

# International Tax Controversies

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## IRS Creates a New Category of Intangible Property—Significant Implications for Code Sec. 367



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A recent IRS Industry Directive (the “Directive”) focusing on Code Sec. 936<sup>1</sup> restructurings contains a troubling statement from the IRS regarding what it believes to be a new class of intangible property subject to the application of Code Sec. 367. The Directive asserts that “workforce-in-place” constitutes a class of intangible property for purposes of Code Sec. 367.<sup>2</sup> According to the IRS, if an outbound restructuring of a Code Sec. 936 company otherwise qualifies as a tax-free transfer (*i.e.*, a Code Sec. 351 exchange), Code Sec. 367(d) will nonetheless cause the taxpayer to realize taxable income to the extent the restructuring results in a transfer of workforce-in-place to a foreign corporation.

If the Directive’s position concerning the classification of workforce-in-place were correct, it would have broad and significant implications for taxpayers well beyond the purview of Code Sec. 936 restructurings. In fact, there are potential implications for any incorporation of a foreign branch—including those completed many years prior to the issuance of the Directive. As discussed in detail below, the IRS’s position as set forth in the Directive is very suspect. It is unsupported by the plain language of the Code, as well as the current Code Sec. 367 regulations. Further, if the Directive’s position concerning workforce-in-place were sustained, it would lead to absurd results regarding the application of the statute of limitations as applied to the incorporation of any foreign branch involving workforce-in-place. The IRS should carefully re-evaluate its decision to classify workforce-in-place as a new class of intangible property.

## The IRS Directive

On February 2, 2007, the LMSB Industry Director, Retailers, Food, Pharmaceuticals, and Healthcare issued the Directive, which addresses certain U.S. federal income tax issues associated with Code Sec. 936 reorganizations.<sup>3</sup> Attached to the Directive was a set of Audit Guidelines, which expand on the issues addressed in the Directive, including the characterization of workforce-in-place for purposes of Code Sec. 367.

One of the more controversial aspects of the Directive is its assertion that taxpayer classifications of workforce-in-place as either goodwill or going concern value should be “carefully scrutinized” to determine if the workforce-in-place should be characterized as an intangible subject to Code Sec. 367(d). The Directive challenges taxpayer classifications of workforce-in-place as either goodwill or going concern value because those categories of intangible assets are expressly exempted from the application of Code Sec. 367.<sup>4</sup>

The Audit Guidelines state that workforce-in-place “is an intangible asset for purposes of Code Sec. 936(h)(3)(B) and must be analyzed: 1) under section 367(d), if transferred offshore under sections 351 or 361; or 2) under section 482 in the case of all other controlled transactions.”

The IRS’s assertion that workforce-in-place constitutes an intangible asset for purposes of Code Sec. 936(h)(3)(B) is incorrect. As discussed below, the statutory provisions of Code Secs. 936 and 367, as well as the regulations issued thereunder, support a contrary conclusion.

### Classification of Foreign Workforce-in-Place Under Code Secs. 367 and 936

The controlling authority supports the conclusion that workforce-in-place should not be classified as “intangible property” for purposes of either Code Sec. 367 or 936(h)(3)(B). Rather, the relevant statutory provisions, as well as the regulations, confirm that workforce-in-place constitutes going concern value, which does not trigger the application of Code Sec. 367.

Code Sec. 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in connection with an exchange described in Code

Sec. 332, 351, 354, 356 or 361, then the foreign corporation will not be characterized as a corporation for purposes of determining if gain is recognized as a result of the transaction. Unless an exception applies, Code Sec. 367(a)’s characterization of the foreign transferee as a noncorporate entity results in an otherwise tax-free transaction becoming fully taxable. Code Sec. 367(a)(3)(A) provides that except as otherwise provided in regulations, a foreign corporate transferee will be classified as a corporation (allowing the transfer to qualify for tax-free characterization) with respect to any property transferred to the foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.<sup>5</sup>

Code Sec. 367(d) contains a special rule that overrides the active trade or business exception of Code Sec. 367(a)(3)(A) with respect to any transfer of an intangible property interest. In general, Code Sec. 367(d) provides that if a U.S. person transfers any intangible property to a foreign corporation in what would otherwise qualify as a tax-free exchange under Code Sec. 351 or 361, then the transfer shall be treated as a taxable sale of the intangible asset in exchange for payments which are contingent upon the productivity, use, or disposition of such property. If triggered, Code Sec. 367(d) essentially gives rise to a deemed royalty stream for the transferor.

