful life of the IP, the U.S. transferor does not recognize gain, and the related person that receives the intangible property is treated as the transferee foreign corporation (the "related party transfer rule").[14] Thus, after the related party transfer, the U.S. transferor continues to take into account deemed payments and the related party that receives the offshored IP is treated as making such payments. In most cases, the primary effect of the related party transfer rule is merely to change the change the identity of the transferee foreign corporation to reflect the person that owns the offshored IP (i.e., the person whose E&P and tested income or subpart F income is reduced by reason of the deemed payment).

The related party transfer rule does not explicitly require that the related party to which the offshored IP is subsequently transferred be a foreign person. Therefore, under a literal interpretation of the section 367(d) regulations, after the repatriation of the offshored IP to a related U.S. person (e.g., a member of the U.S. transferor's group), the U.S. transferor may be treated as receiving a deemed payment from such related U.S. person as a transferee foreign corporation, notwithstanding that the related U.S. person is not foreign. Further, as discussed above, the deduction paid by a transferee foreign corporation for a deemed payment may only be allocated and apportioned to subpart F income or tested income, categories of income of foreign corporations; it cannot reduce income of a U.S. person. Therefore, as acknowledged by Treasury and the IRS in the preamble to the Proposed Regulations (the "Preamble"), the related party transfer rule as applied to a repatriation of offshored IP may lead to excessive taxation; while the U.S. transferor continues to take into income the deemed payments with respect to the repatriated IP, the related U.S. person is not afforded an offsetting deduction against its taxable income.

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[9] Treas. Reg. § 1.367(d)-1T(g)(2).
[10] Treas. Reg. § 1.367(d)-1T(f)(1)(i).
[11] Treas. Reg. § 1.367(d)-1T(f)(1)(ii).
[12] Treas. Reg. § 1.367(d)-1T(f)(2).
[13] *But cf.* Treas. Reg. § 1.951A-2(c)(2)(ii) (including in "allowable deductions" for purposes of allocating and apporting to tested income "a deemed payment…under section 367(d)(2)(A)," which subparagraph includes both the deemed payment under section 367(d)(2)(A)(i) and the gain recognized upon a direct or indirect disposition of the offshored IP under section 367(d)(2)(A)(ii), as determined under Treas. Reg. § 1.367(d)-1T(e) and (f)).
[14] Treas. Reg. § 1.367(d)-1T(f)(3).

Discretionary relief for certain repatriations of IP to affiliated U.S. corporations

To mitigate the adverse impact of section 367(d) with respect to the repatriation of offshored IP, the IRS has recently issued PLRs that effectively turn off the deemed payment in cases involving the repatriation of offshored IP to a related U.S. person that is a member of the same U.S. consolidated group as the U.S. transferor (the "section 367(d) PLRs").[15] Each section 367(d) PLR relies on Treas. Reg. § 1.1502-13(c)(6)(ii)(D) (the "discretionary rule") to alleviate the excessive taxation that results from the repatriation of offshored IP. The discretionary rule permits the IRS, at its discretion, to treat certain intercompany items (i.e., items of income or expense attributable to transactions between members of the same U.S. consolidated group) as excluded from the gross income of a U.S. consolidated group member if such exclusion is consistent with the intercompany transaction rules and "other applicable provisions of the Internal Revenue Code, regulations, and published guidance."

A taxpayer may not rely on the discretionary rule unless it obtains a PLR. Also, the rulings in a PLR are directed only to the taxpayer that requests the ruling, and other taxpayers may not cite or use the PLR as precedent. Therefore, under current law, a taxpayer can only obtain relief with respect to the excessive taxation that results from the application of section 367(d) with respect to the repatriation of offshored IP by filing for and obtaining a section 367(d) PLR, which can be time consuming and expensive. In addition, even for taxpayers willing to engage in the PLR process, the repatriation of offshored IP may not always be eligible for relief under the discretionary rule. For instance, if the offshored IP is repatriated to a related U.S. person that is not a member of the same consolidated group as the U.S. transferor, or potentially to the U.S. transferor itself, the deemed payments after the repatriation would not be intercompany items to which the discretionary rule could apply.

