Code Sec. 367(d) and "Commensurate with Income": Old Rules in a New Era

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It has been more than three decades since 1986 when Congress amended Code Sec. 367(d)[1] to add a requirement that payments with respect to a transfer of intangible property ("IP") be "commensurate with the income attributable to the intangible" ("CWI").[2] Notwithstanding the lengthy passage of time, there are many aspects of the CWI standard that continue to remain unclear, misunderstood, or perhaps even both. Beyond the discussion in the legislative history of the Tax Reform Act of 1986,[3] there has been relatively little in the way of published guidance regarding the scope and purpose of CWI, particularly in the context of Code Sec. 367(d). Indeed, a recent judicial decision addressing a reorganization transaction involving an outbound transfer of IP subject to Code Sec. 367(d) did not address, or even mention, CWI.[4]

In this article, we consider the scope and continued viability of CWI in the context of a transfer of IP subject to Code Sec. 367(d). To that end, we revisit the statutory language of Code Sec. 367(d), as well as the legislative history underlying the adoption of CWI. In so doing, we review the concerns that prompted Congress to enact the CWI standard in the first place and attempt to offer a few modest observations on how those motivating factors have (or have not) withstood the test of time over the last approximately 36 years, including, more recently, the enactment of the so-called Tax Cuts and Jobs Act[5] (also known as the "TCJA") in 2017 and the subsequent introduction of two new taxing regimes based on financial statement income: the corporate alternative minimum tax ("CAMT"), enacted as part of the Inflation Reduction Act of 2022,[6] and the Organisation for Economic Co-operation and Development's ("OECD's") Base Erosion and Profit Shifting ("BEPS") Pillar 2 project.[7] Finally, we examine the relevance of CWI going forward in light of recent judicial decisions addressing the CWI standard in the context of Code Sec. 482.[8]

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Code Sec. 367(d) and Other Guidance

Code Sec. 367(d) generally provides rules governing the outbound transfer of IP by a U.S. person to a foreign corporation in certain nonrecognition transactions. Specifically, if a U.S. person transfers IP to a foreign corporation in a transaction described in Code Sec. 351[9] or 361,[10] the U.S. transferor is treated as having sold the IP in exchange for payments contingent on the productivity, use, or disposition of the IP, and receiving amounts that reasonably reflect the amounts that would have been received annually over the useful life of the IP (the "deemed payment"), or upon a direct or indirect disposition following the transfer.[11]

The deemed payment must be commensurate with the income attributable to the IP.[12] Although Code Sec. 367(d) does not provide additional detail regarding the CWI standard, the regulations under Code Sec. 367(d) provide that the amount of the deemed payment is determined generally by reference to Code Sec. 482 and the regulations thereunder, presumably reflecting Treasury's intent to incorporate by reference the full gamut of authority under Code Sec. 482, including as it relates to CWI.[13]

On the administrative front, the regulations under Code Sec. 367(d) provide an election to include in gross income the deemed payment over a 20-year horizon, where the useful life of the intangible is greater than 20 years or indefinite, provided that "for purposes of determining whether amounts included during the 20-year period are commensurate with the income attributable to the transferred intangible property, the Commissioner may take into account information with respect to taxable years after that period, such as the income attributable to the transferred property during those later years."[14]

The government has also issued guidance in Notice 2012-39 addressing the treatment under Code Sec. 367(d) of certain "boot" payments made in connection with a transfer of IP pursuant to an exchange described in Code Sec. 361(a) or (b).[15] In that notice, the Internal Revenue Service ("IRS") states, without further elaboration, that "[a]ny income taken into account under this notice must be commensurate with the income attributable to the section 367(d) property transferred in the outbound section 367(d) transfer."[16]

A Few Pages of CWI History (Hopefully) Worth a Volume of Logic[17]

Congress amended Code Secs. 367(d) and 482 to include the CWI standard as part of a larger, and more fulsome, overhaul of the U.S. tax code in 1986.[18] And yet, despite CWI existing in Code Secs. 367(d) and 482 since 1986, there has been very little published guidance as to what CWI actually means, particularly in the context of Code Sec. 367(d), requiring taxpayers to divine the contours of the CWI standard from the accompanying legislative history and a 1988 Treasury and IRS "white paper" on Code Sec. 482 (the "White Paper"),[19] as well as judicial decisions arising in the context of transfer pricing disputes under Code Sec. 482, as discussed below.

As a threshold matter, in enacting the CWI standard, it appears that Congress intended generally for it to apply equally, and to the same degree, to both IP transfers under Code Sec. 367(d), in the case of an exchange or reorganization under Code Sec. 351 or 361, and IP transfers under Code Sec. 482, in the case of a license or sale, notwithstanding the obvious (and not so obvious) differences between those two provisions, in that the application of CWI should not depend on the form of the transaction chosen by the taxpayer. This intent is evident in the legislative history and early guidance.

