

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

Number: **AM 2022-003**

Release Date: 9/23/2022

CC:INTL:B04

PRESP-118018-21

UICL: 367.30-00

date: September 09, 2022

to: John E. Hinding  
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from: Peter H. Blessing  
Associate Chief Counsel  
(International)

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subject: Advance Payments of Annual Section 367(d) Inclusions

This memorandum addresses payments claimed to be made in respect and in advance of annual inclusions under section 367(d)(2)(A)(ii)(I) of the Internal Revenue Code (the "Code"). This memorandum should not be used or cited as precedent.

Issue

Does section 367(d) permit taxpayers to choose to make advance payments of annual inclusions under section 367(d)(2)(A)(ii)(I)?

Conclusion

No, section 367(d) does not permit taxpayers to choose to make advance payments of annual inclusions under section 367(d)(2)(A)(ii)(I) except in limited circumstances involving "other property or money" transferred by a transferee foreign corporation to a U.S. transferor in connection with an initial exchange of intangible property subject to section 367(d).

Facts

USP is a domestic corporation that owns all the stock of FC, a foreign corporation. In Year 1, USP transfers intangible property, as defined in section 367(d)(4), with an expected useful life of ten years to FC solely in exchange for stock in FC in a section

351(a) exchange to which section 367(d) applies.<sup>1</sup> As a result, USP takes into account an annual inclusion under section 367(d)(2)(A)(ii)(I) and Treas. Reg. §1.367(d)-1T(c)(1) with respect to the transferred intangible property (an “annual section 367(d) inclusion”) in Year 1 of \$10x and an annual section 367(d) inclusion in Year 2 of \$12x. USP establishes a separate account receivable with respect to the annual section 367(d) inclusion for each year pursuant to Treas. Reg. §1.367(d)-1T(g)(1)(i). Both accounts receivable remain unpaid as of the beginning of Year 3.

In Year 3, USP takes into account an annual section 367(d) inclusion of \$12x. USP wishes to accelerate all or a portion of the remaining annual section 367(d) inclusions it would otherwise take into account over the remaining useful life of the intangible property, rather than taking each such inclusion into account annually. To that end, FC makes a payment of \$60x to USP in Year 3. USP intends that \$34x of such payment will correspond to USP’s annual inclusions for each of Year 1, Year 2, and Year 3 (\$10x, \$12x, and \$12x, respectively), and the remaining \$26x will correspond to an advance payment (which USP describes as a prepayment) in respect of USP’s annual section 367(d) inclusion for Year 4 and, to the extent the remaining \$26x exceeds the annual section 367(d) inclusion for Year 4, for other future years.

## Law and Analysis

### **Section 367(d) and the section 367(d) regulations**

Congress enacted section 367(d) of the Code in substantially its present form to address “specific and unique problems” that exist with respect to outbound transfers of intangible property.<sup>2</sup> Congress generally identified the cause of such problems as follows:

[T]ransferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.

S. Rep. No 169, 98th Cong., 2d Sess., at 360 (1984); H.R. Rep. No. 432, 98th Cong., 2d Sess., at 1315 (1984).

Section 367(d) addresses these problems by creating a system under which a U.S. person is deemed to transfer intangible property to a foreign corporation in exchange for notional annual payments that the U.S. person takes into account over the useful life of the intangible property.

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<sup>1</sup> USP is a “U.S. transferor” and FC is a “transferee foreign corporation” within the meaning of section 367(d) and the regulations under section 367(d).

<sup>2</sup> See S. Rep. No 169, 98th Cong., 2d Sess., at 360 (1984); H.R. Rep. No. 432, 98th Cong., 2d Sess., at 1315 (1984).

