INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-108926-08

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Amount A =
Amount B =
Business A =
Corporation K =
Corporation L =
Corporation M =
Corporation N =
Corporation O =
Corporation P =
Corporation Q =
Corporation R =
Country Y =
Date 1 =
DE =
Partnership =
Region X =
Taxpayer =

Year 1	=	
$C	=	
$D	=	
X%	=	
Y%	=	

ISSUE(S):

1. Whether the Network, associated with Business A, is a type of intangible property described in section 936(h)(3)(B)?

2. Whether Corporation M's transfer of the Network to Corporation O is exempt from section 367(d) on the grounds that the Network represents foreign goodwill or going concern value, as defined in Treas. Reg. §1.367(a)-1T(d)(5)(iii)?

CONCLUSION(S):

1. The Network is a type of intangible property described in section 936(h)(3)(B).

2. The Network does not represent foreign goodwill or going concern value, as defined in Treas. Reg. §1.367(a)-1T(d)(5)(iii). Therefore, Corporation M's transfer of the Network to Corporation O is subject to section 367(d).

FACTS

I. The Transaction

At the time of the transaction at issue (the "Transaction"), Taxpayer, a domestic corporation, owned all of the stock of Corporation K and Corporation L. Corporation L owned all of the stock of Corporation M, which owned all of the stock of Corporation N. Corporations K, L, M, and N were members of Taxpayer's consolidated group. Corporation M operated Business A in Region X and had developed, over the course of operating this business, a network of contracts with a large number of foreign agents in numerous countries ("Network").

On Date 1 of Year 1, Taxpayer reorganized its business model and centralized its Business A outside of the United States. Specifically, Corporation M created a wholly-owned subsidiary, Corporation O, located in Country Y. Corporation O set up three controlled foreign corporations ("CFCs") as defined in section 957(a), Corporation P, Corporation Q, and Corporation R, which formed a partnership ("Partnership"). Corporation M then transferred all of the assets of Business A, except for the accounts receivable, to Corporation O. The transferred assets included intercompany services agreements, cash, software, and the Network. Corporation O subsequently transferred these assets to Corporations P, Q, and R, which in turn transferred the assets to

Partnership. After the Transaction, DE, an entity disregarded as separate from its owner, Partnership, conducted Business A. Corporation N licensed trademarks to Corporation K, which sublicensed these trademarks to Partnership.

II. Taxpayer's Business and the Network

Business A is a delivery business that allows a customer to have units transferred from one location to another location. The Network comprises contracts with a large number of foreign agents in numerous countries. The contracts are typically for a five-year term, subject to renegotiation and renewal, and obligate the agents to provide delivery services to the public on behalf of Taxpayer. Agents are not typically given exclusive rights within a territory. Agents receive a commission for their services. Agents may recruit and contract with sub-agents to help them provide the Business A service in their areas, subject to Taxpayer's approval. Taxpayer's standard contracts with its agents require that the agents set up call centers that are open twenty-four hours a day for customers to call and inquire about their deliveries. The contracts also require that the agents spend at least X% of their gross revenue from Business A on marketing the Business A service. Taxpayer often voluntarily reimburses up to Y% of these expenses. Taxpayer must approve all marketing campaigns and materials. The agents must purchase computers and equipment as specified by Taxpayer to conduct the deliveries. They must buy forms for the customers to use, the formats of which are specified by Taxpayer. Agents are prohibited from adding charges or providing discounts on the fees established by Taxpayer. The agents also agree to a non-compete provision that prohibits them from offering a competing service during the period of the contract plus one year.

Taxpayer provides the agents with detailed service manuals and requires in the contracts that the agents adhere to the standards outlined in those manuals. Taxpayer provides training for the agents and also provides regional operations centers to support the agents. Taxpayer handles the processing of the delivery requests, provides accounting of all the Business A transactions, and also settles the amounts owed between agents for these transactions.

Before the Transaction, Taxpayer had also established several CFCs that provided support to foreign agents and managed the development of agent relationships by recruiting and training new foreign agents. In the approximately nine years preceding the Transaction, Taxpayer's number of foreign agents grew significantly, from Amount A to Amount B (a more than twenty-fold increase).

III. Taxpayer's Return Position Regarding the Transaction

On its return filed for Year 1, Taxpayer took the position that Corporation M's transfer to Corporation O of the assets associated with Business A qualified as a section 351 exchange. On its Form 926, Taxpayer treated the Network as part of the goodwill associated with, and the going concern value of, Business A. It reported that the value of the foreign goodwill and going concern value transferred to Corporation O was approximately $C, while the value of all other assets transferred to Corporation O was approximately $D. Thus, Taxpayer reported that the value of the foreign goodwill and going concern value was approximately ninety-seven percent of the total value of the Business A assets transferred in the section 351 exchange.

LAW

I. Section 367(d), in General

Section 367(d) requires a U.S. person that transfers intangible property to a foreign corporation in an exchange described in section 351 or 361 to take into income annual payments over the useful life of the intangible as though the transferor had sold the intangible for payments contingent upon productivity, use, or disposition of the property.[1] Further, the statute requires that the payments be commensurate with the income attributable to the intangible. Section 367(d)(2)(A). Thus, although sections 351 and 361 normally allow a transferor to exchange property for stock of a corporation without any recognition of gain, section 367(d) requires a U.S. person to recognize income when it exchanges intangible property for stock of a foreign corporation. The transferor must recognize such income regardless of whether the transferee corporation actually makes payments to the transferor.

Section 367(d) refers to section 936(h)(3)(B) for the definition of intangible property. Section 936(h)(3)(B) provides that the term "intangible property" means any:

(i) patent, invention, formula, process, design, pattern, or know-how;
(ii) copyright, literary, musical, or artistic composition;
(iii) trademark, trade name, or brand name;
(iv) franchise, license, or contract;
(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
(vi) any similar item,

which has substantial value independent of the services of any individual.