For purposes of Code Sec. 367(d), the term “intangible property” is defined by reference to Code Sec. 936(h)(3)(B). Thus, in order for Code Sec. 367(d) to be implicated with respect to the transfer of workforce-in-place, that asset must be specifically identified in Code Sec. 936(h)(3)(B) as “intangible property.” It is not.

Code Sec. 936(h)(3)(B) defines the term “intangible property” to include any (1) patent, invention, formula, process, design, pattern or know-how; (2) copyright, literary, musical or artistic composition; (3) trademark, trade name or brand name; (4) franchise, license or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or (6) any similar item. The flush language of Code Sec. 936(h)(3)(B) adds the further clarification that in order to constitute “intangible property” for purposes of Code Sec. 936(h)(3)(B), the property right must have substantial value independent of the services of any individual.

The term “workforce-in-place” is not identified in Code Sec. 936(h)(3)(B) as constituting “intan-

gible property.” Thus, under the controlling “plain meaning” doctrine of statutory construction, workforce-in-place should not be classified as intangible property for purposes of Code Sec. 367.<sup>6</sup>

The IRS could assert that workforce-in-place is captured by the reference to “any similar item” in Code Sec. 936(h)(3)(B). However, under principles of statutory construction, such an interpretation of “any similar item” should be rejected by a court.

Code Sec. 936(h)(3)(B)’s general reference to “any similar item” leaves open the possibility of multiple interpretations of that phrase. A general statutory reference (such as “any similar item”) does not provide the IRS with *carte blanche* with respect to the interpretation of that phrase. As summarized by the Supreme Court: “Words that can have more than one meaning are given content, however, by their surroundings. ...”<sup>7</sup> In deciding which of multiple definitions to apply when interpreting a statute, the courts “look to the words nearby.”<sup>8</sup>

Based on the specific categories of intangible property identified in Code Sec. 936(h)(3)(B), the reference to “any similar item” should be limited to specific intangible property rights (e.g., patents, trademarks, formula) that have substantial value independent from the services of any individual(s). The flush language of Code Sec. 936(h)(3)(B) supports such an interpretation, as it indicates Congress specifically sought to exclude from the definition of “intangible property” any service-based property right that would be primarily dependent upon the services of an individual—such as workforce-in-place. Workforce-in-place derives its value (hence the name) from the services of the employees of a company—its workforce. For this reason, it is clear that workforce-in-place should not be considered “similar” to the specific property rights delineated in Code Sec. 936(h)(3)(B).

The most reasonable interpretation of workforce-in-place in the context of Code Sec. 367 is that it constitutes “going concern value.” The regulations at Temporary Reg. §1.367(a)-1T(d)(5)(iii)<sup>9</sup> provide that “going concern value” and “foreign goodwill” represent 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. Workforce-in-place should be interpreted as being synonymous with the term “going concern value.” How possibly could there be any “going concern value” with respect to a trade or business without the workforce-in-place? Or in other words, if there is no workforce-in-place, how could there be a “going concern”?

The IRS might seek to support its position by analogizing to Code Sec. 197(d)(1)(C)(i), which identifies workforce-in-place as a “section 197 intangible.” Such an analogy, however, would be misplaced since it would disregard the clear intent of Code Sec. 197, which limits that definition set forth in Code Sec. 197(c) to the application of that specific Code section. Moreover, such an argument would further exacerbate the issue, as additional classes of intangibles would also become subject to the application of Code Sec. 367(d). For example, under such an

analysis “market share” and “relationships” (both of which are identified in Code Sec. 197(c) as Code Sec. 197 intangibles) also would become assets separate and distinct from goodwill and going concern value, and would therefore be subject to Code Sec. 367(d). Like

workforce-in-place, “market share” and “relationships” are not identified as “intangible property” in Code Sec. 936(h)(3)(B), so any analogy to Code Sec. 197 should fail.

