UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

December 17, 2015

Associate Chief Counsel (International)
1111 Constitution Avenue, N.W.
Washington, DC 20224

Revised Comments Re: Proposed regulations under sections 367 and 482 (IRS REG-139483-13)

Dear Sir:

USCIB is pleased to have the opportunity to comment on proposed regulations under section 367(a) and (d) of the Internal Revenue Code along with related final and temporary regulations under section 482 of the Code filed for publication in the Federal Register on September 14, 2015. With a few exceptions, the proposed, final, and temporary regulations would all apply to transfers occurring on or after September 14, 2015.

Taken together, these regulations indicate a misinterpretation of the arm's length standard under section 482 and a very consequential exercise of the IRS's authority under section 367(a) and (d) to exempt or not exempt from gain recognition specified categories of property transferred to a foreign corporation.

We comment first on the proposed section 367 regulations, taking note of instances where the final or temporary section 482 regulations are relevant to the interpretation or application of the proposed section 367 regulations. We then comment on the implications of the final and temporary section 482 regulations for transactions not covered by section 367. We also comment on the conformity of these regulations with transfer pricing guidance provided by the OECD as part of the BEPS project and with US tax treaty obligations generally.

Comments on Proposed Regulations under Section 367

1. Statutory Background

If a U.S. person transfers "property" to a corporation in exchange for stock, gain ordinarily is not recognized (1) under section 351(a) if the transferor controls the corporation immediately after the transfer or (2) under section 361(a) if the transfer is pursuant to a section 368 reorganization. Section 367 provides that, except as otherwise provided in section 367 itself or in IRS regulations, property that is transferred to a foreign corporation in a transaction to which section 351(a) or 361(a) would otherwise apply shall not be treated as transferred to a corporation, as a result of which gain shall be recognized as if sections 351(a) and 361(a) were inapplicable.

Section 367(a) contains several exceptions to this denial of non-recognition treatment, including an exception in section 367(a)(3)(A) for property to be used by the foreign corporation in the "active conduct of a trade or business" ("ATB") outside the United States. This ATB exception does not apply to several categories of property listed in section 367(a)(3)(B), including "intangible property (within the meaning of section 936(h)(3)(B))." Under sections 367(a)(3)(A), (a)(3)(B), and (a)(6), the IRS may by regulation except property transfers from the gain recognition provision, from the ATB exception to that provision, and from the exception of 936(h)(3)(B) intangibles from the ATB exception.

Section 367(d)(1) provides that transfers of 936(h)(3)(B) intangibles are governed, not by section 367(a), but instead by section 367(d), which provides at section 367(d)(2)(A) that such property is treated as having been sold in exchange for annual amounts over the useful life of the property that are "contingent on the productivity, use, or disposition" of the property." Under section 367(d) the IRS may by regulation except any 936(h)(3)(B) intangible from the application of section 367(d), the result of which would, except as otherwise provided by regulations, be application of the section 367(a) gain recognition provision to a transfer of the intangible.

2. <u>Proposed Regulations</u>

The proposed regulations under sections 367(a) and (d) deal primarily with the treatment of "goodwill and going concern value" ("GWGCV") and, more specifically, "foreign goodwill and going concern value" ("FGWGCV"), defined in the current regulations as "the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued." Treas. Reg. § 1.367(a)-1T(d). The current regulations except transfers of FGWGCV from the application of the deemed-sale provision of section 367(d)(2) as well as from the exception of 936(h)(3)(B) intangibles from the ATB exception, Treas. Reg. §§ 1.367(d)-1T(b), 1.367(a)-5T(e). Thus, under the current 367 regulations a transfer of FGWGCV to a foreign corporation for active use in a foreign trade or business is generally not taxable, whether the transfer is governed by section 367(a) or 367(d). The proposed regulations completely reverse the current rules, subjecting outbound transfers of FGWGCV to taxation whether the transfer is governed by section 367(a) or 367(d).

The rationales given in the preamble of the Proposed Regulations ("the 367 Preamble") for removing the FGWGCV exceptions are that some taxpayers (1) have overvalued FGWGCV by valuing other intangible property on "an item-by-item basis, when valuing the items on an aggregate basis would achieve a more reliable result," (2) have not performed "a full factual and functional analysis of the business in which the intangible property is deployed," or (3) have treated as FGWGCV "value . . . associated with a business operated primarily by employees in the United States" or "value created through customer-facing activities occurring within the United States."

The rationale given in the 367 preamble for changing to an exclusive list of ATB-eligible property from an inclusive list with exceptions is that some taxpayers take the position that GWGCV is not a 936(h)(3)(B) intangible and therefore is not subject to the deemed-sale provisions of section 367(d) and is not excepted from the ATB exception by section 367(a)(3)(B)(iv). Although not mentioned by the 367 preamble, there is considerable authority for that position, such as the several IRS regulations that list GWGCV separately from 936(h)(3)(B) intangibles. *See* Treas. Reg. §§ 1.861-9T(h)(ii), 1.954-2(e)(3)(iv), and *Veritas Software Corp. v. Comm'r*, 133 T.C. 297, 318-27 (2009). *See also* New York State Bar Association, "Report on Section 367(d)" (Oct. 14, 2010).

