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DEPARTMENT OF THE TREASURY

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Unit Name	Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

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Issue and Transaction Overview

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Worldwide transfers of high value intangible property ("IP") or rights to IP may have significant economic and tax consequences. It may occur as part of a global tax management strategy. The offshore transfer of IP or rights to IP may occur as part of or in conjunction with a sale, a license, a capital contribution, a corporate restructuring, the provision of services, a cost sharing arrangement, or any combination of these. Transfers to related parties in low-tax jurisdictions may warrant special attention. Transfers may be part of a taxpayer strategy to reduce its effective tax rate for financial statement purposes.

This Practice Unit addresses the factors to consider in determining whether a transaction is characterized as a sale or license of IP, or an outbound IP transfer described by IRC § 351 or 361. IRC § 482 applies to the pricing of a sale or license. IRC § 367 applies if the U.S. person to foreign corporation transfer is one described by IRC § 351 or 361. IRC § 367(d) treats the transfer of certain IP as a sale for payments contingent on the productivity of the transferred intangible. An arm's length deemed royalty is determined. This unit doesn't cover an IP cost sharing platform contribution, an inbound IP transfer from a foreign parent to U.S. subsidiary, or IP transferred in a taxable reorganization.

Generally a U.S. person's transfer of IP in a sale or license to a related foreign corporation requires in return an IRC § 482 arm's length sale payment or annual royalty commensurate with the income attributable to the IP. The exam team will evaluate the contracts and complete the functional analysis to identify the terms and rights, sublicense and form of payment to determine whether the IP was sold or licensed to a foreign corporation.

Issue and Transaction Overview (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Generally, a U.S. person's transfer of IP to a foreign corporation in a transaction described by IRC § 351 or 361 is treated as a sale of the IP in exchange for certain payments, § 367(d). The deemed payments constitute ordinary income. They are reported as income over the useful life of the property, not to exceed 20 years. If within the useful life, the foreign corporation transfers the IP to an unrelated party, then the U.S. transferor shall recognize gain to the extent the value of the property at the time of the foreign corporation's transfer of the IP exceeds the U.S. transferor's adjusted tax basis.

The appropriate charge for the deemed royalty under IRC § 367(d) must be determined within the provision of IRC § 482 of the Code and the regulations, including both the arm's length standard and commensurate with income. IRC § 367(d) does not apply to the transfer of foreign goodwill or going concern value ("FGWGC").

Transfers of intangible property in a sale or license, and in an IRC § 367(d) transfer, are treated similarly because in both cases the payments must be determined according to the provisions of IRC § 482 and the regulations there under (see Treas. Reg. § 1.367(d)-1T(d)), and in both cases the payments must satisfy the commensurate with income (CWI) standard. The main differences between transfers subject to IRC § 482 and IRC § 367(d) are: (a) the source and character of the income may be different for certain sale transactions, (b) only IRC § 367(d) transfers are eligible for the foreign goodwill exception (Treas. Reg. § 1.367(d)-1T(b)), and (c) only IRC § 367(d) transfers are subject to a 20-year limitation (Treas. Reg. § 1.367(d)-1T(c)(3)).

Issue and Transaction Overview (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Understanding how the IP was developed, who owns it, and how it's used provides critical facts needed for any IP audit issue. Some of the factors that contribute to a decision to **sell an intangible** to a controlled foreign corporation (CFC) includes:

- USP acquired the IP recently and has high tax basis
- USP has net operating losses, and can absorb the gain resulting from the sale
- USP has excess foreign tax credit limitation, and is indifferent as to the source of the income
- The economy is in a downturn which could lead USP to take a position that the IP has a lower value. The sale would result in minimal taxable gain

Factors that might contribute to a decision to **license an intangible** to a CFC includes:

- USP may have a preference for retaining IP ownership
- USP is in an excess foreign tax credit position
- Desire to retain tax benefit of research and development (R&D) deduction or credit in US
- Various operational and business considerations

Factors that might contribute to a decision to **transfer an intangible offshore** to a CFC include:

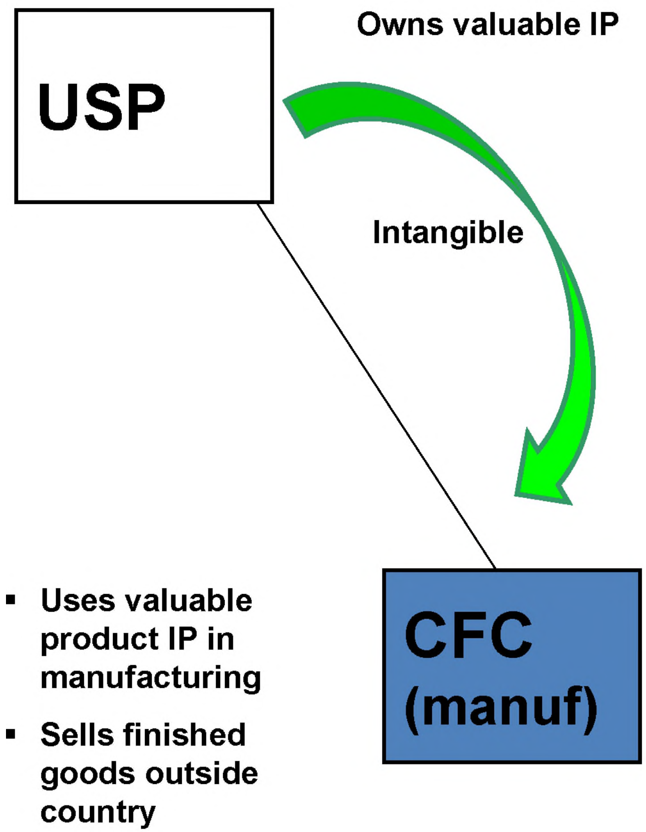
- Desire to transfer IP offshore and claim the IRC § 367(d) exception for foreign goodwill and going concern value
- Desire to transfer trademarks or other IP having an indefinite useful life offshore and claim the 20-year limitation under IRC § 367(d)

