

JULIA SKUBIS WEBER is a Partner in Baker McKenzie's Chicago office.

NEIL DONETTI is an Associate in Baker McKenzie's Chicago office.

SHELBI NELSON is an Associate in Baker McKenzie's Chicago office.

ETHAN KROLL is a Partner in Baker McKenzie's Los Angeles office.

STEWART LIPELES is a Partner in Baker McKenzie's Palo Alto office.

International Tax Watch

The Tax Court Misses the Forest for the Trees in TBL Licensing LLC

By Julia Skubis Weber, Neil Donetti, Shelbi Nelson, Ethan Kroll, and Stewart Lipeles

The dispute in *TBL Licensing LLC, et al. v. Commissioner*¹ arose from a restructuring that occurred after VF Corporation (“VF”), a Pennsylvania corporation, and The Timberland Company (“Timberland”), a Delaware corporation, combined their businesses in 2011. The taxpayer and the Internal Revenue Service (the “Service”) agreed that the restructuring transactions implicated an outbound transfer of intangible property subject to Code Sec. 367(d). The parties’ dispute centered around the timing and amount of income arising from that Code Sec. 367(d) transfer.

I. The Transactions

VF specialized in branded lifestyle apparel. Through its subsidiaries, VF designed, manufactured, and sold apparel and footwear under several brands, including Lee, Wrangler, Nautica, Vans, and The North Face. Timberland similarly designed, developed, manufactured, marketed, and sold footwear, apparel, and accessories under its own brand and others. In June 2011, VF agreed to acquire Timberland. VF believed Timberland’s brands would be a strong addition to VF’s portfolio of outdoor and action sports brands.²

VF undertook a complex series of transactions in connection with its acquisition of Timberland, as shown in the following diagrams. In August 2011, VF organized TBL International Properties, LLC (“TBL International”), a Delaware limited liability company that was disregarded for U.S. federal income tax purposes. Then, International Properties formed TBL Licensing LLC (“TBL Licensing”), a Delaware limited liability company that made an initial election to be classified as a corporation for U.S. federal income tax purposes (*see* Diagram 1).

In the third step, VF Enterprises S.à.r.l. (“VF Enterprises”), an indirect subsidiary of VF organized in Luxembourg, formed TBL GmbH, a Swiss entity classified as a corporation. VF next contributed the shares of VF Enterprises, Inc., a U.S. corporation and the merger subsidiary, to TBL International (*see* Diagram 2).

In step five, VF transferred its interest in TBL International to VF Enterprises. VF then assigned its rights under the merger agreement with Timberland to TBL International (*see* Diagrams 3 and 4).

DIAGRAM 1.

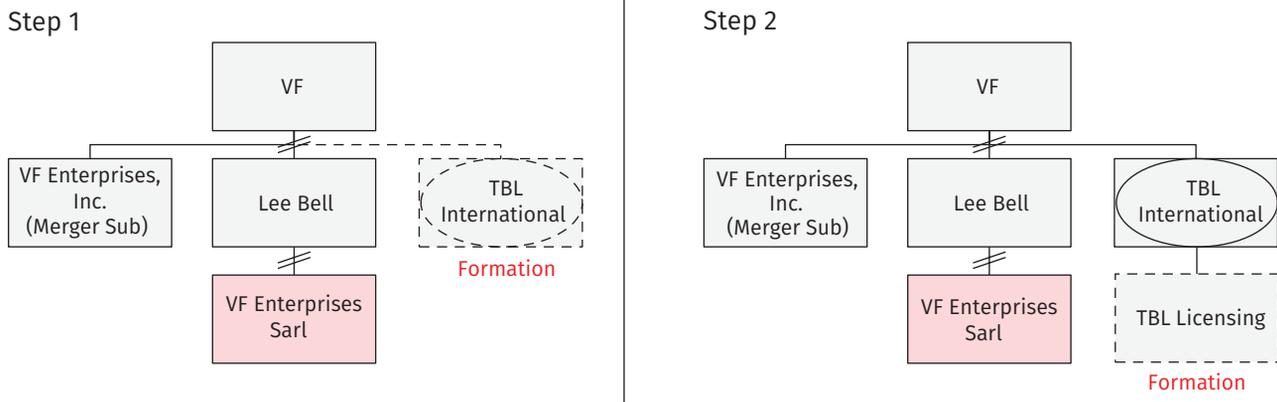
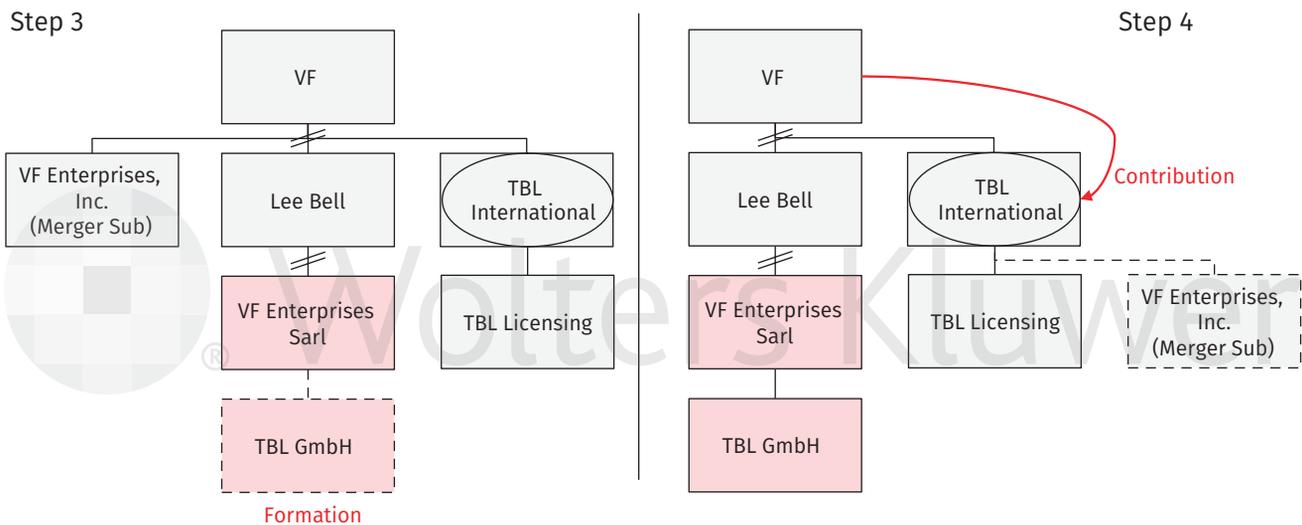


DIAGRAM 2.



Then, on September 13, 2011, VF Enterprises, Inc. merged into Timberland. In the merger, former Timberland shareholders received cash in exchange for their Timberland stock (see Diagram 5).

Following the merger, VF restructured its subsidiaries. TBL International contributed the shares of Timberland that it had received in the merger to TBL Licensing. Then, Timberland converted to a disregarded limited liability company (“Timberland LLC”) (see Diagram 6).

Timberland LLC transferred its intellectual property, including trademarks, foreign workforce relationships, and foreign customer relationships (the “Timberland IP”), to TBL Licensing. TBL Licensing and the Service each valued the trademarks TBL Licensing acquired from Timberland at \$1,274,100,000. TBL Licensing sold its interest in Timberland to Vans, an indirect subsidiary of VF (see Diagram 7).

On September 22, 2011, VF Enterprises contributed its interest in International Properties to TBL GmbH (the “TBL International Transfer”). Finally, TBL Licensing elected to be treated as a disregarded entity effective September 24, 2011 (the “Election”) (see Diagram 8).

II. The Dispute

TBL Licensing and the Service agreed that the combined “drop-and-check” transaction (*i.e.*, the TBL International Transfer and subsequent Election) constituted an “F” reorganization under Code Sec. 368(a)(1)(F). The “F” reorganization changed TBL Licensing’s place of incorporation from Delaware to Switzerland for U.S. tax purposes. This “F” reorganization also resulted in a constructive outbound transfer of the Timberland IP from TBL Licensing to TBL GmbH that was subject to Code Sec. 367(d). The

DIAGRAM 3.