Termination of section 367(d) inclusion

The Proposed Regulations would terminate the application of section 367(d) if offshored IP is repatriated to a "qualified domestic person" (QDP) and certain reporting requirements are satisfied. Further, even if these requirements are satisfied, as discussed below, a U.S. transferor may still be required to recognize gain as a result of the transaction, depending on the structure of the repatriation.

Qualified domestic person definition

The Proposed Regulations would define a QDP as either—

1. The U.S. transferor,
2. A U.S. person treated as the U.S. transferor under Treas. Reg. § 1.367(d)-1T(e)(1),[16] provided that such U.S. person is an individual or a corporation other than a corporation exempt from tax under section 501(a), a regulated investment company (as defined in section 851(a)), a real estate investment trust (as defined in section 856(a)), a domestic international sales corporation (DISC) (as defined in section 992(a)(1)), or an S corporation (as defined in section 1361(a) (such U.S. person, a "successor," and a domestic corporation other than those listed, a "taxable domestic corporation"), or

[15] PLR 202107011 (Nov. 24, 2020); PLR 201936004 (June 5, 2019).
[16] Treas. Reg. § 1.367(d)-1T(e)(1) addresses subsequent transfers of stock of the transferee foreign corporation to a related U.S. person. Under that provision, the related U.S. person that acquires the stock is treated as receiving a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor.

3. A U.S. person that is an individual or a taxable domestic corporation that is related, within the meaning of Treas. Reg. § 1.367(d)-1T(h)(2)(ii), to the U.S. transferor or a successor.[17]

The Proposed Regulations would not treat a domestic partnership as a QDP, notwithstanding the identity of its partners and that a domestic partnership is generally treated as a U.S. person in the Code.[18] Thus, even if all the partners in a domestic partnership are QDPs in their own right, the domestic partnership will not be a QDP.

KPMG observation

The Proposed Regulations represent a welcome expansion of potential U.S. persons that would qualify for relief from the excessive taxation that results from the application of section 367(d) with respect to the repatriation of offshored IP. Specifically, the Proposed Regulations would terminate the deemed payment with respect to offshored IP repatriated to the U.S. transferor itself or a related U.S. person that is not a member of the U.S. transferor's consolidated group. As discussed above, the discretionary rule, on which the IRS has relied in the section 367(d) PLRs, does not appear to permit relief except where the IP is repatriated to another member of the U.S. transferor's consolidated group.

However, a repatriation of offshored IP to a domestic partnership would not terminate section 367(d), even if the domestic partnership is wholly owned by members of the U.S. transferor's consolidated group. In reaching this determination, Treasury and the IRS considered, but ultimately declined, to adopt an aggregate approach to partnerships on the basis that it could allow taxpayers to potentially circumvent the purposes of the section 367(d) regulations following a repatriation to a domestic partnership. The Preamble notes that this could occur if, for example, partnership allocations are changed after the repatriation or if the transferee foreign corporation (or a related foreign corporation) has liquidation rights to the intangible property following the transfer.

Gain recognition rule

If offshored IP is transferred to a QDP and certain reporting requirements are met, the Proposed Regulations would terminate the application of section 367(d) to the offshored IP. However, the Proposed Regulations would require the U.S. transferor to include a deemed payment for the portion of the year that the transferee foreign corporation held the offshored IP prior to the repatriation. Further, under certain circumstances, the Proposed Regulations would require the U.S. transferor to recognize gain (the "gain recognition rule").

