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December 14, 2015

VIA ELECTRONIC TRANSMISSION AND HAND-DELIVERY

CC:PA:LPD:PR (REG–139483–13)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on proposed § 367 regulations in REG–139483–13

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced proposed regulations issued under § 367 of the Internal Revenue Code of 1986, as amended, in REG–139483–13, 80 Fed. Reg. 55568 (September 16, 2015). SVTDG members are listed in the Appendix of this letter.

I respectfully request that the Treasury Department and the IRS hold a public hearing on these proposed regulations under § 367.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

I. Introduction and Summary

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

B. Recommendation the current rules be retained and the proposed regulations be withdrawn or modified

The central thrust of the proposed regulations is to eliminate any exception from taxation under § 367 of the Code for foreign goodwill and going concern value ("***GW/GCV***"). The proposed regulations would preclude taxpayers from arguing that foreign GW/GCV qualifies for the exception in § 367(a)(3) from immediate taxation under § 367(a) for transfers of property used in the active conduct of a trade or business outside the U.S. The proposed regulations tax outbound transfers of GW/GCV in a way depending on whether or not taxpayers treat GW/GCV as § 936(h)(3)(B) intangible property—if they do so treat it, taxation under § 367(d) applies; if they don't, taxation under § 367(a) applies.

Treatment of GW/GCV in the proposed regulations is directly contrary to Congress's intent. The legislative history of §§ 367(a) & (d) shows clearly that Congress intended that GW/GCV <u>not</u> be treated as intangible property subject to § 367(d). The current regulatory "exception" under § 367(d) for foreign GW/GCV thus is redundant. The legislative history also shows clearly that Congress intended transfers of GW/GCV would instead be subject to § 367(a), so that transfers of foreign GW/GCV would qualify for the § 367(a)(3) exception because such GW/GCV would be used by the transferee foreign corporation in its trade or business outside the U.S. Regulations contrary to the expressed intention of Congress cannot be the result of reasoned decisionmaking. If finalized, the validity of any such regulations would be subject to challenges. The proposed regulations should accordingly be withdrawn.

The preamble to the proposed regulations signals concern <u>not</u> that transfers of foreign GW/GCV are abusive, but rather that, allegedly, (1) some taxpayers improperly allocate value from § 936(h)(3)(B) intangibles to GW/GCV, and (2) taxpayers are characterizing domestic GW/GCV as foreign GW/GCV. The valuation and characterization concerns in (1) & (2), respectively, can be handled through existing audit, Appeals, and litigation processes, or perhaps by promulgating different regulations that narrowly target the concerns yet hew to the clear Congressional intent outlined in the prior paragraph.

The revised definition of "intangible property" in the proposed regulations improperly alters the boundaries of § 367(d), which by its terms applies only to transfers of § 936(h)(3)(B) intangible property. While Congress is free to change the definition of such intangible property—and the Obama Administration has repeatedly signaled intent to do so—existing authority demonstrates that GW/GCV aren't § 936(h)(3)(B) intangibles. The proposed revision to the definition of intangible property should be withdrawn.

The proposed regulations eliminate the current 20-year cap on the useful life of intangibles and replace it with a rule basing useful life in part on the period of exploitation of any subsequently-developed intangible property. This proposed rule is arguably contrary to the arm's length standard, will be difficult for taxpayers and the IRS to administer, and lead to protracted disputes with taxpayers. The proposed regulations on useful life should be withdrawn and replaced with rules not suffering these shortcomings.

Finally, we recommend any final regulations only apply to transfers occurring on or after the day such regulations are published.

II. Specific concerns with proposed § 367 regs in REG–139483–13

A. Background on § 367(d), the active trade or business exception in § 367(a), and the current GW/GCV rule

Subsection 367(a) provides a general rule that if, in certain subchapter C nonrecognition exchanges, a U.S. person transfers property to a foreign corporation, the foreign corporation isn't treated as a corporation. Because corporate status is required for application of subchapter C nonrecognition provisions, those nonrecognition provisions are overridden and the U.S. person recognizes gain on the transfer. Paragraph 367(a)(3) provides an exception to this gain recognition result for property transferred to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside the U.S. (the "***ATB exception***"). Subsection 367(d) provides a different exception for intangible property described in § 936(h)(3)(B): § 367(a) doesn't apply to transfers of such intangible property by a U.S. person to a foreign corporation; instead the U.S. person is treated as having sold the property in exchange for annual payments contingent on the use of the property.

