

# TAX 101: DEEMED ANNUAL ROYALTY ON OUTBOUND TRANSFERS OF I.P. TO FOREIGN CORPORATIONS

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## Tags

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For many years, the U.S. government has been concerned about U.S. businesses reducing or deferring U.S. income tax liabilities through the use of foreign corporations. Recently, the issue has come to the fore with respect to transfers of intangible property, and the government has sought to rein in these activities by tightening regulations under Code §367.

## BACKGROUND

In the early 1930s, when the world and tax laws were simpler, Congress enacted Code §367 to discourage the transfer of appreciated property by U.S. persons (e.g., U.S. citizens or residents, domestic partnerships, domestic corporations) to foreign corporations. The concern was that a U.S. person could transfer appreciated property to a foreign corporation formed in a low-tax jurisdiction. The transaction could be structured as a nonrecognition transaction for U.S. Federal income tax purposes (such as a tax-free contribution of capital or a tax-free outbound reorganization). The foreign corporation could subsequently sell the appreciated asset and the gain generally could escape U.S. taxation.

Somewhat later, Code §367 was used to target the reorganization of a U.S. corporation into a foreign corporation that would be based in a low-tax jurisdiction – a transaction ultimately referred to as a corporate inversion. Under an earlier version of the regulations under Code §367, outbound transfers of intangible assets, including intellectual property (“I.P.”), could qualify for nonrecognition treatment in certain instances. By the 1980s, Congress became concerned that a number of U.S. businesses were developing I.P. at U.S. facilities and transferring the I.P. to foreign manufacturing subsidiaries incorporated in a low-tax jurisdiction. The ownership of the I.P. by the manufacturing subsidiary abroad enabled the U.S. company to increase the transfer price paid on purchases from that subsidiary. After all, the subsidiary owned the I.P. Consequently, by engaging in this type of practice, the U.S. company could achieve three tax planning bonanzas. First, the research and development expenses could be deducted when and as incurred.<sup>1</sup> Second, the operating profits derived abroad by the foreign manufacturing subsidiary could be deferred for income tax purposes<sup>2</sup> and permanently deferred for financial accounting purposes.<sup>3</sup> Third, the ownership of manufacturing I.P. abroad justified higher prices for inventory transactions, which allocated greater profit to the foreign subsidiary without resulting in higher import tariffs in some circumstances.<sup>4</sup> During this time, Congress

<sup>1</sup> Code §174.

<sup>2</sup> HR Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. (Mar. 5, 1984).

<sup>3</sup> S.F.A.S. 109.

<sup>4</sup> The U.S. has adopted a Generalized System of Preferences in tariffs.

addressed the concern with the enactment of Code §367(d), which introduced the deemed annual royalty regime for outbound transfers of intangible assets – those transfers are treated as transfers pursuant to a sale involving contingent payments.<sup>5</sup>

Despite the government’s efforts, Code §367 has not deterred some U.S. businesses from inverting, as they may find that the tax cost of Code §367 is worth the benefit of removing or deferring income from the reach of relatively high U.S. Federal corporate income tax (currently, the rates are 34% and 35%), potential exposure to tax under Subpart F on profits of foreign subsidiaries that are controlled foreign corporations, and the lock-out effect under which publicly traded corporations can trigger deferred tax liabilities for financial statement purposes if they access earnings of foreign subsidiaries.<sup>6</sup>

As a result, Congress and the I.R.S. have continued to implement considerable disincentives for outbound transfers and inversions.

The most important was the 2004 enactment of Code §7874, which will disregard an inversion transaction under certain circumstances. Additionally, the U.S. transfer pricing regime has been used to scrutinize inversion transactions (e.g., the Code §482 regulations may recharacterize the transfer of I.P. as the provisions of technical services and, thus, require the payment of compensation for the U.S. corporation, with the compensation income characterized as U.S. source income which cannot be reduced by foreign tax credits). Further, if the outbound transfer will involve debt, the limitations on interest deductions under Code §163(j) and the debt-equity rules of Code §385 should be considered. Though beyond the intended scope of this article, the foregoing Code sections and regulations should be considered when planning an outbound transfer.



