



IRS issues final section 367(a) and (d) regulations

Global Transfer Pricing Alert 2016-040

The U.S. Department of the Treasury and the Internal Revenue Service on December 15 issued final regulations under section 367(a) and (d) of the Internal Revenue Code that coordinate the valuation rules of sections 367 and 482. The final regulations -- T.D. 9803 -- which generally mirror the proposed regulations,¹ apply retroactively to outbound transfers that occur on or after September 14, 2015 (the date the proposed regulations were filed).²

As discussed in more detail below, the final regulations provide as follows:

- When property is transferred to a foreign corporation pursuant to section 367, the value of such property must be determined under section 482.
- The useful life of intangible property transferred under section 367(d) is no longer limited to 20 years, although taxpayers may make an election to include the entire amount of the property's value in the annual inclusions over a 20-year period.
- The definition of the term "useful life" has been revised to account for the fact that exploitation of intangible property can result in both revenue increases and cost decreases.

¹ 80 Fed. Reg. 55,568 (Sept. 16, 2015); see also T.D. 9738 (Sept. 16, 2015) (temporary regulations under section 482). For coverage of the proposed and temporary regulations, see [Global Transfer Pricing Alert 2015-015](#), dated September 17, 2015. For information on the other international tax implications of these regulations, including the foreign goodwill and going concern rules, see United States Tax Alert dated December 20, 2016, on [Deloitte.com](#).

² Treas. Reg. §§1.367(a)-2(k), 1.367(d)-1(j).

- The IRS and Treasury continue to maintain that intangible property may have an indefinite useful life if it is used in the further development of the next generation of that intangible or of other property.

Valuations under section 367(d) coordinated with section 482

Like the proposed regulations, the final regulations specifically provide that when property is transferred to a foreign corporation, the value of such property must be determined under section 482.³ The preamble explicitly states that these valuation rules were changed under the proposed regulations to better coordinate the regulations under sections 367 and 482, including the temporary regulations under Treas. Reg. §1.482-1T(f)(2)(i), which expanded the aggregation rules to value “all items of value” transferred in a section 367 transaction.⁴ The final regulations continue this approach.

20-year election for income inclusions

The final regulations no longer limit the useful life under section 367(d) to 20 years.⁵ Nevertheless, the final regulations do provide an election whereby the transferor may take into account the entire amount of the section 367(d) inclusions during the 20-year period beginning with the first year in which the U.S. transferor takes into account income pursuant to section 367(d). As a result, if the taxpayer makes this 20-year election, the taxpayer will increase the size of the annual inclusions each year during that 20-year period.⁶ The preamble states that the language “first year in which the U.S. transferor takes into account income” reflects the possibility of delays between the year the intangible property is transferred and the first year in which exploitation results in taxable income being earned by the transferee.

To illustrate how the 20-year election would generally operate, the regulations provide an example whereby the useful life of a product is determined to exceed 20 years. Based on the present value of sales through the property’s indefinite useful life, the sales-based royalty during the useful life normally would have been 6.8 percent. If the taxpayer makes the 20-year election, however, the income inclusions would be taken into account over a 20-year period instead. As a result, the sales-based royalty rate would increase to 10.3 percent.⁷

The final regulations provide a beneficial statute of limitations rule if the 20-year election is chosen. Specifically, if a taxpayer makes the 20-year election, then no adjustments will be made after the conclusion of the 20-year period. Thus, after the statute of limitations expires for taxable years during the 20-year period, a taxpayer will have no further section 367(d) inclusions as a result of an examination of taxable years that begin after the end of the 20-year period. However, despite this 20-year cut-off, for purposes of determining whether amounts included during the 20-year period satisfy the commensurate with income (CWI)

³ Treas. Reg. § 1.367(a)-1(b)(3).

⁴ For additional information on the temporary regulations under section 482, see [Global Transfer Pricing Alert dated September 17, 2015](#).

⁵ Treas. Reg. §1.367(d)-1(c)(3)(i).

⁶ Treas. Reg. §1.367(d)-1(c)(3)(ii).