This Practice Unit will assist in analyzing the factors of the transfer to distinguish whether the transaction was a sale, a license or a transfer of the intangible.

Transaction and Fact Pattern

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Diagram of Transaction



Facts

- United States Parent ("USP") is a U.S. multinational corporation.
- USP developed and owns valuable IP relating to a popular product.
- USP owns Controlled Foreign Corporation ("CFC"), a manufacturing subsidiary, in a lower tax regime country.
- USP wants CFC to manufacture finished product utilizing the valuable IP.
- CFC uses the IP in its manufacturing. It sells the finished products to various affiliates to be sold to 3rd parties.
- USP transferred IP to CFC to allow it to manufacture and sell the products without indicating how the IP was transferred.

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Effective Tax Rate Overview

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

ETR of Company

USP's transfer of valuable (non-routine) IP outside of the U.S. into a lower tax environment for little or no compensation, may result in a substantial decrease in its worldwide effective tax rate. The transferee CFC's income earned from its use of the IP remains offshore and is generally untaxed by the U.S.

ETR Impact of Adjustment

Sale of IP to CFC increases USP's ETR in the year of sale as the gain may be U.S. source and may be ordinary income. The adjustment may result in a reduction of future years' ETR as the adjustment may include a royalty paid to the CFC for the USP's use of IP in US.

Transfer of IP under a license to CFC will result in the royalty income to be included in USP, this would generally increase ETR due to shift of income from a lower tax to higher tax jurisdiction. This will also generate foreign source income which may increase use of foreign tax credit (FTC) in the US.

Transfer of IP under IRC § 367(d) may reduce ETR in the year of transfer depending on the deemed royalty pick up and availability of FTC. During the years following the transfer, the IRC § 367(d) deemed royalty income stream continues to be reported by USP for up to the next 20 years. This shift of income from a lower tax to higher tax jurisdiction will slightly increase ETR consistently. There may be a reduction to ETR as a result of the increase in foreign sourced taxable income from the IRC § 367(d) deemed royalty which may allow for the use of other FTC.

The ETR may be reduced if a large percentage of the transferred IP is foreign goodwill or going concern value.

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Summary of Potential Issues

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors	
Issue 1	How did USP transfer its IP to CFC? What factors must be considered?
Issue 2	If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?
Issue 3	If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

All Issues, Step 1: Initial Factual Development

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Fact Element	Resources	6103 Protected Resources
▪ Confirm USP transferred IP and how it was transferred to CFC. ▪ Determine if CFC utilizes IP and manufactures the products. ▪ Identify the IP USP transferred to CFC: – For example, do the intangibles consist of patented product intangibles, manufacturing know-how and/or processes?	▪ Form 926, Part III, Intangible ▪ Form 926, Part IV, lines 15a and b, 17a and b ▪ Form 5471, Schedule O, Section E ▪ Form 1120, Disclosures, IRC § 6038B ▪ Change in Balance Sheet - Assets ▪ Footnotes to Financial Statements including impact on ETR ▪ Profit & Loss - Royalty income/expenses and trace to underlying asset/liability	

All Issues, Step 1: Initial Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Fact Element	Resources	6103 Protected Resources
<u>How did CFC obtain the ability to use the IP?</u> ▪ Did USP sell the IP (all ownership rights) to CFC? ▪ Does USP retain ownership of IP and license the IP to CFC? ▪ Did USP transfer all ownership of the IP to CFC in a transaction described by IRC § 351 or as part of an asset reorganization described under IRC § 361?	Request: ▪ Pre and Post Organizational Charts ▪ Transfer Pricing Documentation and Background Documents ▪ Steps of Transaction ▪ Tax Opinions on the transaction, if any ▪ Contracts containing critical facts of IP transfer and reorganization. (license agreement, assignment agreement, contribution agreement) ▪ IP Valuation ▪ Valuation Study of CFC if any ▪ Copy of all agreements between USP and CFC relating to the transfer and use of the IP by CFC	