Whether, and the extent to which, a U.S. transferor recognizes gain under the gain recognition rule depends on whether the IP is transferred basis property, as defined in section 7701(a)(43). "Transferred basis property" is property that has a basis "determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor" (e.g., property transferred in a nonrecognition transaction in which the transferee has a carryover basis under section 362(a) or (b)). Property is still transferred basis property if the basis in such property is increased by the amount of gain recognized with respect to the transfer of the property, since such basis is still "determined…in part…by reference to the basis in the hands of…the transferor." Accordingly, offshored IP would be transferred basis property even if it is repatriated in a nonrecognition transaction in which the transferring corporation recognizes gain on the receipt of nonqualifying consideration ("boot"), such as cash.

If offshored IP is transferred basis property by reason of the repatriation transaction, the U.S. transferor would recognize gain equal to the amount of gain, if any, that the transferee foreign corporation would

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[17] Treas. Reg. § 1.367(d)-1T(h) determines relatedness by reference to (i) partners and partnerships described in section 707(b)(1), and (ii) section 267(b), (c), and (f). Importantly, the temporary regulation reduces the threshold for relatedness from 50% to 10%.
[18] *See* section 7701(a)(30).

recognize if its adjusted basis in the IP were equal to the U.S. transferor's original basis in the property. Thus, if the repatriation transaction is a nonrecognition transaction in which the transferee foreign corporation receives no boot, then the U.S. transferor recognizes no gain under the gain recognition rule. If, on the other hand, the transferee foreign corporation receives boot in exchange for the offshored IP and the receipt of such boot is potentially taxable to the transferee foreign corporation (*e.g.*, section 351(b) exchange), the U.S. transferor's gain under the gain recognition rule is determined by reference to its former adjusted basis in the property.

If the IP is not transferred basis property, the gain recognized by a U.S. transferor under the gain recognition rule would be the excess of the fair market value of the IP on the date of the repatriation over the U.S. transferor's original basis in the property. Therefore, a fully taxable transaction (e.g., a section 311(b) distribution) results in full gain recognition to the U.S. transferor, determined by reference to its original basis.

If a U.S. transferor is required to recognize gain by reason of the gain recognition rule, the Proposed Regulations would provide that the transferee foreign corporation makes a corresponding reduction, but not below zero, to its E&P and gross income. The Proposed Regulations would also permit the U.S. transferor to establish an account receivable equal to the amount of any gain recognized under the gain recognition rule. Consistent with these adjustments, the Proposed Regulations would also provide for a reduction of gross income of the transferee foreign corporation to the extent of gain recognized by a U.S. transferor under the gain recognition rule.

KPMG observation

A U.S. transferor would not generally be expected to recognize gain in the case of a repatriation structured as a nonrecognition transaction. A repatriation of offshored IP in a liquidation described in sections 332 and 337 generally would not cause the transferee foreign corporation to recognize gain. Even a repatriation of offshored IP in a reorganization with boot would generally not be expected to result in gain under the gain recognition rule, since a target corporation does not generally recognize gain if it purges the boot to its shareholders under section 361(b)(1). Thus, in general, the gain recognition rule would appear to have very limited application, applying primarily to repatriations of offshored IP through nonrecognition transactions described in section 351(b) (*i.e.*, section 351 exchanges with boot).

The apparent purpose of the gain recognition rule, in tandem with the adjustment and basis rules described below, is to relieve the U.S. transferor and related U.S. persons from being subject to excessive taxation, in the aggregate, by reason of a repatriation transaction, while ensuring that a QDP does not receive a tax-free increase to the adjusted basis in the repatriated IP. However, there are instances where the gain recognition rule may still result in excessive taxation, particularly in the context of offshored IP that is transferred to a related party in a taxable transaction before the repatriation, whether or not such taxable transfer is part of the same plan as the repatriation.