As explained by the Joint Committee on Taxation in its general explanation of the Tax Reform Act of 1986 ("JCT Report"), the "basic requirement" of the amendment is to require deemed payments received by a U.S. person from a related foreign corporation in connection with a transfer of IP in a Code Sec. 351 or 361 exchange, in the case of Code Sec. 367(d), or a sale or license, in the case of Code Sec. 482, to "be commensurate with the income attributable to the intangible."[20] The JCT Report then boldly proclaims that "[t]his requirement is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each."[21]

Similarly, in the White Paper, Treasury and the IRS reexamined the theory and administration of Code Sec. 482, with particular attention paid to transfers of IP, and found that the "general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."[22] In particular, the White Paper stated that the "application of the commensurate with income standard requires the determination of the income from a transferred intangible, and a functional analysis of the economic activities performed and the economic costs and risks borne by the related parties in exploiting the intangible, so that the intangible income can be allocated on the basis of relative economic contributions of the related parties."[23]

Although the JCT Report, the legislative history, and the White Paper do not appear to provide any further explanation as to what is meant by the "basic requirement" or the "objective" of CWI, a review of the legislative history appears to reveal two, interdependent concerns—one legal, one practical—motivating Congress to adopt a CWI requirement with respect to IP transfers to related foreign corporations, such as an outbound transfer pursuant to a transaction governed by Code Sec. 367(d) or a sale or license of IP under Code Sec. 482.

First, Congress was apparently troubled that the U.S. tax code provided a "strong incentive" for U.S. taxpayers to transfer IP to related foreign corporations located in low-tax jurisdictions, especially in cases where the IP had a "high value" in comparison to the costs of manufacturing or assembly of products created as a result of the IP.[24] As articulated in the House Report accompanying the Tax Reform Act of 1986, Congress believed that such transfers could "result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group" (the "tax deferral concern").[25] The tax deferral concern was thus essentially a function of U.S. tax law, as it then existed.

Recent U.S. tax law developments, however, have potentially reduced the tax deferral concern. In 1986, income earned by controlled foreign corporations ("CFCs") of U.S. shareholders was not taxed in the United States unless it was considered passive or mobile subpart F income or was otherwise distributed to the U.S. shareholder. In 2017, 30 years after Congress amended Code Secs. 367(d) and 482 to include the CWI standard, Congress enacted the TCJA, and substantially altered the U.S. international tax landscape.

In particular, Congress curtailed the deferral of income earned by CFCs of U.S. shareholders by enacting the global intangible low-taxed income ("GILTI") regime, which, very generally, requires income other than passive or mobile income of CFCs to be currently included in the U.S. shareholder's income, reduced by a net deemed tangible income return[26] and, subject to certain limitations, a further deduction, resulting in an effective rate of 10.5 percent.[27] Passive income of a CFC, of course, continues to be subject to current taxation at the corporate income tax rate of 21 percent under the subpart F regime.[28] Effectively, most income of CFCs is now taxed currently, either at a lower rate under the GILTI regime or at full corporate rates, in the case of subpart F income. In addition, as part of the TCJA, Congress put into place a quasi-participation exemption system, allowing a 100-percent dividends received deduction to corporate U.S. shareholders on certain dividend distributions from qualifying CFCs, which would include earnings generated by a CFC from the exploitation of IP received in a transaction subject to Code Sec. 367(d), to the extent that such earnings are not otherwise taxed as part of the U.S. transferor's GILTI or subpart F inclusion.[29]

Similarly, the enactment of a deduction for foreign-derived intangible income ("FDII") has served to incentivize many U.S. taxpayers to domesticate IP or at least think twice before moving foreign IP rights abroad, noting, in particular, that even deemed payments under Code Sec. 367(d) may be eligible for the Code Sec. 250 deduction as FDII.[30] Indeed, in situations where the government would apply the CWI standard to require an adjustment to the amount of the deemed payment taken into gross income by the U.S. transferor of the IP in the Code Sec. 367(d) transaction, any such adjustment, in theory, ought to result in either an increase to the U.S. taxpayer's FDII and corresponding reduction to GILTI or *vice versa*.

Thus, while there are still some circumstances in which the deferral may exist, for example, to the extent that income subject to GILTI does not result in a GILTI inclusion due to items of income excluded from it (*e.g.*, certain high-taxed income or the offset of tested income of a CFC by losses of a tested loss CFC) or due to the net deemed tangible income return reduction, which results in untaxed earnings and profits ("E&P") that is subject to deferral, these limited circumstances presumably reflect intentional policy choices made by Congress when it enacted the TCJA.

Indeed, in the context of cross-border transfers of IP under Code Sec. 367(d), the enactment, and complimentary operation, of FDII and GILTI, together with the Code Sec. 245A dividends received deduction, have arguably effectively neutralized the perceived risks that motivated Congress to enact the CWI standard. More specifically, these changes to the Code that Congress enacted in the TCJA have raised the question of whether one of the fundamental motivations that caused Congress to adopt a CWI requirement in the context of outbound IP transfers has diminished relevance in a post-TCJA world.