Section 367(d)(1) provides that, except as provided in regulations, if a U.S. person (a “U.S. transferor”) transfers any intangible property to a foreign corporation (the “transferee foreign corporation”) in an exchange described in section 351 or 361, section 367(d) (and not section 367(a)) applies to the transfer (an “initial section 367(d) exchange”). By turning off the application of section 367(a) in these cases, the section 367(d) annual inclusion regime reflects a Congressional preference against providing immediate gain recognition with respect to intangible property.<sup>3</sup>

Section 367(d)(2)(A) provides the basic inclusion mechanism under section 367(d) by stating that a U.S. transferor that transfers intangible property in an initial section 367(d) exchange is treated as having sold the intangible property in exchange for payments that are contingent upon the productivity, use, or disposition of the intangible property. Under section 367(d)(2)(A)(ii)(I) and (II), the U.S. transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of the intangible property, or, in the case of a direct or indirect disposition of the intangible property following the initial exchange, at the time of that subsequent disposition. Section 367(d)(2)(C) prescribes that, for purposes of chapter 1 of Subtitle A of the Code, any amount included in gross income by a U.S. person pursuant to section 367(d) is treated as ordinary income and, for purposes of applying section 904(d), such amount is treated in the same manner as if it were a royalty.

The section 367(d) regulations supplement the statute by describing the scope of exchanges subject to, and the consequences of applying, section 367(d). Specifically, the section 367(d) regulations, consistent with the statute, only apply to certain outbound transfers of intangible property and do not apply to an actual sale or license of the intangible property by the U.S. transferor to a foreign corporation.<sup>4</sup> And, when section 367(d) applies, the section 367(d) regulations provide that, in determining the period of annual inclusions under section 367(d), “the useful life of intangible property is the entire period during which exploitation of the intangible property is reasonably anticipated to affect the determination of taxable income, as of the time of transfer.”<sup>5</sup> A U.S. transferor, consistent with the notional inclusion regime established by section 367(d), takes an annual section 367(d) inclusion into account “regardless of whether

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<sup>3</sup> Indeed, two years after the 1984 amendment of section 367(d) to substantially its present form, Congress again amended section 367(d), with the House Ways and Means Committee describing the 1984 amendment as follows: “In general, the amounts [taken into account under section 367(d)] are treated as received over the useful life of the intangible property on an annual basis. Thus, a single lump-sum payment, or an annual payment not contingent on productivity, use or disposition, cannot be used as the measure of the appropriate transfer price.” See H.R. Rep. No. 426, 99<sup>th</sup> Cong., 1<sup>st</sup> Sess., at 422 (1985).

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

<sup>5</sup> See Treas. Reg. §1.367(d)-1(c)(3). The regulations explain that “[e]xploitation of intangible property includes any direct or indirect use or transfer of the intangible property, including use without further development, use in the further development of the intangible property itself (and any exploitation of the further developed intangible property), and use in the development of other intangible property (and any exploitation of the other developed intangible property).” *Id.*

such payments are in fact made by the [transferee foreign corporation].”<sup>6</sup> Thus, it is the exploitation of the intangible property in the hands of the transferee foreign corporation that dictates the annual section 367(d) inclusion taken into account by the U.S. transferor, rather than the amount of any payments made by the former to the latter.

Section 367(d) and the section 367(d) regulations describe adjustments and procedures with respect to the transferee foreign corporation corresponding, in relevant part, to each of a U.S. transferor’s deemed annual section 367(d) inclusions. These adjustments and procedures with respect to the transferee foreign corporation prevent excess taxation to the U.S. transferor that could otherwise arise by reason of those inclusions. First, the earnings and profits (“E&P”) of the transferee foreign corporation are reduced by the amount included in the income of the U.S. transferor as an annual section 367(d) inclusion.<sup>7</sup> And, for purposes of applying the provisions of subpart F of Part III of subchapter N of the Code (“subpart F”) as to the transferee foreign corporation, the section 367(d) regulations treat the deemed payment associated with a U.S. transferor’s annual section 367(d) inclusion as “an expense . . . properly allocated and apportioned to gross income subject to subpart F, in accordance with the provisions of §§1.954-1(c) and 1.861-8.”<sup>8</sup> Second, for cases in which a U.S. transferor takes an annual section 367(d) inclusion into account, but that amount is not actually paid by the transferee foreign corporation during the year, the section 367(d) regulations allow a U.S. transferor to establish an account receivable from the transferee foreign corporation “equal to the amount deemed paid that was not actually paid” for a taxable year, and any future payments from the transferee foreign corporation “must be designated as payments upon a particular account and must be deducted from that account.”<sup>9</sup>