For example, assume that a domestic corporation (USP) contributes IP with zero adjusted basis to an upper-tier foreign corporation (CFC Parent), which then contributes such IP to a lower-tier foreign corporation (CFC Sub). Subsequently, CFC Sub distributes the offshored IP to CFC Parent in a taxable transaction described in section 311(b). Because the distribution does not constitute a transfer to a QDP, the distribution would not be afforded relief under the Proposed Regulations. Therefore, CFC Sub's taxable income recognized under section 311(b) would not be reduced under the Proposed Regulations and there is a concern that USP would be required to continue to take into account deemed payments from CFC Parent with respect to the IP under the related party transfer rule, notwithstanding that all the income with respect to such IP has been recognized as tested income or subpart F income by reason of CFC Sub's distribution. If CFC Parent then distributes the IP to USP (either as part of the same plan as CFC Sub's distribution or a separate plan), a QDP, under the Proposed Regulations the gain recognition rule would apply to cause USP to recognize gain based on the difference between the fair market value of the offshored IP and its original basis in the IP (here, zero), which does not take into account the increase in the adjusted basis to fair market value under section 301(d) by reason of the CFC Sub's distribution to CFC Parent. As a result, there is a risk of excessive taxation under the Proposed Regulations: USP would recognize gain under the gain recognition rule while also potentially having to take into account the tested income or subpart F income recognized by CFC Sub under the Code's subpart F rules.

Similarly, it is unclear how the gain recognition rule would operate in the case of a prepayment of the deemed payments that arises by reason of the initial outbound transfer of the IP in a nonrecognition transaction with boot. For example, assume that in Year 1 a U.S. transferor (UST), a domestic corporation, transfers IP with a useful life of 10 years and a fair market value of $100 and an adjusted basis of $0 to a foreign corporation (FA) in an outbound reorganization for stock in FA worth $80 and cash of $20, and distributes the FA shares to its domestic parent (USP). Assume further that, consistent with Notice 2012-39 (the "Notice"),[19] the U.S. transferor treats the $20 of boot as a prepayment of a portion of future deemed payments in the year of the transfer (Year 1), and USP, as a "qualified successor" as defined in the Notice, continues to take into account the deemed payment going forward. Thereafter, in Year 2, FA distributes the IP to USP in a taxable distribution under section 301, recognizing gain under section 311(b). Under the gain recognition rule, because the IP is transferred to a QDP (*i.e.*, a successor to UST), but the IP is not transferred basis property because transferred in a taxable distribution, USP would be required to recognize $100 of gain, equal to the fair market value on the date of the repatriation ($100, assuming the value of the IP did not change) over the U.S. transferor's original basis ($0). The regulations announced under Notice 2012-39 may provide a $20 "credit" against the amount of gain recognized by U.S. transferor in this transaction,[20] which would eliminate this excessive taxation. However, these regulations have not yet been issued and obviously the Notice does not anticipate any of the rules of the Proposed Regulations, so that result is far from certain. A similar uncertainty would exist for the repatriation of IP transferred offshore in exchange for stock and boot in a section 351(b) exchange, which the IRS has treated as a prepayment to the extent of the boot. [21]

Finally, even if there would be a credit provided in the case of a repatriation subject to the gain recognition rule, excessive taxation could still ensue in the case of a repatriation of offshored IP in a nonrecognition transaction. For example, if, instead of a distribution of the offshored IP, FA transfers the IP to USP in a complete liquidation under section 332, USP would recognize no gain upon the repatriation, but under the Proposed Regulations it would be required to succeed to the U.S. transferor's original basis (i.e., $0), thus subjecting USP to excess taxation over the useful life of the IP.

QDP's basis in the IP

The Proposed Regulations provide rules regarding the treatment of basis in the offshored IP repatriated to a QDP. The determination of a QDP's adjusted basis in repatriated IP depends on whether, as part of the repatriation transaction, the IP meets the definition of transferred basis property.