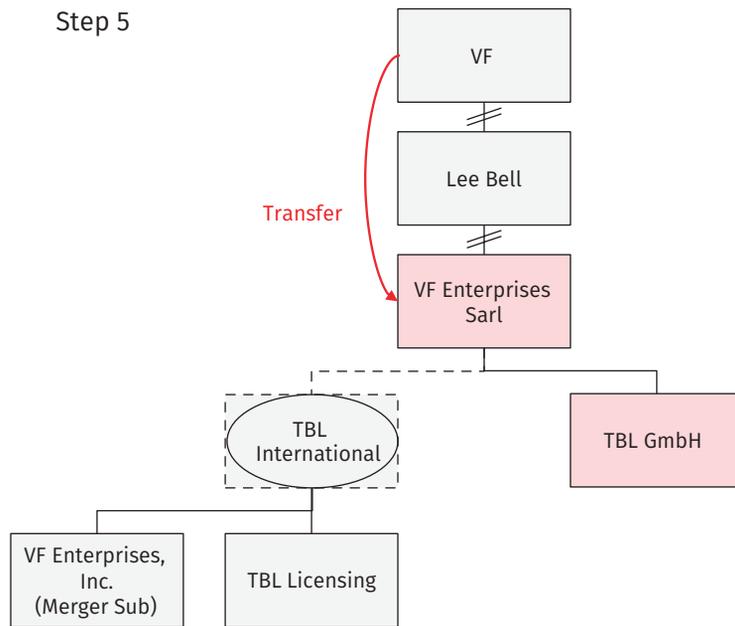
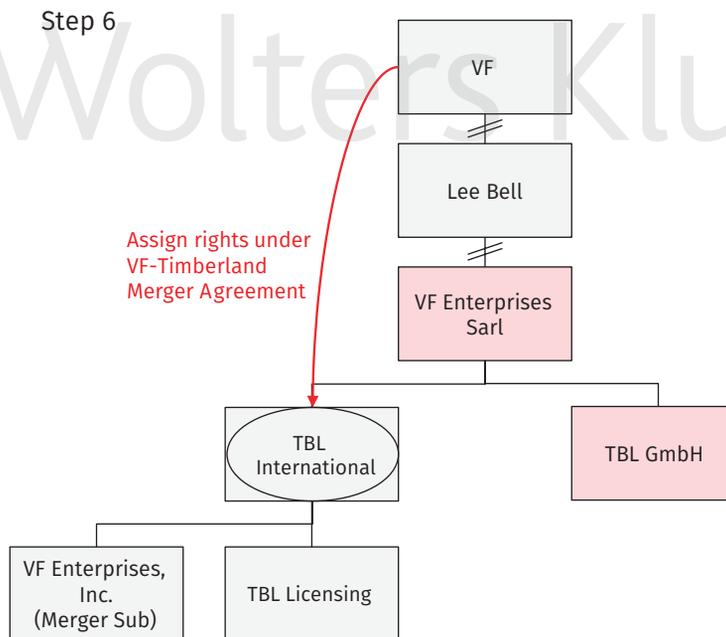


DIAGRAM 4.



parties likewise agreed that, pursuant to Code Sec. 367(d), TBL Licensing was treated as having sold the intangible property to TBL GmbH for one or more contingent payments. The primary disagreement arose with respect to the timing of income recognition under Code Sec. 367(d). The taxpayer took the position that the income should have been received annually in the form of payments over

the useful life of the Timberland IP. Accordingly, Lee Bell, Inc. ("Lee Bell"), an indirect domestic subsidiary of VF and indirect parent of VF Enterprises, reported income with respect to deemed annual payments under Code Sec. 367(d)(2)(A)(ii)(I) for the taxable years 2011 through 2017.³ The Service challenged this position and asserted that TBL Licensing should have recognized the entire

DIAGRAM 5.

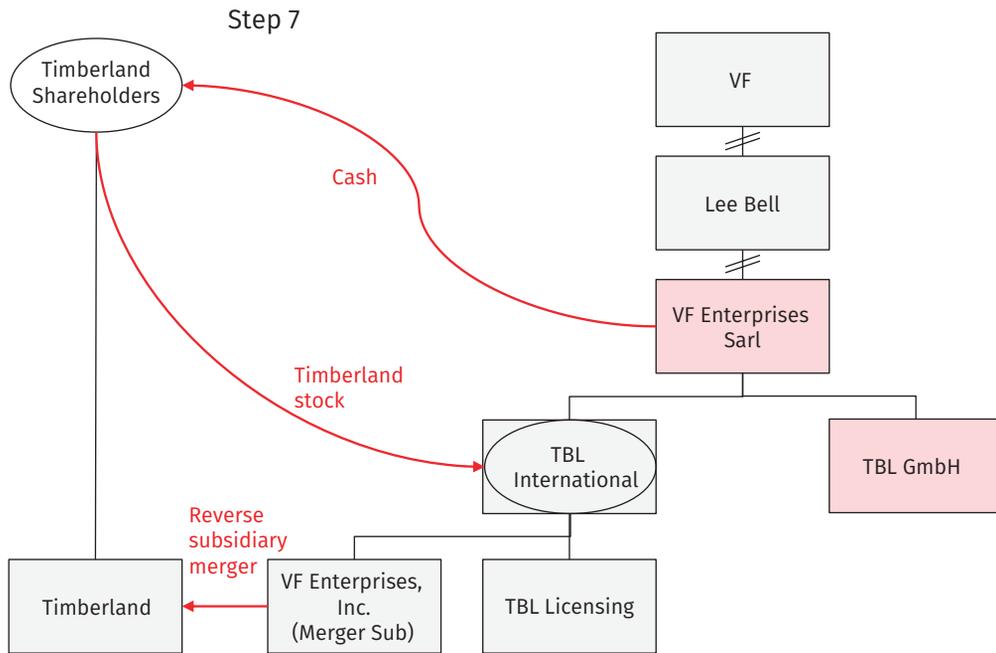


DIAGRAM 6.

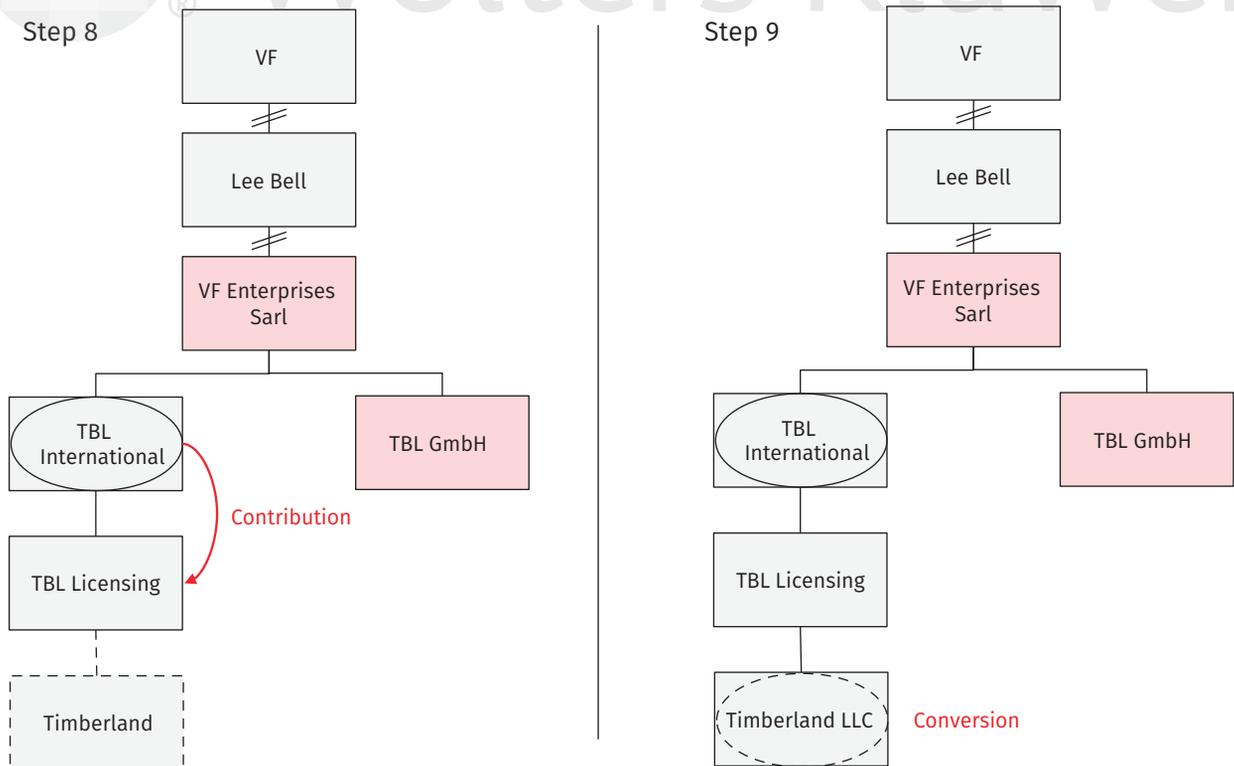


DIAGRAM 7.

