

Office of Chief Counsel
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Memorandum

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to:

from: Associate Area Counsel

subject:

This memorandum responds to your request for field advice regarding the acquisition buy-in issue described below, and may not be used or cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views before any disclosure is made.

LEGEND

Acquirer =
Target =
Acquirer CFC =
Target CFC =
Date 1 =
Date 2 =

ISSUES

(1) Whether a buy-in payment described in Treas. Reg. § 1.482-7(g) is due from Acquirer CFC to Acquirer on the grounds that Acquirer, as the controlling shareholder of

Target CFC as the result of an “A” reorganization¹, is considered to own and make available intangible assets held by Target CFC relevant to the CSA between Acquirer CFC and Acquirer.

(2) Whether section 367(d) applies with respect to the “A” reorganization or subsequent “D” reorganization².

FACTS

Acquirer, a domestic corporation, wholly owns Acquirer CFC, a foreign corporation. Target, a domestic corporation unrelated to Acquirer, wholly owned Target CFC, a foreign corporation. Acquirer has an ongoing cost sharing arrangement (“CSA”) with Acquirer CFC, and Target had an ongoing CSA with Target CFC.³ Both CSAs permitted the foreign party to participate in research and development using pre-existing intangible property (as that term is used in Treas. Reg. § 1.482-7(g)(2)) to develop covered intangibles (as that term is used in Treas. Reg. § 1.482-7(b)(4)(iv)) by sharing intangible development costs (as that term is used in Treas. Reg. § 1.482-7(d)) with its U.S. parent.

Both CSAs divided interests in the commercial exploitation of the covered intangibles on a territorial basis such that Acquirer CFC and Target CFC each had rights of commercial exploitation in the applicable covered intangibles in its territory. The territories assigned to the foreign participants in the two CSAs were not identical. Also at the inception of their respective CSAs, Acquirer and Target transferred rights in commercial exploitation of their existing products (“make or sell rights”) to Acquirer CFC and Target CFC, in the same respective territories.

On Date 1, Acquirer acquired Target indirectly (through a disregarded entity) in a statutory merger that constituted a reorganization under section 368(a)(1)(A). As a

¹ As described in § 368(a)(1)(A).

² As described in § 368(a)(1)(D).

³ Solely for purposes of this discussion, we assume that both CSAs satisfied the requirements of Treas. Reg. § 1.482-7 for qualified cost sharing arrangements.

result of such “A” reorganization, Acquirer owned the stock of Target CFC, which continued as a separate entity.

At the same time, Acquirer CFC and Target CFC licensed to each other non-exclusive rights in their respective interests in covered intangibles held by reason of their participation in their respective CSAs, as well as non-exclusive rights in their respective make or sell rights. Approximately one and a half years after Date 1, all of the assets of Target CFC, including its rights in covered intangibles and make or sell rights, were treated for U.S. tax purposes as transferred to Acquirer CFC as a result of a tax-free reorganization of the type described in I.R.C. § 368(a)(1)(D) (the “D’ reorganization”).⁴

LAW

Corporate entities are generally respected as separate from their owners, and the assets of corporations are not generally treated as assets of the shareholders of such corporations. *Commissioner v. Moline Properties*, 131 F.2d 388 (5th Cir. 1952).

The IRS has the authority to allocate income and deductions among taxpayers in any case where two or more organizations, trades, or businesses are owned or controlled, directly or indirectly, by the same interests, if allocations are necessary to prevent evasion of taxes or clearly to reflect income. I.R.C. § 482.

Treas. Reg. § 1.482-7 sets forth the transfer pricing method applicable to qualified cost sharing arrangements (“QCSA”s). Under that provision, a QCSA is an agreement by which participants agree to share the costs of developing intangibles that will be separately exploited by each of the controlled participants. Each participant that participates in a QCSA obtains a separate interest in the covered intangibles developed under the QCSA. Treas. Reg. § 1.482-7(b)(4)(iv).

A buy-in requirement arises when “a controlled participant makes pre-existing intangible property in which it **owns** an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost

⁴ For a detailed description of the facts, please look at the Revenue Agent’s Report and the taxpayer’s Protest dated Date 2.

sharing arrangement....” Treas. Reg. § 1.482-7(g)(2) (*emphasis added*).

Consequently, a buy-in payment is required when, among other circumstances, a controlled participant acquires intangible property from an uncontrolled taxpayer and contributes it to its ongoing CSA for purposes of research. A buy-in payment is not due for a transfer of make or sell rights because such rights are not relevant to research. Nevertheless, arm’s length compensation would be due for such transfer under Treas. Reg. § 1.482-4.