All Issues, Step 1: Initial Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Fact Element	Resources	6103 Protected Resources
Some of the factors to be considered include: ▪ Terms of transfer (whether all substantial rights in IP are licensed, whether license is perpetual, whether license can be terminated by the transferor) ▪ Determine if the IP is completely developed or in process ▪ Is this IP patented? If so, how many years are left on the patent? ▪ Who has the right to further modify the IP (for example, revisions and updates)? ▪ Uniqueness of the IP ▪ Functions and/or services to be performed by each party; assets employed by each party ▪ Read financial statement footnotes, press releases, and Securities and Exchange Commission (SEC) filings regarding the transfer	Request: ▪ Transfer Pricing Documentation and Background Documents ▪ Pre and Post Organizational Charts ▪ Steps of Transaction ▪ Tax Opinions on the transaction, if any ▪ Contracts containing critical facts of IP transfer and reorganization. (license agreement, assignment agreement, contribution agreement) ▪ IP Valuation ▪ Valuation Study of CFC if any ▪ Copy of all agreements between USP and CFC relating to the transfer and use of the IP by CFC ▪ Economist referral/engineer referral ▪ Study the Industry trends	

Issue 1, Step 2: Review Potential Issues

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 1

How did USP transfer its IP to CFC? What factors must be considered?

Explanation of Issue	Resources	6103 Protected Resources
The regulations under IRC § 482 use the term 'intangible property' as it is defined under IRC § 936(h)(3)(B). If USP transferred IP rights to CFC under a license /contract, IRC § 482 requires that CFC's payment for the IP be an arm's length amount. IRC § 367(d) provides special rules relating to transfers to a foreign corporation of § 936(h)(3)(B) intangibles in transactions described by IRC § 351 or 361.	▪ IRC § 482 ▪ IRC §1235 Sale or exchange of patents ▪ Treas. Reg. § 1.1235-2(b) substantial rights ▪ IRC § 367(d) ▪ IRC § 936(h)(3)(B) ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), definition of foreign goodwill/going concern. ▪ Treas. Reg. § 1.482-4(b)	

Issue 1, Step 2: Review Potential Issues (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 1

How did USP transfer its IP to CFC? What factors must be considered?

Explanation of Issue	Resources	6103 Protected Resources
▪ Transfer of tangible property with an embedded intangible would be addressed solely under the IRC § 482 rules and would not be subject to IRC § 367(d). Instead, the transaction would be viewed as a transfer of tangible property subject to IRC § 367(a), with the embedded intangible being potentially subject to an adjustment under IRC § 482.	▪ Rev. Rul. 64-56, 1964-1 C.B. 133.	
▪ In addition to the transfer of the IP, did the USP agree to provide technological assistance? ▪ Since manufacturing has shifted to a CFC, were the technical workers also moved to the CFC? As long as the licensed IP has substantial value independent of the services then it is considered intangible property under IRC § 936(h)(3)(B). On the other hand, if the intangible property does not have substantial value independent of the services it must be analyzed as the rendering of services under IRC § 482.	▪ IRC § 936(h)(3)(B)	

Issue 1, Step 3: Additional Factual Development

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 1		
How did USP transfer its IP to CFC? What factors must be considered?		
Fact Element	**Resources**	**6103 Protected Resources**
▪ Some factors of the transaction to consider in determining whether it is a IRC § 367(d) or a sale or a license IP transfer include (but are not limited to): – Determine the developmental stage of the IP transferred by USP to CFC. ▪ Generally no one will license something incomplete. Incomplete IP may have a Cost Sharing Agreement associated with it.	▪ Contracts containing critical facts of IP transfer and reorganization. (license agreement, assignment agreement, contribution agreement) ▪ Copy of all agreements between USP and CFC relating to the transfer and use of the IP by CFC ▪ Valuation study by taxpayer and/or third party	
Factors to consider ▪ How was the transaction treated under CFC's local country law? ▪ Are there any other types of IP involved? For example customer list, contracts to manufacture and sell, manufacturing know how or special processes, marketing IP, etc. ▪ Did the affiliates take title? ▪ Does the IP transfer allow the CFC to sell products?	▪ Issue Information Document Request (IDRs) requesting for a copy of local country tax returns, financial statements. ▪ Interview key personnel to determine the type of transfer.	

Issue 1, Step 3: Additional Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 1

How did USP transfer its IP to CFC? What factors must be considered?

Fact Element	Resources	6103 Protected Resources
Did USP sell the intangible to CFC for its exclusive use? ▪ Did USP transfer legal title to CFC? ▪ Did USP transfer all substantial rights? Did USP retain bare legal title? ▪ Did USP receive compensation in the form of a lump-sum or installment; *or* contingent royalty for a term of years? – Income with respect to the transfer must be commensurate with the income attributable to the intangible.	▪ Form 1120, Sch D ▪ Form 4797 ▪ Form 926 ▪ Sales Contract/Agreement ▪ Valuation Study ▪ Notes to Financial Statement ▪ Schedule of Payments Received	
Did USP license the IP to CFC? ▪ The term must be limited (it may not be forever), no legal title passes to CFC. For example, rights limited to make/sell, research. ▪ Income with respect to the license must be commensurate with the income attributable to the intangible; ▪ Royalty payments paid by CFC may be subject to foreign withholding tax.	▪ License Agreement ▪ Form 1118, Royalty Income and related FTC ▪ Schedule of Royalty Payments Received ▪ Foreign Tax Returns relating to withholding taxes	