3. Legislative History

The current versions of sections 367(a) and (d) resulted from the Deficit Reduction Act of 1984. The 367 preamble refers to statements in the concurrent tax committee reports indicating that GWGCV would ordinarily qualify for the ATB exception: *"The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business."* H.R. Rep. No. 432, 98th Cong., 2d Sess., Part 2, at 1320; S. Rep. No. 169, 98th Cong., 2d Sess., Vol. I, at 365.

However, the ATB exception is relevant only if the transfer is covered by 367(a) rather than section 367(d). Although not mentioned in the 367 preamble, the House and Senate Reports were equally clear that section 367(d) ("the intangibles rule") would not apply to FGWGCV: *"The committee contemplates that the transfer of goodwill or going concern value developed by a foreign branch will be treated under this exception rather than a separate rule applicable to intangibles."* H.R. Rep. No. 432, 98th Cong., 2d Sess., Part 2, at 1320. *"The intangibles rule does not apply to goodwill or going concern value developed by a foreign branch."* Staffs of the Joint Committee on Taxation, Committee on Ways and Means, and Committee on Finance, "Summary of Tax and Spending Reduction Provisions (within the Jurisdiction of the Committees) on Ways and Means and Finance of H.R. 4170 as Passed by the House and Senate," JCS-26-84, at 28 (Comm. Print, June 30, 1984).

Given this background there is a substantial question whether the IRS has the authority to issue regulations that either applies section 367(d) to FGWGCV or eliminates the exception under section 367(a). The IRS should have the authority to deal with abuse cases such as those described in the preamble. The basic case that Congress clearly considered non-abusive still exists and may be the majority of cases. Eliminating any exception for FGWGCV should, therefore, require a legislative change to the section 367.

The IRS rejects as impractical to administer an approach that would provide an exception to taxation for transfers of GWGCV that taxpayers created through the conduct of activities conducted outside the United States through an actual foreign branch. It is not clear why this is any more difficult to administer than the alternative adopted by the IRS (see discussion below and which the IRS itself acknowledges will be challenging to administer). Taxpayers do have genuine foreign branches – particularly in cases that require significant capital investment and that may generate substantial start-up losses or that may never become profitable. In such cases, companies may incorporate these branches after the start-up phase has been completed (subject to applicable branch loss recapture rules) and the business has become profitable. This structure is both common and not abusive.

Other than administrative concerns, the 367 preamble articulates no rationale for not providing an exception in such cases. Further, an approach based on distinguishing bona fide transfers of FGWGCV from abusive transfers, would have the virtue of implementing the intent of Congress. A rule that narrows a legislative exception that is limited to actual abuse cases is likely a valid exercise of the IRS's authority, while the broad rule the IRS proposes is probably not. At a minimum, the IRS ought to provide safe harbors or provide taxpayer's with the ability to seek a ruling, which would include an APA on the value of the FGWGCV. Finally, in light of the regulation's questionable authority, the effective date is particularly aggressive.

4. Effective Date

Even if the IRS believes it has authority for the proposed regulation, for the reasons explained below, USCIB believes that the IRS should reconsider its decision to use the date of issuance as the effective date of the proposed regulations.

First, the process of incorporating a foreign business that will use property of the U.S. transferor is often long, costly, and complex. Among other practical concerns, the U.S. transferor must take account of U.S. and foreign laws and regulations, both tax and nontax, that will apply to the transfer of property and the subsequent conduct of business in that country. The U.S. transferor may need to relocate key executives and staff, which itself raises a number of governance and tax issues.

During the past year, members of USCIB have made considerable investments of time and money in planning the incorporation of foreign businesses on the assumption that FGWGCV could be transferred tax-free and would not even need to be valued separately from other property being transferred. That assumption was premised, not only on the fact that the FGWGCV exception has been part of the section 367 regulations since the section was substantially re-written by Congress in 1984, but also on the fact that Congress itself repeatedly stated and "contemplated" that transfers of FGWGCV would be exempt from the non-recognition provisions of sections 367(a) and (d).

Even if some taxpayers have committed some of the abuses mentioned in the preamble, the proposed regulations will impose unanticipated tax burdens on many transactions that are already under way and may not be abusive in any respect. The taxpayers that initiated those transactions have acted in reliance on longstanding Congressional and IRS guidance , and changing the tax consequences in midstream is inequitable. To the extent that the IRS intends to apply the regulation retroactively, such retroactive application should be limited to clear cases of abuse. It is the IRS's burden to clearly define what is abusive and what is not abusive in this situation. If the IRS cannot clearly define what is abusive, then there should be no retroactive application of the regulations at all.

Second, as discussed further below, the proposed regulations under section 367 and related provisions of the final and temporary section 482 regulations raise many new issues, making it likely that some, if not many, of the provisions of the final version of the regulations will differ materially from the provisions of the proposed regulations. Application of the originally proposed effective date to provisions that are materially altered would be unlawful under section 7805(b) of the Code. Given that all provisions of the proposed regulations are tightly interrelated, application of that date to any provision of a materially modified final set of regulations would also arguably be unlawful.