Thus, a U.S. person will be required to recognize annual payments under section 367(d) upon the transfer of any of these enumerated intangibles or similar items to a foreign corporation in an exchange described in section 351 or 361. These payments must represent an appropriate arm's length charge for the use of the property, and the charge is determined in accordance with the provisions of section 482 and regulations thereunder. Treas. Reg. § 1.367(d)-1T(c)(1).

Congress enacted section 367(d) because it thought it was inappropriate to allow a foreign corporation to earn deferred income from intangible property that was

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1 Except as otherwise noted, section references are to the Internal Revenue Code of 1986, as amended, and Treas. Reg. § references are to the Treasury Regulations promulgated thereunder.

developed by claiming significant expenses in the United States. See H.R. Rep. No. 98-342 (1984); S. Rep. No. 98-169, at 361 (1984) ("the transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.")

To prevent this mismatch between expenses that offset taxable income in the United States and deferred income in a foreign country, Congress enacted a regime to ensure a U.S. transferor of intangible property continues to be taxed on amounts commensurate with the income attributable to the transferred intangible. See § 1231(e) of Pub. L. No. 99-514 (adding the "commensurate with income" requirement to section 367(d)(2)(A)).

II. Exception for Transfers of Foreign Goodwill or Going Concern Value

Section 367(d) does not contain any statutory exceptions or special rules for transfers of particular types of intangibles. However, Congress stated in the legislative history to the enactment of section 367(d) that the transfer of goodwill or going concern value developed by a foreign branch did not represent the kind of abuse that it wanted to target by enacting this provision. S. Rep. No. 98-169, Vol. 1, p. 362 (1984). Nevertheless, the legislative history does not give any specific direction to exclude these items from section 367(d), and the accompanying Joint Committee report indicates only that such an exception would be provided in regulations "where appropriate."[2] Section 1.367(d)-1T(b), following on this legislative history, provides that section 367(d) and the regulations thereunder do not apply to the transfer of foreign goodwill or going concern value. For this purpose, "foreign goodwill or going concern value" is defined as "the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued." Treas. Reg. § 1.367(a)-1T(d)(5)(iii).

ANALYSIS

I. Overview of Taxpayer and IRS Positions

The IRS Exam team ("Exam") and Taxpayer have requested this TAM because of a disagreement over how to characterize the Network. Exam argues that the Network is an intangible asset described in section 936(h)(3)(B). Specifically, Exam argues that the Network is a collection of contracts, a franchise, a system, a method, a

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[2] General Explanation of H.R. 4710, 98th Congress (1984), p. 435 ("where appropriate, it is expected that the regulations relating to tainted assets and the special rule for intangibles will provide exceptions for this type of property"). The reference to regulations relating to tainted assets is to the provision in section 367(a)(3)(B)(iv) that excludes intangibles as defined in section 936(h)(3)(B) from the active trade or business exception of section 367(a)(3)(A). The reference to the special rule for intangibles is to section 367(d).

program, or a similar asset. See section 936(h)(3)(B)(iv) through (vi). Under this view, Corporation M's transfer of the Network to Corporation O is subject to section 367(d).

Taxpayer argues that the Network satisfies definitions of goodwill or going concern value derived from case law ("traditional definitions") and that these traditional definitions were intended to be used when applying section 367(d). Specifically, Taxpayer argues that the Network meets the definition of going concern value, defined as "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern," a vital part of which is "the ability of a business to continue to function and generate income without interruption as a consequence of a change in ownership." VGS Corp. v. Comm'r, 68 T.C. 563, at 592 (1977). Alternatively, Taxpayer argues that the Network meets the definition of goodwill, defined as "the expectancy of continued patronage" or the expectation that "the old customers will resort to the old place." See Boe v. Comm'r, 307 F.2d 339, 343 (9th Cir. 1962); Comm'r v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) (quoting Nelson Weaver Royalty Co. v. Comm'r, 307 F.2d 897 (5th Cir. 1962)).

Part II of this Analysis provides initial discussion of Issue 1 regarding whether the Network is intangible property described in section 936(h)(3)(B). We agree with Exam and conclude that the Network is intangible property described in section 936(h)(3)(B) because it satisfies the definition of several of the items specified under that section.

Part III of this Analysis discusses whether the "enhanced value" of the Network, as described by the Taxpayer,[3] corresponds to the intangibles described in Part II or to a separate asset that may qualify as foreign goodwill or going concern value. We conclude that the enhanced value of the Network is attributable to intangible assets discussed in Part II and does not constitute a separate asset.

Part IV of this Analysis addresses Issue 2, whether the Network represents foreign goodwill or going concern value. We conclude that the Network does not represent foreign goodwill or going concern value under the definition provided by Treas. Reg. §1.367(a)-1T(d)(5)(iii). In analyzing whether the Network represents foreign goodwill or going concern value, we discuss why the traditional definitions relied upon by Taxpayer do not apply.

In Part V of this Analysis we conclude that Corporation M's transfer of the Network to Corporation O is subject to section 367(d).

II. Whether the Network is Described in Section 936(h)(3)(B)

Section 936(h)(3)(B) lists intangibles that are subject to section 367(d). Although it does not specifically identify every conceivable type of intangible property, the breadth of this list suggests that it was intended to cover, at a minimum, all identifiable intangibles. This is reinforced by the fact that the list includes not only the enumerated

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[3] Taxpayer's letter dated March 25, 2008 at p. 11.

intangibles, but also "any similar item." Section 936(h)(3)(B)(vi). Thus, if the Network fits within the definition of one or more of the listed intangibles, or constitutes a similar item, its transfer must be subject to section 367(d) absent the possible application of the exception for foreign goodwill or going concern value.

The Network fits within the definition of several of the intangibles listed in section 936(h)(3)(B). In particular, the Network consists of a collection of contracts with foreign agents. The Network also satisfies the definition of several other listed intangibles, including a collection of "franchises," a "system," a "method," and a "procedure." Because these terms are not defined in sections 936 or 367 or the regulations thereunder, the common and ordinary use of the terms applies. See Amoco Production Co. v. Southern Ute Indian Tribe, 526 U.S. 865, 873-874 (1999).

