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Global Tax Perspectives

No Income, No Problem?—U.S. International Tax Implications of LTR 202009002

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On February 28, 2020, the IRS released LTR 202009002 (the "Ruling"). In the Ruling, the IRS concluded that a business line that had yet to generate income constituted a "trade or business" within the meaning of Reg. §1.355-3(b)(2)(ii). In this column, we focus on the implications of the Ruling outside the context of Code Sec. 355, for provisions of the Code and/or Treasury Regulations that also incorporate an income or revenue-based standard. We view the Ruling as a positive development for taxpayers, particularly in the current environment, because it informs a construction of these provisions that largely separates the financial results of a company's activity from the analysis of whether the company satisfies such a standard. As we discuss below, in our view, so long as a company's activity is consistent with the policy behind the standard, the results of that activity, which may depend on forces outside the company's control (*e.g.*, economic, regulatory, *etc.*), should not determine whether the company satisfies that standard.

The Ruling

In the Ruling, the distributing corporation ("Distributing") had one business line that engaged in R&D to bring products to a pre-commercial point, and then entered into license and collaboration agreements with third parties pursuant to which the third parties ultimately commercialized the products. A second business line, with respect to which Distributing had incurred "significant" salary and wage expense, was able to move the products further along in the commercialization process. Although Distributing could have entered into similar, revenue-bearing license and collaboration agreements with third parties in connection with this business line, Distributing concluded that it could generate more income by declining to enter into these agreements and allowing the business line to progress the products further. Distributing proposed to contribute this separate business line to a controlled corporation ("Controlled") and spin off Controlled in a transaction to which Code Secs. 355 and 368(a)(1)(D) applied.

One of the requirements for a tax-free spinoff is that both Distributing and Controlled are engaged in the conduct of a trade or business immediately after the distribution.[1] Reg. §1.355-3(b)(2)(ii) provides that a company is engaged in a trade or business to the extent it carries on "a specific group of activities … for the purpose of earning income or profit[.]" This group of activities must "include every operation that forms a part of, or a step in, the process of earning income or profit," and "ordinarily must include the collection of income and the payment of expenses."[2] The IRS ruled that the Controlled business line constituted a trade or business within the meaning of Reg. §1.355-3(b)(2)(ii) even though it had never generated income.

Observations

We expect that other commentators will address the Ruling's implications in the spin-off context. As noted above, we address the Ruling's implications for other provisions of the Code and/or Treasury Regulations. In particular, the Ruling is a welcome development for companies that have significant lags between the first dollar of R&D spend and product launches. For instance, companies in the healthcare sector can spend several years and a significant amount of resources on R&D, additional years on clinical trials, and more years after that applying for and trying to secure government approvals before they see a single dollar of product revenue, let alone profit. From our perspective, while the prospect of income generation may constitute evidence of a particular kind of business activity, it cannot be dispositive of the issue. In some cases, companies that invest hundreds of millions of dollars, and thousands of employee hours, in a particular venture emerge with a product that fails and lacks any other identifiable commercial use. That does not mean that the company is engaged in passive, or "bad," activity. As we discuss below, the analysis of whether a company satisfies an income or revenue-based standard properly turns on the company's efforts, and not its fortunes.

Worthless Stock Deduction

Code Sec. 165(g)(3) allows a U.S. company to deduct against ordinary income the amount of its tax basis in the stock of a subsidiary, including a CFC, that becomes worthless.[3] The ordinary nature of the deduction turns on whether more than 90 percent of the subsidiary's aggregate gross receipts are from active sources.[4]

How should Code Sec. 165(g)(3) apply in the case of an entity that never generated revenue? The IRS addressed this issue in Technical Advice Memorandum 200914021 (the "TAM").[5] In the TAM, the IRS advised that the absence of gross receipts did not preclude ordinary deduction treatment under Code Sec. 165(g)(3)(B). In reaching this conclusion, the IRS noted that the subsidiary's activities "would have generated substantial gross receipts" if they were successful. The IRS also commented that "[t]he gross receipts test was apparently designed to determine whether a subsidiary is an operating company (for which an ordinary loss is allowed) or a holding or investment company (for which an ordinary loss is not allowed)." The IRS stated that the legislative history of Code Sec. 165(g)(3) supports the view that "Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company" and that "the test should not be applied to deny operating company classification to a truly operating company (with no disqualifying passive income) that just happens to have no gross receipts."