For the foregoing reasons, USCIB respectfully requests that the IRS announce, as soon as possible, that an effective date prior to publication of final or temporary regulations will not apply to any transfer of property to a foreign corporation if the taxpayer can demonstrate that on or before that date the taxpayer had a fixed intention to cause such transfer or had materially invested in investigating or planning the transfer or a transaction of which the transfer would have been a material element.

5. Practical Concerns with the Proposed Regulations

There may be cases of abuse that the IRS should certainly address, however, in non-abusive cases the disparate treatment under section 367 of tangible and intangible property used in the same business will create difficult valuation problems and a range of possible valuation outcomes that will inevitably increase disputes.

Such discrepancies are inherent in any transfer pricing matter where exact comparables are unavailable, and USCIB strongly opposes the solution of the proposed regulations, which is essentially to abandon any attempt to distinguish between taxable intangibles and non-taxable residual value, even though Congress intended that gain should be recognized only on that part of any such residual that consisted of 936(h)(3)(B) property.

As explained below, the solution implemented by the proposed regulations gives rise to a number of equally difficult and potentially contentious issues that should be studied and resolved prior to finalization.

a. When is an Intangible Residual

Under the current regulations, taxpayers need only value the 936(h)(3)(B) intangibles being transferred. Under the proposed regulations they will also need to value the "eligible property" as well as the value of the whole business, presumably using an income method (so that they may arrive at GWGCV by subtracting from the value of the whole the values of the "eligible property" and the 936(h)(3)(B) intangibles). Although the prime motivation for the proposed regulations appears to have been the difficulty of distinguishing intangibles that are 936(h)(3)(B) intangibles from intangibles that are GWGCV, allowing taxpayers an election to apply either section 367(a) or 367(d) to that part of intangible value that is included in the residual means, for those taxpayers that elect to apply section 367(a), there will still be grounds for significant disputes with the IRS over the very valuation issues that the proposed regulations seek to resolve.

b. <u>When are Residual Values "Property"</u>

The current section 367 regulations do not state expressly that GWGCV is a 936(h)(3)(B) intangible, but they imply as much by excluding FGWGCV from property to which section 367(a)(3)(B) and section 367(d) would otherwise apply. By eliminating those exceptions, the proposed regulations no longer take even an implied position on that longstanding issue. Instead, proposed section 1.367(a)-1(b)(5) allows a taxpayer to decide for itself whether to treat GWGCV as a 936(h)(3)(B) intangible by electing or not electing to apply the deemed-sale provisions of section 367(d) to any property that is subject to the non-recognition provisions of section 367(a), i.e., any transferred property other than "eligible property." Although this election would in principle remove any contest between taxpayers and the IRS over whether GWGCV is a "similar item" under section 936(h)(3)(B), eliminating the FGWGCV exceptions would resurrect the otherwise dormant question whether GWGCV, or at least certain forms of GWGCV, are "property" at all. Section 367, like sections 351 and 361, applies only to transfers of "property." Although the courts have defined the term broadly for these purposes, *see, e.g. United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984), the notion that an item of value must enjoy some legal protection in order to be "property" has been repeatedly recognized by the IRS, s*ee, e.g.,* Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 79-288, 1979-2 C.B. 139.

In some cases, GWGCV may reflect the costs of recreating the business by separately purchasing the assets used in the business, recruiting an equally able workforce, establishing goodwill through advertising, etc. However, there ordinarily are no reliable methods for calculating those hypothetical "avoided costs," other than valuing the whole business and assuming that those avoided costs are captured in the residual. Consider, for example, "workforce in place." Although workforce in place is recognized under Code section 197(d)(1) as an "intangible" distinct from "goodwill" or "going concern value," the current section 367 regulations effectively incorporate workforce in place into GWGCV by defining FGWGCV as the residual value of a business after all other property has been valued. What would happen if a U.S. employer were to assign a team of employees to a foreign subsidiary--is the employer required to recognize gain on the avoided costs of recruiting an equivalent team? How could one calculate such costs? The avoided cost of having to assemble a new workforce would certainly figure into the value a buyer would pay to purchase an existing business, but workforce in place is arguably not "property" since the seller of the business has no legal right to prevent other employers from recruiting them. (Employee contracts may have some value, but they are separately treated as a 936(h)(3)(B) intangible. I.R.C. § 936(h)(3)(B)(iv).)