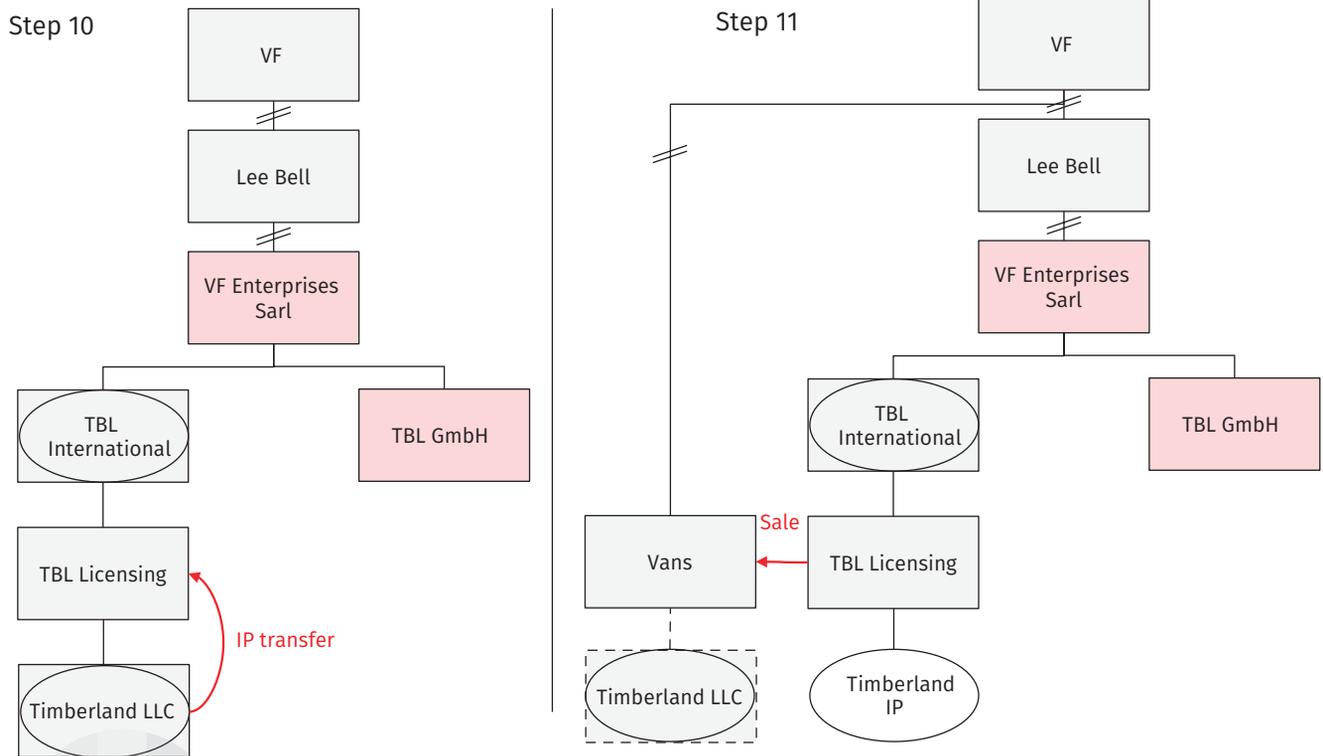
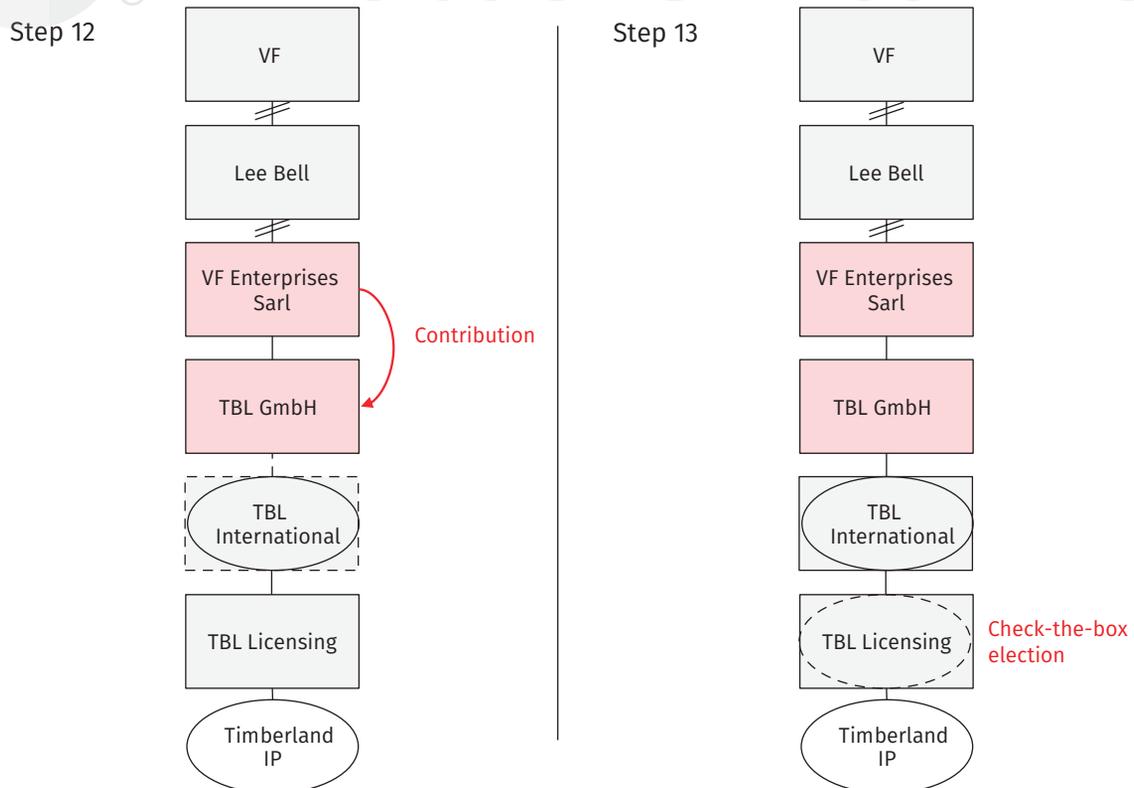


DIAGRAM 8.



amount of built-in gain inherent in the Timberland IP as a lump sum at the time the Timberland IP was “disposed of” under Code Sec. 367(d)(2)(A)(ii)(II).⁴ Secondly, the parties disagreed on whether, in determining the amount of income TBL Licensing had to recognize, the intangible property had a useful life limited to 20 years.

Granting summary judgment to the Service, the Tax Court held that TBL Licensing was required to recognize immediate U.S.-source ordinary income on the constructive transfer of its intangible property to TBL GmbH at the time it disposed of TBL GmbH stock to VF Enterprises. The court also held that the fair market value of the intangible property should be determined based on its actual useful life.

III. Second 367(d) Transfers and Subsequent Dispositions

Under Code Sec. 367(d)(1), if a U.S. person (the “U.S. Transferor”) transfers intangible property to a foreign corporation (the “Foreign Transferee”) in a Code Sec. 351 or 361 nonrecognition transaction, Code Sec. 367(d) applies to the transfer (a “Code Sec. 367(d) Transfer”) instead of the Code Sec. 367(a) rules generally applicable to outbound transfers. The rules under Code Sec. 367(d)(2) determine how income is taken into account when there is an outbound transfer of intangibles in a Code Sec. 351 or 361 nonrecognition transaction. First, under Code Sec. 367(d)(2)(A)(i), the U.S. Transferor transferring the intangible property is treated as having sold the intangible property in exchange for payments contingent on the productivity, use, or disposition of the property.