A. The Network Constitutes a Collection of Contracts

The Network is founded on the contracts between Taxpayer and its agents. Contracts are specifically listed in section 936(h)(3)(B)(iv) and therefore constitute intangible property that is subject to section 367(d). Taxpayer agrees with this position but asserts that each contract separately has little value relative to the value of the Network as a whole. In fact, Taxpayer argues that the aggregate value of the separately valued contracts equals less than three percent of the value of the transferred Business A assets. Taxpayer then argues that the value of the relationships among the agents represents approximately ninety-seven percent of the value of the transferred Business A assets.

Although the Network comprises individual contracts, it functions as a single, integrated unit and therefore should be considered as a single asset rather than the sum of individual assets. There are many examples of circumstances in which it is more reliable to view a collection of assets in this manner. For instance, a business that purchases a new car does not treat a portion of the cost as goodwill to the extent the price of the car exceeds the sum of the values of the car's parts. Likewise, the business does not depreciate the car's separate parts but rather the car as a whole. Similarly, a group of individual patents that are used in combination to make a product may each have little value separately if the entire group of patents is necessary to make the product. Nevertheless, the group of patents has a value greater than the sum of its parts because it is the collection of patents that enables the holder to make a valuable product. This added value is attributable to the patents themselves and is not goodwill or going concern value. See, e.g., Kraft Foods Co. v. Comm'r, 21 T.C. 513 (1954) (discussed further in Part III below).

The value of the Network resides in the value of the contracts determined on an aggregate basis, as discussed further in Part III below. This value does not represent foreign goodwill or going concern value for purposes of section 367(d), as discussed in Part IV below.

B. The Network Constitutes a Collection of Franchises

The Network may also be described as a group of franchises that constitute a franchise operation. Although sections 936 and 367 and the related regulations do not define "franchise," there is a general definition of the term in section 1253(b)(1). That provision states that a franchise "includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area."[4] This definition is consistent with the ordinary meaning of the term. Webster's Third New International Dictionary, Unabridged (1986) ("Webster's") defines "franchise" to mean "the right granted to an individual or group to market a company's goods or services in a particular territory." The Tax Court, when considering whether a Federal Communications Commission ("FCC") license was a franchise under section 1253, stated "we read the word 'franchise,' as used in section 1253, broadly to mean 'franchises' as that term is commonly understood, including any agreement which gives one party the right to distribute, sell, or provide goods, services, or facilities within a specified area." Jefferson-Pilot Corp v. Comm'r, 98 T.C. 435, 441 (1992), aff'd, 995 F.2d 530 (4th Cir. 1993). Indeed, this definition has been applied in the context of other Code provisions that do not contain their own definition of "franchise."[5] Because the section 1253 definition reflects the common understanding of the term, because Congress did not indicate that it intended a different meaning, and because policy considerations do not favor a different meaning, that definition applies for purposes of sections 936(h)(3)(B) and 367(d) as well. The arrangements with the agents meet the definition of a franchise because the contracts give the agents the right to offer Taxpayer's Business A service in a defined area.

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[4] See also Rev. Rul. 87-63, 1987-2 C.B. 210.

[5] See Int'l Multifoods Corp. v. Comm'r, 108 T.C. 25, 38 (1997) (applying the section 1253 definition of "franchise" for purposes of section 865: "Since we find no indication that Congress intended "franchise" to carry a different meaning in the context of section 865, we adopt this definition for purposes of this section."); see also Treas. Reg. § 1.197-2(b)(10) (incorporating the section 1253 definition for purposes of section 197).

Taxpayer argues that this definition of "franchise" is too broad and that the ordinary meaning of "franchise" is "an agreement whereby the franchisor grants to the franchisee the right to operate a turnkey business for its own account."[6] Taxpayer cites no authority to support this narrow definition, however, which is at odds with the common meaning of franchise and the meaning provided in section 1253. This definition is also at odds with the case law applying the section 1253 definition broadly to include many arrangements not traditionally considered franchises, such as cable television franchises,[7] FCC broadcast licenses,[8] and the right of licensees to distribute computer programs.[9]

Finally, Taxpayer argues that a broad definition of "franchise" would contravene Congressional intent to exclude foreign goodwill and going concern value from the application of section 367(d).[10] This assumes that Congress intended that foreign goodwill and going concern value be defined broadly in a way that included most franchises; however, this argument is belied by the narrow definition of goodwill discussed below in Part IV. It is also belied by court opinions that view goodwill arising from a franchise operation as being attributable to the value of the franchise itself and not as a separate intangible.[11] In other words, case law directly contradicts Taxpayer's argument that the intangible commonly understood to be a franchise is, in fact, not a franchise but goodwill instead. The authorities reject such attempts to recharacterize franchise value as goodwill value.

Thus, the Network fits within the definition of "franchise" for purposes of section 936(h)(3)(B)(iv) and therefore is an intangible subject to section 367(d). As discussed further in Parts III and IV below, the value of the Network resides in the franchises as valued on an aggregate basis and does not constitute foreign goodwill or going concern value.

C. <u>The Network Constitutes a Method, Program, and Procedure</u>

The list of intangibles under section 936(h)(3)(B) also includes the items "method," "program," and "procedure." Webster's defines "method" to include "a procedure or process for attaining an object." It defines "program" to include "a

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6 Taxpayer's Letter dated March 25, 2008 at p. 20.

7 <u>Tele-Communications Inc. v. Comm'r</u>, 95 T.C. 495 (1990), <u>aff'd</u>, 12 F.3d 1005 (10th Cir. 1993).

8 <u>Jefferson-Pilot</u>, 98 T.C. 435, 441 (1992), aff'd, 995 F.2d 530 (4th Cir. 1993).

9 <u>Syncsort Inc. v. United States</u>, 31 Fed. Cl. 545 (1994).