The section 367(d) regulations also reflect Congressional preference for preserving the continued application of the annual section 367(d) inclusion stream in the case of a subsequent direct or indirect transfer of the intangible property as long as the U.S. transferor retains a certain nexus to the intangible property.<sup>10</sup> The tax consequences of a subsequent direct or indirect transfer of the intangible property under section 367(d) generally depend on whether the transferee is related to the U.S. transferor, and the section 367(d) regulations lower certain thresholds that typically apply in determining

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<sup>6</sup> See Treas. Reg. §1.367(d)-1T(a); see also Treas. Reg. §1.367(d)-1T(c)(1) (general determination of the annual section 367(d) inclusion).

<sup>7</sup> See section 367(d)(2)(B) and Treas. Reg. § 1.367(d)-1T(c)(2)(i).

<sup>8</sup> See Treas. Reg. §1.367(d)-1T(c)(2)(ii); see also Treas. Reg. §1.951A-2(c)(2)(ii) (generally providing that the deemed payment may be treated as an allowable deduction when determining tested income or tested loss as described in Treas. Reg. §1.951A-2(b)).

<sup>9</sup> See Treas. Reg. §1.367(d)-1T(g)(1)(i) (these accounts receivable “may be established and paid without further U.S. income tax consequences to the U.S. transferor or the transferee foreign corporation.”).

<sup>10</sup> See Treas. Reg. §1.367(d)-1T(a) (in general, annual inclusions under section 367(d) “will continue if the transfer is made to a related person, while gain must be recognized immediately if the transfer is to an unrelated person.”) and Treas. Reg. §1.367(d)-1T(d) through (f) (subsequent transfer or disposition rules, which cover direct transfers of the intangible property and indirect transfers of the intangible property through a transfer of the stock of the transferee foreign corporation).

relatedness in order to preserve the continued application of section 367(d).<sup>11</sup> This preference, by preserving the application of the annual section 367(d) inclusion stream, implements the primary policy underlying section 367(d), namely the approach that determines annual section 367(d) inclusions by reference to the exploitation of the intangible property annually over its useful life.<sup>12</sup>

As discussed below, the Service has issued relevant guidance under section 367(d) regarding initial section 367(d) exchanges described in section 361 involving boot. But the Service has not addressed advance payments corresponding to annual section 367(d) inclusions for future years outside of these limited circumstances.

### **Notice 2012-39**

Notice 2012-39 (the “Notice”) addressed an initial section 367(d) exchange described in section 361(b).<sup>13</sup> The Notice provides that the Service and the Department of the Treasury will issue regulations, applying to transfers occurring on or after July 13, 2012, incorporating the guidance described in the Notice. Those regulations have not yet been issued.

The Notice applies to transfers by a domestic corporation (the U.S. transferor) of intangible property to a transferee foreign corporation in an exchange described in section 361 where a shareholder of the U.S. transferor (a “qualified successor”) receives cash or other property in the exchange and/or certain liabilities of the U.S. transferor are assumed by the transferee foreign corporation or satisfied by the U.S. transferor with money or other property provided by the transferee foreign corporation.<sup>14</sup> Where the Notice applies, it generally prorates the boot received in the exchange and treats the boot received with respect to the intangible property as an advance payment

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<sup>11</sup> See Treas. Reg. §§1.367(d)-1T(d) through (f) for the subsequent transfer or disposition rules and §1.367(d)-1T(h) for the definition of related person for section 367(d) purposes.

<sup>12</sup> See *also* Treas. Reg. §§1.367(d)-1T(g)(4)(ii) (applying section 367(d) in the case of a sham license or sale) and (g)(6) (anti-abuse rule in the case of certain transfers that treats the intangible property as transferred to a foreign corporation in an exchange subject to section 367(d)).