The proposed 367 regulations provide no answer to these sorts of questions and do not even define "property." Of course, the current regulations do not provide answers to these questions either, but there is no need to do so because the residual value of a transferred business is not subject to gain recognition. If the residual value is included in the amount realized on a taxable exchange, as would happen under the proposed regulations, then both the taxpayer and the IRS will be faced with the challenge of dividing the residual value between items that are "property" and others that are not, which could very well lead to widely divergent positions comparable to those that the proposed regulations seek to preclude. At the very least, if the IRS concludes that exclusion of residual values from non-recognition is essential to its mission, then the proposed regulations should be amended to deal with the issue of what constitutes "property" for purposes of sections 351, 361, and 367.

c. <u>What is the Distinction Between "Synergies" and "Going Concern Value"?</u>

According to the 367 preamble, one of the perceived abuses warranting taxation of residual value was the undervaluation of 936(h)(3)(B) intangibles, effectively assigning the missing value to the nontaxable category FGWGCV. The temporary section 482 regulations combat that abuse through a three-step process: section 1.482-1T(i)(B) provides that, where synergies exist among transferred items, valuing them in the aggregate may be a more reliable method than valuing them separately; section 1.482-1T(C) provides that the valuation of separate transactions may need to be coordinated to ensure that the "overall value" of the transactions is properly taken into account; and section 1.482-1T(D) provides, inter alia, that the full value of transactions covered by different Code sections must be reliably allocated.

When a going concern that includes many items of property is transferred, the distinction between values that arise from "synergies" as opposed to "avoided costs" will often be murky. Under the current section 367 regulations, aggregate valuation may have been appropriate for 936(h)(3)(B) intangibles, which needed to be distinguished from residual values, but the transferor did not have to distinguish between the value of its other ATB property and the value of any associated GWGCV because both were excepted from the non-recognition provisions of section 367.

Under the proposed regulations, the taxpayer and the IRS must now distinguish between the value of "eligible property" to be used in the ATB and the GWGCV of the business. If the transferor is transferring a substantial amount of eligible property that constitutes a valuable, going concern, this implies that the various items making up the "eligible" category are, from a valuation standpoint, "greater than the sum of the parts." How will the distinction between "synergy," in the sense of the parts being well suited to each other, and therefore part of the value of the eligible property, and what part is the avoided cost of finding and acquiring an equally advantageous grouping of property and therefore part of GWGCV be made?

The IRS believes that the current regulations invite abuse by taxing only one category of property, 936(h)(3)(B) intangibles, leading to controversy over how much of that value may have "slipped into" the nontaxable residual value. The "aggregation" and "coordination" provisions of the temporary section 482 regulations deal directly with that; however, by adding on top of that a second level of defense in the proposed regulations 367, the IRS surely opens the door to a new round of controversy over how much of the residual value U.S. transferors may have "slipped into" the aggregate valuation of "eligible" property.

At the very least, if the IRS concludes that exclusion of residual values from non-recognition is essential to its mission, then the proposed regulations should be amended to distinguish between "synergies" that are captured in valuing "eligible" property and subject to non-recognition and "going concern value" that is captured in the residual value and therefore subject to recognition.

d. Alternative Approach

In the view of USCIB, both taxpayers and the government would be better served if the problems identified in the preamble were addressed directly rather than indirectly through the blanket denial of an exemption from recognition that Congress expressly contemplated. (Indeed, one of the problems--valuations that overlook synergies--is directly and forcefully addressed in the temporary section 482 regulations.)

From the preamble it is clear that the focus of concern is businesses in which 936(h)(3)(B) intangibles are significant and whose exploitation would likely account for most of the business's future profits. From that standpoint, the temporary section 482 regulations suggest a more measured approach to the perceived abuse. Section 1.482-1T(C) provides that the valuation of separate transactions may need to be coordinated to ensure that the "overall value" of the transactions is properly taken into account, while section 1.482-1T(D) provides, inter alia, that the full value of transactions covered by different Code sections must be reliably allocated.

Under the proposed section 367 regulations, the taxpayer will still need to value separately its 936(h)(3)(B) intangibles and its "eligible property." Because the residual value will be included in the amount realized under section 367(a) or (d), the aggregate value of the business will also need to be valued. Since these valuations must be performed by the taxpayer and reviewed by the IRS if examined, a less draconian means of countering the perceived abuse would be to apportion the residual value between the eligible property and the 936(h)(3)(B) intangibles, in accordance with temporary section 1.482-1T(D).

What Makes GWGCV "Foreign"

USCIB has recommended above that the FGWGCV exceptions not be eliminated. In the event they are not eliminated, USCIB recommends that the IRS consider clarifying what makes GWGCV "foreign."

USCIB does not agree with the statement in the preamble that goodwill and going concern value cannot be "foreign" if it is associated with a business operated by U.S. employees or through customer-facing activities occurring within the United States. Although some of the legislative history refers to the exclusion from section 367(d) as applying to GWGCV "developed by a foreign branch," the legislative history pertaining to the 367(a) exclusion does not. The appropriate reconciliation of these different approaches to phrasing the exclusion is that when referring to GWGCV "developed by a foreign branch," Congress was simply reflecting a pre-Internet understanding that GWGCV that is useful outside the United States would ordinarily result from activities performed outside the United States. For no other category of property exempt from gain recognition did Congress state or imply that an "origination" test should be imposed.

When property is transferred to a foreign corporation, non-recognition should not depend on whether the property was *originated* outside the United States but whether it will be actively *used* in a business conducted outside the United States. If a U.S. corporation disassembles a factory in Georgia and transfers the components to a foreign subsidiary that will manufacture the products in Mexico, there is no doubt under the proposed regulations that it will qualify as "eligible property." Similarly, if a U.S. corporation employs a team of professionals in Florida that operates an Internet music service and transfers the team to a location in Brazil where they will be employed by a foreign subsidiary, the question presented should be not whether the team was originally trained in the United States or developed a "following" from that location but whether they will actually conduct their income-generating activities from outside the United States.