A QDP's adjusted basis in the repatriated IP that qualifies as transferred basis property would equal the lesser of the U.S. transferor's original basis in the IP or the transferee foreign corporation's adjusted basis in the IP immediately before the repatriation, increased by the greater of the amount of gain recognized by

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[19] Notice 2012-39, 2012-31 I.R.B. 95.
[20] The Notice provides that a qualified successor is permitted a "credit amount" to the extent of the amount treated as a prepayment of the deemed payment. *See* Notice 2012-39, §4.04. In addition, the Notice contemplates that this credit amount would reduce the gain recognized by the U.S. transferor upon a subsequent disposition of the offshored IP. *See* Notice 2012-39, §4.04 ("Alternatively, for example, if a qualified successor subsequently transfers qualified stock to a U.S. person that is unrelated to the qualified successor or to a person that is not a U.S. person, §1.367(d)-1T(d) will apply to such transfer. In this case, a proportionate amount of any remaining credit amount attributable to the qualified successor can be taken into account to reduce the amount of gain recognized under §1.367(d)-1T(d).").
[21] CCA 200610019 (March 10, 2006).

the U.S. transferor as result of the repatriation or the amount of gain recognized by the transferee foreign corporation upon the repatriation. Alternatively, if the IP does not qualify as transferred basis property, a QDP's adjusted basis in the IP would be equal to the fair market value of the IP as of the date of the repatriation.

KPMG observation

There is a long-standing question as to whether a transferee foreign corporation takes a carryover basis in IP transferred outbound in a transaction subject to section 367(d). The question arises because, while the section 367(d) regulations contemplate a contingent sales construct for IP transferred outbound in a section 351 or section 361 exchange (i.e., treating U.S. transferor as retaining ownership of the transferred IP and the transferee foreign corporation as paying for the use of such IP), no provision in section 367(d) or the section 367(d) regulations explicitly turns off the normal operation of the carryover basis rules in section 362 applicable to property transferred in such exchanges. The inclusion of the "lesser of" rule in determining the QDP's adjusted basis in the repatriated IP would appear to tacitly acknowledge that some taxpayers may have taken the position to amortize IP subject to a section 367(d) inclusion in the hands of the transferred foreign corporation. However, in the Preamble, Treasury and the IRS emphasized that the Proposed Regulations "do not address, nor is any implication intended as to, the appropriate treatment of adjusted basis" in the IP in the hands of the transferee foreign corporation, indicating instead that "general basis rules under section 367(d)" will be addressed in future regulations.

In the earlier example involving the distribution of IP by CFC Sub to CFC Parent, if, instead of a subsequent distribution by CFC Parent to USP, the repatriation were structured as a section 332 liquidation of CFC Parent into USP, such that the IP qualified as transferred basis property, the effect of the QDP basis rule would be to subject USP to excessive taxation in this alternative fact pattern as well. In that case, USP would still take into account CFC Sub's tested income or subpart F income, whereas QDP would be limited to a transferred basis in the IP equal to its original basis (which could be zero). In effect, USP would have recognized all the income with respect to the IP, albeit potentially at GILTI rates, without any increase in its basis in the IP.

Allowable deductions

The Proposed Regulations would provide that a transferee foreign corporation may generally treat the deemed payment as an allowable deduction (whether or not paid) properly allocated and apportioned against the transferee foreign corporation's classes of gross income in accordance with Treas. Reg. §§ 1.882-4(b)(1), 1.954-1(c), and 1.960-1(c) and (d), rather than to subpart F income in all circumstances.

KPMG observation

The section 367(d) regulations currently treat a deemed payment as an expense properly allocated and apportioned to gross income subject to subpart F, while the regulations under section 951A also treat a deemed payment under section 367(d) as an allowable deduction against tested income or loss. The current regulations do not treat the payment as an allowable deduction for purposes of computing effectively connected income (ECI).

The Proposed Regulations would generally retain the rule that permits a transferee foreign corporation to treat the deemed payment as an allowable deduction against subpart F income and tested income, but would incorporate the rule applicable to tested income, which currently exists in the section 951A regulations, into the section 367(d) regulations. More substantively, the Proposed Regulations would expand the categories of income which the "allowable deduction" can reduce to include ECI.