Issue 1, Step 3: Additional Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 1		
How did USP transfer its IP to CFC? What factors must be considered?		
Fact Element	**Resources**	**6103 Protected Resources**
Did the CFC further develop the product IP under a cost sharing agreement? ▪ If the facts indicate a possible cost sharing agreement, go to related Practice Unit.	▪ See related Practice Unit – "Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangement (CSA) – Initial Transaction" (DCN: ISO/9411.01-01_01) for more details.	
Did the USP transfer the intangibles to CFC in an exchange under IRC §§ 351 or 361 subject to IRC § 367(d)? ▪ Did USP receive any other property in the exchange other than CFC stock (or deemed CFC stock)? Boot? ▪ Were all the rights and ownership of the IP transferred to CFC? ▪ Did USP file a Form 926 on the outbound transfer of intangibles?	▪ Form 926 Part III , Part IV, Questions 15a and b, 17a and b ▪ IRC § 351 or 368 Disclosure on the return ▪ IRC § 6038B disclosures on outbound transfer of intangibles per Treas. Reg. § 1.6038B-1T(d) ▪ Step Plan ▪ Tax Opinion on IP Transfer, if any ▪ See related Practice Unit – "Deemed Annual Royalty Income Under IRC § 367(d)" (DCN: ISO/9411.02_02(2013)) on further analysis under IRC § 367(d) transfer of intangibles.	

Issue 1, Step 4: Develop Arguments

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 1

How did USP transfer its IP to CFC? What factors must be considered?

Explanation of Approach	Resources	6103 Protected Resources
<u>Type of transaction invokes different tax treatments</u> ▪ Sale or license – IRC § 482 arm's length sale price / royalty ▪ IRC § 351 or 361 transfer – IRC § 367(d) deemed royalty determined in accordance with the arm's length and commensurate with income standards	▪ IRC § 936(h)(3)(B) - Intangibles ▪ IRC § 865 – Sourcing rule ▪ Treas. Reg. § 1.367(d)-1T(g)(4)(i) – Coordination with IRC § 482 ▪ IRC § 482 White Paper, 1988-2 C.B. at 458.	

Issue 1, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 1		
How did USP transfer its IP to CFC? What factors must be considered?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
Under early IRS rulings a license of IP was subject to IRC § 351 only if it was a transfer of "all substantial rights" in the IP. ▪ perpetual license, ▪ license for the full term of the patent, ▪ license that was not terminable at will Later case law focused on whether the transferor relinquished control over IP rather than whether all substantial rights were transferred.	▪ Rev Rul 64-56 – IRC § 351 – Transfer to corporation controlled by transferor ▪ Rev Rul 69-156 – Transfer to corporation controlled by transferor ▪ DuPont v. United States, 471 F.2d 1211 (Ct. Cl. 1973)	

Issue 1, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 1

How did USP transfer its IP to CFC? What factors must be considered?

Explanation of Approach	Resources	6103 Protected Resources
CONSULTATION: ▪ The team should consult with an economist/engineer to determine whether the IP transferred is considered an intangible defined in IRC § 936(h)(3)(B) ▪ Consult with an economist/engineer regarding the valuation of the IP. ▪ Are sales, licenses, and IRC § 367(d) transactions properly characterized as such? In reporting an IRC § 367(d) transfer, to what extent is fair market value (FMV) of the transferred intangibles classified as foreign goodwill (and thereby excluded it from income or gain recognition.) ▪ IRC § 367(d) does not apply in the case of an actual sale or license of intangible property by a USP. IRC § 482 is appropriate because if CFC obtained the use of the IP by purchase or license, the special rule for transfers of intangibles can't be applied to USP.	▪ IRC § 936(h)(3)(B) - Intangibles ▪ IRC § 865 – Sourcing rule ▪ Treas. Reg. § 1.367(d)-1T(g)(4)(i) – Coordination with IRC § 482 ▪ IRC § 482 White Paper, 1988-2 C.B. at 458.	

Issue 1, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 1		
How did USP transfer its IP to CFC? What factors must be considered?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
▪ An actual license is not a transaction to which IRC § 351 or § 367(d) applies. The IRC § 367(d) regulations further state that an actual license is not an IRC § 367(d) transfer even if a very low royalty is charged and an IRC § 482 adjustment is required. ▪ Under the IRC § 367(d) regulations, a license of intangible property with less than arm's-length consideration will not be re-characterized as an IRC § 367(d) transfer, instead it will be subject to an IRC § 482 adjustment. ▪ Application to "Sham" Sales and Licenses: A purported sale or license of intangible property to a related party may be disregarded and treated as an IRC § 367(d) transfer if its terms of sale or license differ so greatly from the economic substance of the transaction or a unrelated taxpayer would not enter into such terms, then the sale or license is considered as a sham.	▪ IRC § 367(d) – Outbound transfer of intangibles ▪ Treas. Reg. § 1.367(d)-1T – Transfer of intangibles to foreign corporation	