<sup>13</sup> The Service analyzed a similar issue in Chief Counsel Advice 200610019, which addressed the taxation of boot received in an initial section 367(d) exchange described in section 351(b). The Taxpayer and the Service agreed that the exchange was described in both sections 351(b) and 367(d), creating a potential conflict between these statutory provisions that could have caused double taxation. While the Taxpayer and the Service agreed double taxation (to the extent of the boot) was not a proper result, they disagreed as to the appropriate coordination of sections 351(b) and 367(d). The Service concluded that, to the extent the boot received in the exchange exceeded the annual section 367(d) inclusion for the year of the exchange, that excess was treated as an advance payment on future annual section 367(d) inclusions, which under general tax principles, should be recognized in the year received. Treating the boot received in exchange for the transferred intangible property as an advance payment corresponding to annual section 367(d) inclusions for future years was intended to avoid double taxation while preserving the application of section 367(d).

<sup>14</sup> See Notice 2012-39, Sections 4.01 and 4.02.

of annual section 367(d) inclusions.<sup>15</sup> The Notice contemplates that “with respect to all outbound section 367(d) transfers, the total income to be taken into account under section 367(d) is either included in income by the U.S. transferor in the year of the reorganization or, where appropriate, over time by one or more qualified successors.”<sup>16</sup> Thus, if the annual section 367(d) inclusions over the useful life of the intangible property exceed the value of the boot received with respect to the intangible property in the initial section 367(d) exchange, any qualified successors must take into account annual section 367(d) inclusions once the value of the prepaid inclusion attributable to such boot is exhausted. The Notice’s conclusion, that the boot attributable to the intangible property transferred is treated as an advance payment corresponding to annual section 367(d) inclusions for future years, was intended, in part, to prevent transactions that were perceived as resulting in an inappropriate repatriation of cash in excess of income recognized under section 356(a)(1).<sup>17</sup>

### **Application to the Facts**

Neither section 367(d) nor the section 367(d) regulations allow USP to take into account a payment received from FC as an advance payment of annual section 367(d) inclusions corresponding to future years. The conclusion of the Notice, which only addressed the treatment of payments in the different setting where boot is received in an initial section 367(d) exchange, is not inconsistent with the conclusion in this Memorandum. The receipt of boot in an initial section 367(d) exchange is distinguishable factually, legally, and in terms of applicable policy, from the advance payment at issue in this Memorandum.

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), which provide for a specific inclusion mechanism, determined on an annual basis, for the U.S. transferor and related adjustments for the transferee foreign corporation.

Because Congress provided for a specific notional inclusion regime under section 367(d), analogizing to rules and principles that may apply under other provisions of the Code to different types of transfers does not resolve the issue raised in this Memorandum. For example, while an outbound transfer of intangible property subject

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<sup>15</sup> See Notice 2012-39, Sections 4.01 through 4.05. The Notice refers to this as a “prepayment” of the annual section 367(d) inclusions, which is synonymous with the “advance payments” described in Chief Counsel Advice 200610019. For purposes of this memorandum, any reference to an advance payment associated with annual section 367(d) inclusions should be considered to mean the same as the term “prepayment” as used in the Notice.

<sup>16</sup> See Notice 2012-39, Section 4.01.

<sup>17</sup> The Notice did not address any cost recovery aspects of such a payment.

to section 367(d) may be viewed as resembling a contingent sale in certain respects – that is, a sale in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs – there are important differences between section 367(d) and the rules applicable to contingent sales.<sup>18</sup> Namely, the tax treatment regarding the character and timing of the income received by the payee and any attendant adjustments for property of the payor under a contingent sale arrangement may differ fundamentally from what is provided in section 367(d) and the section 367(d) regulations. Alternatively, an outbound transfer of intangible property subject to section 367(d) may be viewed as resembling a licensing arrangement in certain respects. However, in contrast to a licensing arrangement, an exchange subject to section 367(d) involves a deemed payor that actually owns the intangible property in respect of which annual section 367(d) inclusions are taken into account by the U.S. transferor.<sup>19</sup> Also, in contrast to a licensing arrangement, where the licensee is obligated to make payments to the licensor, section 367(d) does not impose any payment obligations upon the transferee foreign corporation.<sup>20</sup> Because of these significant differences between licensing arrangements and section 367(d), whether advance payments are given effect under U.S. income tax law with respect to a licensing arrangement is irrelevant in determining whether advance payments are permitted for one or more annual section 367(d) inclusions.