Section 1.367(a)-2T of the current regulations provides rules for determining when the ATB exception applies (the "***current ATB rule***"). The current ATB rule requires the components of the ATB exception determination—i.e., whether the activities constitute a trade or business, whether the trade or business is actively conducted, and whether the business is conducted outside of the U.S.—be determined under all facts and circumstances. The current ATB rule isn't limited to certain classes of assets, although certain property—e.g., inventory, installment obligations, foreign currency and property denominated in foreign currency, intangible property, and property with respect to which transferor is a lessor—is excluded from the ATB exception by statute.[1]

Subsection 1.367(d)-1T(b) of the current rules provides: "[§ 367(d)] and the rules of this section shall not apply to the transfer of foreign goodwill or going concern value, as defined in § 1.367(a)-1(d)(5)(iii) . . . ." (the "***current GW/GCV rule***"). Foreign GW/GCV is defined in § 1.367(a)-1T(d)(5)(iii) as "the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued." The value of the right to use a corporate name in a foreign country is treated as foreign GW/GCV.

B. The proposed rules relating to the ATB exception and GW/GCV

1. The proposed rules and their effect

The proposed regulations eliminate the statement in § 1.367(d)-1T(b) that § 367(d) doesn't apply to transfers of foreign GW/GCV. The proposed regulations also limit the ATB exception to transfers of "eligible property," defined as tangible property, working interests in oil and gas property, and certain financial assets. There's also a rule proposed whereby taxpayers can elect to apply § 367(d) to a transfer of property (other than "eligible property") that would otherwise be subject to § 367(a).

The proposed regulations <u>don't</u> state whether GW/GCV is intangible property under § 936(h)(3)(B). Instead, the proposed regulations redefine, for purposes of §§ 367(a) and (d), "intangible property" as <u>either</u> property described in § 936(h)(3)(B) or property to which a U.S. person elects to apply § 367(d).

The combined effect of these rules is to make the transfer of GW/GCV to a foreign corporation taxable to a U.S. person. A U.S. transferor of GW/GCV can either treat the GW/GCV as a § 367(d) intangible and annually include in income amounts contingent on the use of such GW/GCV, or be subject to immediate taxation under § 367(a) (the proposed regulations yielding this result referred to as the "***proposed GW/GCV rule***").

2. Comments on the proposed rules

a. The proposed GW/GCV rule is contrary to Congress's intent expressed in the legislative history

The proposed GW/GCV rule is directly contrary to Congress's intent, and Treasury's attempt to distinguish statements in the legislative history is misleading. The legislative history is clear that Congress intended (1) transfers of GW/GCV to a foreign corporation for use in its

1 § 367(a)(3)(B).

trade or business outside the U.S. shouldn't be taxable to the U.S. transferor (2) by reason of the ATB exception (rather than an exception to § 367(d)). The House Report stated:

> The committee contemplates that the transfer of goodwill or going concern value developed by a foreign branch will be treated under this exception [the ATB exception] rather than a separate rule applicable to intangibles.[2]

Likewise, in the Senate Report:

> 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.[3]

The Joint Committee on Taxation also left no doubt as to how GW/GCV should be treated:

> The intangibles rule <u>does not apply</u> to good will or going concern value developed by a foreign branch.[4]

The preamble to the proposed regulations doesn't mention this language from the House Report or Joint Committee on Taxation Summary at all; it mentions but doesn't discuss the Senate Report language. Instead, the preamble focuses on other language from the House and Senate Reports:

> The committee does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system.[5]

The preamble cites this statement without explaining <u>why</u> the transfer of foreign GW/GCV was unlikely to result in abuse. The Joint Committee on Taxation, however, states, "[g]oodwill and going concern value are generated by earning income, not by incurring deductions," such that "ordinarily, the transfer of these (or similar) intangibles does not result in the avoidance of Federal income taxes."[6]

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[2] H.R. REP. NO. 98-432, at 1320 (1983).

[3] S. Rep. No. 98-169, at 365 (1984). This statement is in the section explaining the ATB exception, not the section explaining § 367(d).

[4] 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, June 1984 (emphasis added)..

[5] H.R. Rep. No. 98-432, at 1317 (1983); *see also* S. Rep. No. 98-169, at 362 (1984)

[6] Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369) (JCS–41–84) at 428, December 1984.