⁷ Treas. Reg. §1.367(d)-1(c)(3)(iii).

standard, the IRS may still take into account information with respect to taxable years after the 20-year period, such as the income attributable to the transferred property during those later years.⁸

The application of the 20-year election will have to be reflected in a statement attached to a timely filed original income tax return (including extensions) for the year of the transfer. Once made, the election is irrevocable, and failure to file a timely statement for the election may not be remedied.⁹

Revised definition of useful life

In addition to the 20-year election, the final regulations also expand the definition of useful life. Now this definition includes the entire period during which exploitation of the transferred intangible property is reasonably anticipated to “affect the determination of taxable income.”¹⁰ The preamble states that this definition was revised to account appropriately for the fact that exploitation of intangible property can result in both revenue increases and cost decreases.

Like the proposed regulations, the final regulations state that exploitation of intangible property includes “any direct or indirect use or transfer of the intangible property, including . . . use in the development of other intangible property (and any exploitation of the other developed intangible property).”¹¹

The preamble explains the reasoning behind this definition, stating that the value of many types of intangible property is derived not only from use of the intangible property in its present form, but also from its use in further development of the next generation of that intangible and other property.

To illustrate this, the preamble posits the following hypothetical. Assume that a software developer sells all of its copyright rights in its software to an unrelated party, and the copyright rights are expected to derive value both from: (i) the exclusive right to use the current-generation computer code to make and sell *current-generation* software products; and from (ii) the exclusive right to use the current-generation code in the development of other versions of the software, which will then be used to make and sell *future-generation* software products. In that case, the IRS and Treasury maintain that the software developer would expect to be compensated for the latter right. That is, if the software has value in developing a future generation of products, the software developer would not ignore the value of the use of the software in future research and development and hand over those rights free of charge. In addition, an uncontrolled purchaser would be willing to compensate the developer to obtain such rights.

This example continues the same line of reasoning as the definition of useful life in the proposed regulations. It also continues the line of reasoning adopted by the IRS and Treasury in the cost sharing regulations under Treas. Reg. §1.482-7(g)(1), which require valuation of all profits attributable to subsequently

⁸ Treas. Reg. §1.367(d)-1(c)(3)(ii)

⁹ *Id.*

¹⁰ Treas. Reg. §1.367(d)-1(c)(3)(i).

¹¹ *Id.*

developed intangibles in a platform contribution transaction payment over the entire duration of the cost sharing activity.

Observations

Continuing along the lines the Treasury adopted in its rulemaking for the cost sharing regulations under section 482, these regulations under section 367 appear to be intended to reassert the position the IRS took in *Veritas Software Corp. & Subs. v. Commissioner*.¹² There, the transaction at issue involved a buy-in payment of technology under Treas. Reg. §1.482-7A (1996). The IRS economist assumed that the transferred technology had a perpetual useful life for purposes of the section 482 valuation, but the Tax Court disagreed. In pertinent part, the Tax Court stated:

In calculating his valuation of the buy-in payment, [the IRS economist] assumed a perpetual useful life for the transferred intangibles, yet acknowledged that “if you had 1999 products that you left untouched, that technology would age and eventually become obsolete” and that the preexisting product intangibles would “wither on the vine” within 2 to 4 years without ongoing R&D. The useful life of the preexisting product intangibles was, on average, 4 years, and certainly was not perpetual. Petitioner established that something, however, was perpetual—VERITAS US was in a perpetual mode of innovation. Before and after the CSA VERITAS US released numerous versions of its products. *Even with substantial ongoing R&D, VERITAS US products had finite lifecycles.* By the time a new product became available for purchase, the next generation was already in development.” (Emphasis added)

The discussion of useful life in Treas. Reg. §1.367(d)-1(c)(3) appears to be inconsistent with the Tax Court’s interpretation of the facts presented in *Veritas*.

The issuance of the final regulations may indicate that useful life assumptions, both in the context of cost sharing arrangements under section 482 and now in outbound transfers of intangibles under section 367, will receive expanded scrutiny by the IRS. The reference in Treas. Reg. §1.367(a)-1(b)(3) to section 482, along with the reference in the preamble to the expanded aggregation rules under Treas. Reg. §1.482-1T(f)(2)(i), suggests that the IRS will link sections 367 and 482 to value “all items of value” transferred in a section 367 transaction, as well.

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