Assuming workforce-in-place constitutes going concern value, the transfer of this asset to a foreign corporation should not trigger the application of Code Sec. 367. The regulations at Temporary Reg. §1.367(d)-1T(b) specifically exclude foreign goodwill and going concern value from the application of Code Sec. 367(d).<sup>10</sup>

The legislative history of Code Sec. 367 confirms that Congress specifically intended to exclude goodwill and going concern value from the scope of Code Sec. 367.<sup>11</sup> Both Houses of Congress stated that transfers of goodwill and/or going concern value developed by a foreign branch would not result in an abuse of the U.S. tax system.<sup>12</sup> The specific abuse with which Congress was concerned when it enacted current Code Sec. 367 was that taxpayers would use deductions for R&D to develop intangibles, and then transfer the resulting intangibles offshore at the point

**Rather, the relevant statutory provisions, as well as the regulations, confirm that workforce-in-place constitutes going concern value, which does not trigger the application of Code Sec. 367.**

when they began to be profitable.<sup>13</sup> Goodwill and going concern value developed by a foreign branch do not share the same potential for abuse because, in the words of the Joint Committee, they “are generated by earning income, not by incurring deductions.”<sup>14</sup>

Similarly, the value of workforce-in-place accrues through the profitable operations of a business in its ordinary course. Like going concern value or goodwill, the assembled workforce is a part of the business, not a separate asset developed through capital expenditures (or through accelerated deductions provided as a spur to R&D). The expenses of training and hiring workers are deductible expenses ordinary and necessary to the business’ ability to generate a profit,<sup>15</sup> just like the expenses a branch incurs to create goodwill. Workforce-in-place is akin to goodwill, constitutes going concern value, and should also be excluded from Code Sec. 367(d).

In the event a court were to determine that workforce-in-place is not going concern value or foreign goodwill, then the transfer of workforce-in-place to a foreign corporation should nonetheless not give rise to taxable gain pursuant to the application of Code Sec. 367(a) provided (1) workforce-in-place is not intangible property as described in Code Sec. 936(h)(3)(B) (which it is not); and (2) the workforce-in-place is used by the transferee foreign corporation in an active trade or business outside the United States (which would typically be the case).

In addition to lacking statutory and regulatory support, the IRS’s newly announced position concerning the classification of workforce-in-place also directly contradicts its prior guidance on the issue. The IRS has consistently stated in its prior written guidance that the value of having a workforce-in-place represents the going concern value of a business.

In a previously released industry specialization coordinated issue paper, “Amortization of Assembled Workforce,”<sup>16</sup> the IRS stated that any value associated with having a trained staff of employees in place represents the going concern value of an acquired business. In a second industry specialization program coordinated issue paper, “Amortization of Assembled Workforce,”<sup>17</sup> the IRS explained that its historic position was that an assembled workforce intangible is,

as a matter of law, nonamortizable going concern value. These coordinated issue papers show the IRS’s view was that workforce-in-place constituted going concern at the time it drafted the Code Sec. 367 regulations, and are in direct contrast with the position set forth in the Directive and Audit Guidelines.

## Absurd Results If Foreign Workforce-in-Place Is Intangible Property for Purposes of Code Sec. 367

If workforce-in-place were in fact a separate and distinguishable asset subject to the application of Code Sec. 367, then there is a substantial risk that every taxpayer that ever incorporated a foreign branch has open statutes of limitations periods pursuant to Code Sec. 6501(c)(8). The absurdity of this result lends further weight to the conclusion that the IRS’s position concerning the application of Code Sec. 367

with respect to workforce-in-place should not be sustained by a court.

Code Sec. 6501(c) contains a number of exceptions to the general three-year statute of limitations provision set forth in Code Sec. 6501(a). Specifically, Code Sec.