Combined with the statutory language of §§ 367(a) and (d), the legislative history demonstrates that Congress intended that GW/GCV not be treated as intangible property under § 367(d). Transfers of GW/GCV would instead be subject to § 367(a) and eligible for the ATB exception. Transfers of foreign GW/GCV would qualify for the ATB exception because such GW/GCV would be used by the transferee foreign corporation in its trade or business outside the U.S. Transfers of domestic GW/GCV wouldn't qualify for the ATB exception because the transferee foreign corporation wouldn't use such GW/GCV outside the U.S.[7]

Instead of discussing the statements indicating that GW/GCV isn't intangible property and is eligible for the ATB exception, the preamble discusses various "policy concerns" that are "inconsistent with the expectation, expressed in legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system."[8] Congress's intent to allow tax-free transfers of foreign GW/GCV, however, was unconditional. The language discussed by the preamble is in the "Reasons for Change" section of the House and Senate Reports, not in the "Explanation of Provision" section. The two statements explaining the provision, by contrast, are in the "Explanation of Provision" sections of the House and Senate Reports, respectively. These statements regarding Congress's intent are clear and without caveat. Congress could have remained silent about GW/GCV. But by specifically directing treatment for GW/GCV under the ATB exception rather than § 367(d), Congress expressed its intention and precluded Treasury from promulgating a contrary rule.

Regulations contrary to the statute and expressed intention of Congress (including in legislative history) cannot be reasoned decisionmaking. These regulations, if finalized, would violate § 706 of the *Administrative Procedures Act*. *See Dominion Resources, Inc. v. U.S.*, 681 F.3d 1313, 1317 (Fed Cir. 2012); *see also Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 845 (1984) (examining statute and its legislative history); *Feller v. Commissioner*, 135 T.C. 497, 508 (2010) (courts will overturn agency action if it appears from statute or its legislative history Congress wouldn't have sanctioned action). Treasury and the IRS shouldn't promulgate regulations inconsistent with Congressional intent. Congress always acts based on certain assumed facts. An agency's subsequent disagreement with those assumed facts isn't reasonable grounds for ignoring Congress's clearly expressed intent.

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7 Similarly, references in the proposed regulations' preamble to the "foreign goodwill exception" are misleading. Because, as described above, GW/GCV isn't intangible property, § 367(d) doesn't apply, and a regulatory exception to § 367(d) isn't needed. Subsection 1.367(d)-1T(b) therefore isn't an "exception" but rather a statement, consistent with Congress's intent, that GW/GCV isn't intangible property and instead should be eligible for the ATB exception.

8 80 Fed. Reg. 55571 (Sept. 16, 2015).

The proposed GW/GCV rule, which automatically excludes from the ATB exception all GW/GCV, whether foreign or domestic, is thus contrary to Congress's intent and should be withdrawn.

b. Treasury/IRS's alleged reasons don't justify proposed rule

Treasury and the IRS assert the proposed GW/GCV rule is necessary to stop taxpayers from taking aggressive transfer pricing positions and broadly interpreting foreign GW/GCV:

> [C]ertain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367.
>
> * * *
>
> [S]ome taxpayers have asserted that they have transferred significant foreign goodwill or going concern value when a large share of that value was associated with a business operated primarily by employees in the United States . . . .[9]

Treasury's concern here is not that transfers of foreign GW/GCV are abusive; it's that, allegedly, (1) some taxpayers are improperly allocating value from § 936(h)(3)(B) intangibles to GW/GCV, and (2) taxpayers are characterizing domestic GW/GCV as foreign GW/GCV. This distinction is important. Congress anticipated transfers of foreign GW/GCV wouldn't be abusive, and nothing in the preamble to the proposed regulation asserts otherwise. Rather, the concerns expressed by the preamble are valuation and characterization of transferred assets (domestic vs. foreign GW/GCV). The proposed regulations are overbroad because they respond to the IRS's characterization and valuation concerns by making taxable all transfers by U.S. persons of GW/GCV, foreign or domestic.

The preamble states that Treasury's concerns "are inconsistent with the expectation, expressed in legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system."[10] This may be an attempt to distinguish the legislative history. It's unclear if Treasury believes that if Congress had been aware of the "aggressive transfer pricing" positions some taxpayers are allegedly taking, it wouldn't have intended transfers of foreign GW/GCV be tax-free. Nonetheless, Congress was clear in its desired treatment of GW/GCV, and, despite Treasury's valuation and characterization concerns, transfers of foreign GW/GCV continue not to be abusive.

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9 *Id*. at 55570.

10 *Id.* at 55571 (emphasis added).