Even more recently, the introduction of two new taxing regimes, both of which are based on financial statement—as opposed to taxable—income, raise interesting questions as to the continued viability of the CWI standard, particularly in light of the tax deferral concern. On the home front, Congress enacted the CAMT in 2022 and abroad, the OECD has been busy pressing implementation of the BEPS Pillar 2 project, the Global Anti-Base Erosion Rules ("GloBE Rules"), which is now

charging ahead in many jurisdictions. The two regimes differ, for example, in that the GloBE Rules preclude jurisdictional blending (but rather require computations to be made on a country-by-country basis), yet they also have some important similarities.

In particular, both CAMT and Pillar 2 impose a 15-percent minimum tax on a base that starts with financial statement income, subject to certain adjustments. It goes without saying that the adoption of a base predicated on financial statement income generally differs markedly from one based on taxable income, and the treatment of items of income for financial statement purposes may differ in meaningful ways from the treatment of the same items of income for taxable income purposes, especially in the absence of any corresponding CWI principle.

What has any of this got to do with Code Sec. 367(d) and CWI? Because the deemed payment construct under Code Sec. 367(d) is a uniquely U.S. tax fiction, it effectively has no direct relevance outside of the computation of a U.S. taxpayer's U.S. federal income tax liability. As such, with respect to the deemed payment under Code Sec. 367(d), if and whether the CWI standard is satisfied may have very little impact on the U.S. taxpayer's overall tax liability, as computed under CAMT or Pillar 2, at least as it pertains to the determination of the taxpayer's financial statement income that is the basis for computing its tax liability.

Indeed, in the absence of any corresponding provision under CAMT or Pillar 2 that would require principles similar to the CWI standard in the context of a transfer of IP among entities under common control, it is unclear for certain larger taxpayers whether the CWI standard would continue to have any significant independent import, particularly where the applicable accounting standard does not require recognition of financial statement income pursuant to a Code Sec. 367(d) type of transfer of IP.

Of course, U.S. tax imposed on the deemed payment would be expected to factor into the determination of a U.S. taxpayer's regular tax and, therefore, ultimate minimum tax computations, in the case of CAMT, and determination of covered taxes, in the case of Pillar 2. However, taxation of a U.S. multinational group's financial statement income at a 15-percent minimum rate under CAMT or Pillar 2, akin to the TCJA would, again, seem to address, at least in part, Congress's tax deferral concern in enacting CWI under Code Sec. 367(d) because income from the exploitation of such IP would be subject to a minimum level of taxation somewhere in the world, and specifically taxed in the United States in cases under the CAMT and GILTI regimes where intangibles are transferred to related parties in low-tax jurisdictions.

Second, and perhaps appropriately viewed as a natural outcome of the tax deferral concern, Congress was also apparently nervous that the provisions of Code Sec. 367(d) (and Code Sec. 482) that "allocate income to a U.S. transferor of intangibles may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations."[31] In other words, because U.S. taxpayers could transfer so-called "high-profit intangibles" to a foreign corporation and effectively shield from U.S. taxation future income attributable to that IP, these taxpayers may be tempted to ascribe a lower value to the IP and/or underestimate future income anticipated to be generated from exploiting the IP (the "insufficient allocation concern").[32]

The insufficient allocation concern was particularly problematic, according to Congress, in the case of a transfer of IP to a related foreign corporation, such as under Code Sec. 367(d), because transfers "between related parties do not involve the same risks as transfers to unrelated parties."[33] In this regard, Congress expressed apprehension that there was a "powerful incentive to establish a relatively low royalty rate without adequate provisions for adjustment as the revenues of the intangible vary," noting that there are "extreme difficulties" in determining whether arm's length transfers between unrelated parties are comparable.[34]

Congress further noted that the insufficient allocation concern is "particularly acute" in the case of transfers of high-profit potential intangibles.[35] In that situation, "[t]axpayers may transfer such intangibles to foreign related corporations ... at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items."[36]

Unlike the tax deferral concern, the insufficient allocation concern is largely a practical concern, involving questions such as taxpayer–government information asymmetry and the difficulty in determining whether the transfer of IP satisfied arm's length principles. This concern was ostensibly compounded by the difficulty of identifying comparable uncontrolled transactions that could reliably be used as benchmarks for transfers of high-profit potential intangibles.[37] Tax administrations continue to regard this as a problem, as reflected in the

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incorporation of "hard-to-value intangibles" guidance in the OECD Transfer Pricing Guidelines following the initial BEPS project.[38]

To address perceived problems associated with the insufficient allocation concern, Congress intended for the CWI requirement to permit *ex post*, after-the-fact adjustments to a taxpayer's income allocations under Code Sec. 367(d).[39] In particular, Congress explained that it did not intend that the "inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer."[40] Rather, Congress intended that "consideration also be given the actual profit experience realized as a consequence of the transfer."[41]