Issue 1, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 1		
How did USP transfer its IP to CFC? What factors must be considered?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
Once you have determined the type of transaction, you must properly determine how IRC § 482 or IRC § 367(d) apply to the transaction. **DECISION POINT:** ***IRC § 482:*** If you determine that USP has sold or licensed the intangible to CFC, then IRC § 482 should be applied. **Continue to Issue 2 in this Unit.** ***IRC § 367(d):*** If you determine that USP has "transferred" all ownership and rights of the IP to CFC under IRC §§ 351 or 361, then IRC § 367(d) must be applied to the outbound transfer of the IP to CFC and an arm's length charge determined. **Continue to Issue 3 in this Unit.**	▪ IRC § 482 ▪ IRC § 367(d) ▪ U.S. Tax. Int'l Mergers, Acquis. & Jt. Ventures ¶ 18.02 (USTIMAJV WGL ¶ 18.02) – Forms of Transfer of Developed Intangibles by U.S. Person to Foreign Corporation ▪ U.S. Tax. Int'l Mergers, Acquis. & Jt. Ventures ¶ 18.05 (USTIMAJV WGL ¶ 18.05) – Choosing Among the Alternatives – U.S. Multinational Corporation	

Issue 2, Step 2: Review Potential Issues

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 2

If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?

Explanation of Issue	Resources	6103 Protected Resources
Your task as the examiner is to gather the facts, evaluate the factors and determine whether the IP was sold or licensed. Be sure to keep in mind that separate rights may constitute a separate item of IP. ▪ For example, when licensing a patent, the Developer / Licensor may be the owner of the Patent IP, while the Licensee is the owner of the License of the Patent (a separate item of IP) ▪ NOTE: In many cases, there may be multiple licenses of the patented rights for different geographies or industries. Some IP (e.g. patents) can be broken into several different IP rights and thus several parties may each own one or more of these rights.	▪ IRC § 482 ▪ Treas. Reg. § 1.482-4(f)(3) - Contribution to the value of intangible property owned by another ▪ Treas. Reg. § 1.482-4(b) ▪ Functional Analysis ▪ Transfer Pricing IDR's ▪ Including Transfer Pricing Background Documents ▪ Industry Overview ▪ WGL-TAXTINTL para 5.04	

Issue 2, Step 2: Review Potential Issues (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 2

If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?

Explanation of Issue	Resources	6103 Protected Resources
Questions the team should consider when developing the issue include: ▪ Who is the holder of rights under contractual arrangements? ▪ Who is in control of the IP? ▪ Who is liable under the product liability insurance policies? ▪ Obtain copies of all related contracts and agreements Keep in mind ownership must be consistent with economic substance: ▪ Facts and circumstances, including contractual terms, will determine whether the IP was licensed or sold ▪ Look to who performs the functions & bears the risks.	▪ IRC § 482 ▪ Treas. Reg. § 1.482-4(f)(3) - Contribution to the value of intangible property owned by another ▪ Treas. Reg. § 1.482-4(b) ▪ Functional Analysis ▪ Transfer Pricing IDR's - Including Transfer Pricing Background Documents ▪ Industry Overview ▪ WGL-TAXTINTL para 5.04	

Issue 2, Step 3: Additional Factual Development

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 2

If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?

Fact Element	Resources	6103 Protected Resources
If you concluded that: ▪ USP has **sold** all of its rights in the IP to CFC and ▪ CFC has full ownership in the IP, rights to receive residual profits from the IP, and bears all risks relating to the IP then a determination of the appropriate amount of the **gain** on **sale** to be reported by USP must be completed.	▪ Copy of all agreements between USP and CFC relating to the transfer and use of the IP by CFC ▪ Contracts containing critical facts of the IP transfer and reorganization. (license agreement, assignment agreement, contribution agreement) ▪ Copy of the gain calculation prepared by USP ▪ Third Party Valuation Studies	
If you concluded that: • USP has retained all ownership rights to the IP and ▪ CFC has the ability to utilize the IP in its manufacturing and has the right to sell the products then a determination of the appropriate **royalty income** on such **license** to be reported by USP must be completed.	▪ Copy of all agreements between USP and CFC relating to the transfer and use of the IP by CFC ▪ Contracts containing critical facts of the IP transfer and reorganization. (license agreement, assignment agreement, contribution agreement ▪ Copy of USP's methodology for royalty rate ▪ Copy of the royalty calculations.	

Issue 2, Step 3: Additional Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 2		
If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?		
Fact Element	**Resources**	**6103 Protected Resources**
If a license or contract exists: ▪ Determine from its provisions the risks assumed by the CFC such as economic or product liability risk ▪ Existence/extent of any collateral transactions ▪ Functions or services to be performed by each party ▪ Analyze comparables used to set price; what business and transaction types are being compared (I.e. compare USP's license to a comparable license transactions not to a sale transaction)	▪ Copy of all agreements, including any related collateral agreements ▪ Functional analysis of USP and CFC ▪ Review comparables	

Issue 2, Step 4: Develop Arguments

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 2		
If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
In this scenario you determine USP **sold** the IP to CFC and provided a valuation of the IP. You must determine if the purchase price satisfies the arm's length standard. The functional analysis is a determination of the functions performed and resources employed in a transaction between USP and CFC. It is a fundamental part of your transfer pricing analysis and it is the process through which you evaluate and determine the best method and the arm's length price. Payment may be in the following forms: ▪ lump-sum sale with an immediate and fixed payment in the year of sale, ▪ installment sale with a series of payments fixed in amount over time, or ▪ contingent sale with a series of payments variable in amount over time.	▪ Treas. Reg. § 1.482-1(b) – Arm's length methods ▪ Treas. Reg. § 1.482-1(c)(2) – Determining best method ▪ Treas. Reg. § 1.482-1(d) – Comparability ▪ See Process Unit: Information gathering to conduct Functional Analysis of a U.S. distributor (DCN: ISI/9422.07_01(2013)) (to be developed) ▪ Transfer Pricing Roadmap	

Issue 2, Step 4: Develop Arguments (cont’d)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 2

If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?

