IRS Memo May Change IP Royalty Tax Prepayment Planning

By **William Skinner** (October 27, 2022)

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Taxpayers with royalties owing from a foreign affiliate may wish to negotiate a prepayment of the future royalty stream for a lump sum price.

This could include accelerating foreign source income or repatriating cash from a foreign entity without a dividend subject to local withholding tax.

Case law and rulings from the Internal Revenue Service have respected prepayments and sales of income streams as acceleration of income, if properly structured and effected on arm's length terms.[1]

However, can a taxpayer that has contributed intellectual property offshore under Section 367(d) similarly prepay contingent Section 367(d) royalties?[2] In the case of an outbound transfer of intangible property, Section 367(d) treats the IP as sold to the foreign affiliate for a series of payments contingent on the use, productivity or disposition of the IP.

In a recent Office of Chief Counsel Memorandum, AM 2022-003, released Sept. 9, the IRS ruled that the answer was no, taking a different approach from that taken in earlier guidance.[3]

Whatever the merits of the memorandum's legal conclusion, it highlights the potential differences between an actual license and a deemed license under Section 367(d), which should not be overlooked.

Section 367(d) Background

Section 367(d), enacted in its current form in 1984, was intended to prevent U.S. corporations from transferring valuable intangibles offshore as a contribution to capital outside the scope of Section 482. While an actual license or sale of intellectual property to an affiliate must be at arm's length, Section 482 generally does not override the nonrecognition provisions of the code, including Section 351.[4]

In its 1985 Eli Lilly & Co. v. Commissioner decision,[5] and its 1987 G.D. Searle & Co v. Commissioner decision,[6] the U.S. Tax Court held that contributions of patents to Puerto Rico possessions corporations in Section 351 transactions were not subject to Section 482.

In order to tax the future profits attributable to IP in a case similar to Eli Lilly or Searle, Section 367(d) treats the contribution of IP as a deemed sale of the IP to the foreign affiliate, for annual amounts commensurate with the income attributable to the IP.

While intended to put contributions on par with a sale for contingent payments for purposes of Section 482, Section 367(d) has its own detailed and complex mechanics for the treatment of the deemed sale transaction.

The amounts must be contingent with the use of the IP over a period equal to its useful life, except for limited exceptions in which the taxpayer may elect to recognize a lump sum amount. The amounts are treated as royalties, but only for certain purposes of the code.[7]

Special rules are provided for dispositions of either the IP or the stock of the transferee corporation.[8] As the IRC Section 367(d) deemed royalties arise, they are deductible by the payor for computing earnings and profits, Subpart F income and global intangible low-tax income.[9]

The U.S. taxpayer can establish an account receivable for the Section 367(d) deemed royalties, which can be repaid tax-free for three years.[10]

Results of AM 2022-003 and Comparison With Earlier IRS Guidance

One question that has arisen is how to treat a Section 367(d) transfer in part for stock and in part for money or other property, or in the case of the memorandum, a payment of cash by the foreign affiliate in excess of previously accrued royalty amounts.

On two prior occasions, the service issued guidance treating a payment of boot in an initial Section 367(d) transfer as a prepayment of the Section 367(d) royalty amount."Boot" is money or other property received in connection with a non-recognition exchange, such as a Section 351 transfer or tax-free reorganization under Section 368.

In the 2006 Chief Counsel Advice 200610019, the service addressed an outbound transfer of IP by a U.S. corporation in return for a mix of common stock and boot. The boot was taxable under Section 351(b). The transfer of IP to the foreign corporation would give rise to royalties taxable to the U.S. parent under Section 367(d).

Both the taxpayer and the service agreed: The application of these two provisions should not result in double taxation. The issue, however, was how to reconcile these two provisions to avoid that result.

The taxpayer argued that the transfer of IP should be split into two components: (1) a sale component for a lump sum taxable under Section 351(b); and (2) a contribution component that would give rise to Section 367(d) inclusions. The service, on the other hand, rejected this bifurcated treatment.

Although the service agreed that Congress did not intend for the same royalty to be taxed twice, it determined that the best way to harmonize the two provisions was to treat the payment of boot as an advance payment of the Section 367(d) royalty amount.

Under general tax accounting principles, an advance payment is generally recognized as income in the year in which it was received. Presumably, the actual Section 367(d) royalties would be excluded to the extent already taxed as a prepayment.

Second, the service also followed the prepayment approach to boot in an outbound Section 368 reorganization involving intangibles in Notice 2012-39. In the fact patterns described in the notice, a newly purchased U.S. corporation holding Section 367(d) intangibles was a party to tax-free reorganization into a foreign corporation, in which some element of boot was received.