In this manner, Congress intended to "require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible," but did not specify whether the taxpayer, or the government, could make such adjustments.[42] Later-issued administrative guidance, however, purports to preclude taxpayers from Monday-morning quarterbacking, although that guidance addressed only CWI in the context of taxpayer-initiated adjustments under Code Sec. 482, and it is not entirely clear from the legislative history whether a parallel interpretation ought to apply equally for purposes of Code Sec. 367(d).[43]

In any event, "[i]n requiring that payments be commensurate with the income stream" associated with the transferred IP, Congress explained that it did not "intend to mandate the use of the 'contract manufacturer' or 'cost-plus' methods of allocating income or any other particular method."[44] Instead, Congress intended that "all the facts and circumstances [were] to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts."[45] However, the actual profit or income stream generated by, or associated with, the IP is generally given more weight.[46]

In its conclusions on the background and scope of CWI, the White Paper states, importantly, that, under the CWI standard, income earned from IP is required to be redetermined and reallocated periodically to reflect changes. This is consistent with the legislative history as described above addressing the CWI standard and reiterates Congress's insufficient allocation concern. However, the White Paper stated that the adoption of CWI was a "clarification" of prior law but noted that the existing rules did not provide "appropriate" attention to income generated by the transfer of IP where comparables did not exist.[47] On its face, the legislative history does not appear to go that far and, arguably, the adoption of CWI could even be interpreted as evidence that Congress had lost faith in the traditional arm's length standard, at least in the context of transfers of high-value intangibles.[48]

The White Paper attempts to harmonize CWI's shift in focus to an income-based approach, concluding that by "[l]ooking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do" under an arm's length approach.[49] In so doing, the White Paper appears to engraft (or at least mirror) the mechanics of Code Sec. 367(d) into the Code Sec. 482 construct, asserting that the "periodic adjustment of lump sum royalty or sale payments would merely achieve parity with section 367(d) transfers."[50] For example, the White Paper states that "[i]n essence, the commensurate with income standard treats related party transfers of intangibles as if an intangible had been transferred for a license payment that reflects the intangible's value throughout its useful life, a result similar to section 367(d)."[51]

The White Paper further states: "Because the section 367(d) source of income rule can apply to certain transactions cast in the form of a sale or license, the temporary regulations could be amended to specify which sales or licenses are subject to both the commensurate with income standard and the U.S. source income characterization of section 367(d). Moreover, a license payment that is less than some specific percentage of the appropriate arm's length amount could be considered so devoid of economic substance that the arm's length charge should be subject to section 367(d). Thus, those related party transfers which deviate substantially from the proper commensurate with income payment would be subject to [section] 367(d), even if cast in the form of a sale or license."[52]

The legislative history and the White Paper's reexamination of Code Sec. 482 echo the insufficient allocation concern that existed 30-plus years ago. However, the enactment of the TCJA and CAMT, as well as the wide-spread adoption of Pillar 2, as discussed above, may serve to alleviate the insufficient allocation concern associated with related-party outbound transfers of IP for a relatively insignificant upfront or periodic payment

that effectively places the IP development downside risk in the United States and the upside profit potential abroad, particularly where the treatment of related-party IP transfers for financial statement purposes requires no such income allocation and, ultimately, the enterprise's global profits are effectively subject to a minimum rate of taxation in the United States, regardless of where the underlying income is earned.

Importantly, in the context of Pillar 2, the CWI standard arguably has no immediate bearing on U.S. shareholder taxation, except that determining the amount of top-up tax owed, if any, derived from financial statements in the CFC's home country (that do not deem payments back to the United States) may result in more CFC-level taxes, which could serve to increase the FTCs that benefit a U.S. shareholder, effectively shifting taxing rights on additional IP income to the CFC jurisdiction. Having said that, Pillar 2 does, however, prevent CFC income from being low-taxed, which could effectively discourage outbound IP transfers, and thus further serve to ameliorate the income allocation concern.

Has CWI outlived its utility? Changes in the underlying U.S. tax system address the problems it was originally intended for, and the IRS has rarely invoked CWI to make adjustments based on the actual profitability of an intangible[53]—notwithstanding the fact that, as discussed below, it has become a rallying cry in government litigation positions. The relative disuse of CWI may reflect its underlying tension with the arm's length principle: Treasury concluded that the two are mutually consistent, but only after conducting an intensive study, while some commentators have suggested that periodic adjustments based on *ex post* data are incompatible with arm's length behavior.[54] Foreign tax authorities may be similarly skeptical about the compatibility of CWI periodic adjustments with the arm's length principle, and the IRS may deliberately shy away from making adjustments that would be difficult to defend in a mutual agreement procedure case. One might wonder if CWI is rarely used and arguably is no longer needed, why keep it on the books?

Judicial Reinvigoration of CWI[55]

Having reviewed the legislative and administrative beginnings of the CWI standard, we now turn our attention to the judicial branch. If the courts have been silent on what CWI means in the context of Code Sec. 367(d), there are signs that could be about to change. The twinned language in Code Sec. 482 also went through a long period of dormancy and has only recently begun to awake—indeed, to erupt—in previously unanticipated ways. Whether these recent developments reflect simply the reinvigoration of a previously underutilized provision or the imposition of unintended meaning into broad statutory language remains up for debate.