## THE MECHANICS OF CODE §367(A)

Code §367(a) applies to transfers by U.S. persons of property, including stock or securities, to foreign corporations in transactions otherwise qualifying for nonrecognition treatment, including contributions to controlled corporations under Code §351 and certain transfers relating to corporation reorganizations. It states, in the case of such a transfer, that the foreign corporation will not be treated as a corporation for the purposes of determining the extent to which gain must be recognized on the transfer. Since nonrecognition treatment in transactions covered by Code §367(a) hinges on the transferee being a corporation, negating the foreign corporation’s existence as a corporation has the effect of denying nonrecognition treatment. Additionally, it should be noted that Code §367(a) requires the recognition of gain, but not loss, in the transaction.

The general rule of Code §367(a) has several exceptions, including an exception for property transferred to a foreign corporation for use by the foreign corporation in an active trade or business outside the U.S., often referred to as the Foreign Trade or Business Exception.<sup>7</sup> This exception recognizes that in a globalized economy,

<sup>5</sup> Code §367(d)(2).

<sup>6</sup> See Donald J. Marples and Jane G. Gravelle, “Corporate Expatriation, Inversions, and Mergers: Tax Issues.” Congressional Research Service (August 17, 2017).

<sup>7</sup> Code §367(a)(3).

a U.S. person may have *bona fide* business reasons for forming or reorganizing a foreign corporation. Importantly, the Foreign Trade or Business Exception does not apply to transfers of intangible property, as defined in Code §936(h)(3)(B), which broadly defines the term and includes most forms of I.P.

## THE DEEMED ANNUAL ROYALTY REGIME OF CODE §367(D)

Before the enactment of Code §367(d) and certain amendments that made the application of Code §367(a) based on more objective standards (e.g., the tightening of the Foreign Trade or Business Exception to specifically exclude intangible property), the transfer of I.P. by a U.S. person to a foreign corporation could potentially qualify for tax-free treatment if the foreign corporation used the I.P. in an active trade or business. If the transfer could not qualify for the Foreign Trade or Business Exception, it generally would be subject to Code §367(a) and, therefore, immediate recognition of any built-in gain.

Code §367(d) introduced a deemed annual royalty regime, thus generally removing the transfer of intangible property by a U.S. person to a foreign corporation from the application of Code §367(a). Under the deemed annual royalty regime, a U.S. person that transfers any intangible property, as defined in Code §936(h)(3)(B), to a foreign corporation in an exchange under Code §351 (relating to the tax-free contribution of capital to a controlled corporation) and Code §361 (relating to nonrecognition treatment for a distributing corporation in certain reorganization transactions) is treated as having sold the property for payments that are contingent upon the property's productivity, use, or disposition and having received amounts that reasonably reflect the amounts that would have been received annually in the form of the deemed payments over the useful life of the property. In the case of a direct or indirect disposition following the transfer, the amount should reflect the amount paid at the time of the disposition.<sup>8</sup>

The deemed annual royalty regime requires the U.S. transferor to treat the deemed payments as “commensurate with the income attributable to the intangible.”<sup>9</sup> This concept is derived from the U.S. transfer pricing rules on intangible assets, under which the U.S. transferor is deemed to charge the foreign transferee an arm's length amount for the foreign transferee's use of the intangible asset over the asset's useful life.

One of the few taxpayer-favorable provisions of the deemed annual royalty regime is that the earnings and profits of the transferee foreign corporation are reduced by the amount of the deemed annual royalty payments.<sup>10</sup>

Another favorable rule is that deemed royalty payments are considered foreign-source income, although they are treated as ordinary income, not capital gain.<sup>11</sup> Since they are treated as foreign-source income, the deemed royalty payments are considered foreign-source royalty income and can be used to calculate the U.S.

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<sup>8</sup> Code §367(d)(2).

<sup>9</sup> Code §367(d)(2) flush language.

<sup>10</sup> Code §367(d)(2)(B).