The preamble doesn't discuss why current transfer pricing rules aren't sufficient to combat the perceived valuation and characterization abuses. The Treasury and the IRS have a core competency in identifying and valuing intangible property in licensing and cost sharing arrangements. The concerns expressed in (1) and (2) above can be handled through the audit, Appeals, and litigation processes. The preamble doesn't cite any court cases turning on GW/GCV that yielded an inappropriate result.

Eliminating the possibility of tax-free transfers of foreign GW/GCV is contrary to Congress's intent, and isn't a reasonable means of addressing these concerns. Under the proposed regulations, if a U.S. taxpayer incorporates a foreign branch, it will have to pay tax on the transfer of <u>any</u> GW/GCV, even if generated entirely outside the U.S. and if the foreign branch doesn't have any losses to recapture. If any change to the rules is necessary, the change should be narrowly tailored to address the specific concerns—i.e., valuation and characterization. A blanket imposition of tax on all transfers of GW/GCV is unreasonable.

The preamble indicates Treasury and the IRS considered a narrower rule but rejected it as impractical to administer because there would still be incentives for taxpayers to take aggressive transfer pricing positions:

> Given the amounts at stake, as long as foreign goodwill and going concern value are afforded favorable treatment, <u>taxpayers will continue to have strong incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value</u>, however defined, and <u>thereby erode the U.S. tax base</u>.
>
> For the reasons discussed in this section of the preamble, the Treasury Department and the IRS have determined that allowing intangible property to be transferred outbound in a tax-free manner is <u>inconsistent with the policies of section 367 and sound tax administration</u> and therefore will amend the regulations under section 367 as described in the Explanation of Provisions section of this preamble.[11]

Taxpayers will always have incentives to take certain positions whenever there is disparate tax treatment for different but related items. U.S. tax law has many such situations, and the IRS isn't authorized to remove favorable treatment for an item if such treatment has been mandated by Congress. The transfer pricing area, moreover, has a strong incentive for taxpayers to be accurate in their transfer pricing: there are severe § 6662 penalties for valuation misstatements.

[11] *Id*. (emphasis added).

c. Proposed regulations improperly alter the bounds of § 367(d) and the definition of intangible property

The proposed regulations allow a taxpayer to choose to apply § 367(d) to transfers of property other than "eligible property" and revise the definition of "intangible property" accordingly. That is, while disclaiming any position on the definition of "intangible property" under § 936(h)(3)(B), the proposed regulations have the effect of treating GW/GCV as a § 936(h)(3)(B) intangible, with a taxpayer election to instead be immediately taxed under § 367(a).

This redefinition of intangible property improperly alters the boundaries of § 367(d). As described above, Congress intended transfers of GW/GCV to be treated under the ATB exception, not as transfers of intangible property to which § 367(d) applied. Neither goodwill nor going concern value are listed in § 936. Subsection 367(d) incorporates the definition from § 936 without expanding it. While an agency can interpret a statute, an agency can't add to or subtract from it.

The revised definition of intangible property, which essentially makes GW/GCV § 936(h)(3)(B) intangible property unless a taxpayer opts for immediate taxation, is also contrary to other guidance. In *VERITAS Software Corp. v. Commissioner*, the Tax Court noted that, while there were Administration proposals to change § 482, there was no authorization to include workforce-in-place, goodwill, or going concern value in the definition of "intangibles" under § 482.[12] Treasury and the IRS previously recognized this exclusion. In 1993, the IRS published proposed § 482 regulations and requested comments on expanding the definition of § 482 intangibles:

> Comment is requested as to whether the definition of intangible property incorporated in §1.482-4T(b) should be <u>expanded</u> to include items not normally considered to be items of intellectual property, such as work force in place, goodwill or going concern value.[13]

For these reasons, the proposed GW/GCV rule should be abandoned, and the current ATB exception and § 1.367(d)-1T(b) should be retained.

C. The proposed rule on useful life

1. The proposed rule and its effect

Under the proposed regulations—

12 133 T.C. 297, 316 (2009).

13 INTL–0401–88, 58 Fed. Reg. 5312 (Jan. 21, 1993) (emphasis added).

> the useful life of intangible property is the entire period during which exploitation of the intangible property is reasonably anticipated to occur, as of the time of the transfer. Exploitation of intangible property includes any direct or indirect use or transfer of the intangible property, including use without further development, use in the further development of the intangible property itself (and any exploitation of the further developed intangible property), and use in the development of other intangible property (and any exploitation of the developed other intangible property).[14]

Thus, the proposed useful life rule eliminates the current 20-year cap on useful life and defines use to include use—even indirect use—in developing and exploiting other intangibles.