In large part, CWI's slumber may be traced to the Treasury's conclusion in its White Paper,[56] only two years after the amendments to Code Secs. 367(d) and 482, that CWI was—at least in the context of Code Sec. 482—fully consistent with the arm's length principle. That conclusion made sense, in light of both the legislative history behind CWI and Treasury's extensive treaty commitments to the arm's length principle, but it also conveyed a clear message: nothing new to see here.

Indeed, the few courts to substantively address CWI during the first two decades of its existence did not find it to be revolutionary in the Code Sec. 482 context.[57] Neither did they regard it as a nonentity; CWI altered the rules, but it did so in a manner consistent with the existing transfer pricing framework. In 2005, the Tax Court in *Xilinx* acknowledged—and soundly rebuffed—the IRS' contention that “the commensurate with income standard replaced the arm's-length standard,” holding instead that CWI “was intended to supplement and support, not supplant, the arm's-length standard.”[58]

The situation changed with the Ninth Circuit's 2019 opinion in *Altera*[59]—or perhaps with its 2018 opinion in the same case that was withdrawn.[60] There, the court upheld, contrary to a unanimous 15:0 Tax Court decision, the validity of Treasury regulations requiring the inclusion of stock-based compensation costs in intangible development costs shared pursuant to a qualified cost-sharing arrangement.[61] A cornerstone of the Ninth Circuit's reasoning was its conclusion that the introduction of CWI reflected a fundamental rethinking of the arm's length principle: “in implementing the commensurate with income amendment, Treasury was moving away from a purely method-based, comparable-transaction view of the arm's length standard in attempting to achieve tax parity.”[62]

The Ninth Circuit in *Altera* stopped short of finding an inconsistency between CWI and the arm's length principle, but it did conceptualize CWI as authorizing Treasury to apply that principle in a very different way: through “a purely internal, commensurate with income approach in dealing with related companies.”[63] This view of CWI allowed the court to view Code Sec. 482 as authorizing the regulations in question notwithstanding

a lack of evidence that uncontrolled parties acting at arm's length would share stock-based compensation costs. Outside of this context, the contours of the "purely internal" analytical approach endorsed in *Altera* are hazy at best.

The situation was further complicated by the Tax Court's 2023 decision in *3M*, which was decided without a majority opinion.[64] Of the 17 Tax Court judges to consider the case, seven subscribed to the opinion of the court authored by Judge Morrison, and eight dissented; the remaining two concurred in the result only.

3M addressed the validity of Reg. §1.482-1(h)(2)'s so-called "blocked income" rules, which were adopted in 1994[65] and effectively abrogated certain prior judicial decisions.[66] In concluding that the regulation is valid, the opinion of the court cast the introduction of CWI as a watershed development that was not restricted to addressing the specific situations discussed in the legislative history. On the contrary, the opinion stressed the broad language of CWI under Code Sec. 482—language that is mirrored in Code Sec. 367(d)—and proclaimed that "[i]t was the text of the 1986 amendment that was enacted by Congress, not the purpose behind the amendment."[67] Under this view, the prior judicial precedents became effectively irrelevant because they had not addressed the post-1986 version of Code Sec. 482.

Judge Copeland, concurring in the result, urged a reading of CWI that went beyond the opinion of the court: "In my view," she wrote, "the result of this case is dictated by the plain text of section 482—specifically, the second sentence added by amendment in 1986."[68] Stated differently, the validity of the challenged regulation was beside the point; in the view of Judge Copeland and the three others who joined her opinion, the statutory command in itself was dispositive:[69] "In the case of any transfer (or license) of intangible property ... the income with respect to such transfer or license *shall* be commensurate with the income attributable to the intangible."[70] The language in Code Sec. 367(d) is similar, and thus may be similarly susceptible to construction as a mandate: "The amounts taken into account under [Code Sec. 367(d)(2)(A)(ii)] shall be commensurate with the income attributable to the intangible."[71]

In any event, what the *3M* opinions have to say on CWI is *dicta*. *3M* charts out potential courses for the future evolution of CWI jurisprudence under Code Sec. 482, but as of now, they remain mere potential. It is worth underscoring that not every judicial pronouncement on CWI needs to conceptualize it as revolutionary; perhaps it is telling that the cases that have grappled with the fundamental nature of CWI have been regulatory validity cases rather than more standard valuation controversies under Code Sec. 482.

Ultimately, while the cases evoking a more expansive role for CWI have been government victories, it should not be assumed that that will remain the case: the reimagining of CWI makes for a sharp sword, and one that will inevitably cut both ways. For instance, under Code Sec. 482, taxpayers that overpay for IP relative to the income generated by that property could argue that the CWI's statutory "shall" language requires a subsequent downward adjustment to U.S. income, notwithstanding the regulatory prohibition on untimely downward transfer pricing adjustments.[72]

This is particularly the case now that transferees of IP are now more likely to be located in jurisdictions that have meaningful tax rates and income tax treaties with the United States, rather than tax havens. Assume that a U.S taxpayer transfers IP to a foreign subsidiary for an annual royalty of $100x, and the foreign subsidiary is entitled to deduct the royalties paid. In a subsequent year, assume further that it becomes clear from the performance of the IP that, under the CWI principle, the arm's length royalty should be $40x, not $100x.