Consistent with the section 367(d) regulations, the Proposed Regulations still appear to contemplate a deduction only with respect to categories of income earned by foreign corporations (*i.e.*, subpart F income, tested income, and ECI), rather than a "true" deduction for all U.S. federal income tax purposes. Thus, if the offshored IP were subsequently transferred to a domestic partnership that is wholly owned by members of the consolidated group that includes the U.S. transferor, because the domestic partnership is not a QDP, it appears that the U.S. transferor would continue to take into account deemed payments from the domestic partnership under the related party transfer rule, while the deduction permitted to the domestic partnership (as the "transferee foreign corporation") would not be available to reduce the domestic corporate partners' taxable income.

Special Rule for related transactions

The Proposed Regulations would provide that, if the transferee foreign corporation transfers the offshored IP to a person that would otherwise be a QDP ("initial transferee") and, as part of a series of related transactions, the IP is thereafter disposed of to any other person, including by reason of multiple dispositions, then the initial transferee is treated as a QDP only if the ultimate recipient of the intangible property is a QDP (the "special related party rule").

KPMG observation

The special related party rule is a one-way street; it can disqualify a transfer of offshored IP to a person that would be a QDP if such IP is ultimately transferred pursuant to the same plan to a person that is not a QDP, but it cannot qualify a transfer of offshored IP to a person that is not a QDP even if the IP is ultimately transferred to a QDP pursuant to the same plan. Therefore, in the example above relating to a repatriation of IP through a tiered CFC structure, the distribution of the offshored IP from CFC Sub to CFC Parent would not be treated as a transfer to a QDP, notwithstanding that, pursuant to the same plan, CFC Parent distributes that IP to USP, a QDP.

Multiple U.S. transferors

The Proposed Regulations would address cases in which there are multiple U.S. transferors with respect to the same IP. In those cases, the Proposed Regulations would apply separately with respect to each U.S. transferor.

KPMG observation

The Proposed Regulations would also provide guidance related to multiple U.S. transferors with respect to the same IP, which may occur, for example, if a U.S. transferor subsequently transfers a portion of its stock in the transferee foreign corporation to a successor U.S. transferor. In these cases, because the section 367(d) regulations apply separately as to each U.S. transferor, the requirements of the gain recognition rule also apply separately with respect to each U.S. transferor. Accordingly, to terminate the continued application of section 367(d) with respect to a particular U.S. transferor, the recipient of the transferred IP must be a QDP with respect to that U.S. transferor and the U.S. transferor must otherwise satisfy the information reporting requirements.

Reporting

As a precondition to terminating the continued application of section 367(d), the Proposed Regulations would require the U.S. transferor to report certain information related to the offshored IP and the repatriation transaction.[22] If a U.S. transferor fails to provide the required information, the repatriation would continue to be subject to the section 367(d) regulations, including the requirement for the U.S. transferor to take a deemed payment into account over the useful life of the IP. However, a U.S. transferor may claim relief from this result under the Proposed Regulations if the required information was not provided and the U.S. transferor who otherwise qualifies for the relief contained in the Proposed Regulations, upon becoming aware of its failure, promptly provides the required information and explains its failure to comply.

Section 904 proposed regulations

Background

Section 904 provides for separate foreign tax credit limitations to apply to certain categories of income, including foreign branch income. The regulations under section 904 provide that the gross income attributable to a foreign branch (and the amount of gross income attributable to its foreign branch owner) must be adjusted to reflect a transfer of IP from a foreign branch to its foreign branch owner, or from a foreign branch owner to its foreign branch, or from a foreign branch to another foreign branch, regardless of whether a disregarded payment is made in connection with the transfer.[23] The principles of sections 367(d) and 482 apply in determining the amount of gross income that is attributable to a foreign branch that must be adjusted by reason of a disregarded transfer of IP.[24]

Interaction of section 367(d) and section 904(d) foreign branch income

The Proposed Regulations would provide that, if the same IP is transferred in a series of disregarded transactions, each successive disregarded transfer of that IP is treated separately for purposes of the rules under section 904 governing the attribution of gross income to the foreign branch "basket" to determine a taxpayer's foreign tax credit. According to the Preamble, the scope and purposes of section 367(d) and section 904 branch regulations differ, and, as such, if there are multiple IP transfers over time, each transfer must be evaluated on its own merit and result in (potentially) differing amounts of deemed payments depending upon any changes in the value of the IP between successive transfers.