10 Taxpayer's letter dated March 25, 2008 at p. 20.

11 <u>Canterbury v. Comm'r</u>, 99 T.C. 223, at 249 (1992) ("we find that petitioners acquired no goodwill that was separate and apart from the goodwill inherent in the McDonald's franchise"); <u>Int'l Multifoods</u>, 108 T.C. at 36-37 (noting that the taxpayer's argument that goodwill was transferred separately from a Mr. Donut franchise, trademarks, and system "mistakes goodwill for the intangible assets which embody it" and that "intangible assets such as trademarks and franchises are 'inextricably related' to goodwill").

schedule or system under which action may be taken toward a desired goal." Lastly, it defines "procedure" to include "a particular way of doing or going about the accomplishment of something." As their definitions indicate, these three terms are similar in that they all suggest a particular way or plan for accomplishing a goal.

The Network fits the definition of a method, program, or procedure. Taxpayer has designed a particular process for carrying out Business A, the foundation of which is the collection of contracts with its agents. The contracts require the agents to use specific software and equipment to conduct Business A transactions.[12] The contracts require agents to establish regional call centers for customer support. In addition to various other requirements, the contracts also specify that the agents will spend at least X% of their transaction fees on advertising for Business A and that all advertising must be approved by Taxpayer.

In short, the contracts embody Taxpayer's design for carrying out Business A. This particular way of doing Business A is thus a method, program, or procedure for purposes of section 936(h)(3)(B)(v) and therefore is an intangible subject to section 367(d).

D. The Network Constitutes a System

Finally, we agree with Exam that the Network comprises a "system" within the meaning of section 936(h)(3)(B)(v). Webster's defines a "system," in part, as "a group of devices or artificial objects forming a network or used for a common purpose…" and "a set of units combined by nature or art to form an integral, organic, or organized whole." The Network fits this definition because it is an organization of agents forming an integrated delivery network serving the common purpose of engaging in Business A. The agents are integrated because of the interrelationship among the worldwide locations through which Taxpayer conducts Business A. A single agent location could not conduct Business A because there must be at least two locations for a Business A transaction to take place. Furthermore, each additional agent location that is added to the Network confers a benefit to existing locations as well, by adding new customers located in that area, and by enabling customers in other countries to engage in Business A transactions with customers in the new area. Because each agent location is connected to and relies upon the others to conduct Business A, it is apparent that the Network represents an integrated "system" for purposes of section 936(h)(3)(B)(v).

E. Taxpayer's Argument that Network is Neither a System, Method, Program, Nor Procedure is Not Persuasive

Taxpayer makes several arguments that the Network is neither a system, method, program, nor procedure. For example, Taxpayer states "any manuals or procedures assembled by [Taxpayer] for its agents in the ordinary course of business

[12] Taxpayer acknowledges the software is subject to section 367(d).

arguably might be considered a system," but goes on to state that the collection of agents cannot be viewed as a system because to define "system" so broadly would capture items that are neither proprietary nor commercially transferable.[13] As we understand Taxpayer's first argument, a system, method, program, or procedure must have a commercially transferable value to be an intangible under section 936(h)(3)(B); that is, they must be something for which someone else would pay consideration.[14] We believe that Taxpayer's intangibles, whether labeled as a method, program, procedure, or system, do have value, but we do not undertake to value them here. Nevertheless, we note that if Taxpayer is correct that these assets have no value and do not generate income, then whether or not they are intangibles under section 936(h)(3)(B) makes no difference because they will not result in a deemed payment under section 367(d). And if they do have value, then Taxpayer's argument for excluding these assets from section 367(d) fails.

Further, Taxpayer argues that the way in which it conducts Business A is not proprietary and does not share with any of the intangibles listed in section 936(h)(3)(B) the common characteristic of being legally protected or subject to legal protection as a matter of contract.[15] This argument is premised on two apparently incorrect assumptions. First, Taxpayer assumes that the way in which it conducts Business A is not proprietary and, therefore, valueless. However, the course of conduct between Taxpayer and its agents suggests the Network is indeed proprietary. Taxpayer exercises control over who joins the Network and the services they provide and prohibits agents from working for a competitor. That Taxpayer's competitors in Business A also have their own networks does not mean that Taxpayer's network is not proprietary and therefore without value. Second, Taxpayer assumes that legal protection is a necessary characteristic of section 936(h)(3)(B) intangibles. It is well recognized that valuable intangibles may not be legally protected, for example, in the form of a patent. A taxpayer that develops a patentable formula or process may choose not to seek a patent. In so doing, the taxpayer takes the calculated risk that it will be able to successfully protect its formula or process without the legal protection of a patent in exchange for the possibility that the taxpayer will have a monopoly on that formula or process for a longer period than patent protection would provide. Yet still, a taxpayer may very well resort to private contracts if it seeks legal protection. Whether the taxpayer has the legal protection of a patent (or of a contract) does not affect the fact that the taxpayer has valuable know-how and trade secrets that meet the section 936(h)(3)(B) definition of intangible.

Taxpayer also argues that Exam's characterization of the Network is analogous to the government's assertion in <u>Merck & Co. v. United States</u>, 24 Cl. Ct. 73 (1991) that Merck's affiliate structure, pricing mechanism, and group wide planning structure was

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13 Taxpayer's letter dated March 25, 2008, p. 24.

14 Taxpayer's letter dated March 25, 2008, p. 25.

15 Taxpayer's letter dated March 25, 2008, p. 24.

an intangible. There, the court stated, “Defendant’s intangible property argument essentially is no more than a recognition that Merck is the parent of the foreign affiliates and MSDQ.” Id. at 88. The court rejected the argument that that relationship constituted a method, program, or procedure or any other asset subject to section 482. However, Exam does not assert, nor do we conclude, that Taxpayer’s role as the parent of DE or any other entity is itself an intangible that is subject to section 367(d). Rather, the intangible in this case consists of the methods and programs discussed above, which relate to how the agents actually carry out Business A in a carefully coordinated manner. These are not simply a function of Taxpayer’s particular corporate structure. Therefore, Merck & Co. is inapposite.