<sup>11</sup> Code §367(d)(2)(C).

transferor's foreign tax credit limitation.<sup>12</sup>

It should be noted that the subsequent sale of the I.P. by the transferee foreign corporation to an unrelated party during the I.P.'s useful life yields a harsh result for the initial U.S. transferor under Code §367(d). The regulations state that at the time of the I.P.'s sale by the transferee foreign corporation seller, the initial U.S. transferor must recognize gain, but not loss, on the sale equal to the difference between the I.P.'s fair market value at the time of the sale and the initial U.S. transferor's original adjusted basis, without any increase for any deemed royalty payments that the initial U.S. transferor may have recognized as income during the I.P.'s useful life before the sale. Additionally, during the tax year of the sale, the initial U.S. transferor must recognize any deemed royalty income attributable to the part of the tax year before the date of the sale. However, if the transfer is to a related U.S. person or a related foreign person, the application of the deemed royalty regime continues unaffected.<sup>13</sup>

*“Deemed royalty payments are considered foreign-source royalty income and can be used to calculate the U.S. transferor’s foreign tax credit limitation.”*

## SPECIAL ELECTION TO TREAT AN OUTBOUND TRANSFERS AS A SALE

In very limited circumstances, a U.S. person may elect to treat the transfer of intangible assets, including in some instances I.P., as a sale rather than deemed royalty income.

The circumstance most relevant in the I.P. context is the outbound transfer of intangible property to a newly formed foreign corporation in which the intangible property constitutes a significant portion of the foreign corporation's assets, as follows:

The U.S. transferor transfers the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation.

Immediately after the transfer, the U.S. transferor owns at least 40% but not more than 60% of the total voting power and value of the stock of the transferee foreign corporation. This is intended to avoid any tax consequences arising from an inversion transaction.

Immediately after the transfer, at least 40% of the total voting power and the total value of the stock of the transferee foreign corporation is owned by unrelated foreign persons.

The intangible property constitutes at least 50% of the fair market value of the property transferred to the foreign corporation by the U.S. transferor.<sup>14</sup>

Where a deemed sale election is made, the fair market value of transferred property is the single payment arm's-length price that would be paid for the property by an unrelated purchaser determined in accordance with the principles of Code §482. The allocation of a portion of the purchase price to intangible property agreed to by the parties to the transaction will not necessarily be controlling for this purpose.<sup>15</sup>

<sup>12</sup> *Id.*

<sup>13</sup> Treas. Reg. §1.367(d)-1T(f).

<sup>14</sup> Treas. Reg. §1.367(d)-1T(g)(2)(iii).

<sup>15</sup> Treas. Reg. §1.367(d)-1T(g)(5).

As an alternative to a contribution of I.P. in return for shares, a U.S. taxpayer may make an actual sale or license of intangible property by a U.S. person to a foreign corporation. In that case, the rules of Code §367 are inapplicable. If an adjustment under Code §482 is required with respect to an actual sale or license of intangible property, Code §367(d) will not apply to the required adjustment. Rather, the sale price will be adjusted upward.<sup>16</sup> On the other hand, a purported sale or license of intangible property may be disregarded, and treated as a transfer subject to Code §367(d), if the purported sale or license is made to a foreign corporation in which the transferor holds (or is acquiring) an interest and the terms of the purported sale or license differ so greatly from the economic substance of the transaction or the terms that would be obtained between unrelated persons that the purported sale or license is a sham.<sup>17</sup> The terms of a purported sale or license will be determined by reference not only to the nominal terms of the agreement but also to the actual practice of the parties. Contractual terms that exist on paper, but are not followed, will be ignored. Note that a sale or license of intangible property will not be disregarded solely because other property of an integrated business is simultaneously transferred to the foreign corporation by the U.S. transferor in a transaction described in Code §367(a)(1).

## CONCLUSION

While the toll-charge of Code §367(a) may be a burden, Code §367(d) can be an even harsher response to the concern over U.S. businesses shifting income and gain outside the U.S. tax jurisdiction. This reflects the fact that intangible assets are relatively easy to move from one jurisdiction to another and are increasingly the key income-generating assets of many businesses. The only exceptions to the application of Code §367(d) are a deemed sale of property in controlled circumstances (as discussed above) or a true sale that is honored in the way the taxpayer and its foreign subsidiary carry out the written terms.

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<sup>16</sup> Treas. Reg. §1.367(d)-1T(g)(4)(i).

<sup>17</sup> Treas. Reg. §1.367(d)-1T(g)(4)(ii).