Second, the U.S. Transferor is treated as receiving amounts that would have been received either (i) annually in payments over the useful life of the intangible (Code Sec. 367(d)(2)(A)(ii)(I)) or (ii) in the case of a disposition following the transfer of intangible property (whether direct or indirect), at the time of the disposition (Code Sec. 367(d)(2)(A)(ii)(II)) (the “Disposition Rule”). In either case, the amounts taken into account under Code Sec. 367(d)(2)(A)(ii) must be commensurate with the income attributable to the intangible property, and the U.S. Transferor’s income inclusion is treated as U.S.-source ordinary income.⁵

The statutory Disposition Rule does not provide a further gloss on what constitutes a direct or indirect “disposition.” The Code does not provide whether a “disposition” is to a related or unrelated person. The legislative history suggests that the rule is concerned with the ultimate disposition of the underlying intangible property

itself, either directly or through a disposition of Foreign Transferee stock:

The conferees intend that disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor’s interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor. The amount of U.S.-source ordinary income will depend on the value of the intangible at the time of the second transfer.⁶

A straightforward reading of the Disposition Rule, taking into account Congressional intent, suggests that the gain in the intangible property is triggered when the U.S. Transferor completely relinquishes its interest in the intangible property itself, either directly or through an “indirect” ownership vehicle such as stock of an affiliated entity through which the U.S. Transferor indirectly owns the intangible property. Temporary regulations promulgated under Code Sec. 367(d) (the “Temporary Regulations”) support this interpretation. The Temporary Regulations only specify certain scenarios that require the U.S. Transferor to recognize income immediately when the Foreign Transferee subsequently disposes of the transferred intangible property or when the U.S. Transferor disposes of the Foreign Transferee stock.

The only rules under the Temporary Regulations requiring immediate gain recognition involve dispositions to *unrelated* persons. Temporary Reg. §1.367(d)-1T(f)(1)(i) provides that, if the Foreign Transferee disposes of the property received in the Code Sec. 367(d) Transfer to an unrelated person, the U.S. Transferor must recognize gain equal to the difference between the fair market value of the intangible property at the date of the subsequent disposition and the U.S. Transferor’s adjusted basis in the property as of the date of the initial transfer.⁷ This situation appears to represent the “direct” mode of disposition stated in the Disposition Rule. Conversely, if the Foreign Transferee subsequently transfers the intangible property to a related person, the U.S. Transferor’s (or a related U.S. transferee’s) obligation to recognize income or gain is not affected, and the related person that receives the intangible property is treated as the Foreign Transferee.⁸

Under Temporary Reg. §1.367(d)-1T(d)(1), if the U.S. Transferor disposes of the Foreign Transferee’s stock to an *unrelated* person, the U.S. Transferor is treated as having simultaneously sold the intangible property to the unrelated person acquiring the stock of the Foreign Transferee. The U.S. Transferor recognizes gain immediately in an amount equal to the difference between the fair market value of the transferred intangible property on the date

of the subsequent disposition and the U.S. Transferor's former adjusted basis in that property. This rule would appear to articulate the "indirect" mode of disposition provided in the Disposition Rule.

If the U.S. Transferor transfers stock of the Foreign Transferee to a *related* person, Temporary Reg. §1.367(d)-1T(e) applies instead, and the exceptions to income acceleration described below generally apply. If a U.S. Transferor transfers intangible property in a Code Sec. 367(d) Transfer and subsequently transfers the stock of the Foreign Transferee to *related U.S. persons*, there are three consequences. First, each related U.S. person is treated as receiving a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. Transferor. Second, each related U.S. person includes as ordinary U.S.-source income in their annual gross income, over the useful life of the property, a proportionate share of the amount that would have been included in the income of the U.S. Transferor over the useful life of the property. Finally, the amount the U.S. Transferor must recognize is reduced pursuant to a formula set forth in the regulations.

Temporary Reg. §1.367(d)-1T(e)(3) is titled, "*Transfer to related foreign person not treated as disposition of intangible property.*" Under this rule, if the U.S. Transferor instead transfers stock of the Foreign Transferee to *related foreign persons*, "the U.S. transferor shall continue to include in its income the deemed payments described in [Temporary Reg. §1.367(d)-1T(c)] in the same manner as if the subsequent transfer of stock had not occurred." The rule provided in paragraph (e)(3), however, does not apply with respect to the subsequent transfer by the U.S. Transferor of any of the remaining stock to any related U.S. person or unrelated person. Those transfers continue to be governed by Temporary Reg. §1.367(d)-1T(d), (e), and (f).

Notably, the rule in Temporary Reg. §1.367(d)-1T(e)(3) does not address Code Sec. 361 transfers in which the U.S. Transferor may cease to exist—*e.g.*, in an asset reorganization of the U.S. Transferor into a Foreign Transferee corporation. The Temporary Regulations' silence on this fact pattern left taxpayers with a "gap" in guidance with respect to how the rules should apply when the U.S. Transferor is deemed to transfer the intangible property to a Foreign Transferee by reorganizing into that Foreign Transferee. If the U.S. Transferor had a foreign exchanging shareholder, the deemed transactions of an asset reorganization (discussed below), would result in the U.S. Transferor's deemed transfer of the Foreign Transferee stock to a related foreign person, thus falling squarely within the "no disposition" rule in Temporary Reg. §1.367(d)-1T(e)(3). Thus, the statutory language, the legislative history, and

the framework provided in the Temporary Regulations suggest that an asset reorganization of a U.S. Transferor into a Foreign Transferee, where that U.S. Transferor has a foreign exchanging shareholder, could avoid the application of the Disposition Rule. As discussed below, the Tax Court decided that TBL Licensing "disposed of" the Timberland IP, and it did so without examining the interpretive "gap" in the Temporary Regulations.

IV. Did TBL Licensing "Dispose of" Its Intangible Property?

A. Deemed Transactions in an "F" Reorganization

The main issue before the court was whether the restructuring transactions described above—in particular, the TBL International Transfer and subsequent Election (collectively, the "Transactions")—resulted in a transfer of TBL Licensing's intangible property subject to income inclusion over time, or gave rise to a "disposition" requiring immediate gain recognition under the Disposition Rule. The Tax Court therefore first needed to determine which deemed transactions arose as a part of the outbound "F" reorganization of TBL Licensing.

The Tax Court looked to the reorganization rules to recharacterize the transaction. A substance-over-form view of the Transactions resulted in the "drop-and-check" of TBL Licensing into TBL GmbH, a newly formed Swiss corporation with no attributes, being treated as a "mere change in identity, form, or place of organization of one corporation, however effected"—in other words, an "F" reorganization.⁹ Applying the factors listed in *Berghash v. Commissioner*,¹⁰ the Tax Court concluded that the Transactions were indeed an "F" reorganization.¹¹ In particular, TBL GmbH emerged from the deemed transactions as essentially the same corporation as TBL Licensing, with the only substantive difference being a reincorporation of TBL Licensing in Switzerland, as opposed to the United States. TBL GmbH owned the same assets and had the same sole stockholder as TBL Licensing immediately prior to the Transactions, and TBL Licensing's business simply survived in a new legal form.

Having verified that the Transactions were an "F" reorganization, the Tax Court turned to the question of what, exactly, happened to TBL Licensing's assets *vis-à-vis* the application of Code Sec. 367(d). The Service relied on Reg. §1.367(a)-1(f) to argue that, in the Transactions, TBL Licensing distributed TBL GmbH stock to VF Enterprises and Code Sec. 361 therefore applied to the Transactions.¹²

Under Reg. §1.367(a)-1(f), an “F” reorganization causes the following events to be deemed to occur:

- (i) A transfer of assets by the transferor corporation to the acquiring corporation under Code Sec. 361(a) in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation’s liabilities;
- (ii) *A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation;* and
- (iii) An exchange by the transferor corporation’s shareholders (or shareholders and security holders) of their stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under Code Sec. 354(a).¹³

Under this construct, the Transactions would give rise to the following deemed events: (i) TBL Licensing transferred its assets to TBL GmbH in exchange for stock of TBL GmbH; (ii) TBL Licensing distributed the TBL GmbH stock to TBL Licensing’s shareholder, VF Enterprises; and (iii) VF Enterprises exchanged its TBL Licensing stock for stock of TBL GmbH, resulting in cancellation of the TBL Licensing stock.

