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In this article, Antoon and Brewer discuss the implications of the Tax Cuts and Jobs Act's changes to the rules for valuing intangible property.

"You can't change the past."

We don't know who owns the copyright to that saying, but most of us have probably infringed on that intangible property (IP) right many times. A quick Google search will expose dozens of famous people for the same transgression. If nothing else, the sentiment expressed in the quote (whether copyrighted or not) seems to be universally accepted.

Undaunted by conventional wisdom, however, Congress appears to have engaged in an effort to change legislative history by means of subsequent legislation in the Tax Cuts and Jobs Act (P.L. 115-97). Specifically, the TCJA included a provision (section 14221) that appears to be an attempt to retroactively change the interpretation of code sections 367 and 482 regarding the required valuation method for the transfer of IP rights in the context of outbound restructuring transactions, as well as in intercompany transfer pricing arrangements.

We would note at the outset that the potential exposure addressed in this article is more likely to exist when the fair market value of the transferred IP is based, for tax purposes, on a valuation of the same IP that was conducted for financial reporting purposes. However, it is possible (although somewhat less likely) that the exposure may also exist when the IP was valued using standard transfer pricing methods applied in accordance with the principles in the regulations under code section 482 (like the comparable uncontrolled transaction method). For purposes of this article, we will discuss the former situation.

The Change in Question

The change relates to an issue regarding which the IRS has suffered some rather high-profile litigation losses.[1] The issue is whether transfers of IP should be valued on an item-by-item basis or on an aggregate basis, and whether the realistic alternative principle should be applied. The IRS's position is that sections 367 and 482, as they existed before the TCJA, authorized it to require aggregate basis valuation and the application of the realistic alternative principle if it determined that those approaches would achieve a more reliable result. However, the IRS has had little success in convincing courts to accept that position.[2] As a result, Congress codified the IRS's position in TCJA section 14221(b).

There is little question that Congress has the authority to codify the IRS's position prospectively, but there would seem to be a

[1] *See, e.g.*, *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009); and *Amazon.com Inc. v. Commissioner*, 148 T.C. No. 8 (2017).

[2] *Id.*

legitimate question regarding its authority to change the past. The possibility that Congress may have attempted to do this appears to be evidenced by its choice of wording for the heading to TCJA section 14221(b) and for the effective date language in section 14221(c). The heading reads: "Clarification of Allowable Valuation Methods." That alone seems to send a clear message that this Congress believes that the IRS's position has been correct all along.

Regarding the effective date language in TCJA section 14221(c), it is relevant to note that the valuation rules added by the TCJA to code sections 367 and 482 were added by the same section of the TCJA (section 14221) that changed the definition of IP to include goodwill and going concern value. The change in the definition was made by TCJA section 14221(a), and the valuation rules were added by section 14221(b). The effective date provision in section 14221(c)(1) provides that "the amendments made by this section shall apply to transfers in taxable years beginning after December 31, 2017." Section 14221(c)(2) then goes on to say the following:

> Nothing in the amendment made by subsection (a) shall be construed to create any inference with respect to the application of section 936(h)(3) of the Internal Revenue Code of 1986, or the authority of the Secretary of the Treasury to provide regulations for such application, with respect to taxable years beginning before January 1, 2018.

It is important to note that this section does not say that the amendment made by subsection (b) should not be construed to create an inference regarding prior law. A long-standing canon of statutory construction, known by its Latin name as *inclusio unius, exclusio alterius,* supports the conclusion that the provision of an explicit rule saying that subsection (a) does not create an inference regarding prior law, with no corresponding rule for subsection (b), should be construed to mean that subsection (b) was intended to create an inference regarding prior law.[3] That, together with the heading of subsection (b), would appear to provide the Service with a strong argument that the valuation rules set forth in the TCJA amendments to sections 367 and 482 should be applied retroactively to transfers in tax years beginning before January 1, 2018.

Taxpayer Counterargument

While *inclusio unius*, *exclusio alterius* clearly provides a technically valid argument in support of an IRS position to apply the TCJA IP valuation rules retroactively, it is important to understand the relative weight that should be accorded to any canon of statutory construction. Canons of statutory construction are no more than suggestions. They are tools used by judges (and by those attempting to predict what judges will decide) to interpret the language in statutes and regulations where there is some ambiguity as to their meaning. As a legal matter, canons of construction create presumptions, based on logical analysis of the language chosen by the drafters as well as other relevant circumstances, as to what the drafters intended. But like most presumptions, those created by canons of statutory construction may be rebutted.

That Congress specifically expressed its intention that TCJA section 14221(a) not be construed to create any inference regarding prior law does not necessarily mean its failure to express a similar intention for section 14221(b) indicates that it intended section 14221(b) to create an inference regarding prior law. On the contrary, the specific expression of intent regarding section 14221(a) might be explained as being all about the implications of section 14221(a) and have nothing to do with those of section 14221(b). The decision to specifically express its intention regarding section 14221(a) might be explained as an effort by Congress to affirmatively rebut what would be an obvious implication of the amendment made by section 14221(a) regarding prior law that would arise in the absence of a specific expression of intent to the contrary.

