CHALLENGE POINT:

SURVEYING THE SHOALS: **TAX HAZARDS LURK OFFSHORE**

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INTRODUCTION: Last year we introduced this new feature—the Challenge Point—to highlight some of the excellent work done by members of the Young Lawyer's Forum who develop the problem that forms the basis of the Section's Law Student Tax Challenge Competition. This year the competition grew to include LLM students as well as JD students, and drew a record number of entries (see page 25 for a list of the winners). Tom Greenaway served as Co-Chair of the 2005 competition and in this piece he sets out some of the issues that challenged the competitors. His exposition provides a useful checklist of issues that arise in the increasingly common practice of transferring patents to offshore subsidiaries which may also be involved in developing intellectual property of their own.
–Alice G. Abreu, Philadelphia, PA

Interesting and complex tax issues arise when a U.S. corporation transfers existing patents to—and develops new patents in—a foreign entity. While transferring patents or other intangible property offshore may be a straightforward business decision, especially for a U.S. corporation regularly engaged in worldwide markets, the federal tax consequences of such transfers are complicated, owing to a panoply of provisions in the Code and attendant regulations designed to protect the revenue. This article surveys a few of the issues that lie beneath the surface.

THE **TRANSACTION**

Assume HavenCo, located in a fictional tax-advantaged foreign jurisdiction, has two shareholders: a U.S. pharmaceutical corporation, U.S.Co, and a British pharmaceutical firm, BritCo. In 1999, U.S.Co and BritCo created HavenCo by contributing property to the new corporation. In exchange, U.S.Co and BritCo each took back one-half of the common stock in HavenCo. BritCo contributed patents, and U.S.Co contributed cash. HavenCo used most of the cash received from U.S.Co to buy patents from U.S.Co at fair market value. HavenCo licensed these "legacy" patents to third party manufacturers, and HavenCo also developed new patents using research facilities in South Korea. By 2005, as the value of the legacy patents dwindled, almost all of HavenCo's revenue came from licensing new patents it developed.

THE **ANALYSIS**

FORMATION

Ordinarily, the formation of HavenCo would easily qualify for non-recognition under section 351, since U.S.Co and BritCo, together, transferred property to HavenCo in exchange for all the common stock in HavenCo. The answer here is not that simple, though, because certain transactions involving U.S. and foreign persons trigger section 367. In certain circumstances, section 367 denies the favorable treatment otherwise made available to those transactions under the organization and reorganization provisions of Subchapter C.

Generally, section 367(a) forces U.S. persons to recognize gain on transfers of appreciated property to a foreign corporation in exchange for stock in the foreign corporation. Furthermore, there are follow-on consequences for transactions subject to section 367, including basis adjustments and effects on earnings and profits. Since U.S.Co, a U.S. person, contributed property to HavenCo, a foreign corporation, solely in exchange for stock, section 367 was implicated when HavenCo was formed.

But the general rule of section 367(a) most likely does not apply in this case, since U.S.Co transferred only cash in exchange for HavenCo stock. Where, as here, the sole asset transferred to the foreign corporation is cash, section 367 does not require the transferor to recognize gain on the transaction, since the transferor realized no gain. Treas. Temp. Reg. §§ 1.367(a)-1T(b)(1), -(b)(3)(i); CMI Int'l, Inc. v. Commissioner, 113 T.C. 1, 6 (1999). *See* Rev. Rul. 68-43, 1968-1 C.B. 146. Furthermore, regulations limit the follow-on effects of section 367 to recognized gain. Treas. Temp. Reg. § 1.367(a)-1T(b)(4)(B). Where recognized gain would have been zero, section 367 has no subsequent effect on earnings and profits or basis. Nevertheless, U.S.Co had to report to the IRS the outbound transfer of its cash to HavenCo. I.R.C. § 6038B(a). Failure to report outbound transfers, on Form 926, can result in penalties and extends the statute of limitations on assessment. I.R.C. § 6501(c)(8); Treas. Reg. § 1.6038B-1(b)(1)(i); Treas. Temp. Reg. § 1.6038B-1T.

A question remains, however, whether U.S.Co's transfer of cash to HavenCo should be "stepped together" with HavenCo's subsequent cash purchase of U.S.Co's patents, under the step transaction doctrine. If the step transaction doctrine applies, U.S.Co will be treated as if it directly transferred the patents to HavenCo, and the circular flow of cash will be ignored. Therefore, U.S.Co would be subject to section 367(d) regarding intangibles—treating HavenCo's income attributable to the patents as current royalty payments to U.S.Co. *Cf., e.g.*, CCA 200610019 (March 10, 2006).

1 The analysis provided here reflects only the individual views of the author and does not represent the views held by the Internal Revenue Service or the Treasury Department.