Explanation of Approach	Resources	6103 Protected Resources
In this scenario you determine USP **licensed** the right to use the product IP in the manufacture and sale of products to CFC, but did not transfer ownership of the IP because he wanted to keep legal title in the U.S. The functional analysis is a determination of the functions performed and resources employed in a transaction between USP and CFC. It is a fundamental part of your transfer pricing analysis and it is the process through which you evaluate and determine the best method and the arm’s length price to arrive at the arm’ length royalty. Royalty payments with respect to the license: ▪ Must be commensurate with the income attributable to the intangible; ▪ May be subject to foreign withholding; ▪ Foreign sourced ordinary income; ▪ Likely no capital gain treatment.		

Issue 2, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 2		
If USP transferred its IP to CFC via a sale or license, did USP properly apply the transfer pricing rules (IRC § 482) to the transaction?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
CONSULTATION: When IP is transferred in a **<u>sale or license</u>** the team should have a consultation with the assigned economist/engineer or a possible outside expert, as well as local counsel in order to properly evaluate the arm's length price and royalty rates to be used in the sale or license of IP. If there is a significant difference of opinion between the IRS and the taxpayer on valuations, best method, life of intangibles and discount rates provided for in IRC § 482, request Counsel involvement during the development of the potential issue is important.		

Issue 3, Step 2: Review Potential Issues

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Explanation of Issue	Resources	6103 Protected Resources
What factors might contribute to a decision to transfer an intangible under IRC § 351/361? ▪ Incorporation of a foreign branch operation to achieve deferral of foreign earnings ▪ Asset reorganization of a recently acquired U.S. target corporation into a foreign acquiring corporation to achieve deferral, and to repatriate foreign earnings in connection with the reorganization	▪ IRC § 367(d) – Outbound transfer of intangibles ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), definition of foreign goodwill/going concern ▪ Treas. Reg. § 1.367(d)-1T – Transfers of intangibles property to foreign corporations ▪ Treas. Reg. § 1.367(d)-1T(c) – Use of IRC § 482 provisions for calculation of IRC § 367(d) deemed royalty rate. ▪ Treas. Reg. § 1.367(d)-1T(d) – (f) – 367(d) disposition rules ▪ BNA 920-3rd TMFEDPORT No. 919 § III – Section 367(d) Transactions	

Issue 3, Step 2: Review Potential Issues (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 3		
If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
Based upon your review, the outbound transfer of the intangible property occurred as a result of a corporate restructuring transaction under IRC §§ 351 or 361. IRC § 367(d) requires that the U.S. transferor recognize a continuing deemed royalty as ordinary income, whose amount must be determined under the IRC § 482 regulations and must satisfy the commensurate with income standard. You have determined that USP has transferred the product IP, patents, and manufacturing processes to CFC. As a result, USP should recognize the annual payments are recognized over the life of the intangibles, not to exceed 20 years. You have also determined based upon consultation with the economist/engineer that the useful life of these intangibles exceeds 20 years.	▪ IRC § 367(d) – Outbound transfer of intangibles ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), definition of foreign goodwill/going concern ▪ Treas. Reg. § 1.367(d)-1T – Transfers of intangibles property to foreign corporations ▪ Treas. Reg. § 1.367(d)-1T(c) – Use of IRC § 482 provisions for calculation of IRC § 367(d) deemed royalty rate. ▪ Treas. Reg. § 1.367(d)-1T(d) – (f) – 367(d) disposition rules ▪ BNA 920-3rd TMFEDPORT No. 919 § III –Section 367(d) Transactions	

Issue 3, Step 2: Review Potential Issues (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Explanation of Issue	Resources	6103 Protected Resources
In addition, USP claims that a substantial amount of the FMV is attributable to foreign goodwill. IRC § 367(d) does not apply to the outbound transfer of Foreign Goodwill and Going Concern Value (FGWGC) to CFC. If the value of FGWGC is correct there is no tax imposed on the transfer to CFC. USP may attempt to minimize their exposure to IRC § 367(d) income inclusion by allocating a substantial amount of the FMV of the assets transferred to foreign goodwill and/or going concern. As a result, it is imperative that all of the intangibles are properly identified and valued. A thorough functional analysis, review of contracts and IP valuation will assist in the identification of transferred intangibles that are subject to IRC § 367(d). Any outbound transfer of intangible that meets the definition of IRC § 936(h)(3)(B) under IRC §§ 351 or 361 will require a deemed royalty income inclusion under IRC § 367(d).	▪ IRC § 367(d) – Outbound transfer of intangibles ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), definition of foreign goodwill/going concern ▪ Treas. Reg. § 1.367(d)-1T – Transfers of intangibles property to foreign corporations ▪ BNA 920-3rd TMFEDPORT No. 919 § III –Section 367(d) Transactions	