2. Comments on the proposed rule

The proposed rule redefining "useful life" could lead to inappropriate results. Intangibles developed by "further development of the intangible property itself" and by "development of other intangible property" are just subsequently developed intangibles—i.e., intangibles different than transferred intangibles. Subsection 367(d) deems a U.S. transferor to receive annual contingent payments for the use of the transferred intangibles.

The requirement that useful life include the period of exploitation of subsequently developed intangible property is contrary to the arm's length standard. An arm's length party would only pay for the transferred intangible itself, which might include the right to make derivative works. An arm's length party required to make contingent payments wouldn't pay significant royalty payments for commoditized technology. Intangibles such as trade secrets and know-how lose their value once the knowledge they embody has become widespread. For patents, arm's length payments wouldn't extend beyond the life of the patent—i.e., a useful life of at most 20 years. Therefore "useful life" should depend on economic substance, based on facts and circumstances of transferred intangible property. In many industries, including high tech, useful life may be quite short because of rapid obsolescence and replacement of intangibles.

The lengthy and confusing definition of useful life in the proposed regulations is likely to create a burden for taxpayers and hinder administrability for the IRS. Taxpayers and the IRS will need for valuation purposes to determine, at the time of transfer, how long an intangible would be used, including indirectly, in the subsequent development of other intangibles. This will be extremely difficult to estimate,[15] necessarily involve significant guesswork, and lead to numerous disputes between taxpayers and the IRS.

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14 Prop. § 1.367(d)-1(c)(3) (emphasis added).

15 Oddly, the preamble to the proposed regulations signaled that a rule preserving favorable treatment for transfers of foreign GW/GCV would be "impractical to administer" (80 Fed. Reg. at 55571), yet is complacently silent on the ability of the IRS to administer the proposed, open-ended rule on useful life of intangible property.

The proposed regulations are also vague as to what constitutes an "indirect use" of intangible property. The only uses that should be considered are those for which an arm's length party would pay—that is, only uses that would violate the intangible's legal protection or that would require access to proprietary knowledge. The final regulations should so clarify or delete the reference to "indirect use."

D. Effective date

The proposed regulations are proposed to apply to transfers occurring on or after September 14, 2015. The proposed regulations contain major changes from the current rules and will have an effect on all outbound § 367 transactions—i.e., whether allegedly abusive or not. For example, the incorporation of a foreign branch can require lengthy planning, and such incorporation may no longer be desirable if the U.S. transferor is taxed on the deemed transfer of foreign GW/GCV. Moreover, because of the significant concerns raised in this letter, it's likely significant changes are appropriate to the regulations before they're finalized. Thus, any regulations should be effective for transfers occurring on or after the date the final regulations are published.

Appendix—SVTDG Membership

Accenture
Acxiom Corporation
Adobe Systems, Inc.
Advanced Micro Devices, Inc.
Agilent Technologies, Inc.
Altera Corporation
Amazon.com
Apple Inc.
Applied Materials, Inc.
Autodesk
Avago Technologies
BMC Software
Broadcom Corporation
Brocade Communications Systems , Inc.
Cadence Design Systems, Inc.
Chegg, Inc.
Cisco Systems, Inc.
Cypress Semiconductor
Dolby Laboratories, Inc.
Dropbox Inc.
eBay, Inc.
Electronic Arts
EMC Corporation
Expedia, Inc.
Facebook, Inc.
FireEye, Inc.
Fitbit, Inc.
Flextronics
Fortinet
Genentech, Inc.
Genesys
Genomic Health, Inc.
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic, Inc.
Google, Inc.
GoPro, Inc.
Groupon
Hewlett-Packard Company
Ingram Micro
Integrated Device Technology, Inc.
Intel Corporation
Intuit, Inc.
Intuitive Surgical
KLA-Tencor Corporation
Lam Research Corporation
LinkedIn Corporation
Marvell Semiconductor, Inc.
Maxim Integrated
Mentor Graphics
Microsemi Corporation
Microsoft Corporation
NetApp, Inc.
Netflix, Inc.
Oracle Corporation
Palo Alto Networks, Inc.
Pandora Media, Inc.
PayPal Holdings, Inc.
Pivotal Software, Inc.
Plantronics, Inc.
Qualcomm, Inc.
Rovi Corporation
salesforce.com
SanDisk Corporation
Sanmina Corporation
SAP
Seagate Technology
ServiceNow, Inc.
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
Trimble
Twitter, Inc.
Uber Technologies
Visa
VMware Corporation
Yahoo!
Yelp, Inc.