The taxpayer pointed out that Code Sec. 367(a) applies only to transfers of tangible property, and that Reg. §1.367(a)-1(f) therefore did not apply with respect to transactions governed by Code Sec. 367(d) or its regulations.

The Tax Court concluded that TBL Licensing’s argument, while not without merit, was unpersuasive. The Tax Court reasoned that Treasury added paragraph (f) “to prevent tax avoidance” in outbound “F” reorganizations more broadly, not merely to prevent avoidance of Code Sec. 367(a).¹⁴ The court could not find any reason that concerns about tax avoidance in outbound “F” reorganizations were limited only to tangible property. Beyond this, any other construct used to explain the Transactions would have necessarily included an asset transfer described in Code Sec. 361(a), otherwise Code Sec. 367(d) would not have applied (contrary to the agreement of the parties). TBL Licensing necessarily would be treated as having transferred its intangible property in exchange for TBL GmbH stock. Because TBL Licensing no longer owned TBL GmbH stock after the Transactions, TBL Licensing must have transferred the TBL GmbH stock to VF Enterprises in some manner. The Tax Court determined this transfer was a distribution because “[t]he circumstances [did] not allow” for TBL Licensing having received consideration for that stock.

B. Application of the Code Sec. 367(d)(2)(A)(ii)(II) Disposition Rule

After determining the Transactions were an “F” reorganization to which Code Sec. 367(d) applied, the Tax Court then turned to the question of *how* Code Sec. 367(d) applied—*i.e.*, whether the outbound transfer of TBL Licensing’s intangibles should give rise to income over time, or whether the transfer was subject to the Disposition Rule, requiring immediate gain recognition under Code Sec. 367(d)(2)(A)(ii)(II).

The Service argued that TBL Licensing’s constructive liquidating distribution of TBL GmbH stock to VF Enterprises was a “disposition.” To support this view, the Service cited the conference report, discussed above, on the Deficit Reduction Act of 1984, which stated that the conferees’ intent “that disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor’s interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor.”¹⁵ According to the Service’s interpretation, the report’s use of “direct disposition” meant “a disposition of the IP [intangible property] itself by the transferee foreign corporation,” and its reference to “indirect” dispositions encompasses “a disposition by the domestic corporation of an interest in, *i.e.*, the stock of, the transferee foreign corporation that owns the IP.” The court did not address the fact that the conference report offered no further evidence as to whether a “disposition” to a related person should fall within the ambit of the rule. TBL Licensing argued that its distribution of TBL GmbH stock was not a disposition within the meaning of Code Sec. 367(d)(2)(A)(ii)(II), but the opinion indicates that the taxpayer offered no support for that position. The Tax Court agreed with the Service in the absence of a credible argument from TBL Licensing to the contrary and concluded that TBL Licensing’s deemed distribution of TBL GmbH stock to VF Enterprises was a “disposition” within the meaning of Code Sec. 367(d)(2)(A)(ii)(II) that followed TBL Licensing’s deemed transfer of the Timberland IP to TBL GmbH.

Interestingly, the opinion’s discussion of whether the Transactions gave rise to a “disposition” did not address the ambiguity inherent in the term “disposition,” other than determining what was intended by the qualifier “directly or indirectly.” The important question that the parties and the court omitted from the analysis was whether to *whom* the property was transferred mattered in determining whether a transfer constituted a “disposition.” The court accepted the Service’s interpretation and made no further inquiry into how “disposition” should be applied, implying that the intended meaning of the term was plain on its face and there was no ambiguity. Before jumping

to this conclusion, the Tax Court should have examined how Treasury and the Service have interpreted and applied that language in the regulations.

As discussed above, the Temporary Regulations provide only certain circumstances in which a subsequent transfer of the intangible property, or of the property through which the intangible property is owned (*i.e.*, Foreign Transferee stock), triggers gain. Importantly, all of these situations involve transfers to unrelated persons. In addition, Temporary Reg. §1.367(d)-1T(e)(3) is titled, “*Transfer to related foreign person not treated as disposition of intangible property*,” and it provides that, if the U.S. Transferor transfers stock of the Foreign Transferee to *related foreign persons*, “the U.S. transferor shall continue to include in its income the deemed payments described in Temporary Reg. §1.367(d)-1T(c) in the same manner as if the subsequent transfer of stock had not occurred.” Therefore, the only rule governing transfers of Foreign Transferee stock to related foreign persons (which is what was deemed to happen when TBL Licensing was deemed to distribute the stock of TBL GmbH, the Foreign Transferee, to VF Enterprises, a foreign related person) explicitly provides that such a transaction is *not* a disposition. Moreover, the rule does not require the transaction to be recharacterized as a disposition in the event that the U.S. Transferor reorganizes into the Foreign Transferee or otherwise goes out of existence. Thus, the Temporary Regulations provide a strong inference, at a minimum, that the U.S. Transferor’s reorganization into a Foreign Transferee should not give rise to a “disposition” that triggers gain under the Disposition Rule. While it is possible that the court may have disagreed with this interpretation, it is perplexing and disappointing that the court did not at least consider the Temporary Regulations or these arguments in reaching its conclusion.

The Tax Court also assessed whether the disposition occurred within the Timberland IP’s “useful life.” TBL Licensing asserted that, if it distributed TBL GmbH stock after its Code Sec. 367(d) Transfer of the Timberland IP, it did not need to recognize gain immediately because the transfer occurred before the Timberland IP’s useful life began. TBL Licensing argued in the alternative that, even if the transfer occurred during the Timberland IP’s useful life, Temporary Reg. §1.367(d)-1T(c)(3) (as in effect in 2011) provided that the useful life of intangible property could not exceed 20 years. The Tax Court disagreed with the taxpayer on both points, holding that TBL Licensing was required to recognize its full gain in the transferred Timberland IP, not limited to a 20-year useful life, at the time of the disposition.¹⁶

V. Lee Bell, the Unreasonable Proxy

The Tax Court then directed its attention to whether Lee Bell could have properly included the deemed annual payments between 2011 and 2017. For this portion of the analysis, the parties did address the Temporary Regulations. The general rule for income inclusion resulting from a Code Sec. 367(d) Transfer is provided in Temporary Reg. §1.367(d)-1T(c)(1):

If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, then such person shall be treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property.

TBL Licensing asserted that Lee Bell could properly include the annual payments because Lee Bell indirectly owned the transferred Timberland IP and was the first U.S. person that owned both TBL Licensing and TBL GmbH. The Tax Court flatly dismissed this argument as contrary to the plain terms of the Temporary Regulation—TBL Licensing, not Lee Bell, was the U.S. person that transferred intangible property. Therefore, the regulations’ plain language did not permit a “reasonable” substitute to report the deemed annual payments.

Similarly, TBL Licensing argued that Lee Bell’s reporting complied with Temporary Reg. §1.367(d)-1T(e)(3), which provides:

If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more foreign persons that are related to the transferor within the meaning of paragraph (h) of this section, then the U.S. transferor shall continue to include in its income the deemed payments described in paragraph (c) of this section in the same manner as if the subsequent transfer of stock had not occurred

TBL Licensing argued that VF Enterprises was related to TBL Licensing, and therefore this exception allowing the U.S. Transferor to continue to include deemed payments in income when it transfers Foreign Transferee stock to a foreign related person applied. The Tax

Court rejected that argument because Lee Bell was not “the U.S. transferor” of the Timberland IP, and there is no “reasonable proxy” exception in the regulations. Although TBL Licensing argued that Temporary Reg. §1.367(d)-1T(e)(3) was not limited to an “initial ‘U.S. transferor’” and contained no other limitations, the Tax Court dismissed any supposed limitation language as unnecessary.

Likewise, the Tax Court determined that TBL Licensing itself could not report deemed annual payments instead of recognizing immediate gain under Temporary Reg. §1.367(d)-1T(e)(3). Temporary Reg. §1.367(d)-1T(e)(3) was simply inapplicable to TBL Licensing because, as a result of the Election, TBL Licensing no longer existed as a separate entity for U.S. federal income tax purposes. Nor could TBL GmbH, which was organized under Swiss law, stand in as a successor to TBL Licensing, as it was “essentially different” from a U.S. Transferor.