Knowing this, the foreign subsidiary may not be able to claim—or may face penalties for claiming—a deduction for the full royalty payment of $100x. At the same time, the Code Sec. 482 regulations prevent the U.S. taxpayer from going back and adjusting the transfer price downwards so that it can claim income of $40x instead of $100x, and so if the foreign subsidiary does deduct only $40x, the group will have voluntarily incurred double taxation on $60x of income. That avoids potential penalties but may preclude effective mutual agreement procedure ("MAP") relief, depending on the foreign competent authority's willingness to negotiate cases arising from taxpayer-initiated adjustments. On the other hand, if the taxpayer waits for an audit and a transfer pricing adjustment in the foreign jurisdiction, it should be able to access MAP—but MAP may not be able to address any penalties it incurs.[73]

In the Code Sec. 367(d) context, the ability to make such an adjustment may be further complicated in many cases by the lack of any intercompany agreement relating to the transferred IP, let alone an agreement authorizing retroactive adjustments. Moreover, the risk of double taxation is exacerbated by the fact that the counterparty jurisdiction would not view the Code Sec. 367(d) payments as deductible royalties. The government's efforts to ensure that CWI adjustments only cut one way raise the

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question of whether CWI is not so much a principle as a thumb on the scale in favor of the U.S. fisc.

Conclusion

What does the judicial reinvigoration of Code Sec. 482’s CWI provision mean for CWI under Code Sec. 367(d)? Perhaps much: courts scrutinizing CWI in the Code Sec. 482 context have discovered hitherto unguessed-at potential in its broad and cryptic language. Or perhaps little: what the courts have discovered there is not, or at least not yet, a practical principle for resolving the questions CWI was actually meant to answer—namely, the challenging valuation issues connected with unique IP—but rather a totemic shift in the statute that can be evoked to legitimize Treasury’s far-reaching regulatory projects under Code Sec. 482. Under Code Sec. 367(d), long the object of comparative regulatory neglect, there does not appear to be the same need for legitimization.

In the perhaps not-so-final analysis, as the courts continue to examine the CWI standard, additional guidance under CAMT is developed and eventually released, and the Pillar 2 rules continue to take form, taxpayers that have undertaken, or are considering, Code Sec. 367(d) transfers of IP will need to closely monitor the impact of such guidance on the timing and amount of any deemed payments under Code Sec. 367(d), and how the Code Sec. 367(d) treatment otherwise interplays with the CAMT and Pillar 2 regimes. Indeed, as part of this exercise, taxpayers may, themselves, question how—and even if—the CWI standard can co-exist in a world where tax regimes that impose a minimum level of tax based on financial statement income are becoming more and more prevalent.

ENDNOTES

* The authors dedicate this article to the cherished memory of the late Sean Foley. Sean was a beloved colleague, a transfer pricing luminary, and a human being endowed with a singular brightness. His four-decade career spanned private practice and all three branches of government, including service as a legislative director on Capitol Hill during the time of the Tax Reform Act of 1986. We join countless others in mourning his untimely passing.

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[1] All references to “the Code” are references to the Internal Revenue Code of 1986, as amended. All references to “Code Sec.” are to sections of the Code, and all references to “regulations” or “Reg. §” are to the Treasury Regulations issued under the Code. All references to “IRS” or the “Service” are references to the Internal Revenue Service. All references to the “Treasury” are references to the U.S. Department of the Treasury.

[2] §1231(e)(2), The Tax Reform Act of 1986, Pub. L. No. 99-514 (“Tax Reform Act of 1986”). At the same time, Congress also amended Code Sec. 482 to include a requirement that income associated with a transfer or license of intangible property satisfy the CWI standard. §1231(e)(1), Tax Reform Act of 1986.

[3] Tax Reform Act of 1986; *see also* H.R. Rep. No. 99-426, 99th Cong., 1st Sess. (“House Report”); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987 (“JCT Report”).

[4] *See, e.g.*, *TBL Licensing LLC*, 158 TC No. 1, Dec. 62,003 (2022), *aff’d*, *TBL Licensing LLC v. Comm’r*, No. 22-1783 (1st Cir. Sept. 8, 2023). By contrast, in the context of Code Sec. 482, recent decisions have addressed, or at least peripherally mentioned, CWI. *See, e.g.*, *Medtronic, Inc.*, 111 TCM 1515, Dec. 60,627(M), TC Memo. 2016-112 (2016), *vacated and remanded by*, *Medtronic, Inc.*, CA-8, 2018-2 USTC ¶50,379, 900 F3d 610 (2018), *decision on remand*, *Medtronic, Inc.*, 124 TCM 69, Dec. 62,094(M), TC Memo. 2022-84 (Aug. 18, 2022). *See also Coca-Cola Co.*, 155 TC No. 10, Dec. 61,779 (2020); *3M Co.*, 160 TC No. 3, Dec. 62,159 (2023).