Finally, Taxpayer makes two statutory construction arguments to support its view that the Network does not constitute a “method,” “program,” “procedure,” or “system” under section 936(h)(3)(B).[16] First, it argues that under the doctrine expressio unius est exclusio alterius (to express one thing is to exclude others), the intangibles enumerated in section 936(h)(3)(B) are the only intangibles covered by the statute and because the Network is not specifically listed there, it is not subject to section 367(d). This argument is flawed on its face because section 936(h)(3)(B) includes not only the listed intangibles but also the category “or other similar item,” which clearly would include the Network because it is at least similar to many of the listed items as described above. Second, Taxpayer argues that the term “system” cannot be understood as including the Network because of the doctrine of noscitur a sociis, which requires that terms in a statute be interpreted by reference to the surrounding words. It argues that because the term “system” is accompanied in the statute by “method,” program,” and “procedure,” we must interpret “system” as including “an organized and established procedure” but nothing more. This interpretation would require us to conclude that the other terms found in the same clause, including “campaign, survey, study, forecast, estimate, customer list, or technical data,” also must mean only “an organized and established procedure,” which cannot be correct. If Congress had wanted to encompass only those qualities that these various terms share in common, it would have provided a clearer and narrower definition rather than a list of apparently unrelated terms. Moreover, both of these statutory construction arguments fail for the reason that they would render other parts of the statute meaningless, which violates the more general rule of statutory construction that all terms in a statute should be given effect.[17]

Therefore, the Network is a system, method, program, or procedure that is a section 936(h)(3)(B) asset and is therefore subject to section 367(d).

III. Whether the Network is Valued as a Single Intangible

[16] Taxpayer’s letter dated March 25, 2008, pp. 21-23.

[17] Mason v. United States, 260 U.S. 545, 554 (1923) (noting that a canon of statutory construction “cannot be employed to render general words meaningless, since that would be to disregard the primary rules, that effect should be given to every part of a statute…”).

Taxpayer argues that although the contracts that comprise the Network are subject to section 367(d), the vast majority of the Network's value is not attributable to the contracts and is instead foreign goodwill or going concern value.[18] Exam argues that the Network's value is attributable to the intangibles that comprise it. We agree with Exam for three reasons. First, the Network should be analyzed and valued as a single intangible asset, as explained in Part II above, because it operates as an integrated whole. Second, the appropriate charge that Taxpayer must include in income under section 367(d) upon its transfer of the Network is determined under section 482 principles. Treas. Reg. §1.367(d)-1T(c)(1). Those principles militate in favor of valuing the Network as an integrated asset rather than as the sum of individual contracts valued separately outside the context of the Network.[19] Third, case law supports a conclusion that it is appropriate to value interrelated assets in the aggregate and that the synergistic value of a collection of assets is attributable to those assets rather than a conceptually distinguishable goodwill or going concern value element.

A. Applicable Section 482 Principles Require the Network to be Valued on an Aggregate Basis Rather Than on an Item-by-Item Basis

The charge that Taxpayer must include under section 367(d) is determined using section 482 principles. As discussed above, a U.S. person that transfers intangible property to a foreign corporation in a transaction subject to section 367(d) shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arm's length charge for the use of the property. Treas. Reg. § 1.367(d)-1T(c)(1). The appropriate charge is determined in accordance with the provisions of section 482 and regulations thereunder. Id. Taxpayer must adopt the most reliable method of determining the arm's length consideration for a controlled transaction(s) pursuant to Treas. Reg. § 1.482-1(f)(2)(i), which provides,

> The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in Treas. Reg. § 1.6038A-3(c)(7)(vii).

Corporation M's transfer of the foreign agent contracts can be viewed as either a single controlled transaction or as multiple controlled transactions. Because both Corporation M and Corporation O constitute "controlled parties" within the meaning of section 482, the transfer of the contracts could be viewed as part of a single "controlled

[18] Taxpayer's letter dated March 25, 2008, p. 11.

[19] Furthermore, it may also be the case that other identifiable intangibles transferred to Corporation O, such as the software, are so inextricably related to the contracts that it is more reliable to value them with the contracts on an aggregate basis.

transaction." Under this view, the appropriate arm's length charge would be determined as though Corporation M had transferred a single asset, that is, the collection of contracts, to Corporation O. This single controlled transaction approach also applies if the transfer is viewed as a transfer of a collection of "franchises," or as a transfer of a single "system, method, program, or procedure." Alternatively, the transfer could be viewed as though Corporation M separately transferred each contract to Corporation O. Under this alternative view, the transfer would be viewed as numerous "controlled transactions" under section 482.[20]

It is more reliable to determine the arm's length consideration for the transfer of the contracts by considering the separate contracts "as a whole" because they are "so interrelated." See Treas. Reg. § 1.482-1(f)(2)(i). First, before the transfer, a single company, Corporation M, used the contracts as an integrated network to conduct Business A. The individual contracts were not used for separate business purposes or by separate legal entities. Instead, they all were used as part of a single business enterprise and by a single legal entity. Moreover, these numerous contracts were transferred together -- as a single network -- to a single legal entity, Corporation O, so that after the transfer, the contracts would continue to be used in a single business enterprise. As a matter of economic reality and fundamental valuation principles, a taxpayer transferring Network at arm's length would conclude that the contracts should be valued in the aggregate in a manner that properly reflects their synergistic relationship. The numerous contracts are used as a single integrated asset, so it would be inappropriate to value the contracts as separate, stand-alone assets when they have functioned in the past, and will function in the future, as a single asset. Treas. Reg. § 1.482-1(f)(2)(i) recognizes such economic realities by providing that multiple transactions should be considered a single transaction "if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration."