For purposes of Treas. Reg. § 1.482-7, all members of the same affiliated group (as defined by I.R.C. § 1504(a)) that join in the filing of a consolidated return for the taxable year under I.R.C. § 1501 are treated as one taxpayer. Treas. Reg. § 1.482-7(c)(3). Foreign corporations generally are not included within the definition of affiliated group because they are not includible corporations. I.R.C. § 1504(a)(1) and (b)(3). I.R.C. § 367(d) applies to certain transfers of intangible property from a U.S. person to a foreign corporation.

ANALYSIS

Prior to Acquirer’s acquisition of Target in Date 1, both Acquirer CFC and Target CFC obtained separate interests in covered intangibles by virtue of their ongoing CSAs with Acquirer and Target, respectively.

When Acquirer acquired ██████████ in Date 1, it stepped into the shoes of Target and obtained the assets of Target, which included the stock of Target CFC. After the “A” reorganization, Acquirer and Target CFC were commonly owned by the same interests within the meaning of I.R.C. § 482. Nonetheless, because Target CFC continued as a separate entity for U.S. tax purposes, Acquirer was not considered the owner of Target CFC’s assets⁵, such as the interests in intangibles held by reason of Target CFC’s participation in a CSA with Target or the make or sell rights transferred to Target CFC by Target. See *Moline Properties*, 131 F.2d 388. A different result would not apply by reason of Treas. Reg. § 1.482-7(c)(3) because Target CFC, as a foreign corporation, could not and did not file a consolidated return with Acquirer

⁵ Acquirer owns the stock of Target CFC.

and so cannot be treated as one taxpayer with Acquirer for purposes of Treas. Reg. § 1.482-7.

Consequently, Acquirer's acquisition of Target, by itself, would not obligate Acquirer CFC to make a buy-in payment to Acquirer on account of any pre-existing intangible property of Target CFC for the simple reason that Acquirer would not be considered the owner of such pre-existing intangible property.⁶

However, this narrow conclusion does not mean that no buy-in payments under Treas. Reg. § 1.482-7 or other arm's length compensation (e.g., under Treas. Reg. § 1.482-4) is required upon or after the "A" reorganization between any of the surviving parties. As just one example, Acquirer CFC may owe a buy-in payment or other arm's length payment to Acquirer with respect to assets that Acquirer itself owns directly as a result of the "A" reorganization. The facts presented, including those associated with the licenses between Acquirer CFC and Target CFC and the subsequent "D" reorganization should be further developed and subsequent advice sought concerning whether any such arm's length compensation is warranted.

As explained above, section 367(d) applies only to certain transfers of intangible property from a U.S. person to a foreign corporation. The "A" reorganization involved only a transfer between two domestic corporations, and the "D" reorganization involved only a transfer between two foreign corporations. However, if further factual development indicates that the economic substance of these two reorganizations involves a transfer from a U.S. person (e.g., Acquirer or Target) to a foreign corporation (e.g., Acquirer CFC or Target CFC), then section 367(d) may apply.

CONCLUSION

For purposes of applying the buy-in provisions of Treas. Reg. §1.482-7(g), a domestic corporation is not considered to own the assets of its foreign subsidiary by

⁶ For the same reasons, Acquirer is not considered the owner of Acquirer CFC's assets, such as the interests in intangibles held by reason of Acquirer CFC's participation in a CSA with Acquirer or the make or sell rights transferred to Acquirer CFC by Acquirer. This same rationale applies generally to the subsequent D Reorganization.

virtue of owning such subsidiary. In the instant case, this means that buy-in payments are not owed to Acquirer by Acquirer CFC with respect to Target CFC's pre-existing intangible property solely by virtue of Acquirer's acquisition of the stock of Target CFC. The facts presented should be further developed and subsequent advice sought concerning whether any such arm's length compensation is otherwise warranted.

In addition, section 367(d) does not apply to either the "A" reorganization or the "D" reorganization on their face, because neither involved a transfer of intangible property from a U.S. person to a foreign corporation. However, if further factual development indicates that the economic substance of either of these two reorganizations involves a transfer from a U.S. person (e.g., Acquirer or Target) to a foreign corporation (e.g., Acquirer CFC or Target CFC), then section 367(d) may apply.

If you have any questions, please contact

Associate Area Counsel
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