

**The IRS Continues to Assert Workforce in Place
Constitutes an “Intangible” for Purposes of Code Sections 367 and 482**

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The Internal Revenue Service (IRS) continues to advance the proposition that workforce in place constitutes an “intangible” for U.S. federal income tax purposes. This position has potential application both with respect to property transfers subject to the application of section 367(d) of the Internal Revenue Code (the Code), as well as transactions generally subject to section 482. Based on a number of recent developments, both at the administrative level as well as in the field, it is clear that the IRS is intent upon reinterpreting the definition of “intangible” as a basis to increase its reach with respect to the application of sections 367 and 482.

The IRS’s position concerning workforce in place was articulated by the IRS in a 2007 IRS Industry Directive (the Directive) focusing on the U.S. federal income tax implications associated with taxpayer conversions of Code section 936¹ operations into controlled foreign corporation (CFC) structures. The issue reappeared earlier this year as a proposed statutory “clarification” in the Obama administration’s Fiscal Year 2010 Budget Proposal. More recently, it was the subject of comments made by a high-ranking IRS official at a recent Organisation for Economic Co-operation and Development (OECD) meeting in Paris, in which the IRS official suggested the potential application of the position to a broader range of transactions beyond the traditional purview of section 367(d). The progressive development of the issue is not limited to the theoretical. We have seen this issue raised in audit and have noted attempts at the field level to further expand its application.

The 2007 Directive asserts that workforce in place constitutes a class of intangible property for purposes of Code section 367. According to the Directive, if an outbound incorporation of a section 936 branch operation otherwise qualified as a tax-free transfer,² to the extent the transfer involves workforce in place, the taxpayer would nonetheless be required to recognize taxable income pursuant to section 367(d). This conclusion is based on the assumption that workforce in place constitutes an “intangible” for purposes of section 367(d). We believe this position is not supported by controlling law and would in fact require a statutory change.³

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1. Code section 936 provided for a credit against a taxpayer’s U.S. federal income tax liability arising from income earned by a U.S. corporation from business operations conducted from within Puerto Rico.
 2. E.g., pursuant to section 351.
 3. We note that any change to the definition of “intangible” would in fact be a *change* in the law—not a “clarification.”

The Obama administration has proposed such a change: it would expand the definition of “intangible property” for purposes of Code sections 367 and 482 to include workforce in place, goodwill, and going concern value.

The recently issued Joint Committee of Taxation’s Description of the administration’s proposals (JCT Description) explicitly confirms what a number of taxpayers are already facing in audits: the IRS takes the position that, even absent the administration’s proposed change, workforce in place, goodwill, and going concern value are intangibles under current law. Many in the tax community disagree and consider the administration’s proposal a major shift from current law.

The stakes are substantial: the transfer of intangibles, often as part of cost-sharing buy-in transactions, has seen intense IRS scrutiny in recent years, and the amounts at issue are often quite high. Both cost-sharing buy-in payments and Code section 936 exit strategies are Tier I compliance issues, meaning that the IRS views these transactions as the highest compliance priorities.

The JCT Description is illustrative for taxpayers because it provides a clear statement of the IRS’s current audit position: “The IRS view, however, is that any workforce in place, goodwill and going concern value that may exist (the existence of these items is itself often disputed by the IRS) are intangible property under section 936(h)(3)(B), because they constitute ‘similar items’ under section 936(h)(3)(B)(vi).” (JCT Description, p. 37)

The issue alluded to in the parenthetical language quoted above—whether workforce in place, goodwill, and going concern value are separate assets—was the subject of recent comments by Steven Musher, IRS Associate Chief Counsel (International). Speaking at the OECD conference on transfer pricing and tax treaties on September 22, Mr. Musher raised a fact pattern involving the license of software by a startup company and the commitment of its research team to the completion of the software. Mr. Musher indicated that he believed that in this situation, the workforce in place should be valued together with the software, rather than as a separate asset, because without the workforce, the intangible would have little value. Although a new workforce could be hired, it would cause the company to lose the key “first mover advantage.”

We believe the IRS’s current approach to the audit of transferred intangibles involves positions directly contrary to statutory and regulatory authority. More broadly, we also strongly believe that workforce in place, goodwill, and going concern value are not intangibles subject to the application of Code sections 367(d) and 482.

Taxpayers that have not yet faced this issue in audit may be surprised by the IRS’s legal arguments, the breadth of transactions to which the IRS may attempt to apply the theory, and the magnitude of the potential adjustments. A clear understanding of the IRS’s position, as well as the inherent weaknesses associated with the theory, can aid taxpayers in preparing to address these issues to the fullest extent possible. There are also a number of important practical counter-arguments that should be asserted in defense at the audit and appeals levels.

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