A Note From the Editor-in-Chief

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Subpart F: Gain from the Sale of Intangible Property

It is common for multinational groups to own intangible property in a separate controlled foreign corporation (CFC) that licenses the intangibles to foreign affiliates for use in their businesses. Royalties earned by the CFC generally are not Subpart F foreign personal holding company income (FPHCI). In contrast, gain recognized from the sale of such intangible property generally is FPHCI. Fortunately, with proper structuring, gain on the sale of intangible property used in the conduct of a group’s business outside the United States should not be subject to Subpart F.

To illustrate, assume a Luxembourg CFC (“LuxCo”) owns certain intangible property (e.g., trademarks, copyrights or patents) and licenses the intangibles to related operating CFCs. The intangible property is used by the related CFCs in their manufacturing, sales or services businesses. Royalties received by LuxCo generally should not be FPHCI under Code Sec. 954(c)(6).1 LuxCo desires to sell the intangible property. What might come as a surprise is that any gain recognized by LuxCo on the sale generally would be FPHCI, even though the royalties earned were not FPHCI. This is the result whether the intangible property is sold to a related or an unrelated person.

More specifically, Code Sec. 954(c)(1)(B) provides, in relevant part, that FPHCI generally includes gains in excess of losses from the sale of property that gives rise to certain types of income.2 Such income includes royalties. Therefore, gain from the sale of intangible property that gives rise to royalty income generally constitutes FPHCI.3

No exception is provided for gain from the sale by LuxCo of the intangible property that it licensed to related CFCs. This is the case even if the intangible property is used in the business of the global group. The fact the royalties are excluded from FPHCI is irrelevant. The result is the same even if the CFC developed the intangible property itself or engaged in an active licensing business.4

On the other hand, gain from the sale of intangible property used by a CFC in its own business operations (other than a licensing business) generally does not give rise to FPHCI. Rather than generating royalty income, the income derived with respect to the ownership of such intangible property is embedded in manufacturing, sales or services income.

More specifically, Code Sec. 954(c)(1)(B) provides, in relevant part, that the definition of FPHCI includes the excess
of gains over losses from the sale or exchange of property that “does not give rise to any income.” The regulations broadly define this phrase to potentially include all property that does not give rise to periodic income (e.g., a piece of art work) or property that itself does not directly generate current income (e.g., property used in a manufacturing and sales business).3

The regulations provide, however, that this category of FPHCI does not include gains from the sale or exchange of property “used or held for use in the controlled foreign corporation’s trade or business.” The regulations expressly apply this exception to intangible property. For this purpose, “intangible property” is broadly defined, and expressly includes goodwill and going-concern value.7

Accordingly, gain from the sale of intangible property used by a CFC in its manufacturing, sales or services business generally is not FPHCI, whether sold to a related or unrelated person.8 The gain should not be FPHCI even if the CFC derives Sub-part F sales or services income from exploiting the intangible property.9

This exception can apply to a CFC that owns intangible property and licenses the property to related entities. If in the above example LuxCo instead licensed the intangible property to entities that were disregarded, the royalty income would be ignored for U.S. tax purposes.10 Thus, the disregarded royalty income would effectively be embedded in manufacturing, sales or services income. Accordingly, gain from the sale of the intangible property by LuxCo should not be FPHCI if the property qualifies for the trade or business exception.11

Additional planning is available when the intangible property is transferred to a related person. The intangible property could be transferred in exchange for shares and qualify for tax-free treatment under Code Sec. 351.12 In addition, a “sale” to a related CFC could be structured as a license whereby LuxCo does not transfer all substantial rights in the intangible property, and thus the payments received by LuxCo (even if a lump sum) should be characterized as a royalty, eligible for the FPHCI exception provided by Code Sec. 954(c)(6).13

In sum, gain from the sale of intangible property licensed to related CFCs for use in their businesses generally is FPHCI. A disregarded entity structure can be used to prevent this result by embedding the intangible property profits in sales or services income, qualifying the gain for the exception for property used in a trade or business. FPHCI treatment of transfers of intangibles to a related person also can be avoided with tax-free transfers or structuring a “sale” as a license.

ENDNOTES

1 The royalty income generally would be FPHCI to the extent the royalty expense reduces Subpart F income of the licensee. Notice 2007-9, IRB 2007-5, 401. See also Code Sec. 954(c)(3)(A); Reg. §1.954-2(b)(5) (same-country exception for royalties).

2 Code Sec. 954(c)(1)(B)(i); Reg. §1.954-2(e)(2)(i).

3 The gain would also be classified as passive income for purposes of the foreign tax credit rules. See Yoder, A Note from the Editor-in-Chief, Intercompany Royalties: Foreign Tax Credit Category, INT’L TAX J., Nov.–Dec. 2011, at 3.

4 An exception is provided for gains from the sale of property that gives rise to royalties derived from an unrelated person in the active conduct of a trade or business. Code Sec. 954(c)(3)(B); Reg. §1.954-2(e)(1)(iii)(C).

5 Reg. §1.954-2(e)(3).

6 This is consistent with the legislative history, which states that this general rule “is not intended to apply to gain on the sale of land, buildings, or equipment used by the seller in an active trade or business of the seller at the time of the sale.” H.R. Rep. No. 841, 99th Cong. 2d Sess., II-615 (1986).

7 Reg. §1.954-2(e)(1)(ii) and (e)(3)(iv).

8 Note that the gain may also need to be tested under the foreign base company sales income rules. Code Sec. 954(d). See Reg. §1.954-3(a)(1)(ii) (exception to definition of “foreign base company sales income” for certain property sold as part of discontinuing a CFC’s trade or business). See also Reg. §1.954-1(e)(4)(iii) (priority rules provide that income excluded from a FPHCI category may be tested under another category of foreign base company income).


10 Reg. §301.7701-2(a). Other tax consequences of a disregarded entity structure should be considered. See Yoder, A Note from the Editor-in-Chief, Code Sec. 954(c)(6) and the Same Country Rules for Sales and Services Income, J. TAX’N GLOBAL TRANS., Fall 2006, at 3; Yoder, A Note from the Editor-in-Chief, Living Without Code Sec. 954(c)(6), Int’l Tax J., Jan.–Feb. 2011, at 3.

11 If LuxCo derived royalty income for a period of time and later elections were made to disregard the licensees, consideration should be given to the change-in-use rule. Reg. §1.952-2(a)(3)(i).