USCIB comments on 482 aggregation regulations

1. Application of 482 Aggregation Regulations May Result in Greater Application of Aggregated Valuation Methodologies such as the Income Method, which is Inconsistent with the "No Loss" Rule in Section 367.

By taking the position that the IRS will aggregate valuation for the pricing of transactions that occur under different code sections, the IRS seems to be trying to pave the way for wider application of the income method. USCIB believes that this approach is inconsistent with the underlying policy of "no losses" in section 367.

The IRS often takes the position that the income method[1] is the best method to value the package of intangibles and services transferred in connection with the CSA. This philosophy is also discernible in IRS practice and guidance. In *Veritas Software Corp. v. Comm'r*, 133 T.C. 297, 318-27 (2009), for example, the Tax Court rejected IRS arguments calling for aggregated valuation and application of the income method, but the IRS rejected the factual findings, result, and reasoning of this decision in AOD 2010-49 (December 6, 2010). The IRS has made good on its promise to continue applying the income method in cost sharing buy-in cases.[2] Moreover, in 2010 IRS NTPCCA 201111013; 2010 IRS NON-TAXPAYER CCA LEXIS 783 (June 25,

[1] The income method is a new valuation method specified in Treas. Reg. § 1.482-7(g)(4). It derives the PCT Payment owed by the transferee to the transferor by comparing the present value of the profits that the transferee would obtain from switching to the cost sharing alternative ("Option A") to the present value of the profits that the transferee would obtain from sticking with licensing the intangibles from the transferor instead of jointly developing them with the transferor in the CSA ("Option B"); hence, under this method, the PCT Payment (or buy-in payment) owed by the transferee (when paid in a lump sum) is the difference in value between Option A and Option B (i.e., Option A minus Option B). *See* Treas. Reg. § 1.482-7(g)(4)(iv).

[2] *See Amazon v. Comm'r*, Tax Court Docket No. 031197-12 (cost sharing buy-in dispute in which taxpayer is contesting IRS application of discounted cash flow method to cost sharing buy-in payment).

2010), the IRS argued that in cost sharing buy-in disputes, the IRS generally believes that the income method is the best method because it is the only method that will allow for "full economic compensation" to the transferor, and the "IRS position is that the economic result should control: there is in general no legal loophole to avoid full economic compensation, and methods that deny full compensation should be rejected"). Furthermore, in the IRS LMSB Coordinated Issue Paper ("CIP") on Cost Sharing Buy-Ins (October 2007), 16 TM TPR 386 (Westlaw), the IRS argued that in certain scenarios where a US entity has provided all of the valuable unique contributions to a CSA, and the foreign cost sharing participant has provided nothing or very little of value, that the income method will be the best method to value the package of intangibles and services transferred by the US entity to the foreign cost sharing participant). The CIP was withdrawn in 2012; however, in our experience, the IRS still very much believes in the material that was put forth in the CIP.[3] Additionally, the 2011 final cost sharing regulations added the following sentence to the regulations: "Each method *must yield results* consistent with measuring the value of a platform contribution by reference to the future income anticipated to be generated by the resulting cost shared intangibles." Treas. Reg. 1.482-7(g)(1) (emphasis added). Thus, while any method can be selected (consistent with the best method rule), that method must yield results consistent with the results the income method would generate.

Prior to the issuance of the September 2015 482 aggregation regulations, the IRS took the position that is allowed to aggregate the valuation for the pricing of two or more transactions "if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions."[4] In our collective experience, we have found that the IRS almost always argues for an aggregated valuation in cost sharing buy in controversies because, as the IRS has explained in its guidance on this issue, it believes that an aggregated valuation is the only way to ensure that the transferor receives "full economic compensation"[5] for the package of services and intangibles transferred. In order to support this position, we have found that the IRS will try to find facts that support synergies between: (a) rights to make and sell products derived from technology intangibles that are provided to the transferee and rights to perform research and development with respect to such technology intangibles provided to the transferee; (b) marketing intangibles made available to the transferee and technology intangibles made available to the transferee; (c) technology intangibles provided to transferee and services to maintain or improve such technology intangibles that are provided to transferee; (d) marketing intangibles provided to transferee and services to maintain or

[3] *See e.g.*, "United States: IRS Has Received Some 500 Applications for Transfer Pricing Practice, Maruca Says," 21 *Tax Mgmt. Trans. Pricing Rep.* 114 (May 31, 2012) ("While [IRS Transfer Pricing Director Sam] Maruca noted that the IRS in January withdrew a 2007 coordinated issue paper on cost sharing buy-ins, he said the Service 'is not backing away' from an income-based approach to measuring the value of IP investments")(citing 20 Transfer Pricing Report 812, 1/26/12)).

[4] Treas. Reg. § 1.482-1(f)(2)(i)(a).