The only basis for permitting an advance payment of annual section 367(d) inclusions must therefore arise exclusively from section 367(d) and the section 367(d) regulations. However, neither section 367(d) nor the section 367(d) regulations give effect to advance payments, but rather determine annual section 367(d) inclusions on a year-to-year basis by reference to a specific form of payment that depends on the productivity, use, or disposition of the transferred intangible property for the duration of its useful life. Thus, there is no basis for accelerating the annual section 367(d) inclusions, and only after an annual section 367(d) inclusion is taken into account by a U.S. transferor may a transferee foreign corporation make a payment to the U.S. transferor corresponding to that deemed inclusion (through the accounts receivable construct).<sup>21</sup> Permitting a U.S. transferor to accelerate its annual section 367(d) inclusions, including by causing the

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<sup>18</sup> Section 453 (describing the installment method) generally provides the tax treatment for contingent sales. If Congress intended to use the installment method as the tax accounting mechanism under section 367(d), Congress could have cross-referenced section 453 rather than providing for the inclusion mechanism described in section 367(d)(2)(A).<sup>19</sup> Notwithstanding this fact, and as noted above, section 367(d)(2)(C) treats the annual section 367(d) inclusion as a royalty for certain limited purposes.

<sup>19</sup> Notwithstanding this fact, and as noted above, section 367(d)(2)(C) treats the annual section 367(d) inclusion as a royalty for certain limited purposes.

<sup>20</sup> See Treas. Reg. §§1.367(d)-1T(a), (c), and (g)(1).

<sup>21</sup> See Treas. Reg. §§1.367(d)-1T(a), (c), and (g)(1). Similarly, only after the annual section 367(d) inclusion is taken into account by the U.S. transferor is the transferee foreign corporation permitted an E&P reduction and, for certain purposes, limited expense treatment, in both cases in the amount of the deemed payment from the transferee foreign corporation (i.e., the annual section 367(d) inclusion). See Treas. Reg. § 1.367(d)-1T(c)(2)(i) (“[f]or purposes of chapter 1 of the Code, the earnings and profits of the transferee foreign corporation shall be reduced by the amount of such deemed payment”); Treas. Reg. § 1.367(d)-1T(c)(2)(ii) (“[f]or purposes of subpart F of part III of subchapter N of the Code, the transferee foreign corporation may treat such deemed payment as an expense (whether or not that amount is actually paid”).

transferee foreign corporation to make payments purportedly corresponding to periods for which the relevant productivity, use, or disposition of the intangible property has yet to occur, would undercut the fundamental connection between the specific form of payment, which depends on the exploitation of the intangible property, and the associated annual section 367(d) inclusions. Additionally, such an approach would require the Service to evaluate whether a purported advance payment ultimately captured undetermined amounts of future inclusions, which would raise significant administrative concerns.

The approach taken by the Notice is nevertheless appropriate at the time of an initial section 367(d) exchange. If a U.S. transferor transfers intangible property to a transferee foreign corporation in an initial section 367(d) exchange and later chooses in a subsequent taxable year to cause the transferee foreign corporation to pay an amount corresponding to some or all of the anticipated annual section 367(d) inclusions for future years, however, the considerations motivating the conclusion reached in the Notice are not present. In such a case, and in contrast to the Notice, there is no transfer of boot in respect of intangible property, no policy concern regarding repatriation, and section 367(d) clearly applies.

Because FC's payment of \$60x to USP in Year 3 occurs after the initial section 367(d) exchange, any payment from FC to USP that does not correspond to an account receivable associated with USP's annual section 367(d) inclusion for Year 1 or Year 2 or to USP's annual section 367(d) inclusion for Year 3 is not treated as an advance payment of annual section 367(d) inclusions. \$34x of the \$60x payment by FC corresponds to USP's annual section 367(d) inclusions already taken into account by USP. The remaining \$26x of FC's payment of \$60x is, however, analyzed under general tax principles.<sup>22</sup>

Please call Chadwick Rowland at (202) 317-5005 if you have any questions.

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<sup>22</sup> In this case, without facts to the contrary, the remaining \$26x of FC's payment of \$60x is treated as a distribution of property by a corporation (FC) to a shareholder (USP) with respect to its stock and is, therefore, subject to the rules that apply to such distributions.