KPMG observation

The Proposed Regulations raise complex questions regarding the operation of the disregarded transaction rules under the section 904 regulations, including the scope of the ordering rule for multiple disregarded payments in Treas. Reg. § 1.904-4(f)(2)(vi)(F). For example, assume that, in Year 1, a U.S. transferor transfers IP with a three-year useful life and a $60 fair market value and $0 adjusted basis to a foreign branch in a transaction that is disregarded for U.S. federal income tax purposes. Further, if the foreign branch were a foreign corporation, the amount included in income by the U.S. transferor under the principles of section 367(d) would be $15 in Year 1, $20 in Year 2,

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[22] The reporting obligations contained in the Proposed Regulations require: (i) a statement noting that Treas. Reg. § 1.367(d)-1(f)(4)(i)(B) applies to the repatriation transaction, (ii) a description of the repatriation transaction and any wider transaction of which it forms a part, including the U.S. transferor's former adjusted basis in the intangible property and the transferee foreign corporation's adjusted basis in the intangible property, the amount of any gain recognized by the U.S. transferor as part of the repatriation transaction the Proposed Regulations, and a description of whether the intangible property was, or is expected to be, subsequently transferred, (iii) a description of the IP, (iv) a copy of the Form 926 with respect to the original transfer of the IP, (v) the name, address, and taxpayer identification number of the qualified domestic person that receives the IP, and (vi) any other information that the Commissioner may prescribe in publications, forms or through other guidance.
[23] Treas. Reg. § 1.904-4(f)(2)(vi)(D).
[24] *Id*.

and $25 in Year 3. Thereafter, in Year 2, the foreign branch transfers the IP back to the U.S. transferor in a disregarded transaction at a time when the value of the IP has increased from $60 to $100 and, under the principles of section 367(d), the foreign branch would be treated as having transferred the IP to the U.S. transferor for annual payments contingent on the productivity or use of the IP, the remaining amount of which would be $40 in Year 2 and $45 in Year 3.

Under the Proposed Regulations, each successive transfer of the IP (*i.e.*, the Year 1 transfer by the U.S. transferor to the foreign branch, and the Year 2 transfer by the foreign branch to the U.S. transferor) would be treated separately under the rules for attributing gross income to or from a foreign branch for purposes of determining the U.S. transferor's foreign tax credit. Thus, under the Proposed Regulations, the transfer of the IP by the foreign branch to the U.S. transferor in Year 2 would not relieve the U.S transferor from continuing to determine an amount of gross income that would be attributed from the foreign branch to U.S. transferor, the owner of the branch, in Years 2 and 3. In addition, the U.S. transferor would need to carefully consider the special ordering rule for multiple disregarded payments in Treas. Reg. § 1.904-4(f)(2)(vi)(F) to ensure appropriate attribution of gross income from / or to the foreign branch and the U.S. transferor, with respect to the deemed southbound and northbound disregarded payments made in Years 2 and 3.

Applicability dates

Generally, the Proposed Regulations apply to dispositions of IP occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. Moreover, the Proposed Regulations relating to the determination of gross income and allowable deductions of a CFC for calculating tested income and tested loss generally apply to tax years of foreign corporations ending on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register, and to tax years of U.S. shareholders in which or with which such tax years end.

KPMG observation

These Proposed Regulations are prospective only, and taxpayers may not rely on the Proposed Regulations with respect to transactions undertaken prior to finalization of the Proposed Regulations. As a practical matter, to be fully assured that a repatriation of IP would terminate future deemed payments, taxpayers generally will continue to be required to obtain a PLR from the IRS.

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