The Ruling represents analogous authority that reaffirms the IRS's position in the TAM. Under the Ruling, not generating income does not prevent a company from satisfying a requirement that expressly references income generation if the company could have generated income. As applied in the worthless stock deduction context, the fact that a subsidiary did not generate active gross receipts should not prevent stock in that subsidiary from giving rise to a deduction against ordinary income if the subsidiary would have generated active gross receipts had events beyond its control—*e.g.*, deterioration of a customer base, a competitor's first mover advantage, unanticipated delays in regulatory review or approval, *etc.*—not prevented it from doing so.[6]

Subpart F

Active Rents and Royalties

The Ruling is also relevant in the context of subpart F. Under Reg. §1.954-2(e), gain that a CFC recognizes on a sale of IP does not constitute foreign personal holding company income ("FPHCI") under Code Sec. 954(c) if the IP gave rise to royalties that qualified for the active royalties exception in Code Sec. 954(c)(2)(A) and Reg. §1.954-2(b)(6). What is the result if the CFC enters into a third-party license in exchange for contingent royalty payments and sells the IP before it receives any royalties? If the CFC does not hold the IP for use in a trade or business,[7] the answer could be that the CFC recognizes FPHCI because the IP never generated income that qualified for the active royalties exception. That answer seems inconsistent with the thrust of Code Sec. 954(c), which typically imposes tax on passive investments.[8] Events beyond a company's control should not change the character of the income that the company recognizes from active to passive. The Ruling provides support for applying the active royalties exception in the context of IP sales irrespective of whether the IP in fact generates royalties so long as (i) a third-party license is in place and (ii) royalties under the license would have qualified for the exception.

Code Sec. 954(c)(6)

Code Sec. 954(c)(6) raises a similar issue. Code Sec. 954(c)(6) provides that dividends, interest, rents, and royalties that a CFC receives from a related CFC do not constitute FPHCI if the amounts are allocated and apportioned to income of the payor CFC that is neither subpart F income nor effectively connected income ("ECI"), and the amounts would not otherwise create or increase a current-year E&P deficit that reduces subpart F income of the payor CFC or another CFC.[9] In many cases, a U.S. company, or foreign subsidiary of a U.S. company, may form a new CFC to operate in a particular jurisdiction. That CFC may need to license IP that another CFC holds. As the licensee CFC is still in the start up phase, it may not have any income for a period of time.

How can a company determine whether the royalties the licensee CFC pays are allocated and apportioned to non-subpart F income/non-ECI of the licensee CFC when the licensee CFC does not have any income? Although Notice 2007-9 provides that payments that are allocable to non-subpart F income, but exceed that income, still can qualify for look through treatment under Code Sec. 954(c)(6), that rule nevertheless presupposes the existence of income in the first place.[10] From our perspective, in light of the Ruling, the right answer is to apply Code Sec. 954(c)(6) in this context based on the income the company expects the CFC to generate as a result of licensing the IP giving rise to the royalties. If the company only expects the CFC to generate non-subpart F income/non-ECI, then all the royalties the licensee CFC pays should qualify for look through treatment, unless they result in, or increase, a current year E&P deficit that reduces subpart F income of the CFC payor or another CFC—*e.g.*, where the licensee CFC performs R&D services outside of its country of organization. If the company expects some portion of the CFC's income to constitute subpart F income, the company should allocate and apportion the royalties as if the CFC had in fact recognized both subpart F income and non-subpart F income. This result is arguably consistent with the policy behind Code Sec. 954(c) because it denies look through treatment only to the extent a pre-revenue CFC's assets reflect passive income generating capabilities.

Foreign-Derived Intangible Income

Code Sec. 250(a)(1)(A) generally allows domestic corporations a deduction equal to 37.5 percent of their foreign-derived intangible income ("FDII"). FDII may include royalties that a U.S. company derives under a license of IP to a non-U.S. person for a "foreign use."[11] The proposed regulations that implement the FDII regime construe the term, "foreign use," in this context to mean that the IP generates revenue from exploitation outside the United States.[12] For IP that a company uses in developing, manufacturing, selling, or distributing a product, the proposed regulations appear to treat the IP as exploited outside the United States based on the revenues that the licensee derives from sales of products to non-U.S. end-customers.[13]

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A non-U.S. third party may license non-U.S. IP rights from a U.S. company, engage in intensive R&D, and ultimately abandon the R&D project if the results disappoint. Can the U.S. licensor establish that the IP was subject to a "foreign use" in the absence of sales of products to non-U.S. customers? Under the Ruling, the answer should be yes. The U.S. licensor should be entitled to treat the IP as subject to a "foreign use" to the extent the non-U.S. licensee would have derived revenues from non-U.S. persons had the project been successful.