[5] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (the “TJCA”), Pub. L. No. 115–97, 131 Stat. 2054 (Dec. 22, 2017).

[6] The new corporate alternative minimum tax, or CAMT, was added to the Code by the enactment of §10101 of Pub. L. No. 117-169, 136 Stat. 1818, 1818-1828 (Aug. 16, 2022), commonly referred to as the Inflation Reduction Act of 2022 (“IRA”).

[7] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, *www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two.htm*.

[8] *Altera Corp.*, CA-9, 2019-1 USTC ¶50,231, 926 F3d 1061 (2019), *rev’ing* 145 TC 91, Dec. 60,354 (2015), *cert. denied*, SCt, 141 SCt 131 (2020); *3M Co.*, 160 TC No. 3, Dec. 62,159 (2023).

[9] Code Sec. 351(a) provides that no gain or loss will be recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control, as defined in Code Sec. 368(c), of the corporation.

[10] Code Sec. 361(a) provides that no gain or loss will be recognized to a corporation a party to a reorganization upon exchange of property in pursuance of a plan of reorganization solely for stock or securities in another corporation a party to the reorganization.

[11] Code Sec. 367(d)(2)(A); Reg. §§1.367(d)-1T(c), (d), and (f).

[12] Code Sec. 367(d)(2)(A) (flush language).

[13] *See* Reg. §1.367(d)-1T(c)(1).

[14] *See* Reg. §1.367(d)-1(c)(3)(ii).

[15] *See* Notice 2012-39, 2012-31 IRB 95.

[16] More recently, the IRS released a general advice memorandum providing that Code Sec. 367(d) prohibits taxpayers from making advance payments of annual inclusions, except in certain limited circumstances, notably,

under the circumstances identified in Notice 2012-39, but does not itself refer to CWI. *See* AM 2022-003 (Sep. 23, 2022).

[17] In addressing an estate tax provision, Justice Oliver Wendell Holmes Jr. famously observed that "a page of history is worth a volume of logic." *New York Trust Co. v. Eisner*, SCt, 1 USTC ¶49, 256 US 345, 349, 41 SCt 506 (1921).

[18] Congress amended Code Sec. 367(d) in 1984 to provide that a transfer of IP to a foreign corporation in an exchange under Code Sec. 351 or a reorganization under Code Sec. 361 "would be treated as a sale of the intangibles." House Report, page 422. *See* §131 of Pub. L. No. 98-369, 98 Stat. 662, Deficit Reduction Act of 1984 (Jul. 18, 1984). The House Report further provided that "Section 367(d) provides that the amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. In general, the amounts are treated as received over the useful life of the intangible property on an annual basis. Thus, a single lump-sum payment, or an annual payment not contingent on productivity, use or disposition, cannot be used as the measure of the appropriate transfer price." House Report, at page 422.

[19] Notice 88-123, 1988-2 CB 458 (the "White Paper"). The White Paper was in response to a recommendation by Congress that the Treasury and IRS conduct a comprehensive study of intercompany pricing rules and whether the then current Code Sec. 482 regulations should be modified as a result of the amendments to Code Sec. 482 in 1986.

[20] JCT Report, at page 1015.

[21] *Id.*

[22] White Paper, at page 21.

[23] *Id.*, at page 23.

[24] House Report, at page 423.

[25] *See id.* Indeed, Congress noted that the "problems are particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items." *Id.*, at page 424.

[26] *See* Code Sec. 951A(b)(2). Net deemed tangible income return represents 10 percent of depreciable assets less certain net interest expense taken into account in determining tested income.

[27] *See* Code Sec. 951A(b)(1); Code Sec. 250. Unlike the subpart F regime, which applies on a separate CFC basis, GILTI is computed with regard to all the CFCs of the U.S. shareholder.

[28] Code Sec. 951(a).

[29] Code Sec. 245A.

[30] Code Sec. 250. *See also* Reg. §1.250(b)-3(b)(16).

[31] House Report, at page 423.

[32] *Id.*

[33] *Id.*, at page 425.

[34] *Id.*

[35] *Id.*, at page 424.

[36] *Id.*

[37] House Report, at pages 424 and 425.

[38] *See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations © OECD*, 2022 Edition. *See also* OECD (2018), *Guidance for Tax Administrations on the Application of the Approach to Hard-to Value Intangibles—BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project*, OECD, Paris. *www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf*.

[39] House Report, at page 425.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] AM 2007-007 (Mar. 23, 2007).