B. Interrelated Assets Must be Treated as an Aggregate, and Enhanced Value of Similar Assets is Attributable to Those Assets, Not Foreign Goodwill or Going Concern Value

The Tax Court has recognized that multiple, related assets may be most appropriately viewed as an aggregate. In cases addressing the acquisition of a collection of related patents, the court has had to determine whether a taxpayer had a depreciable basis in the patents and over what period that basis could be recovered. See, e.g. Kraft Foods Co. v. Comm'r, 21 T.C. 513 (1954). In Kraft, the Tax Court held that a group of thirty-one related patents must be valued as a group and that the useful life for depreciation should be based on the average of the patents' useful lives. Specifically, the court observed:

[20] Alternatively, if the contracts are viewed as "franchises," then the transfer could also be viewed as though Company M transferred each franchise to Company N.

> [W]e agree with the parties that it is not possible to determine the cost of each patent separately. It is undoubtedly true, as the respondent suggests, that some of the patents are worth more than others … In the circumstances here, however, it is not possible to determine within the group, particularly those which are functionally related, where the scope of one patent ends and the other begins. Rather obviously, there is an overlapping and the second or third patent would not have been what it was except for matters covered by those which preceded it.

Id. at 592-93. See also Standard Conveyor Co. v. Comm'r, 25 BTA 281, 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination.").

Thus, because the contracts comprising the Network are interrelated, and the value of the Network arises largely from the value of the connections among the agents, it is more appropriate to value the Network as a single unified intangible than as a collection of discrete intangibles treated artificially as having no economic connection to one another. Taxpayer challenges this aggregate valuation of the Network by arguing that each individual contract has little value. Taxpayer argues that the "enhanced value" of the Network is not attributable to the value of the contracts between Taxpayer and the agents, but rather to the value of the "interlocking relationship" among the agents, which is goodwill and going concern value.[21]

We agree that a substantial portion of the value relating to the Network is due to the number and integration of the numerous separate agent locations. And it is true that a contract corresponding to a single agent location would have little value in itself because there must be at least two locations -- a sending point and a receiving point -- for a delivery system to exist. But the critical integration of thousands of agents and contracts is a result of Taxpayer's risky but successful efforts to develop a highly valuable network that serves as the backbone of its business. We disagree with Taxpayer's position because it disregards the fact that Taxpayer developed the Network as the central intangible for carrying on its business and generating profits and erroneously assigns the labels goodwill and going concern value to that readily identifiable intangible.

The enhanced value of a collection of similar assets, like the contracts (or franchises) at issue here, is attributable to those collected assets and is not separate goodwill or going concern value. For example, in Computing and Software, Inc. v. Comm'r, 64 T.C. 223, (1975), the taxpayer was in the credit reporting business. It acquired the assets, including credit files of three other credit reporting companies. The credit files consisted of individual index cards that held each credit record. While the individual cards probably had little value in themselves, the value of the file collection as a whole was assigned a value of over $1.8 million by the court. Had the court adopted

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[21] Taxpayer's letter dated March 25, 2008 at p. 19.

the petitioner's approach, it would have included the enhanced value as part of the going concern value of the business and therefore would have allocated little or nothing to the credit files themselves. Because the court instead included that enhanced value in the depreciable basis of the credit card files, it is clear that the court considered that enhanced value as part of the value of the card files and not separate goodwill or going concern value.

Likewise, in Massey-Ferguson, Inc. v. Comm'r, 59 T.C. 220 (1972), the taxpayer acquired Mid-Western Industries (MI), a developer of light industrial equipment. Among the assets of MI that the taxpayer acquired was the distribution network through which MI sold most of its products. This distribution network consisted of contracts with eighteen general line distributors. A few years after the acquisition, the taxpayer decided to abandon the distribution network. The last of the contracts with the distributorships was canceled in the taxpayer's 1961 tax year, though some had been terminated in the previous year. The court determined that the taxpayer was entitled to an abandonment loss for the entire network on its 1961 return because that is the year in which the entire asset was abandoned. The court observed: "In the present case, an entire asset, the distributorship system, was abandoned, and the entire intangible value of the system was lost." Massey-Ferguson, 59 T.C. 220, 227. While that case did not involve the issue of enhanced value, it is nevertheless clear that the court treated the distributor network based on multiple contracts as a single asset, rather than as simply a collection of separate contractual arrangements.

Taxpayer's attempt to atomize the Network so that the vast majority of the value of the intangible would escape taxation under section 367(d) is inconsistent with sections 367 and 482, as well as the applicable regulatory framework.[22] Rather, like a pool of interrelated patents, the interrelated agent contracts must be analyzed for transfer pricing purposes in the aggregate. The enhanced value arising from the collection of contracts is attributable to the contracts themselves and is not goodwill or going concern value. Because the value of the Network is attributable to the group of contracts, it is subject to section 367(d).

IV. Whether the Network Represents Foreign Goodwill or Going Concern Value

Taxpayer asserts that the transfer of the Network is not subject to section 367(d) because it qualifies for the exception for transfers of "foreign goodwill or going concern value" under Treas. Reg. § 1.367(d)-1T(b). We disagree with Taxpayer's position for several reasons. The Network cannot satisfy the section 367(d) definition of foreign goodwill or going concern value because the Network, as was explained in Parts II and III, constitutes a single intangible asset or a collection that falls within one or more of the categories listed in section 936(h)(3)(B).

[22] The preceding analysis focused on numerous transfers of individual contracts, but this analysis would also apply to numerous transfers of franchises, systems, methods, processes or procedures.

Furthermore, Taxpayer's insistence that traditional definitions of goodwill and going concern value be applied in the section 367(d) context is flawed because the traditional definitions are too broad. Even in the context of depreciation (from which the traditional definitions were derived), the inquiry of whether an asset satisfies the traditional definitions of goodwill and going concern value has proven unworkable and was therefore abandoned. See Newark Morning Ledger v. United States, 507 U.S. 546, 570 (1993).