[5] *See generally* 2010 IRS NTPCCA 201111013; 2010 IRS NON-TAXPAYER CCA LEXIS 783 (June 25, 2010).

improve such marketing intangibles that are provided to the transferee; (e) marketing services that are provided to transferee and technology services that are provided to the transferee; and (f) any "super-synergies" that result from the combined transfer of (a) through (e).

If the September 2015 482 aggregation regulations are allowed to stand, this approach (that is, the aggregated valuation approach typically using the income method) will be widened to all other tax code sections. The regulations specifically target section 367. But this approach is fundamentally inconsistent with the "no loss" rule in section 367.[6] The "no loss" rule in section 367 goes hand in hand with the exemption of goodwill from being a compensable asset because goodwill is inherently a concept that would require netting of projected income because it is a residual component of value that is left over after all other items of value have been identified and valued. Thus, an aggregated valuation method like the income method, which captures residual aspects of value such as goodwill, would undermine one of the fundamental purposes of the section 367 regulations, which is to ensure that only gain, and not loss, is captured.

Finally, in addition to being inconsistent with the "no loss" rule in section 367, the new aggregation rule will result in new challenges in connection with goodwill and going concern value. Under the current regulations, a purchase price accounting type method for valuation is allowed (whereby each intangible is valued separately, and the residual is goodwill). This had the benefit of matching how standard valuation analyses were conducted for financial purposes with how valuation needed to be done for tax purposes. By shifting away from the purchase price accounting approach, the IRS will be inviting more disputes over what the proper aggregated valuation should be, as well as whether and to what extent such aggregated valuation could be broken back down into allocated or apportioned parts (as the regulations contemplate may be needed for other tax code sections). It should be noted that the temporary 482 regulations, while giving new powers of aggregation to the IRS, also note that there may be circumstances in which allocation or apportionment of the aggregated valuation may be necessary. To the extent that the aggregated valuation would have to be broken down into various portions under such circumstances, the need for an aggregated valuation is called into question. The reason for this is that one of the justifications for an aggregated valuation would seem to be that it is impossible to value each portion by itself, and thus an aggregated valuation of all portions together must be undertaken in order to value all of such parts. But if it is possible to then break down that aggregated valuation into apportioned or allocated portions, then why was an aggregated valuation needed in the first place? The IRS does not explain how to resolve this paradox, but simply assumes that, having done an aggregated valuation, taxpayers will be able to find a way to reliably break that down into constituent parts for other

[6] See Treas. Reg. 1.367(a)-1T(b)(3)(ii): "No loss may be recognized by reason of the operation of section 367." See also Treas. Reg. 1.367(a)-5T(d)(3). The no loss rule is put into the regulations by fiat. Under the 482 regulations, it is possible that the income method might generate a negative value in some circumstances. Thus, the "no loss" rule creates a distinction between results that can be obtained under 482 valuations as compared to results that can be obtained under 367 valuations.

parts of the code. But if taxpayers can reliably break down the aggregated value, then there is no need for aggregating in the first place.

2. The 482 Aggregation Regulations Inappropriately Confuse the Concept of "Value" with Arm's Length Pricing.

USCIB believes that the 482 aggregation regulations inappropriately confuse the concept of "value" with arm's length pricing. Controlled taxpayers have full information about each other's value of specific items of property. Uncontrolled taxpayers do not. A buyer will never be willing to pay more for property than its privately known value—at arm's length the seller does not know that private value. Reciprocally, a seller will never be willing to accept a price for property less than its privately known reservation price (the price at which the seller prefers to keep the property)—at arm's length the buyer does not know that private value. The observed price at which property changes owner is thus always greater than the reservation price of the seller and lower than the private value of that property to the buyer. However it will generally *not* be equal to the private value of that property to the buyer—in most cases it will be less, and often significantly less.

The FMV concept recognizes that fundamental property of the open market by defining value as being established by reference to the price an anonymous knowledgeable, willing and unpressured buyer would be willing to pay an anonymous knowledgeable, willing and unpressured seller for property. FMV is therefore fundamentally different from "intrinsic value"—the FMV is generally neither the intrinsic value of the property to *either* the buyer or the seller. This is the reason why FMV refers to anonymous buyers and sellers. The word "anonymous" meaning that the specific characteristics of the buyer and the seller (which would reveal their intrinsic value) cannot be taken into consideration when establishing FMV.

The arm's length standard defined in Treas. Reg. 1.482-1(b)(1) states that a controlled transaction meets the arm's length standard "*if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).*" The notion of an arm's length result is thus consistent with the view espoused by FMV that the value of property is not to be construed as the *intrinsic value* of the property to either the seller or the buyer, but as the price buyer and seller with private information about the intrinsic value of the property to them would have transacted at. Indeed, a large number of cases and other authorities establish that the arm's length price is equivalent to "fair market value" – "an arm's length price is simply a different label for the fair market value of the goods or services to which the price relates." E.I. DuPont de Nemours and Co. v. United States, 78-1 U.S. Tax Cas. (CCH) P9374, 20 (Ct. Cl. 1978). "Fair market value," in turn, is generally defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." DHL Corp., 76 T.C.M. (CCH) 1122 (1998) (quoting United States v. Cartwright, 411 U.S. 546, 551 (1973)). Therefore, in general, a seller would not be in a position to extract the full intrinsic value of the property from the buyer.