Code Sec. 865(f)

Code Sec. 865(a) generally sources income from the sale of stock based on the residence of the seller. Code Sec. 865(f) provides an exception for the sale of stock in a foreign affiliate if the sale occurs in a foreign country in which the affiliate is engaged in the active conduct of a trade or business, and more than 50 percent of the affiliate's gross income for the three years that precede the sale stems from the active conduct of a trade or business in that foreign country. Under this exception, a U.S. company's sale of a foreign affiliate gives rise to foreign, and not U.S., source income.

The legislative history to Code Sec. 865 explains that the "source rules for sales of personal property should reflect the location of the economic activity generating the income at issue or the place of utilization of the assets generating that income."[14] Gain in the stock of a foreign affiliate functions as a proxy for gain in the affiliate's assets. Where an affiliate deploys its assets in an active business in a foreign country, the location of the affiliate's economic activity is outside the United States, and gain on a sale of the affiliate's stock is appropriately foreign source under Code Sec. 865(f).

Placing all companies on an equal footing in the spin-off and other contexts, and focusing on their activities and not their success or lack thereof, is an equitable and appropriate approach.

As applied to a sale of stock in a pre-revenue CFC, Code Sec. 865(f)'s three-year gross income rule, noted above, could frustrate the policy behind Code Sec. 865. Specifically, a U.S. company could establish a CFC to house a foreign R&D operation. After a number of years, when the CFC has a material amount of pre-revenue IP, the CFC could attract the interest of a third-party buyer. The U.S. company could sell the CFC's stock, with title passing in the CFC's jurisdiction. If applied literally, Code Sec. 865(f) might treat the U.S. company's gain as U.S., and not foreign, source because the CFC never generated any income.[15] The Ruling suggests that a literal application of the statute may not be appropriate. In this case, the source of the income from the CFC stock sale would turn on the economic results of the CFC's activities, and not on the nature and location of the CFC's activities. As in the context of Code Sec. 165(g), Code Sec. 954, and FDII, the U.S. company should arguably be entitled to treat gain on the sale as foreign source income if more than 50 percent of the CFC's income would have stemmed from the conduct of an active trade or business in the foreign country in which the stock sale takes place.

Conclusion

We do not catalogue all the Code provisions to which the Ruling might be relevant here. Our principal objective is to alert taxpayers that the Ruling represents a useful instance of analogous authority that can inform the construction of provisions like Code Sec. 355 in the context of pre-revenue/income businesses. As the current economic environment shows, a company's financial performance depends on factors that are out of the company's control, at least in part. Placing all companies on an equal footing in the spin-off and other contexts, and focusing on their activities and not their success or lack thereof, is an equitable and appropriate approach.

ENDNOTES

* The views expressed in this article are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization.

1 Code Sec. 355(b)(1)(A).

2 Reg. §1.355-3(b)(2)(ii).

3 *See, e.g.*, Rev. Rul. 2003-125, 2003-2 CB 1243 (ruling, in Situation 2, that in the case of an election to change the classification of an entity from a corporation to a disregarded entity, the shareholder of the entity may take a worthless security deduction under Code Sec. 165(g)(3) provided the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities).

4 Specifically, Code Sec. 165(g)(3)(B) states:

> more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

5 TAM 200914021 (04/03/2009).

6 *Accord* Rev. Rul. 82-219, 1982-2 CB 82 (ruling that a company that only generated income for four out of five years nevertheless satisfied the Code Sec. 355 active trade or business requirement due to the "extraordinary facts" of its situation—*i.e.*, because the lack of income in year five arose when the company's only customer went bankrupt).

7 *See* Reg. §1.954-2(e)(3)(iv).

8 Congress saw "no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income." S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 CB 703, 789. *See also* HR Rep. No. 1447, 87th Cong., 2d Sess. 57–58 (1962).

9 Code Sec. 954(c)(6)(A) (determined under rules similar to the rules of Code Sec. 904(d)(3)).

10 *See* Notice 2007-9, 2007-1 CB 501, Section 6.

11 Code Sec. 250(b)(4)(A)(ii).

12 Reg. §1.250(b)-4(e)(2)(i). Presumably, the same rule applies to a license in exchange for contingent, periodic payments. Reg. §1.250(b)-4(e)(2)(ii).

13 Reg. §1.250(b)-4(e)(2)(i).

14 *Int'l Multifoods Corp.*, 108 TC 579, Dec. 52,100 (1997) (quoting H. Rept. 99-426, at 360 (1985), 1986-3 CB (Vol. 2) 1, 360).

15 Note that a pre-revenue CFC is not likely to have Code Sec. 1248 E&P. Thus, it is unlikely that any portion of a U.S. shareholder's gain from the disposition of stock in a pre-revenue CFC will be treated as a "dividend" sourced under the dividend source rules (*i.e.*, sourced based on the location of the payor). *See* Code Sec. 865(k)(1).