[44] House Report, at page 426. Similarly, in its initial decision in *Medtronic*, the Tax Court held that CWI under Code Sec. 482 did not require the application of a particular method such as the comparable profits method. *Medtronic, Inc.*, 111 TCM 1515, Dec. 60,627(M), TC Memo. 2016-112 (2016), *vacated and remanded by*, *Medtronic, Inc.*, CA-8, 2018-2 USTC ¶50,379, 900 F3d 610 (2018), *decision on remand*, *Medtronic, Inc.*, 124 TCM 69, Dec. 62,094(M), TC Memo. 2022-84 (2022). Although the decision was vacated and remanded on appeal, this aspect of the court's reasoning was not questioned. *See* Mark Martin & Mark Horowitz, *'Medtronic v. Commissioner': A Taxpayer Win on Transfer Pricing, Commensurate with Income, and Section 367 Issues,* 45 TAX MGMT. INT'L J. 651 (Nov. 11, 2016) (discussing CWI and the court's reasoning); Mark Martin, Mark Horowitz, & Thomas Bettge, *Vacated and Remanded: Clouded Issues and Silver Linings in the Eighth Circuit's 'Medtronic' Opinion*, 163 DTR 11 (Aug. 22, 2018) (discussing the implications of the remand for the CWI issue).

[45] House Report, at page 426.

[46] *Id.*

[47] White Paper, at page 23.

[48] *Id.*, at page 21.

[49] *Id.*

[50] *Id.*

[51] White Paper, at page 23.

[52] *Id.*

[53] For one view on this, *see* Avi-Yonah *et al.*, *Commensurate With Income: IRS Nonenforcement Has Cost $1 Trillion*, 179 TAX NOTES FEDERAL 1297 (May 22, 2023).

[54] *E.g.*, Finley, *The Expanding Altera Effect: Are Periodic Adjustments Next?*, TAX NOTES TODAY INT'L (Nov. 19, 2018); "Law Firm Comments on OECD Transfer Pricing Project," Tax Notes Today International (Sep. 24, 2010); Elliott, *Commensurate With Income, Arm's-Length Standards Should Be Applied Together, Musher Says*, TAX NOTES TODAY FEDERAL (Jul. 14, 2010) (reporting a debate on this question); *ABA Members Comment on Proposed Cost-Sharing Regs*, TAX NOTES TODAY FEDERAL (Dec. 6, 2006).

[55] For a different take on CWI, *see* Ryan Finley, *The Commensurate with Income Standard's Ambiguity in Context*, 180 TAX NOTES FEDERAL 892 (Aug. 7, 2023) and Ryan Finley, *3M and the Renaissance of the Commensurate With Income Standard*, 178 TAX NOTES FEDERAL 1095 (Feb. 20, 2023).

[56] Notice 88-123, 1988-2 CB 458.

[57] *E.g.*, *Medieval Attractions N.V.*, 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455 (acknowledging the CWI standard, which the taxpayers sought to invoke, but holding that the purported transfers of intangible property were shams; the opinion therefore did not address the application of CWI); *S.D. Podd*, 75 TCM 2575, Dec. 52,765(M), TC Memo. 1998-231 (noting that CWI authorized the court to "consider the *actual* profits realized by the transferee through its use of the intangible property" and finding an apparent contradiction of the 1968 regulations' focus on prospective profits).

[58] *Xilinx Inc.*, 125 TC 37, 56-57, Dec. 56,129, *aff'd*, CA-9, 2010-1 USTC ¶50,302, 598 F3d 1191 (2010).

[59] *Altera Corp.*, CA-9, 2019-1 USTC ¶50,231, 926 F3d 1061 (2019), *rev'ing* 145 TC 91, Dec. 60,354 (2015), *cert. denied*, SCt, 141 SCt 131 (2020).

[60] *Altera Corp.*, CA-9, 2018-2 USTC ¶50,344 (2018), *withdrawn by* 898 F3d 1266 (2018).

[61] The regulations applicable during the years at issue have since been redesignated as Reg. §§1.482-7A(a)(3) and (d)(2). The equivalent provisions under the current regulations are Reg. §§1.482-7(a)(4) and (d)(3).

[62] 926 F3d at 1083.

[63] *Id.* at 1086.

[64] *3M Co.*, 160 TC No. 3, Dec. 62,159 (2023).

[65] T.D. 8552, 59 FR 34972 (Jul. 8, 1994).

[66] For discussion of the nature of the blocked income problem, *see* Mark R. Martin & Thomas D. Bettge, *The Blocked Income Problem in Transfer Pricing*, 171 TAX NOTES FEDERAL 1935 (Jun. 21, 2021).

[67] 160 TC No. 3 at *246.

[68] *Id.* at *281 (Copeland, J., concurring in the result).

[69] *Id.*

[70] Code Sec. 482 (emphasis added).

[71] Code Sec. 367(d)(2)(A).

[72] Reg. §1.482-1(a)(3). *See* AM 2007-007 (Mar. 23, 2007) ("a taxpayer may not invoke section 482 as grounds for making a hindsight, so-called 'CWI' adjustment").

[73] Although many U.S. treaties authorize the competent authorities to negotiate with respect to penalties, in practice this seldom occurs.

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