For these reasons, the Tax Court held that TBL Licensing’s constructive distribution to VF Enterprises of TBL GmbH stock that TBL Licensing constructively received in exchange for the Timberland IP was a “disposition” within the meaning of Code Sec. 367(d)(2)(A)(ii)(II). The Tax Court likewise held that no provision of the Temporary Regulations allowed TBL Licensing to avoid the immediate recognition of gain under that statutory provision. Again, it is odd that the court did not consider the structural interpretive “gap” created by the Temporary Regulations—namely, that the Temporary Regulations specify only certain scenarios requiring immediate gain recognition, all of which involve transfers to unrelated persons, and that transfers of Foreign Transferee stock to foreign related persons are explicitly carved out of “disposition” treatment. Under TBL Licensing’s facts, therefore, there is a valid question of what a U.S. Transferor in this situation is supposed to do to comply with the income inclusion and reporting requirements. The Temporary Regulations could even be interpreted to provide that, where the U.S. Transferor goes out of existence by reorganizing into the Foreign Transferee, the Code Sec. 367(d) income inclusion requirement terminates. TBL Licensing did not take its interpretation of the Temporary Regulations to this extreme conclusion. Instead, TBL Licensing attempted to do the right thing by appointing the proximate U.S. group member, Lee Bell, to include the income as required under Temporary Reg. §1.367(d)-1T(c)(1). Unfortunately, the court did not consider this angle in connection with the silence of the Temporary Regulations on a disappearing U.S. Transferor.

VI. The Service’s Groundwork: Notice 2012-39 and CCA 201321018

TBL Licensing LLC represents the latest installment in a series of the Service’s attacks against transfers of IP in outbound reorganizations. In acquisition structures like the one undertaken in *TBL Licensing LLC*, a U.S. taxpayer would use a foreign acquisition vehicle—and thus foreign cash—to acquire a domestic target, and then redomicile the domestic target as a foreign corporation in a post-acquisition reorganization.

The Service sought to “clarify” the role of Code Sec. 367(d), including the Disposition Rule, through Notice 2012-39 (the “Notice”). The Notice outlined several varieties of what the Service perceived to be abusive transactions, including using stock basis of a recently acquired U.S. target to shield repatriations of foreign cash in an outbound asset reorganization. The Notice also targeted situations that it described as:

... cases in which a controlled foreign corporation uses deferred earnings to fund an acquisition of all or part of the stock of a domestic corporation from an unrelated party for cash, followed by an outbound asset reorganization of the domestic corporation to avoid an income inclusion under section 956. The Service and the Treasury Department believe that these transactions raise significant policy concerns, and, accordingly, intend to revise the regulations under section 367(d) in the manner described in this notice.¹⁷

The modified Code Sec. 367(d) regulations would address a domestic corporation’s transfer of Code Sec. 367(d) property in a Code Sec. 361 exchange with a transferee foreign corporation to “ensure that, with respect to all outbound Code Sec. 367(d) transfers, the total income to be taken into account under Code Sec. 367(d) is either included by the U.S. transferor in the year of the reorganization or, where appropriate, over time by one or more qualified successors.”

Importantly, the Notice defined a “qualified successor” as a domestic corporation (other than a real estate investment trust (“REIT”), regulated investment company (“RIC”), or S corporation) that owns stock in the transferee foreign corporation “immediately after” the reorganization. Conversely, if the U.S. target’s exchanging shareholder were not a qualified successor (*e.g.*, a foreign corporation), the Notice provided that the U.S. target would be required to recognize income immediately under the Disposition Rule.

The Notice provided a prospective applicability date, but qualified this with a statement that the Service would challenge transactions that occurred prior to the Notice's effective date under current law:

The regulations described in this notice will apply to outbound section 367(d) transfers occurring on or after July 13, 2012. No inference is intended as to the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

TBL Licensing argued that the Notice was “directly at odds” with the Service's position with respect to the Transactions, which occurred in 2011, because the result required under the Notice had prospective application to transactions occurring on or after July 13, 2012. Under the Notice, VF Enterprises, a foreign corporation, would not be a “qualified successor,” and TBL Licensing would have recognized gain under the Disposition Rule. TBL Licensing argued that the qualified successor rule should be subject to the applicability date of the Notice. The Service asserted that the same result would arise under 2011 law. TBL Licensing responded that, if that were true, the Service would have had no need to issue the Notice. The Tax Court dismissed TBL Licensing's argument, observing that the Notice's scope extended well beyond the circumstances of the immediate case. The non-qualified successor rule would require gain recognition not only by U.S. Transferors owned by foreign corporations but also by U.S. Transferors owned by individuals. Accordingly, the Tax Court decided that the Notice could have restated existing law and rejected TBL Licensing's argument.

The Tax Court made no reference to Chief Counsel Advice 201321018 (the “CCA”), which the Service issued shortly after the Notice.¹⁸ The CCA articulated the Service's theory for applying the Disposition Rule to outbound “F” reorganizations involving intangibles even in the absence of the revised Code Sec. 367(d) regulations described in the Notice.

In the CCA, Parent, a domestic corporation, owned Sub 1 and Sub 2, both domestic subsidiaries and members of Parent's U.S. consolidated group. Sub 2 owned Foreign HoldCo, a foreign corporation. Foreign HoldCo and Sub 1 jointly acquired Target, a domestic corporation. Target then reorganized into Foreign NewCo through an outbound “F” reorganization. As part of the reorganization, Target was deemed to transfer intangible property that was subject to Code Sec. 367(d) to Foreign NewCo.

Target did not report any income under Code Sec. 367(d), but Parent reported deemed royalty income under Code Sec. 367(d) relating to its transfer of intangible property to Foreign NewCo. The CCA notes that “[t]his position was consistent with the advice provided to Parent by Accounting Firm in an opinion letter . . . , which concluded that the regulations under Code Sec. 367(d) were ambiguous but that it would be prudent for Parent to report the entire Code Sec. 367(d) deemed royalty in its income.” Citing this opinion letter, the CCA states in a footnote that “Target underwent the outbound reorganization prior to the end of the subsequent quarter of Foreign HoldCo's taxable year with the intent that the Parent consolidated group could avoid an income inclusion under Code Sec. 956. The inclusion would have resulted from Foreign HoldCo holding the stock of Target, a domestic corporation, that constitutes U.S. property under Code Sec. 956(c)(1)(B).”

The Service issued a notice of proposed adjustment to Parent, alleging underreporting of Parent's Code Sec. 367(d) deemed royalty income from Target's transfer of the intangible property. Parent filed a protest, asserting that its reported Code Sec. 367(d) deemed royalty reflected an appropriate arm's-length charge for the intangible property. Parent also argued, in the alternative, that because Target went out of existence in connection with the transfer, neither Target nor Parent nor any other taxpayer was required to report the Code Sec. 367(d) deemed royalty. The Service then issued a second notice of proposed adjustment to Target asserting that Target must recognize gain on the intangible property under the Disposition Rule in Code Sec. 367(d)(2)(A)(ii)(II).

As in *TBL Licensing LLC*, the CCA set forth the deemed transactions involved in an “F” reorganization, following the rule provided in Temporary Reg. §1.367(a)-1T(f). The CCA also cited Rev. Rul. 89-103, which ruled that the deemed steps in an inbound “F” reorganization consisted of: (1) a transfer by the foreign target corporation under Code Sec. 361(a) of all of its assets and liabilities to a new domestic corporation in exchange for stock of the domestic corporation; and (2) a distribution by the foreign target corporation under Code Sec. 361(c) of the stock of the domestic corporation to the foreign target corporation's shareholders in exchange for their stock of the foreign target corporation. The Service noted that the Revenue Ruling explicitly applied the international provisions of the Code to the deemed transactions.

With respect to these deemed transactions, the Service observed:

Both the exchange and the distribution must be analyzed separately for purposes of applying the international provisions, including section 367(d). It is particularly important to analyze the exchange and distribution separately when a U.S. person transfers assets to a foreign corporation because the transfer often represents the government's last chance to tax the transferred assets before they leave U.S. taxing jurisdiction. For this reason, the regulations under section 367(a) explicitly set forth the separate steps of an outbound reorganization under section 368(a)(1)(F).

