Tax M&A Update

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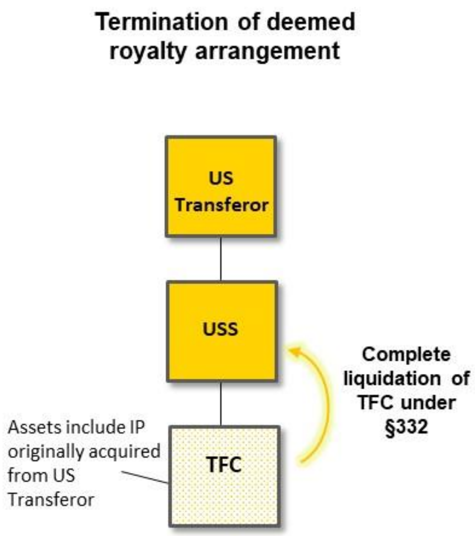
Technical Developments and Musings

When IP comes home: proposed Section 367(d) regulations. The outbound transfer by a US person of intangible property (IP) in a nonrecognition transaction causes a deemed royalty arrangement to come into existence under §367(d), with the US transferor thereafter recognizing income each year "commensurate with the income attributable to the intangible." But what happens if the transferred IP finds its way back to the US transferor or a related US person? The current rules are silent; but in proposed regulations, Treasury and the IRS set forth the rules and conditions by which the deemed royalty arrangement terminates. That is, under the proposed regulations, the current rules addressing subsequent transfers of IP would be modified to terminate continuing annual inclusions if two conditions are met: (i) the transferee foreign corporation (TFC) repatriates the previously-outbounded IP to a "qualified domestic person"; and (ii) certain information is timely reported. For example, and as illustrated here, assume that, following the original outbound IP transfer, all of the stock of the TFC had been transferred in a §351 exchange to a US subsidiary. Under current law, the US subsidiary effectively would have stepped into the shoes of the original US transferor as to the deemed royalty arrangement. In a subsequent year, TFC completely liquidates under §332 and the required information is timely reported. Under the proposed regulations, the complete liquidation of TFC would be a "subsequent disposition" of the transferred IP, as to USS, who would also be a "qualified domestic person." Depending on the form of the subsequent disposition, the regulations would require USS (as successor to the original US transferor) to recognize gain as to the IP. In this case, however, no gain recognition would be required given the operation of §337. That is, even if the transferor's original basis in the IP were used (as prescribed by the proposed regulations for this purpose), USS would not recognize gain with respect to such disposition, because the disposition is a complete liquidation under §332. (Alternatively, USS *would* recognize gain if the IP had been distributed in a taxable distribution of property under §311, but in either case, the deemed royalty arrangement under §367(d) terminates.) For further info, see Tax Alert 2023-0843.



Portion of CEO's compensation treated as constructive distribution. The Fourth Circuit Court of Appeals upheld the Tax Court's determination that a portion of the compensation paid by a closely-held corporation to its CEO, who was also a shareholder, was unreasonable and instead should be treated as a constructive distribution with respect to shares. The corporate taxpayer in *Clary Hood, Inc. v. Comm'r* had "substantial retained earnings and cash" and had never paid any distributions to its shareholders, i.e., the CEO and his spouse, who together owned 100% of the shares of the corporation. While the Tax Court had found that the CEO was under-compensated in prior years, the court concluded that the corporation had gone too far with the bonuses in the taxable years at issue. In affirming the Tax Court on this point, the appellate court endorsed a "reasonable compensation" test that takes eight factors into account, including the employee's qualifications, the nature, extent and scope of the employee's work and the size and complexities of the business.