USCIB therefore believes that with its focus on "full economic compensation" of the seller for all transferred elements of value, including synergistic values that (1) are private to the buyer and at arm's length would not be known (or measurable) to a seller, (2) FMV specifically rejects as being subject to a FMV measurement (no specific characteristics of the buyer and the seller are considered), and (3) requires the buyer to always pay for a price equal to its intrinsic value of the property. The IRS is attempting to require use of valuation rules that are inconsistent with the definition of the arm's length standard of Treas. Reg. 1.482-1(b)(1).

Thus, the proposed 482 aggregation regulations, although purporting to be implementing the arm's length standard, are not in fact implementing the arm's length standard. Under the arm's length standard, we would observe that an uncontrolled seller cannot always extract all the surplus from the buyer, and that in fact such a conclusion would be part of the arm's length analysis. However, in the 482 aggregation regulations, the IRS is attempting to enforce this non-arm's length result.

Accordingly, the USCIB believes that the Treasury should withdraw the 482 aggregation regulations as inconsistent with the arm's length standard and revise the regulations so that they are consistent with the arm's length standard of Treas. Reg. 1.482-1(b)(1).

3. The 482 Aggregation Regulations Are Too Vague and Result in Unpredictability in Law.

USCIB believes that the new guidance on aggregation relies on subjective terminology, for example, when transactions are interrelated or economically interrelated or where synergies are present. This subjectivity could potentially allow the IRS to arbitrarily aggregate transactions whenever it suits the IRS purpose in a given situation, but in a way that is essentially unknowable or unpredictable by taxpayers. Even more problematic, vague and amgibuous rules can often result in paradoxes, as is the case here. For these reasons, courts have repeatedly indicated that where tax rules are ambiguous, that such ambiguity will be interpreted against the government because to do otherwise would be unfair to taxpayers.[7] For

[7] See e.g., United Dominos Industries, Inc. v. United States, 532 U.S. 822, 839 (2001) (Thomas, J., concurring) (where a "complex statutory and regulatory scheme leads itself to any number of interpretations," these inconsistencies are resolved against the government). See also United States v. Merriam, 263 U.S. 179, 188 (1923) ("If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer")). The courts have actually applied this doctrine specifically against the IRS in the context of interpreting the Former Cost Sharing Regulations. See Xilinx v. Comm'r, 567 F.3d 482, 498 (9th Cir. 2009) (J. Noonan, dissenting) ("a very old canon of construction applies in this case, in which the complex statutory and regulatory scheme leads itself to any number of interpretations … [w]e resolve the inconsistencies against the government. This canon of construction is framed in the cases just cited as particularly relevant to tax statutes. It is, however, not a concession to taxpayers. It is the way legal documents are read. The draft is construed against the drafter."). Although this was originally a dissenting opinion, this opinion was withdrawn and the writer of the dissenting opinion (Judge Noonan) became the drafter of the majority opinion when the 9th Circuit issued another opinion reversing its prior opinion after it granted a motion for reconsideration of its prior opinion. See Xilinx v. Comm'r, 592 F.3d 1017 (9th Cir. 2010). In the new opinion, the judge that switched sides issued a concurring opinion explaining that one of the reasons that the court had ruled against the IRS was that its regulations were not clear and that the IRS could (and should) issue regulations that clarified the matter: "Having thoroughly considered not only the plain language of the regulations but also the various interpretive tools the parties and amici have brought before us, including the legislative history

these reasons, USCIB believes that the 482 aggregation regulations proposed in September by the IRS and Treasury are precisely the kind of vague and potentially unlimited subjective expansion of governmental taxing power that is unfair to taxpayers and to which courts are hostile. Accordingly, USCIB recommends that the IRS and Treasury withdraw these regulations.

4. <u>The 482 Aggregation Regulations Reverse Longstanding U.S. Position that Specific and Predictable Rules Should be Preferred to Vague Anti-Abuse Rules</u>.

USCIB is also disturbed by the broad expansion of governmental power that the new 482 aggregation regulations represent because they represent a reversal of the longstanding U.S. position that detailed rules that define a taxpayer's obligations should be preferred to vague rules that are difficult to apply in the general non-abusive situation. For example, most recently, the U.S. took the position during discussion of Action Item 6 in the OECD BEPS Action Plan that there should not be vague general anti-abuse rules (GAAR) in tax treaties, but that, rather, there should be very precise and predictable limitations on benefits provisions like what the U.S. has in its tax treaties. The U.S. objected to GAAR provisions on the grounds that they were too vague and subjective, and thus completely unpredictable – leaving taxpayers at the mercy of the tax authorities. But this is precisely what the new 482 aggregation regulations are doing – submitting US taxpayers to a vague and subjective rule that is completely unpredictable. Accordingly, the USCIB believes that the U.S. should withdraw these 482 aggregation regulations in order to be consistent with its longstanding opposition to GAARs. USCIB believes that taxpayers who are trying to comply with their tax obligations and figure out what they owe will be confused by these regulations as to how to calculate their tax obligation. USCIB believes that taxpayers ought to have guidance that is clear so they are not confused in trying to determine their tax liability. Under these regulations, for example, is the IRS really saying that a taxpayer is obligated to determine the highest price that a buyer would be willing to pay for a transferred asset and pay tax on that amount? This seems to be one possible interpretation of the regulations, but this seems to be a very unfair rule for taxpayers in addition to being inconsistent with the arm's length standard. Accordingly, USCIB recommends withdrawing these regulations.