The CCA then examined the application of the international provisions—in particular, Code Sec. 367(d)—to the deemed transactions resulting from the “F” reorganization. First, the deemed Code Sec. 361(a) exchange created a Code Sec. 367(d) royalty during the useful life of the property (with a maximum duration of 20 years) under what the Service called the “General Rule” of Code Sec. 367(d)(2)(A)(ii)(I). Second, in the deemed Code Sec. 361(c) exchange, immediately before it went out of existence Target distributed to its shareholders the stock of Foreign NewCo. The Service concluded that, while the Code Sec. 361(a) exchange initially established a deemed Code Sec. 367(d) royalty under the General Rule, the deemed distribution of the Foreign NewCo stock constituted a disposition, triggering the Disposition Rule and requiring Target to recognize gain with respect to the intangible property.

Similar to *TBL Licensing LLC*, the dispute centered around whether a deemed stock distribution in a non-recognition Code Sec. 361(c) exchange was properly considered a “disposition” for purposes of the Disposition Rule. Parent argued that “Target’s distribution of the Foreign NewCo stock to its shareholders is not an indirect disposition of the Intangible Property because ‘the distribution is a transaction in which no gain or loss was recognized and the distribution was made to related parties.’” Noting that Parent supplied no support for its position, the Service determined that “a distribution constitutes a disposition without regard to whether it qualifies for nonrecognition treatment or is made to an unrelated party.” The CCA examined other Code provisions invoking the term “disposition” in nonrecognition contexts, as well as Black’s Law Dictionary, finding that these other uses comprehend nonrecognition transfers and noting that “[t]erms in a statute that are not specifically defined carry their ordinary meanings.” Therefore, the plain statutory language of the Disposition Rule “unambiguously requires Target to take into account the Disposition Rule Amount at the time of the distribution

of the Foreign NewCo stock to its shareholders (Sub 1 and Foreign HoldCo).” What the CCA fails to address is how, if the statute is clear and unambiguous, Treasury could expand on and modify the rule in regulations. The regulatory authority under Code Sec. 367(d)(1) appears to be limited to determining whether Code Sec. 367(a) or (d) applies to an initial transfer of property.¹⁹ If transfers to related parties are unambiguously “dispositions” for purposes of the Disposition Rule, it is puzzling how the Temporary Regulations could validly issue regulations providing that related-party dispositions are not “dispositions” for purposes of the Disposition Rule.

Next, the Service examined the Temporary Regulations to see if they modified the result the statute mandated. Temporary Reg. §1.367(d)-1T(d)(1) explicitly requires gain recognition in the event that the U.S. Transferor transfers intangible property to a Foreign Transferee corporation, after which the U.S. Transferor disposes of the Foreign Transferee’s stock to an unrelated person. Conversely, if the U.S. Transferor transfers stock of the Foreign Transferee to a *related* person, Temporary Reg. §1.367(d)-1T(e) applies instead and provides certain exceptions to income acceleration, discussed above, depending on whether the related person is U.S. or foreign. In the case that the related person is foreign, the U.S. transferor continues to include deemed payments in its income as if the subsequent transfer did not occur.

The CCA observed that, just because the only provision in the regulations to require gain (Temporary Reg. §1.367(d)-1T(d)(1)) applied to transfers of Foreign Transferee stock to unrelated persons, this did not limit the recognition of gain to *only* transfers to unrelated persons, nor did “this provision ... purport to set forth the only case in which the Disposition Rule applies.” The CCA concluded that the “Disposition Rule also applies to transfers of the transferee foreign corporation stock to related persons.”

Moving to the provision in the Temporary Regulations that *did* expressly apply to transfers to related persons, the CCA noted that Temporary Reg. §1.367(d)-1T(e) only provided exceptions to immediate gain recognition when the U.S. Transferor continued to retain an indirect interest in the intangible property through a related foreign person, or when there was a transfer to a related U.S. person that could “step into the shoes” of the original U.S. Transferor and include amounts under the General Rule. Where, as in the facts at issue, the U.S. Transferor ceases to exist, and the Foreign Transferee stock is deemed distributed to a *foreign* exchanging shareholder, the exceptions provided in the Temporary Regulations did not apply.

The CCA dismissed Parent’s arguments that a U.S. Transferor did transfer the Foreign Transferee stock to a related foreign person, and that the transaction therefore fell within the terms of Temporary Reg. §1.367(d)-1T(e)(3). Instead, the Service asserted that the regulation’s provision that “the U.S. transferor shall continue to include in its income the deemed payments” did not constitute a *consequence* of the transfer to a related foreign person. Rather, the U.S. Transferor’s ongoing inclusion of the deemed payments under Code Sec. 367(d) constituted a *precondition* to the availability of the exception in the first place. This is, at best, a strained reading of the Temporary Regulations. Temporary Reg. §1.367(d)-1T(e)(3) does not condition the availability of “no disposition” status on the original U.S. Transferor’s ability to continue to include the deemed payments in income under Code Sec. 367(d). What seems more likely is that the Service, when confronted by outbound IP restructuring transactions that it did not like, devised a *post hoc* argument to address the gap in the regulations that it had created.

The Service accused Parent of a “piecemeal and selective interpretation of the exception” that was incorrect. But the Service’s interpretation of the provision put the cart before the proverbial horse. The taxpayer in the CCA—and, indeed, TBL Licensing—interpreted the U.S. Transferor’s ongoing income inclusion to be the default consequence, and, in the event that the U.S. Transferor happened to liquidate as part of the transfer of Foreign Transferee stock to a related foreign person, it was up to *another* related U.S. person to include the income. In any case, it is noteworthy that Temporary Reg. §1.367(d)-1T(e)(3), which dealt expressly with Code Sec. 361 exchanges, did not contemplate the possibility that the U.S. Transferor might go out of existence as part of an asset reorganization. As discussed above, where the Temporary Regulations did address gain recognition, they only did so in connection with a transfer to an unrelated person, and the regulations did not specify treatment of a *deemed* distribution in a Code Sec. 361 transaction under the rule for transfers of Foreign Transferee stock to a related foreign person.

The silence of the Temporary Regulations on these points was the “gap” that the taxpayer in the CCA pointed out, but that the Service rejected by stating that the Disposition Rule in the statute, by itself, mandates the result. In addition, the Service claimed that “[t]he silence of a regulation on a particular point addressed by the statute cannot give rise to an implication that the statute does not apply to that case.” This statement does not take into account the basic problem that Treasury and the Service issued regulations under Code Sec. 367(d) to interpret a statutory provision that, as highlighted by the

very fact that it required interpretive regulations, needed interpretation. Once Treasury and the Service undertook a regulatory project to interpret the Disposition Rule, there is actually a very strong implication that the resulting regulation covers the instances in which the Disposition Rule does, and does not, apply. And, if it is obvious from the statutory plain language that the Disposition Rule covers transfers to foreign related persons, it does not make sense that Treasury could create an exception to this treatment under Temporary Reg. §1.367(d)-1T(e)(3). In any event, the court in *TBL Licensing LLC* considered Temporary Reg. §1.367(d)-1T(d) and (e) in the context of whether Lee Bell was in a position to correctly include the deemed payments under the “General Rule” of Code Sec. 367(d)(A)(2)(ii)(II) and concluded that no “reasonable proxy” was available where the original U.S. Transferor went out of existence. As discussed above, it is unfortunate that the court did not take the opportunity to explore in more depth these interpretive questions about the apparent “gap” left by the Temporary Regulations.