[3] *See, e.g., O'Melvany & Myers v. FDIC*, 114 S. Ct. 2048, 2054 (1994).

Ever since section 936(h)(3)(B) was added to the tax code (in 1984), providing a definition for the term "intangible property," there has been an ongoing and unresolved debate regarding whether that definition includes goodwill and going concern value.[4] It is quite possible that Congress, while amending the definition of the term "intangible property" in the TCJA (to expressly include goodwill and going concern value), was concerned that the amendment would create an inference that the pre-TCJA definition did not include goodwill and going concern value. That inference would be supported by another canon of statutory construction for which we don't happen to have a Latin name. In plain English, it goes something like this: "Modification of a statute indicates an intent to change the meaning of the statute."[5] Thus, it is quite possible that Congress felt the need to include TCJA section 14221(c)(2) to affirmatively rebut the presumption created by that canon, to provide cover for the IRS in any pre-TCJA controversies.

At the same time, it is also possible that Congress did not see a need to address any inference that TCJA section 14221(b) might have regarding prior law. In that case, *inclusio unius, exclusio alterius* should (at least arguably) not apply to create a presumption, based on the language used in section 14221(c)(2), that Congress intended for section 14221(b) to be construed to create an inference regarding the proper valuation methods of IP in pre-TCJA controversies.

Although this argument may rebut the application of *inclusio unius, exclusio alterius* to the construction of TCJA section 14221(c)(2), it is important to remember that the IRS had two arguments (discussed above) to support the position that section 14221(b) creates an inference regarding prior law. This still leaves the IRS with the argument that the heading for subsection 14221(b), "Clarification of Allowable Valuation Methods" indicates that Congress believes the valuation amendments to sections 367 and 482 reflect the proper interpretation of pre-TCJA law. If that belief is correct (and binding on courts), that would seem to require any companies that valued pre-TCJA IP transfers using other methods to record a reserve for the additional tax that would be due on audit, based on aggregate basis valuation and the application of the realistic alternative principle.

But not so fast. It is one thing for Congress to indicate that an amendment to the code is not intended to create any inference regarding prior law, as it is perfectly within its authority to refrain from expressing an opinion on prior law. But it is quite another thing for Congress to indicate that an amendment to the code *is* intended to create an inference regarding prior law. In that case, Congress would be expressing its opinion on prior law. We recognize that this would not be the first time a Congress has sought to "clarify" prior law, but it may be that its ability and authority (if any) to do so may depend to some extent on the age of the law that it is attempting to clarify.

The determination of whether the IRS's position on IP valuation should prevail in fact patterns predating the TCJA would seem to involve (among other things) an exercise in determining legislative intent for sections 367 and 482, as those sections existed before the TCJA. It is relevant that the Congress that made section 367 what it was just before the TCJA was the 98th Congress (by way of the Deficit Reduction Act of 1984), and the Congress that made section 482 what it was just before the TCJA was the 99th Congress (by way of the Tax Reform Act of 1986). Query whether the 115th Congress, more than 30 years later in 2017, had any more authority to say what the 98th and 99th Congresses intended in 1984 and 1986, respectively, than a court (or you, or us).

This would seem to raise an interesting question of constitutional law regarding whether any Congress has the authority to determine the legislative intent of a previous Congress. An in-depth analysis of that constitutional question is beyond the scope of this article, but there would

[4] For more on that debate, see Ken Brewer,"Goodwill Hunting: Without a License," *Tax Notes*, Nov. 9, 2015, p. 803.

[5] *See, e.g., Saint Alphonsus Regional Medical Center v. Gooding City*, 159 Idaho 84, 356 P.3d 377, 382 (2015) ("It is the long-standing rule in this state [Idaho] that when the legislature amends a statute, it is deemed, absent an express indication to the contrary, to be indicative of changed legislative intent.").

appear to be reason to question the existence of any such authority.[6] Putting that point aside, the purpose here is to address the more practical question of how taxpayers should be prepared to deal with what are likely to be attempts by the IRS to apply the TCJA's changes to sections 367 and 482 retroactively to transfers in tax years beginning before January 1, 2018.

Valuation Considerations

The codification of the IRS's long-standing position on the valuation of transferred IP — which now explicitly includes goodwill, going concern, and workforce-in-place, among others — will no doubt alter the debate over the FMV of IP in an outbound transfer. To consider the potential issue at hand — the effect of the IRS successfully using the TCJA to support its position on pre-2018 intangible property transfers — we must first outline the practical effect of the TCJA on the determination of the FMV of IP and the appropriate approach for valuing transferred IP under the law. That discussion will shed light on why this could be a concern for taxpayers that transferred intangibles before the passage of the TCJA and used an FMV for the IP that was determined as part of a financial reporting valuation.