Interaction with Income Tax Treaties and OECD Transfer Pricing Guidelines

---

of § 482, the drafting history of the regulations, persuasive authority from international tax treaties and what appears to have been the understanding of corporate taxpayers in similar circumstances and of others, I conclude that Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible. Traditional tools of statutory construction do not resolve the apparent conflict in these regulations as applied to Xilinx, and the <u>***Commissioner's attempts to square the "all costs" regulation with the arm's length standard have only succeeded in demonstrating that the regulations are at best ambiguous.***</u> Although I would not go so far as Xilinx in characterizing the Commissioner's interpretation as merely a "convenient litigating position," <u>Bowen v. Georgetown Univ. Hosp</u>., 488 U.S. 204, 213 (1988), <u>***we need not defer to it because he has not clearly articulated his rationale until now***</u>. <u>See</u> <u>United States v. Thompson/Ctr. Arms Co</u>., 504 U.S. 505, 518-19 & n.9 (1992) (declining to defer to an agency interpretation of a tax statute where no prior guidance went directly "to the narrow question presented"). Indeed, <u>***I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them***</u>." Id. at 1198 (citations omitted) (emphasis added).

The proposed and temporary regulations are inconsistent with the United States' bilateral tax treaty obligations. The arm's length standard, as interpreted by the OECD Transfer Pricing Guidelines, is enshrined in Article 9 ("Associated Enterprises") of the 2006 U.S. Model Income Tax Convention, the 2015 proposed U.S. Model Income Tax Convention, and nearly every bilateral tax treaty the United States has entered. As we discussed in the previous section, the Treas. Reg. § 1.482-1T(f)(2)(i)(A) language that requires compensation for "all value" provided in controlled transactions and allowing the Service to disregard or impute contractual terms is inconsistent with the OECD Transfer Pricing Guidelines ("OECD Guidelines"). Accordingly, this language should be removed and replaced with language that is consistent with the OECD Guidelines.

Specifically, the OECD Guidelines, as now revised by the BEPS Actions 8–10 Final Reports, provide that the "[a]pplication of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances." OECD Guidelines ¶ 1.33. Compensation in these transactions reflects the functions that each associated enterprise performs taking into account assets used and risks assumed, not a subjective determination of "all value" transferred. *See id*. at ¶ 1.51.

In fact, the OECD Guidelines specifically provide that certain transfers of synergistic value do not require any payment when an associated enterprise "obtains incidental benefits attributable solely to its being part of a larger MNE group," *id.* at ¶ 1.158 and warn that "[a] tax administration should not disregard the actual transaction or substitute other transactions for it unless . . . the transaction viewed in its entirety lacks the commercial rationality of the arrangements between unrelated parties," *id.* at ¶¶ 1.122–1.123. The OECD Guidelines do not permit a subjective determination of "all value" transferred in an intercompany transaction. Instead, the OECD Guidelines require pricing based on prices in comparable transactions or the profits of parties with comparable functional, risks, and asset mixes. The "all value" language of § 1.482-1T(f)(2)(i)(A) is a marked departure from this long-held approach.

Similarly, the OECD Guidelines counsel that the "restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequality of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured." *Id.* at ¶ 1.123. The proposed and temporary regulations' instruction that compensation for "all value" transferred should be determined "without regard to the form or character of the transaction," Treas. Reg. § 1.482-1T(f)(2)(i)(A), calls for the very type of transactional restructuring of legitimate business transactions that the OECD has warned against as arbitrary and leading to double taxation.

The inconsistency between Treas. Reg. § 1.482-1T(f)(2)(i)(A) and the OECD Guidelines will likely result in more instances of double taxation, and thus, further strain on the already resourced strapped Advance Pricing and Mutual Agreement ("APMA") Program in the U.S. and counterpart competent authority offices of treaty partners in countries around the world. Moreover, because IRS initiated adjustments based on the expanded authority in this provision would be difficult to reconcile with the arm's length principle in the OECD Guidelines, cases based on such adjustments will be extremely difficult to resolve under the Mutual Agreement Procedure. For this reason, USCIB calls for Treas. Reg. § 1.482-1T(f)(2)(i)(A) to be removed from any final version of the section 482 regulations or revised to address the comments above.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 450
Washington, DC 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org

Global Business Leadership as the U.S. Affiliate of:
International Chamber of Commerce (ICC)
International Organization of Employers (IOE)
Business and Industry Advisory Committee (BIAC) to the OECD
ATA Carnet System