But the assertion of the step transaction doctrine here may be fruitless. For one thing, since the effect of section 367 on future earnings and profits is contingent on the gain recognized under section 367, this issue has probably been laid to rest by the statute of limitations on assessment, assuming U.S.Co properly reported the outbound transfer of the cash to the Service. *See* I.R.C. §§ 6501(a), -(c)(8). Furthermore, HavenCo paid fair market value for the patents in 1999. It would be odd—to say the least—for the Service to assert the step transaction doctrine five years later in an attempt to *decrease* U.S.Co's gross receipts in 1999. Finally, since U.S.Co presumably paid more federal income taxes in 1999 than it would have if it had contributed the patents and not cash to HavenCo, all else being equal, the tax benefit rule has no place here, either. On the other hand, if the price HavenCo paid for the patents is not commensurate with the income they produce, the IRS—with the benefit of hindsight—may assert that section 367(d) applies.

Here, we avoid that problem by assuming HavenCo paid a price commensurate with income for U.S.Co's patents. By doing so, we also avoid another nearly-intractable problem in international tax: transfer pricing. A taxpayer's assertion of arm's length pricing may be subject to challenge by the IRS under section 482. Nevertheless, we assume the prices HavenCo paid for U.S.Co's patents were correct to avoid a detailed discussion of transfer pricing valuation principles—and the tricky question of whether section 482 would even apply to this case.

CONTROLLED FOREIGN CORPORATION

HavenCo is not a Controlled Foreign Corporation (CFC), since U.S.Co, the only U.S. shareholder, does not own more than fifty percent of the total combined voting power of all classes of stock or more than fifty percent of the total value of the stock. I.R.C. § 957(a). And that's good news for U.S.Co and HavenCo—CFCs are subject to some of the more onerous international tax provisions in the Code, found in Subpart F (sections 951 through 964). For instance, section 956, which taxes U.S. shareholders of CFCs on income from "U.S. property"—including the right to use patents in the United States, section 965(c)(1)(D)(i)—plays little, if any, role here.

PASSIVE FOREIGN INVESTMENT COMPANY

Even though HavenCo is not a CFC, it was probably a Passive Foreign Investment Company (PFIC), at least initially. PFICs include foreign corporations with mostly—75 percent or more—passive income or at least 50 percent passive assets. I.R.C. § 1297(a). Passive income includes royalty payments and patent fees. I.R.C. § 1297(b)(1), *incorporating* § 954(c). There is an exception, however, for rents and royalties derived in the active conduct of a trade or business, as long as those rents and royalties are not received from a related person. I.R.C. § 954(c)(2)(A). It is generally not good—at least from a U.S. shareholder's perspective—for a foreign corporation to be a PFIC. For example, "excess" distributions by PFICs to their U.S. shareholders, or dispositions of stock, subject the U.S. shareholder to taxation and interest charges that compensate the Treasury for deferral. I.R.C. §§ 1291(c)(1), -(f).

In the beginning, HavenCo probably was a PFIC, as almost all of its income came from royalties from U.S.Co and BritCo's "legacy" patents. In contrast, it is likely that HavenCo currently fits within the active trade or business exception, as: (1) almost all of the royalties HavenCo receives are derived from licensing patents it developed; (2) HavenCo is regularly engaged in the development of such patents; and (3) the royalties come from independent drug manufacturing plants, not U.S.Co or BritCo. *See* Treas. Reg. § 1.954-2(d)(1)(i). Nevertheless, whether an activity constitutes an active conduct of a trade or business depends on many different factors, and the case law is barren on the question of what that phrase means in section 954(c)(2)(A). *But see* Electronic Arts, Inc. v. Commissioner, 118 T.C. 226, 250-52 (2002) (holding that taxpayer's subsidiary engaged in "active conduct of a trade or business" in context of section 936 possessions tax credit), *distinguishing* Medchem (P.R.), Inc. v. Commissioner, 116 T.C. 308, 337 (opposite holding), *aff'd*, 295 F.3d 118 (1st Cir. 2002). It is probably essential that HavenCo employees manage the research in South Korea, and the fact that the research facilities are in South Korea—and not in the tax haven—may not hurt. *Cf.* Treas. Reg. § 1.954-2(b)(5)(i)(2).

Even though HavenCo may not be a PFIC now, it still may be subject to the taint of any prior PFIC status. Section 1297(b)(1) treats U.S.Co's HavenCo stock as PFIC stock if *at any time* during U.S.Co's holding period of the stock HavenCo was a PFIC. U.S.Co could purge the taint by making a special election, as long as the election is made within three years of the due date for U.S.Co's tax return for the year that included the last day HavenCo was a PFIC. Treas. Temp. Reg. § 1.1297-3T(b)(1).

CONCLUSION

U.S. corporations may transfer intangible property offshore to try to drive down their U.S. tax liabilities, but as this survey only begins to show, the federal tax consequences may not be certain. The prudent tax advisor will not rely solely on any single aid to navigation when working offshore. ■