6501(c)(8) provides that in the case of any information that is required to be reported pursuant to Code Sec. 6038B, the period for assessment of any tax “with respect to any event or period to which such information relates” will not expire before the date which is three years after the date on which the IRS is furnished the information.<sup>18</sup>

The regulations issued under Code Sec. 6038B require a taxpayer to specifically identify property transferred to foreign corporation.<sup>19</sup> Specifically, Temporary Reg. §1.6038B-1T(d)(1)(iv) states that a taxpayer must separately identify each intangible asset transferred to a foreign corporation.<sup>20</sup> Thus, if foreign workforce-in-place constitutes a separate item of intangible property for purposes of Code Sec. 367, as the IRS asserts in the Directive and Audit Guidelines, then any taxpayer incorporation of a foreign branch including workforce-in-place would cause the statute of limitations to remain open with respect to the year of the transfer unless the work-

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force-in-place was separately identified pursuant to Code Sec. 6038B.

In addition to the year of transfer, statutes of limitations may remain open for a number of succeeding years following the incorporation of the foreign branch if workforce-in-place constitutes a separate class of intangible property for purposes of Code Sec. 367. Code Sec. 367(d) imposes a deemed “royalty” payment in the event intangible property described in Code Sec. 936(h)(3)(B) is transferred to a foreign corporation. The Code Sec. 367(d) royalty is calculated under the commensurate with income standard. Depending upon how long a “royalty” would be required with respect to the transfer of workforce-in-place, the taxpayer may have additional years in which the statute of limitation remains open following the incorporation of the foreign branch.<sup>21</sup>

This statute of limitations debacle with respect to workforce-in-place highlights the overall absurdity of the IRS’s position. A well established principle of statutory construction provides that statutes should not be interpreted in a manner that will create an absurd result.<sup>22</sup> Rather, statutes must be construed in a manner that is consistent with Congress’s intent in enacting the statute.<sup>23</sup> The cross-reference to

Code Sec. 936(h)(3)(B) set forth in Code Sec. 367(d) reflects Congress’s intent that only specific and limited classes of property be classified as “intellectual property.” The creation of a new class of Code Sec. 367 intellectual property out of whole cloth should not result in every taxpayer that ever incorporated a foreign branch with workforce-in-place having multiple statutes of limitations remaining open pursuant Code Sec. 6501. Such a drastic change in the operation of Code Sec. 367 should require a statutory change, which at the very least should be limited to prospective application.

## Conclusion

The IRS’s position concerning the classification of workforce-in-place as intangible property for purposes of Code Sec. 367 is without support in the Code or regulations. Workforce-in-place constitutes going concern value, which should allow a tax-free transfer to a foreign corporation. A contrary conclusion should require a change to the controlling statutory provisions. The IRS should re-evaluate its assertion that workforce-in-place constitutes a new class of intangible property for purposes of Code Sec. 367.

## ENDNOTES

<sup>1</sup> Code Sec. 936 provided for a credit against a taxpayer’s U.S. federal income tax liability arising from income earned by a U.S. corporation that conducted an active trade or business within Puerto Rico. The credit provided by Code Sec. 936 became subject to a 10-year phase-out, which commenced in 1995. As a result of the phase-out, the Code Sec. 936 credit no longer was available for tax years beginning after December 31, 2005.

<sup>2</sup> The Directive represents the first official written guidance from the IRS concerning the classification of workforce-in-place as intangible property for purposes of Code Sec. 367. The IRS has raised this same argument in a number of audits.

<sup>3</sup> As a result of the Code Sec. 936 phase-out, many U.S. companies operating in Puerto Rico under the Code Sec. 936 system restructured their operations into controlled foreign corporation (CFC) structures.

<sup>4</sup> See Temporary Reg. §1.367(d)-1T(b).

<sup>5</sup> See Temporary Reg. §1.367(a)-2T.