The CCA also set forth examples of transactions involving a U.S. person that succeeds to ownership of the Foreign Transferee stock. In these cases, the Service blessed examples where a U.S. person assumed the position of the original U.S. Transferor and provided a corollary to the “qualified successor” rule articulated in the Notice. In Example 1, UST, a domestic corporation, transferred intangible property to TFC, a foreign corporation, solely in exchange for TFC stock in a Code Sec. 351 exchange. UST then transferred all of the TFC stock to USS, a domestic corporation wholly owned by UST, solely in exchange for USS stock in a Code Sec. 351 exchange. The Service concluded that because a related U.S. person continued to include income under the Code Sec. 367(d) General Rule, the exception in Temporary Reg. §1.367(d)-1T(e)(1) applied. In Example 2, USP, a domestic corporation, owned UST, another domestic corporation. UST transferred intangible property to TFC in exchange solely for TFC stock in a Code Sec. 361 exchange resulting from an “F” reorganization. In connection with the reorganization, UST transferred the TFC stock to USP in a Code Sec. 361(c) distribution. The CCA found that the Code Sec. 361(c) distribution was a disposition, but that the exception in Temporary Reg. §1.367(d)-1T(e)(1) applied because UST distributed the TFC stock to USP, a related U.S. person. Therefore, it was “only when the stock is transferred to such a U.S. person that this exception reduces the Disposition Rule Amount.”

From this, taxpayers may conclude that the Service has confirmed that outbound asset reorganizations involving

a *domestic* exchanging shareholder are not subject to the Disposition Rule. The implicit policy justification for blessing this structure is that a domestic corporation that acquires UST presumably would not be able to make the acquisition using deferred foreign earnings that avoid U.S. taxation under Code Sec. 956 or otherwise. Interestingly, the court in *TBL Licensing LLC* dismissed the Service's policy-based arguments supporting immediate taxation of the Timberland IP "disposition." In footnote 4 of the opinion, the court stated, "[w]e see no respect in which the application of Code Sec. 367(d) to the transaction should turn on whether it occurred as part of a larger transaction that may have involved a tax-free repatriation of foreign earnings."

VII. Takeaways

The Service has won the first round in the fight over outbound "F" reorganizations involving intangibles. *TBL Licensing LLC* demonstrates the Service's willingness to hold tenaciously to positions articulated in guidance intended to shut down what it perceives to be "abusive" transactions. Especially interesting is the Tax Court's willingness to fight for the Service when Treasury had issued regulations on point, and those regulations, themselves, created ambiguity as to how to apply the statutory rule.

Perhaps implicitly, the regulatory ambiguity steered the court to focus exclusively on the statutory language, rather than examine the gap in coverage under the Temporary Regulations.

A potentially unintended consequence of *TBL Licensing LLC* is that it may provide taxpayers with an avenue to structure into Code Sec. 367(d) deemed royalty payments or immediate gain recognition as an elective matter. Code Sec. 367(d) was originally enacted to force income recognition over the life of intangible property that would presumably appreciate over time, preventing taxpayers from outbonding intangibles at favorably low valuations and triggering immediate gain under Code Sec. 367(a). The Temporary Regulations explicitly provide only limited circumstances in which a taxpayer may elect to apply Code Sec. 367(a), rather than Code Sec. 367(d), to a Code Sec. 367(d) Transfer.²⁰ The *TBL Licensing LLC* holding supports taxpayers' wielding the Code Sec. 367(d) rules as a club to affirmatively structure into nonrecognition "dispositions" to trigger gain as though the intangibles were outbonded subject to Code Sec. 367(a). Finally, the *TBL Licensing LLC* opinion was a missed opportunity to address the interpretive "gap" in the Temporary Regulations and scrutinize the Service's arguments in the CCA. It remains to be seen whether future taxpayers will take up the challenge.

ENDNOTES

¹ 158 TC No. 1, Dec. 62,003 (2022).

² VF Corporation Press Release, "VF to Acquire The Timberland Company for \$43 Per Share" (www.vfc.com/investors/news-events-presentations/press-releases/detail/1144/vf-to-acquire-the-timberland-company-for-43-per-share).

³ Code Sec. 367(d)(2)(A)(ii)(I) provides that, if a U.S. person transfers intangible property to a foreign corporation in a Code Sec. 351 or 361 exchange, that U.S. person is generally treated as receiving amounts which reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of the property.

⁴ Code Sec. 367(d)(2)(A)(ii)(II) provides that, if a U.S. person transfers intangible property to a foreign corporation in a Code Sec. 351 or 361 exchange and a "disposition" occurs after that transfer, that U.S. person is treated as receiving amounts which reasonably reflect the amounts which would have been received at the time of disposition.

⁵ Temporary Reg. §1.367(d)-1T(c)(1), (d)(1), (e)(1)(ii), (f)(1)(i), and (g)(2).

⁶ H.R. Rep. No. 98-861, 98 Cong., 2d Sess., at 955 (1984) (Conf. Rep.).

⁷ Temporary Reg. §1.367(d)-1T applies to transfers occurring before September 14, 2015, other

than transfers occurring before September 14, 2015, resulting from entity classification elections filed on or after September 14, 2015. Reg. §1.367(d)-1 applies to transfers occurring on or after September 14, 2015, and to transfers occurring before September 14, 2015, resulting from entity classification elections made under Reg. §301.7701-3 that are filed on or after September 14, 2015. Reg. §1.367(d)-1(j).

⁸ Temporary Reg. §1.367(d)-1T(f)(3).

⁹ Code Sec. 368(a)(1)(F).

¹⁰ 43 TC 743, Dec. 27,277 (1965), *aff'd*, CA-2, 66-1 ustrc ¶9446, 361 F2d 257 (1966). While Reg. §1.368-2(m) provides explicit rules treating a "drop-and-check" restructuring such as the Transactions as an "F" reorganization, these regulations did not apply to the tax year at issue in the case, and the Tax Court therefore looked to pre-regulation law to determine "F" reorganization status.

¹¹ The Tax Court noted that, although Treasury issued regulations in 2015 that elaborate on that definition, those regulations apply only to transactions on or after September 21, 2015 and thus did not apply to the Transactions.

¹² While Reg. §1.367(a)-1(f) was not adopted in final form until September 2015 in T.D. 9739, IRB 2015-41, 528, the rule applies "to transactions occurring on or after January 1, 1985."

Reg. §1.367(a)-1(g)(4). The first proposed and temporary regulations containing the rule were issued in January 1990. T.D. 8280, 1990-1 CB 80.

¹³ Emphasis added.

¹⁴ T.D. 8280, 1990-1 CB at 80.

¹⁵ H.R. Rep. No. 98-861, at 955 (1984) (Conf. Rep.).

¹⁶ The Tax Court dismissed TBL Licensing's first argument that the earliest possible date TBL GmbH could have placed the Timberland IP in service was September 26, 2011. TBL Licensing based its argument on Reg. §1.167(a)-3(b)(3), which provides that a taxpayer who depreciates an intangible asset over the specified 15- or 25-year useful life of that intangible asset "must determine the allowance by amortizing the basis of the intangible asset ... ratably over the useful life beginning on the first day of the month in which the intangible asset is placed in service by the taxpayer" The court determined that Reg. §1.167(a)-3 did not apply. The regulation "deals with cost recovery deductions allowable in respect of intangible assets—a question that would be irrelevant to a transferee foreign corporation that received intangible property in a Code Sec. 367(d) transfer unless that foreign corporation were engaged in a U.S. trade or business or subject to the rules of subpart F." Even if the regulation did apply, the plain terms

of Reg. §1.167(a)-3(b)(3) would have started the useful life of the Timberland IP in TBL GmbH's hands on September 1, 2011—weeks before the Transactions occurred—because that useful life would have begun “on the *first day of the month* in which the intangible asset is placed in service by the taxpayer.” With respect to TBL Licensing's second argument, the court determined that, where “useful life” appears in the provisions of

Temporary Reg. §1.367(d)-1T, it has to do with the period during which deemed annual payments must be taken into account. The provisions that actually require or allow gain recognition refer to the fair market value of the intangible property and do not expressly make the property's useful life relevant.

¹⁷ Notice 2012-39, IRB 2012-31, 95 (July 13, 2012).

¹⁸ (November 13, 2012).

¹⁹ See Code Sec. 367(d)(1) (“Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property to a foreign corporation described in Code Sec. 351 or 361—(A) [Code Sec. 367(a)] shall not apply to the transfer and (B) [Code Sec. 367(d)] shall apply to such transfer.”).

²⁰ Temporary Reg. §1.367(d)-1T(g)(2).

This article is reprinted with the publisher's permission from Taxes The Tax Magazine®, a monthly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to Taxes The Tax Magazine® or other journals, please call 1-800-344-3734 or visit taxna.wolterskluwer.com. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.



Wolters Kluwer