To properly frame the issue, we first describe what not to do from a valuation standpoint, given that some of the historical approaches to valuing intangible assets may in fact form the crux of potential issues associated with pre-2018 intangible asset transfers. Generally, do not use a relief-from-royalty approach to value the transferred IP on an item-by-item basis, because this approach does not capture value beyond the rights associated with licensing the specific item of IP in question (thus excluding other items of transferred IP, including goodwill, going concern, workforce-in-place, and others). Moreover, if transferring an intangible asset that was recently acquired from a third party, do not use the value of the asset that was derived for financial reporting purposes if it was estimated using the relief-from-royalty approach. While acceptable for financial reporting purposes, this value typically is not acceptable for tax purposes as part of an outbound transfer of the asset, as previously mentioned.

So what should we do from a valuation standpoint under the TCJA rules? When transferring IP, the default valuation approach (in the absence of a comparable uncontrolled transaction for the same or similar IP, like a recent arm's-length sale or license) should be a multi-period excess earnings method (MPEEM), considering the combined earnings from all items of IP included in the transfer (including goodwill, going concern, workforce-in-place, and others). As you can imagine, the result of the application of the MPEEM and corresponding inclusion of these aggregated intangible assets will often result in a higher FMV for transferred IP. One would not expect this to be a contentious issue for intangible assets transferred after the passing of the TCJA, given the clarity in the new law. However, as previously suggested, the IRS could use the TCJA to support its position of FMV on pre-2018 IP transfers.

Under the premise that the FMV of transferred IP will be higher under the TCJA (relative to a financial reporting value), the issue at hand for taxpayers is that if the IRS uses the TCJA to ascribe value to pre-2018 IP transfers, taxpayers could be susceptible to the possibility that their previously transferred IP was, using hindsight based on the new rules, undervalued. While one cannot predict the actions of the IRS or the supportability of that position, given this uncertainty and the risk of an unfavorable IRS audit, companies may want to consider whether a tax reserve is warranted. This would entail estimating the FMV of the previously transferred IP consistent with the "clarified" standards previously discussed (thus most likely resulting in a higher FMV).

Rebuttal to Aggregate Approach Requirement

An interesting economic question arises for those taxpayers who are willing to concede that the valuation rules in the TCJA may be applied retroactively but who are not willing to concede that the revised definition of IP (to include

[6] *See, e.g.*, *Sullivan v. Finkelstein*, 496 U.S. 617, 631 (1990) (Scalia, J., concurring in part, stating that the "legislative history of a statute is the history of its consideration and enactment. 'Subsequent legislative history' — which presumably means the post-enactment history of a statute's consideration and enactment — is a contradiction in terms.").

goodwill and going concern value) should be applied retroactively. The question relates to how, in applying the MPEEM approach previously described (to determine the value of the transferred IP on an aggregate basis), we can exclude any earnings produced by goodwill and going concern value that are related to the transferred IP.

An example of a situation in which at least a portion of goodwill and going concern value may be excluded is a transfer of technology IP with a finite life. If the position is that only the current generation of IP is being transferred (and not future generations), the valuation should exclude cash flows and hence value attributable not only to future technology generations, but also to goodwill that is associated with the perpetual value of the company. If the rights to the current generation of technology are being acquired and the purchaser of the IP must continually invest in research and development to produce a commercially viable product, arguably the acquirer would pay only for the current technology generation. This, of course, assumes the transferred IP is associated with a developed business.

For cases in which a company has acquired a business that is in an emerging phase and then transfers the IP of that business to a related entity, the IRS will maintain that most, if not all, of the recent purchase price reflects the FMV of the transferred IP (given the lack of significant goodwill in an early-stage company). Essentially, the IP is the entire value of the business.[7] In this case the burden falls to the taxpayer to identify and value assets other than the transferred IP — like working capital, fixed assets, and other intangible assets that may not have been included in the transfer — and deduct the FMV of these assets from the purchase price.

In some (perhaps most) cases, there may not be a reliable method for excluding any earnings produced by goodwill and going concern value that are related to the transferred IP in applying the MPEEM approach previously described (to determine the value of the transferred IP on an aggregate basis). In that case, if goodwill and going concern value are thought to be substantial, the aggregate approach may simply not be a reliable method for valuing the transferred IP compared with an item-by-item approach using some other acceptable approach.

Concluding Comments

Companies that feel comfortable with the position that the 115th Congress does not have the authority to legislate history (by clarifying what was intended by the 98th and 99th Congresses) may not have to consider increasing their tax reserves for pre-TCJA IP transfers to account for the TCJA valuation changes in sections 367 and 482 (if their audit firms agree). Those that cannot get to that comfort level and used an FMV based on a financial reporting valuation should seriously consider creating new reserves based on this recent clarification of prior law rules for the valuation of IP. ■

[7] *See* reg. section 1.482-7(g)(5).