A. The Network Is Not Foreign Goodwill or Going Concern Value Under the Regulations

As described in Parts II and III, the Network constitutes a single intangible or a collection under section 936(h)(3)(B). Thus, to treat the Network as being part of foreign goodwill or going concern value is inconsistent with the narrow definition of "foreign goodwill or going concern value" under the regulations. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines foreign goodwill or going concern value 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." This definition specifically excludes "all other . . . intangible assets . . . identified and valued" ("identifiable intangibles"). The Network constitutes such an identifiable intangible because, as explained in Part II, the Network falls within one or more categories of intangible property as described in section 936(h)(3)(B), and as explained in Part III, the Network is most reliably valued as a single asset. The Network, therefore, must be excluded from the regulatory definition of "foreign goodwill or going concern value."

The regulations' definition of foreign goodwill or going concern value does not depend upon the traditional definitions of goodwill or going concern value. The regulations avoided traditional definitions because such definitions ultimately proved unworkable in the depreciation context. When the section 367(d) regulations were promulgated, taxpayers and the IRS were engaged in bitter and costly disputes concerning the concepts of goodwill and going concern value because, at that time, goodwill and going concern value were non-depreciable assets. See generally H.R. Rep. No. 103-111 at 760 (1993) (describing disputes that led Congress to enact section 197, which mitigated these disputes by allowing for the amortization of intangibles such as goodwill and going concern value). With those well-known disputes in the background, the drafters of the regulations chose to define foreign goodwill or going concern value in a way that did not rely upon such controversial terms.[23]

Despite this well-known history, Taxpayer nevertheless asks us to ignore the regulations' approach and dive back into the abyss of the decades-old disputes about

[23] The section 367(d) approach echoes the method that was, at about the same time, mandated under sections 338 and 1060. Under the section 338 and 1060 approach, any excess paid for a trade or business over the fair market value of the identifiable assets must be allocated to goodwill and going concern value. See S. Rep. No. 313, 252-253 (1986); see also T.D. 8215, 1988-2 C.B. 304.

what constitutes goodwill or going concern value under the traditional definitions. Taxpayer argues that when Congress expressed its intent in the legislative history to exclude foreign goodwill or going concern value from the application of section 367(d), it had the traditional definitions in mind. Taxpayer argues that the definition under the regulations was drafted against the same "jurisprudential backdrop" as these cases.[24]

We disagree with Taxpayer's argument. The traditional definitions are fundamentally inconsistent with the regulations' definition of foreign goodwill or going concern value.[25] The traditional definitions encompassed, among other things, customer-based intangibles that are specifically listed under section 936(h)(3)(B), like customer lists and trademarks.[26] As explained above, such identifiable intangibles are clearly excluded from the section 367(d) definition of "foreign goodwill or going concern value."

The Supreme Court's findings in Newark Morning Ledger ("Newark") support the conclusion that the traditional definitions are too broad to be relied upon for purposes of section 367(d). In Newark, the Court concluded that a newspaper subscriber list was depreciable because it was "an intangible asset with an ascertainable value and a limited useful life."[27] Under a section 367(d) analysis, this customer list would constitute an identifiable intangible that would be excluded from the regulations' definition of "foreign goodwill or going concern value." See section 936(h)(3)(B)(v). The Court, however, also found that the customer list depended upon the continued and voluntary patronage of customers,[28] which is a typical formulation of the traditional definition of goodwill and going concern value. Newark shows that the traditional definitions of goodwill and going concern value are too broad for section 367(d)

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24 Taxpayer's letter dated March 25, 2008 at p. 8-9.

25 For example, under the traditional definition, goodwill was "a useful label with which to identify the total of all the imponderable qualities that attract customers to the business." Newark Morning Ledger v. United States, 507 U.S. 546 at 555-56 (1993). By focusing on the effect of goodwill in enhancing the customer relationship, this definition gave goodwill a substantive meaning. Thus, intangibles such as trademarks could be considered assets "in the nature of goodwill" under this case law. Comm'r v. Killian, 314 F.2d 852 (5th Cir. 1963) (describing information on fire and casualty policies as an asset "in the nature of goodwill"). Cf. Newark at 556 ("This definition … is of little assistance to a taxpayer trying to evaluate which of its intangible assets is subject to a depreciation allowance. The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage."). Indeed, some regulations also adopted a similar formulation. See T.D. 8072 (Temporary Regulations under Section 338(b)(5)), 1986-1 C.B. 111 (establishing the Class IV residual category for "intangible assets in the nature of goodwill and going concern value").

26 Richard S. Miller v. United States, 537 F.2d 446, 450 (Ct. Cl. 1976) ("Goodwill sometimes is used to describe the aggregate of all of the intangibles of a business, including such items as patents, trademarks, leases, contracts, and franchises.").

27 Newark Morning Ledger, 507 U.S. 546, 566.

28 Id. at 557.

purposes because certain intangible assets, such as a customer list, may be included in the traditional definitions but nevertheless excluded from the section 367(d) definition.[29]

In support of its reliance on the traditional definitions of goodwill and going concern value, the Taxpayer cites to several early depreciation cases.[30] See e.g., Northern Natural Gas Co. v. United States, 470 F.2d 1107 (8th Cir. 1973); Black Industries v. Comm'r, 38 T.C.M. 242 (1979); Phillip Morris v. Comm'r, 96 T.C. 606 (1991). These cases dealt with the question of what assets of an acquired business a purchaser could depreciate.[31] Taxpayer's reliance on these cases is misplaced because these cases do not employ a substantive definition of goodwill and going concern value. Rather, they tend to conclude that all non-depreciable assets were goodwill or going concern value, even if they were intangibles described in section 936(h)(3)(B).[32] By treating all non-depreciable assets as goodwill or going concern value, these cases gave goodwill and going concern value a meaning that is much broader than their meaning under section 367(d). See, e.g., Northern Natural Gas Co. v. United States, 470 F.2d 1107 (8th Cir. 1973) (holding that certain assets were depreciable and that the remaining value of the business was non-depreciable but without specifically labeling it as goodwill or going concern value); VGS Corp. v. Comm'r, 68 T.C. 563 (1977) (holding that tangible assets were depreciable and that all remaining value was non-depreciable and therefore goodwill or going concern value).[33]

