International Tax Watch

IRS Modifies Active Lease and Licensing Regulations

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I. Introduction

U.S. taxpayers are generally not subject to U.S. federal income tax on the earnings of their foreign corporate subsidiaries. Instead, U.S. federal taxation on such earnings is generally deferred until the earnings are distributed and repatriated into the United States. The major exception to this rule is the Internal Revenue Code's subpart F regime.[1] Under this regime, " U.S. shareholders" are taxed currently on their *pro rata* share of a "controlled foreign corporation's" (CFC) subpart F income.[2] There are various categories of subpart F income and "foreign personal holding company income" (FPHCI) is one such category.[3] FPHCI generally includes passive-type income and it specifically includes rents and royalties.[4] Nevertheless, an exception applies when rents and royalties are derived from unrelated parties in connect with the active conduct of a trade or business. Rents and royalties qualifying for the exception are not treated as subpart F income.

The rationale for this exception goes to the heart of the distinction between income that is FPHCI and income that is not. In enacting the FPHCI rules, Congress set forth a distinction between a CFC's active business earnings, which should be entitled to U.S. federal income tax deferral, and its passive earnings, which should not.[5] Active earnings are tied to a CFC's business outside of the United States and therefore they are a part of the CFC's ability to compete with other businesses in their local jurisdictions. Therefore, such earnings, as long as they are held in corporate solution, should be subject to the same tax rate as other local businesses, so that they can compete on a level playing field with such local businesses. The assumption underlying the FPHCI is that passive earnings are highly mobile and do not need to be earned abroad for competitive reasons and so should be taxed currently in the United States. Therefore, FPHCI was not intended to include the rental/royalty income of a CFC that is actively engaged in the business of leasing/licensing property. The requirements to qualify for the active rents/royalties exception are provided in treasury regulations, finalized in 1995.

New temporary regulations issued on September 1, 2015 ("Temporary Regulations") modify the language of the regulations and the requirements to qualify for the active rents/royalties exception. The purpose of this column is to summarize key aspects of the pre-September 1, 2015, rules and then explain how the Temporary Regulations modify the rules.

II. Pre-September 1, 2015 Rules

The regulatory framework for the active rents exclusion is very similar to the framework for the active royalties exclusion. In both cases, there is a "development" exception and a "marketing" exception. The full text of the regulations, prior to the Temporary Regulations, is shown in Table 1.[6]

A. Development Exception

The development exception for both rents and royalties required either that the CFC be the developer of the leased/licensed property or add substantial value to the property. Furthermore, the CFC was required to be "regularly engaged" in development and/or addition of substantial value to such or to similar property. However, there was no requirement that the officers or the employees of the CFC be involved in the development of the property or in adding substantial value.

Because there was no requirement that the CFC's own employees perform the development work, taxpayers had been taking the position that the development exception could be satisfied through the CFC's participation in a cost sharing agreement (CSA). This is because the language of the regulations and case law[7] suggested that the cost sharing participant was deemed to develop the intangible property that was the subject of the CSA.

An illustration of this position is as follows. A U.S. parent corporation, USP, is a research and development (R&D) company that develops certain intellectual property (IP) and markets the licenses for its IP to third parties. USP enters into a CSA with its CFC, under which USP will have the right to exploit the IP inside of the United States and the CFC will have the right to exploit the IP abroad (the OUS IP). All of the R&D for and marketing of the IP has been and will continue to be conducted by USP. CFC enters license agreements with third parties to exploit the OUS IP.

Under the regulations, USP and CFC may have taken the position that the development exception applies because both parties to the CSA should be treated as engaging in the activities performed under the CSA. Therefore, CFC was "regularly engaged" in the development or in the addition of substantial value to the

TABLE 1

Exclusion for Active Rental Income	Exclusion for Active Royalty Income
(c) Excluded rents—(1) Active conduct of a trade or business. Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—	(d) Excluded royalties—(1) Active conduct of a trade or business. Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—
(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;	(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or
(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.	(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.
(2) Special rules—(i) Adding substantial value. For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.	(2) Special rules—(i) Adding substantial value. For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.
(ii) Substantiality of foreign organization. For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.	(ii) Substantiality of foreign organization. For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

IP. Therefore, under the prior rules, the OUS license income to CFC, arguably, was not FPHCI and therefore not subpart F income, even though CFC had no operations or employees and was essentially a passive entity that served no purpose other than to collect and defer U.S. realization of royalty income.

B. Marketing Exception

The marketing exception, for both rents and royalties, required that the CFC perform marketing and/or services with respect to the leased/licensed property. The test also required that the marketing and/or servicing

TABLE 2

Exclusion for Active Rental Income	Exclusion for Active Royalty Income
(c) Excluded rents—(1) Active conduct of a trade or business. Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following-	(d) Excluded royalties—(1) Active conduct of a trade or business. Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—
(i) Property that the lessor, through its own officers or staff of employees, has manufactured or produced, or, property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its own officers or staff of employees, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind; . . .	(i) Property that the licensor, through its own officers or staff of employees, has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its own officers or staff of employees, is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or
(iv) Property that is leased as a result of the performance of marketing functions by such lessor ~~if the lessor,~~ through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its own officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.	(ii) Property that is licensed as a result of the performance of marketing functions by such licensor ~~if the licensor,~~ through its own officers or staff of employees located in a foreign country or countries, if the licensor, through its own officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.
(2) Special rules—(i) Adding substantial value. For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.	(2) Special rules—(i) Adding substantial value. For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.
(ii) Substantiality of foreign organization. For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.[1]	(ii) Substantiality of foreign organization. For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section. . . .
(viii) Cost sharing arrangements (CSAs). For purposes of paragraphs (c)(1)(i) and (iv) of this section, CST Payments or PCT Payments (as defined in §1.482-7(b)(1)) made by the lessor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a CSA (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.	(v) Cost sharing arrangements (CSAs). For purposes of paragraphs (d)(1)(i) and (ii) of this section, CST Payments or PCT Payments (as defined in §1.482-7(b)(1)) made by the licensor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a CSA (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.

