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IRS Issues Temporary Regulations on Coordination Between Sections 482 and 367

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The Treasury Department on September 14 released temporary regulations (TD 9738) that clarify the coordination of the application of the arm's length standard and the best method rule under Internal Revenue Code Section 482 with other provisions of the code.

Although the regulations are written in general terms as applicable to coordination between Section 482 and any other provision in the code, they focus specifically on coordination between Sections 367 and 482, and were issued simultaneously with proposed regulations under Section 367(a) and (d) that would eliminate taxpayers' ability to transfer foreign goodwill or going concern value outbound on a tax-free basis. Treasury and IRS officials have made various public statements during the past year indicating that regulations that would "eliminate the daylight" between Section 367 and Section 482 were imminent. The temporary regulations are effective for taxable years ending on or after September 14, 2015.

The Temporary Regulations

The new temporary regulations state that all value (including synergies) provided between the parties in a controlled transaction requires an arm's length amount of compensation determined under the best method rule and without regard to the form or character of the transaction.[1] The regulations also broaden the scope of existing regulations to allow the IRS to aggregate the valuation of separate transactions (whether before, during, or after the year under review) under Section 482 even if those transactions are governed by other sections of the code (and the regulations under those code sections) if the transactions are so interrelated that an aggregate analysis provides the most reliable measure of an arm's length result.[2] Such aggregation would entail a coordinated best method analysis that includes a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed for the relevant transactions, and a consistent measure of the arm's length results, for purposes of all relevant statutory and regulatory provisions.[3]

If compensation determined pursuant to a coordinated best method analysis is required to be allocated (for example, for purposes of determining whether some of the value is attributable to services and other parts of the value is attributable to

[1] *See* Treas. Reg. §1.482-1T(f)(2)(i)(A).

[2] *See* Treas. Reg. §1.482-1T(f)(2)(i)(B).

[3] *See* Treas. Reg. §1.482-1T(f)(2)(i)(C). Situations in which a coordinated best method analysis and evaluation may be necessary include (1) two or more interrelated transactions when either all such transactions are governed by one regulation under Section 482 or all such transactions are governed by one subsection of Section 367; (2) two or more interrelated transactions governed by two or more regulations under Section 482; (3) a transfer of property subject to Section 367(a) and an interrelated transfer of property subject to Section 367(d); (4) two or more interrelated transactions when Section 367 applies to one transaction and the general recognition rules of the code apply to another interrelated transaction; and (5) other circumstances in which controlled transactions require analysis under multiple code and regulatory provisions.

intangibles, because the rules for sourcing are different for services and intangibles), then such allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount.[4] The examples illustrating these rules indicate that the IRS intends to apply these regulations to eliminate the statutory grant of non-compensability for foreign goodwill and going concern value in Section 367 when it believes that such a 367 transaction can be aggregated with another related transaction entered into under 482 (such as a cost sharing arrangement (CSA)).

The new temporary regulations are similar to provisions included in the recently released advance pricing agreement and mutual agreement procedure revenue procedures, in which the IRS states that the scope of an APA or MAP may be expanded to cover interrelated matters (interrelated issues in the same years, covered issues or interrelated issues in other years, and covered issues or interrelated issues in the same or other years as applied to other countries).[5]

Reasons for Change

The preamble to the regulations indicates that the Treasury promulgated the regulations because it is concerned about situations in which controlled groups evaluate economically integrated transactions involving economically integrated contributions, synergies, and interrelated value on a separate basis in a manner that results in a misapplication of the best method rule and fails to reflect what it believes is an arm's length result. The preamble states that the regulations specifically target transactions in which taxpayers assert that, for purposes of Section 482, separately evaluating interrelated transactions is appropriate simply because different statutes or regulations apply to the transactions (for example, when Section 367 and the regulations thereunder apply to one transaction and the general recognition rules of the code apply to another related transaction).

Treasury maintains that taxpayers combine a disaggregated approach to Section 482 and other statutes with an inappropriately narrow interpretation of Treas. Reg. 1.482-4(b)(6) (which provides guidance on when an item is considered similar to other items identified as constituting intangibles for purposes of Section 482) to yield a result where no compensation is required for certain value provided in controlled transactions. Treasury indicates its belief that this result is not arm's length, and the regulations are designed to eliminate the conclusion that no compensation is required for the provision of such value in controlled transactions.

Examples

The regulations add several new examples that clarify how they will be applied. In Example 6,[6] Treasury targets an intellectual property (IP) migration strategy whereby a U.S. parent (USP) first transfers IP to a foreign subsidiary (FS) in a transaction governed by Sections 351 and 367 in Step 1. Later, USP and FS enter into a CSA under Treas. Reg. §1.482-7 in Step 2 to further develop the IP transferred in Step 1, but the taxpayer maintains that FS does not need to make a platform contribution transaction (PCT) payment for the items of value that it obtained in nonrecognition transactions in Step 1. Example 6 indicates that if the IRS determines that the formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement, the IRS may impute one or more agreements between USP and FS that fully reflect their respective reasonably anticipated commitments in terms of functions performed, resources employed, and risks assumed over time. The example provides that the taxpayer may present additional facts that could indicate whether this or another alternative agreement best reflects the economic substance of the underlying transactions and course of conduct, provided the taxpayer's position fully reflects the value of the entire arrangement consistent with the realistic alternatives principle.

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[4] *See* Treas. Reg. §1.482-1T(f)(2)(i)(D).

[5] Rev. Proc. 2015-40, §2.04 and Rev. Proc. 2015-41, §2.02(4).

[6] *See* Treas. Reg. § 1.482-1T(f)(2)(i)(E)(Example 6).

Example 7 has a similar fact pattern as that in Example 6.[7] The facts in Example 7 are not as clear as Example 6, but it appears that the parties have entered into a Section 367(d)/CSA "two-step" bifurcated transaction (because there is a 351/367 transaction followed by a valuation done under Treas. Reg. §1.482-7(g)(2)(ix), implying that the parties are in a CSA). In Example 7, the taxpayer takes the position that the items of value transferred in the 351/367 transaction do not need to be valued under the Section 482 valuation. Example 7 rejects this position, indicating that whether an item was transferred for no value under Section 367 is irrelevant for purposes of determining the total value of the interrelated transactions under Section 482. This conclusion suggests that the IRS intends to apply these regulations to eliminate the statutory grant of non-compensability for foreign goodwill and going concern value in Section 367. The example further states that the IRS could alternatively determine under all the facts and circumstances that the transaction in fact constitutes an exchange of property subject to, and therefore to be taken into account under, Section 367.

There are no examples discussing another IP migration strategy employed by taxpayers – one similar to Example 6, but using the 721 nonrecognition provisions for IP migration to a foreign partnership (i.e., an IP partnership). However, the regulations are worded broadly enough to apply to those transactions, so taxpayers should be cautious of the risks the new regulations may pose when entering into such IP partnerships. Taxpayers should also carefully consider the potential impact of these regulations combined with Notice 2015-54 (applying Section 482 to transfers to foreign partnerships) when entering into IP partnerships.

For further guidance on the new regulations, please contact your local Deloitte transfer pricing adviser or the persons listed here.

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[7] *See* Treas. Reg. § 1.482-1T(f)(2)(i)(E)(Example 7).