Issue 3, Step 2: Review Potential Issues (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Explanation of Issue	Resources	6103 Protected Resources
Under IRC § 367(d), USP will include in income an annual deemed royalty amount (up to 20 yrs.) over the useful life of the property. Such royalty income will be foreign sourced if the intangible is used outside the U.S. For purposes of FTC limitations, look-thru rules apply. Subsequent direct or indirect disposition of the intangible by the CFC (or the CFC stock by USP) may impact the IRC § 367(d) annual income inclusions or generate a taxable gain on the "disposition" of the intangible. This is known as the "IRC § 367(d) disposition rule". A future Practice Unit will cover the "disposition rule". The CFC (transferee) will reduce its earning and profits (E&P) by the annual deemed royalty amount for U.S. tax purposes, but it will not reduce CFC's income for local country tax purposes (deemed payment for U.S. purposes only). The deemed royalty expense may be allocable against Subpart F income of the CFC, as well.	▪ IRC § 367(d) – Outbound transfer of intangibles ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), definition of foreign goodwill/going concern ▪ Treas. Reg. § 1.367(d)-1T – Transfers of intangibles property to foreign corporations ▪ IRC § 367(d)(2)(A)(ii)(II) and Treas. Reg. § 1.367(d)-1T(d) – (f) – IRC § 367(d) disposition rules ▪ ILM 201321018 – IRC § 367(d) Disposition rule ▪ BNA 920-3rd TMFEDPORT No. 919 § III –Section 367(d) Transactions	

Issue 3, Step 3: Additional Factual Development

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Fact Element	Resources	6103 Protected Resources
▪ From the review, you learn that USP transferred IP to CFC1 in exchange for stock (IRC § 351 or IRC § 361) and that IRC § 367(d) applies. ▪ You should issue IDRs requesting the relevant agreements and the taxpayer's IP valuation. ▪ The next step is to determine the appropriate FMV of the intangibles transferred that meet the definition of IRC § 936(h)(3)(B) that are subject to IRC § 367(d) and the appropriate annual royalty rate. ▪ NOTE: The IRC § 367(d) annual royalty income inclusion by USP may require periodic adjustments in accordance with the commensurate with income standards under IRC §§ 367(d) and 482 over the useful life of the intangible (up to 20 years).	▪ Form 926, Part I, 1a-c, Part III, Part IV, Questions 10, 15-17 ▪ Treas. Reg. § 1.6038B-1T(d) disclosure ▪ Form 5471, Schedule O, Section E ▪ Treas. Reg. § 1.6038B-1(b)	

Issue 3, Step 3: Additional Factual Development (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 3		
If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?		
Fact Element	**Resources**	**6103 Protected Resources**
▪ A taxpayer presentation of the outbound transfer of the intangibles may be necessary to obtain a clear understanding of the intangibles involved. The presentation should be made by employees knowledgeable of the transaction, especially key employees. ▪ Identify all of the intangibles that have been transferred, which may include some intangibles that have been transfer but not identified on the tax return or valuation study. NOTE: Self-created/developed intangibles are often not reflected on the balance sheet, as the costs of development are currently expensed. ▪ A functional analysis is necessary to identify intangibles compensable under both IRC §§ 367(d) and 482.	▪ Transfer Pricing Documentation and Background Documents ▪ Organizational Charts ▪ Steps of Transaction ▪ Contracts containing critical facts of IP transfer and reorganization. ▪ IP Valuation ▪ Analyze R&D by cost center to ascertain if IP was developed ▪ Review U.S. Patent Office Web Site for patent applications and approvals by taxpayer and affiliates ▪ Consult with domestic agents on their review of R&D for identifying potential IP	

Issue 3, Step 4: Develop Arguments

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Explanation of Approach	Resources	6103 Protected Resources
▪ USP may attempt to allocate too much of the FMV to foreign goodwill and/or going concern (FGWGC) to avoid IRC § 367(d). ▪ Identify what intangibles were transferred and how they were valued ▪ Determine what was considered by USP as FGWGC and how did they value it. ▪ Does the allocation of the FMV clearly represent the foreign operations prior and subsequent to the transfer? ▪ See Practice Unit "Deemed Annual Royalty Income Under IRC § 367(d)" (DCN: ISO/9411.02_02(2013)) for further guidance on the existence of FGWGC and the proper FMV attributable to such FGWGC.	▪ Transfer Pricing Documentation and Background Documents ▪ Organizational Charts ▪ Steps of Transaction ▪ Tax Opinions, if any ▪ Contracts containing critical facts of IP transfer and reorganization. ▪ IP Valuation ▪ Economist referral/engineer referral	

Issue 3, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 3		
If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
CONSULTATION: The team should have a consultation with the assigned economist/engineer or a possible outside expert as well as local counsel in order to properly evaluate the FMV allocation (including any allocation to FGWGC) and royalty rates to be used in the 367(d) income inclusions. It is common to have a significant difference of opinion between the IRS and the taxpayer on FMV allocations and/or the identification of intangibles subject to 367(d). As a result, Counsel involvement throughout the examination is important.		