ENDNOTES

[1] The new temporary regulations also add a safe harbor for substantiality that is specific to aircraft and vessels and that is not discussed in this column.

function be substantial compared with the income derived from leasing/licensing the property. Whether or not the marketing and/or service activity was substantial was determined based on the facts and circumstances; however, the regulations provided a safe harbor that, generally stated, treated such activities as substantial if their arm's-length cost was greater than 25 percent of the income derived from the leased/licensed property.[8] The marketing test included the additional requirement that the marketing of and/or services with respect to the property be performed by officers or the employees of the CFC. Furthermore, the language in the regulation "located in a foreign country" made it unclear whether or not the marketing and/or services needed to be provided in a single jurisdiction or if the exception would apply if they were provided across multiple jurisdictions (as long as the marketing/servicing was performed by officers and employees of the CFC).

III. September 1, 2015 Rules

The language of the Temporary Regulations, as compared to the prior rule, is provided in Table 2.[9]

The new language changes three things:

1) It adds a requirement to the development test, requiring that development activities be performed by the officers and employees of the CFC.
2) It clarifies that for the purpose of the marketing test, a CFC may count marketing and service activities across multiple jurisdictions in determining whether its activities are substantial.
3) It generally emphasizes that for both the development exception and the marking exception, the activities must actually be performed by officers and employees of the CFC and not through attribution. To drive the point home with respect to CSAs, the new language specifically indicates that CSA payments do not cause activities under the CSA to be attributed to a party to the CSA for the purpose of either the development test or the marking exception.

As such, the Temporary Regulations would prohibit the application of the development exception in the illustration we relayed above, where the CFC had no officers or employees.

Importantly, the preamble to the new temporary regulations reaffirms that satisfaction of the development exception and/or the marketing exception are the *only* ways for a CFC to be treated as having active rents/royalties. As mentioned above, the prior regulations had been finalized in 1995. Before 1995, in addition to development exception and the marketing exception, the regulations included a general facts and circumstances test for active rents and royalties . The general fact and circumstances language was deleted in the final 1995 regulations. The preamble to the new temporary regulations explicitly states that the development exception and the marketing exception are now the only ways that a CFC is treated as having active rents/royalties. Arguably, this limitation of the active rent/royalty exception is contrary to the statute, which broadly states that rents and royalties which are derived in the active conduct of a trade or business are not FPHCI. If a taxpayer were to take this position based on the statute, however, they would have to argue that the language in the preamble (and the intimation in the regulations that there is no facts and circumstances test) is an invalid interpretation of the statute. The lack of a cogent explanation for this statement in the preamble will likely hurt the IRS in this regard.[10]

IV. Conclusion

The Temporary Regulations are a mixed bag for taxpayers. Those taxpayers who were relying solely on their participation in a CSA in order to qualify for the active rents/royalties exception to FPHCI will likely have to consider adding substance to their CFCs in order to meet the development exception. On the bright side, the regulations make it easier for CFCs to satisfy the marketing exception by, for example, electing to treat one or more of its subsidiaries as a disregarded entity for U.S. tax purposes. It is clear now that the fact that active marketing personnel are located in a number of different countries should not prevent the CFC from satisfying the marketing exception.

ENDNOTES

[1] Unless otherwise note, all Code, section and Reg. § references are to the United States Internal Revenue Code of 1986, as amended, and regulations issued pursuant thereto.

[2] Code Sec. 951(a)(1).

[3] Code Secs. 952(a)(2); 954(a)(1).

[4] *See* Code Sec. 954(c).

[5] S. Rep. No. 1881, 87th Cong. 2d Sess. 82 (1962); H.R. Rep. No. 1447, 87th Cong. 2d Sess. 57 (1962).

[6] Code Sec. 954(c)(2). Additionally, the rents/royalties may not be received from a related

person, as defined under Code Sec. 954(d)(3).

[7] *See, e.g., R.F. Cleveland*, CA-4, 62-1 USTC ¶9142, 297 F2d 169 (although not directly on point, suggests that partner in a partnership is deemed to be engaged in the research activities conducted by the partnership).

[8] Reg. §1.954-2(c)(2)(ii) and (d)(2)(ii).

[9] The text of the new temporary regulations can be found in T.D. 8618, 1995-2 CB 89.

[10] *See, e.g.*, *Altera Corporation and Subsidiaries*, 145 TC No. 3, Dec. 60,354 (2015) (where the court focused extensively on the failure of a preamble to articulate a rationale reason for the rule provided in the regulation as a basis for arguing a section 482 regulation was invalid).