The notice stated that regulations would provide that the cash payment would be treated as an advance payment of the Section 367(d) royalty amount. To the extent that the actual Section 367(d) royalties did not exceed the advance payment, the regulations would provide that the U.S. parent or its qualified successor could exclude those deemed royalties from income.[11]

From these authorities one might extrapolate that an advance payment of an existing Section 367(d) royalty is also permissible. In AM 2022-003, however, the service changed course.

There, the controlled foreign corporation had an ongoing Section 367(d) royalty obligation, and in year three, after the IP transfer, sought to make a prepayment of some or all of the remaining royalties. The taxpayer received a payment that was designated as an advance payment against the next three years' expected inclusions.

In AM 2022-003, the service advised that the Section 367(d) royalties were not susceptible of a prepayment. The amount of the cash payment was applied against the Section 367(d) accounts receivable — to the extent thereof — and, thereafter, would be treated as a distribution on the CFC's stock. Therefore, the payment did not accelerate the Section 367(d) royalty income or the payor's deduction for the deemed royalties under the Section 367(d) regulations.

In reaching this conclusion, the service reasoned that Section 367(d) was intended to require the taxpayer to include amounts in income over the useful life of the intangible or on a subsequent transfer.

Under the regulations, the memorandum stated, it was the use of the intangible property, not the payments received that determined the amount of income. A section 367(d) notional royalty was different from an actual royalty or sale, according to the memorandum. The memorandum also cited administrative difficulties in tracking the prepaid amount.

Regardless of the merits of these interpretations, they run counter to the position taken in the prior authorities discussed above. If the cash payment in the recent memorandum is bifurcated from the Section 367(d) royalty, why was it treated as part of that transaction in the prior authorities?

The memorandum's answer, in part, was to distinguish the prepayment approach in Notice 2012-39 as "intended, in part, to prevent a transaction perceived as an inappropriate repatriation of cash."

Perhaps more fundamentally, the memo stresses the differences between a Section 367(d) transfer and an actual license or sale. In relevant part, it states:

> A U.S. person that wishes to transfer intangible property to a foreign corporation may choose how that transfer occurs. For example, the U.S. person may sell the intangible property to the foreign corporation, license the intangible property to the foreign corporation, or transfer the intangible property to a foreign corporation in an exchange described in section 351 or 361. If a U.S. person chooses to transfer intangible property pursuant to an exchange described in section 351 or 361, such a transfer will be governed by the rules that Congress enacted in section 367(d).

As illustrated by the prepayment scenario, the Section 367(d) rules can yield significantly different and sometimes surprising results as compared to an actual license or sale.

As a separate line of 2019-2020 private letter rulings illustrates,[12] the Section 367(d) royalty charge may, absent specific relief by ruling, remain in place even after the intangibles are repatriated to the U.S.[13]

Where an actual sale or license is possible, this would often leave the taxpayer with more planning flexibility than that afforded under the Section 367(d) regulations.

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[1] See, e.g., Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973); PLR 201131023 (Apr. 28, 2011); PLR 200829011 (Mar. 28, 2008). Even concurrently with this article, the service advised that a prepayment of royalty income should be treated as an advance payment of royalties under Section 61. See Field Attorney Advice 20224001F (Oct 7, 2022) (citing Reg. Section 1.61-8(a) with respect to the treatment of advance rentals).

[2] https://www.taxnotes.com/research/federal/usc26/367; Internal Revenue Code Section 367(d).

[3] https://www.irs.gov/pub/lanoa/am-2022-003.pdf.

[4] https://www.irs.gov/pub/irs-apa/482_regs.pdf; IRC Section 482.

[5] Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985).

[6] https://casetext.com/case/gd-searle-co-v-commissioner-of-internal-revenue.

[7] https://www.taxnotes.com/research/federal/usc26/367.

[8] https://www.govinfo.gov/content/pkg/CFR-2010-title26-vol4/pdf/CFR-2010-title26-vol4-sec1-367d-1T.pdf.

[9] Reg. Section 1.367(d)-1T(c)(2); Reg. Section 1.951A-2(c)(2)(ii).

[10] Reg. Section 1.367(d)-1T(g)(1). The net effect of this account receivable is similar to a Rev. Proc. 99-32 account to allow a taxpayer suffering a Section 482 adjustment to repatriate the amount of the adjustment tax-free.

[11] https://www.irs.gov/pub/irs-drop/n-12-39.pdf.

[12] See PLR 202107011 (Nov. 24, 2020) and PLR 201936004 (June 5, 2019).

[13] A guidance project to fix this potential glitch in the Section 367(d) regulations apparently is underway at the service. See Andrew Velarde, "IRS Aims for Proposed Regs on IP Repatriation by End of Year," 2022 TNTI 181-2 (Sept. 20, 2022).