Issue 3, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors		
Issue 3		
If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
You need to determine the appropriate arms' length rate for the deemed royalty for each IRC § 936(h)(3)(B) intangible asset transfer over the useful life of such intangible. Be aware that USP may attempt to shorten the useful life of the intangible in order to reduce the amount of IRC § 367(d) royalty stream. A comparison of the IP valuation, USP's calculations of the IRC § 367(d) royalty, and your economist's valuation/royalty calculations is needed to determine if an adjustment to the reported deemed royalty under IRC § 367(d) is warranted. See Practice Unit "Deemed Annual Royalty Income Under IRC § 367(d)" (DCN: ISO/9411.02_02(2013)) for further information on the determination of the FMV of the intangibles and the appropriate arms length royalty rate.	▪ Transfer Pricing Documentation and Background Documents ▪ Organizational Charts ▪ Steps of Transaction ▪ Contracts containing critical facts of IP transfer and reorganization. ▪ IP Valuation ▪ Economist referral/engineer referral ▪ Taxpayer's workpapers in computing the IRC § 367(d) royalty rate	

Issue 3, Step 4: Develop Arguments (cont'd)

Distinguishing Between Sale, License and other Transfers of Intangibles to CFCs by U.S. Transferors

Issue 3

If USP transferred its IP to CFC in a transaction subject to IRC Section 367(d), is USP properly including the required deemed annual income?

Explanation of Approach	Resources	6103 Protected Resources
Once the IRC § 936(h)(3)(B) IP is properly identified, the IRC § 367(d) deemed royalty is computed using one of the transfer pricing methods under Treas. Reg. § 1.482-4. The deemed royalty must satisfy the commensurate with income standard. Such deemed royalty income is included in USP's taxable income for the year of transfer. For years following the transfer, USP will continue to include the deemed royalty income (periodic adjustments for commensurate with income may be required) over the useful life of the intangible. See Practice Unit "Deemed Annual Royalty Income Under IRC § 367(d)" (DCN: ISO/9411.02_02(2013)) on further analysis under IRC § 367(d) transfer of intangibles.	▪ Transfer Pricing Documentation and Background Documents ▪ USP's computation of IRC § 367(d) royalty rate workpapers ▪ Contracts containing critical facts of IP transfer and reorganization. ▪ Reorganization step plan ▪ IP Valuation ▪ Economist referral/engineer referral ▪ IRC § 367(d) ▪ Treas. Reg. § 1.367(a)-1T(d)(5) – Definition of intangible property subject to IRC § 367(d), foreign goodwill/going concern ▪ Treas. Reg. § 1.367(d)-1T – Transfers of intangibles property to foreign corporations	

Training and Additional Resources

Chapter 1.2.2 Transfers to Which IRC 367(d) Applies		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ “IBC IRC 367(d) #44752” - FY12 IBC CPE CENTRA recording ▪ “IBC Hot Topics IRC 367” CENTRA recording	
Reference Material - Treatises	▪ BNA Overview IRC § 367(d) Transactions ▪ OECD Guideline Principles: Transfer of IP	▪ BNA 920-3rd TMFEDPORT No. 919 § III – Section 367(d) Transactions ▪ WGL-TAXTINTL- ITPOECD WGL p 5.02 Chapter 1 Part 5

Glossary of Terms and Acronyms

Acronym	Definition
BNA	Bureau of National Affairs Inc.
CFC	Controlled Foreign Corporation
CWI	Commensurate with Income
DCN	Document Control Number
E&P	Earnings & Profits
ETR	Effective Tax Rate
FGWGC	Foreign Goodwill and Going Concern
FMV	Fair Market Value
FTC	Foreign Tax Credit
IBC	International Business Compliance
IDR	Information Document Request
IP	Intangible Property
IRC	Internal Revenue Code
ISI	Income Shifting Inbound
ISO	Income Shifting Outbound

Glossary of Terms and Acronyms (cont'd)

Acronym	Definition
NOPA	Notice of Proposed Adjustment
OECD	The Organization for Economic Co-operation and Development
SEC	Security and Exchange Commission
USP	U.S. Parent Corporation

Index of Related Issues

Issue	Associated UIL(s)	References
Cost Sharing Agreement – Initial Transaction	9411.01	▪ Practice Unit “Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangement (CSA) – Initial Transaction” (DCN: ISO/9411.01-01_01)
Cost Sharing Agreement – Acquisition of Subsequent IP	9411.01	Practice Unit “Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangements (CSA) – Acquisition of Subsequent IP” (DCN: ISO/9411.01-01_02) (to be developed)
IRC § 482 Licensing of Intangibles	9411.01; 9411.02	Practice Unit to be developed
Deemed Annual Royalty Income Under IRC §367(d)	9411.02-02	▪ Practice Unit “Deemed Annual Royalty Income Under IRC § 367(d)” ISO/9411.02_02(2013)
Outbound Transfer of Property to Foreign Corporation – IRC § 367 Overview	9411.08	▪ Practice Unit “Outbound Transfer of Property to Foreign Corporation – IRC § 367 Overview” ISO/9411.08_01(2013) –
Information gathering to conduct Functional Analysis of a U.S. distributor	9422.07	Practice Unit “Comparability/Functional Analysis of a U.S. Distributor” ISI/9422.07_01(2013) (to be developed)