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29 As a further argument based on the traditional definition, Taxpayer asserts that the value associated with the location and reach of the Network is foreign goodwill. Taxpayer's letter dated March 25, 2008 at p. 14. It cites several cases in which courts observed that the location of a business is an element of goodwill because it contributes to the expectancy that customers will return to the old location. Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 681 (5^{th} Cir. 1971); L.A. Central Animal Hospital v. Comm'r, 68 T.C. 269 (1977); Metro Auto Auction of Kansas City, Inc. v. Comm'r, 48 T.C.M. (CCH) 894 (1984). Again, reliance on the traditional definition of goodwill misses the point, which is whether the Network is foreign goodwill under the section 367(d) regulations. Further, it is not clear that the "geographical footprint" of the Network is the type of "locational" goodwill described in these cases, which dealt with the purchase of established bricks-and-mortar businesses that were landmarks in the community and operated without interruption by the new owners.

30 Taxpayer's letter dated March 25, 2008 at pp. 11-14.

31 It is puzzling that the Taxpayer relies upon these depreciation cases for their definition of "goodwill or going concern value" given that it attempts to downplay the importance of a more relevant case, Newark, on the grounds that it only deals with depreciation. Taxpayer's letter dated March 25, 2008 at p. 16.

32 The cases cited by Taxpayer tend to employ a broad definition of goodwill and going concern value, but the scope of these definitions varies in some cases. Both the breadth of these definitions and their varying scope underscore that the application of the traditional definitions of goodwill and going concern value in the context of section 367(d) is unworkable. "In some cases [goodwill] has been used in a general sense to describe all intangible assets arising in connection with the operation of a business; in other cases, it has been used in a more limited sense to describe a single intangible asset." Massey-Ferguson, Inc. v. Comm'r, 59 T.C. 220 (1972). Thus, the assets defined in some of the depreciation cases were not strictly goodwill or going concern value but rather were considered to be assets "in the nature of" goodwill and going concern value.

33 See also Black Industries v. Comm'r, 38 T.C.M. 242 (1979) (holding that tangible assets were

The problem of using the terms “goodwill and going concern value” loosely to include all non-depreciable intangibles was highlighted in Newark. Because the Court held that the depreciability of the customer list at issue in that case turned on whether it had a useful life and ascertainable value, it did not look to whether it satisfied the traditional definition of goodwill.[34] Thus, Newark severed the historical nexus between whether an asset represents goodwill and whether the asset is depreciable. This had the effect of rendering irrelevant the early depreciation cases in so far as they used the term “goodwill and going concern value” as shorthand for any intangible that was non-depreciable. Thus, the cases that predate Newark treating a particular intangible as “goodwill” solely to make that intangible non-depreciable are not relevant in determining whether that intangible is “goodwill and going concern value” for other tax purposes, such as section 367(d).

B. Taxpayer’s Position Violates the Fundamental Policy of Section 367(d)

Taxpayer’s characterization of the Network violates the fundamental policy of section 367(d) because treating ninety-seven percent of the value of the Network as foreign goodwill or going concern value would allow a virtually tax-free transfer of valuable intangible property that was developed by incurring significant expenses that reduced income otherwise taxable in the United States. If Taxpayer’s view were the law, Corporation O would be free to exploit the value of the Network while earning deferred income. This is precisely the abuse Congress sought to address by enacting section 367(d). H.R. Rep. No. 98-342 (1984); S. Rep. No. 98-169 (1984), at 361 (“the transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.”)

Exam submitted a table demonstrating expenses that Taxpayer incurred over a period of ten years. Taxpayer disputes the amounts in the Table as misleading because they are not limited to expenses of Business A. Nonetheless, because Business A produces a very large portion of Taxpayer’s overall income, Business A is also likely responsible for a correspondingly large portion of Taxpayer’s overall expenses. Although it is not perfectly precise, Exam’s table is persuasive in showing that Taxpayer’s development of the Network, and Business A generally, relied upon incurring significant expenses that reduced income otherwise taxable in the United States. Thus, after reaping the benefits of offsetting income taxable in the United States

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depreciable and that intangibles were not depreciable, without distinguishing between types of intangibles, such as goodwill, going concern value, etc.); Phillip Morris v. Comm’r, 96 T.C. 606 (1991) (court admitted that the term goodwill, in the broad sense, encompasses a number of intangibles).

[34] Newark, 507 U.S. at 570 (“the relationship this asset may have to the expectancy of continued patronage is irrelevant, for it satisfies all the necessary conditions to qualify for the depreciation allowance under § 167 of the Code”).

with the expenses incurred to develop the Network, Taxpayer now seeks to claim, contrary to section 367(d) policy, that Corporation O will be free to earn deferred income from its exploitation of the Network.

The exception for foreign goodwill or going concern value was intended only to exclude from tax the goodwill or going concern value developed by a foreign branch, the development of which (at the time section 367(d) was enacted) never gave rise to a U.S. tax benefit. S. Rep. No. 98-169, Vol. 1, p. 362 (1984). Taxpayer's broad construction of this limited exception eviscerates the general rule.

V. Conclusion

The Network meets the definitions of a contract, system, franchise, method and program for purposes of sections 936(h)(3)(B) and 367(d). Taxpayer's contracts with the agents are best viewed as an integrated asset, and the value that arises from the collection of contracts is attributable to the contracts and not to foreign goodwill or going concern value. The exception for transfers of "foreign goodwill or going concern value" does not apply to the transfer of the Network because the Network does not constitute foreign goodwill or going concern value within the meaning of section 367(d). Not only does Taxpayer's characterization of the Network conflict with the regulatory definition of foreign goodwill or going concern value, but Taxpayer's treatment also violates the fundamental policy of section 367(d) because it allows for a virtually tax-free transfer of intangible property that was developed by incurring significant expenses that offset income otherwise taxable in the United States. In sum, Corporation M's transfer of the Network to Corporation O is subject to section 367(d).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.