<sup>6</sup> The Supreme Court has repeatedly held that if the language of a statute has a plain and ordinary meaning, courts need look no further and should apply the statute as it is written. See, e.g., *N.E. Soliman*, S Ct, 93-1 USTC ¶ 50,014, 506 US 168, 174,

113 S Ct 701 (“In interpreting the words in a revenue Act, we look to the ‘ordinary, everyday senses’ of the words.” (citations omitted)); *Caminetti*, S Ct, 242 US 470, 485, 37 S Ct 192 (1917) (“It is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain ... the sole function of the courts is to enforce it according to its terms.” (citations omitted)).

<sup>7</sup> *Whitman v. Am. Trucking Ass’n*, S Ct, 531 US 457, 466, 121 S Ct 903 (2001) (citing *FDA v. Brown & Williamson Tobacco Corp.*, S Ct, 529 US 120, 132-33, 120 S Ct 1291 (2000) and *L. Jones*, S Ct, 527 US 373, 389, 119 S Ct 2090 (1999)).

<sup>8</sup> *Microsoft Corp.*, CA-9, 2002-2 USTC ¶ 50,800, 311 F3d 1178 (citing *Limited, Inc.*, CA-6, 2002-1 USTC ¶ 50,353, 286 F3d 324, 334).

<sup>9</sup> Temporary Reg. §1.367(a)-1T(d)(5)(i) references Code Sec. 936(h)(3)(B) for the definition of “intangible property” for purposes of Code Sec. 367 generally. As discussed above, workforce-in-place is not identified in Code Sec. 936(h)(3)(B) as constituting intangible property.

<sup>10</sup> Temporary Reg. §1.367(d)-1(b) states in relevant part: “[S]ection 367(d) and the rules of this section shall not apply to the transfer of

foreign goodwill or going concern value, as defined in section 1.367(a)-1T(d)(5)(iii), or to the transfer of intangible property described in section 1.367(a)-5T(b)(2).”

<sup>11</sup> See Joint Committee of Taxation Explanation of the Tax Reform Act of 1984, at 428.

<sup>12</sup> See House Ways & Means Committee Report, H.R. REP. 98-432, at 1317; Senate Finance Committee Report, S. RPT. 98-169, at 362.

<sup>13</sup> See Senate Finance Committee Report, *supra*, at 360-61; House Ways & Means Committee Report, *supra*, at 1316.

<sup>14</sup> Joint Committee of Taxation Explanation of the Tax Reform Act of 1984, at 428.

<sup>15</sup> See, e.g., *B.K. Rankin*, 17 BTA 1301 (1929); *Knoxville Iron Co.*, 18 TCM 251, Dec. 23,504(M), TC Memo. 1959-54.

<sup>16</sup> *Amortization of Assembled Workforce* (Apr. 23, 1991).

<sup>17</sup> *Amortization of Assembled Workforce* (Feb. 19, 1996).

<sup>18</sup> Code Sec. 6038B also imposes a penalty for any failure to satisfy the reporting requirements. See Code Sec. 6038(c).

<sup>19</sup> See Temporary Reg. §1.6038B-1T.

<sup>20</sup> Temporary Reg. §1.6038-1T(d)(1)(iv) states: Provide a description of the intangible property transferred, including its adjusted basis. Generally, each *intangible asset must be sep-*

ENDNOTES

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arately identified. Operating intangibles and foreign goodwill or going concern value, as defined in section 1.367(a)-1T(d)(5) (ii) and (iii), should be so identified and classified.” (emphasis added).

<sup>21</sup> Would a workforce-in-place royalty continue forever, or would it be viewed as having a limited or declining life? What

does commensurate with income mean in this context?

<sup>22</sup> See *American Trucking Associations, Inc.*, SCt, 310 US 534, 543, 60 SCt 1059 (1940) (“When [the] meaning has led to absurd or futile results ... this Court has looked beyond the words to the purpose of the act.”).

<sup>23</sup> See *Gentsch v. Goodyear Tire & Rubber*

*Co.*, CA-6, 45-2 USTC ¶9460, 151 F2d 997, 1001 (“All statutes must be construed in light of their purpose. A literal reading of them which would lead to absurd results is to be avoided when they can be given a reasonable application consistent with their words and legislative purpose.”).

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