Office of Chief Counsel
Internal Revenue Service

Memorandum

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date: June 16, 2022

to: Team Manager
(SE:LB:EC:TR1:1705)
Attn:

from: Attorney
(CC:LB:3:CIN:2)

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subject: Character Payments of Royalties

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

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ISSUES

1. Was the taxable as ordinary prepaid royalty income under § 61(a)(6) of the Internal Revenue Code, rather than §§ 61(a)(3) and 1001 gain from the disposition of property?

2. Assuming arguendo that the generated gain rather than § 61(a)(6) income, would § 1234A apply to treat the as capital gain ?

CONCLUSIONS

1. The was taxable ordinary income arising from a .

2. Even if the were a § 1001(b) amount realized that generated taxable gains under §§ 61(a)(3) and 1001, § 1234A would not apply to treat that gain as capital gain because the claimed gain

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LAW AND ANALYSIS

As relevant here, the net result of was that

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The remainder of this memo explains why the was a prepayment of ordinary royalty income under § 61(a)(6) (not §§ 61(a)(3) and 1001 gain).[32] The memo also explains why § 1234A would not apply even if the had generated gain, rather than ordinary royalty income.

A. The Was a

Gross income includes income from all sources derived, including payments. [33]

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[32] In certain circumstances, can be subject to the separate 3.8% tax imposed by § 1411. For purposes of this memo only, we have assumed

[33] IRC § 61(a)(6); Treas. Reg. § 1.61-8(a).

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Because the was income, did not generate § 1001 gain that could be .

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Regardless, however, the title and labels assigned to a do not determine or control the tax consequences of a transaction if at odds with the substance of an arrangement.[37] Rather, the tax consequences are determined by economic realities.

> Take "income." If a taxpayer receives something of value, 26 U.S.C. §61(a), he can call it whatever he wants—this, that, or something else. What the taxpayer cannot do is claim that the label he affixes on the transaction precludes it from being "income" under the Code or prevents the courts from treating it as "income" under the Code.[38]

The substance will control the tax consequences of a transaction, with factual issues being resolved according to the reality of the situation, not the label used.[39]

> If a kennel and a taxpayer agree that a tail is a leg, a taxpayer might say he has a five-legged dog. But unless the Code or regulations tell us differently, his dog still has only four legs for tax law.[40]

The Commissioner is not bound by "misleading labels and distracting forms."[41] Where a taxpayer mislabels a transaction, such labels can be ignored and the true economic substance of the transaction considered in order to determine the proper tax consequences.[42]

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[37] *Schering-Plough, Corp. v. United States*, 651 F.Supp.2d 219, 242 (D.N.J. 2009) ("calling a club a spade does not make it one"), *aff'd sub. nom Merck & Co, Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011).

[38] *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 785 (6th Cir. 2017), *rev'g* T.C. Memo 2015-119. *See also id.* at 787-88 (quoting Joseph Isenbergh, *Musings on Form and Substance in Taxation: Federal Taxation of Incomes, Estates, and Gifts*, 49 U. CHI. L. REV. 859, 865 (1982)) ("When someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means.")

[39] *Billy F. Hawk, Jr., GST Non-Exempt Marital Trust v. Commissioner*, 924 F.3d 821, 825 (6th Cir. 2019) (citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)) ("While taxpayers are free to arrange their affairs to minimize taxes, they must do so in real ways"), *aff'g Hawk v. Commissioner*, T.C. Memo. 2017-217.

[40] *Mazzei v. Commissioner*, 150 T.C. 138, 195 (2018) (Holmes, J., dissenting), *rev'd*, 998 F.3d 1041 (9th Cir. 2021).

[41] *Hawk*, 924 F.3d at 826.

[42] *See Mazzei*, 150 T.C. at 198 n.13 (Holmes, J., dissenting).

Regardless of the label affixed to the agreement, it is underlying economic realities that dictates the tax consequences of the transactions at issue. It is inescapably clear that

There is no logical reason that

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A change in the *timing* of a payment for the use of property by the payor does not change the nature of the payment made (a payment for the use of property).[43] That proposition might be illustrated by some hypothetical examples. Assume,

In this case,

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[43] *See* Treas. Reg. § 1.61-8(b) ("gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer").

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B. Section 1234A is Not Applicable

Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, is treated as gain or loss from the sale of a capital asset. For § 1234A to apply to the , the payment must be attributable to (1) gain or loss from a cancellation or termination and (2) made with respect to property that is a capital asset. The payment here is not attributable to gain or loss from a payment made to terminate and is not made with respect to an underlying capital asset.

First, § 1234A applies only to gain or loss "*attributable to* the cancellation, lapse, expiration, or other termination of" certain rights and obligations.

Second, § 1234A applies only where the terminated right or obligation is with respect to property which is, or on acquisition would be, a capital asset in the hands of the taxpayer.

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A capital asset, in general, includes all property, regardless of whether the property is connected to a business.[45] Property used in a trade or business that is depreciable under § 167 is excluded from the definition of capital asset.[46] For purposes of Chapter 1 (*i.e.*, §§ 1 through 1400Z-2), an amortizable § 197 intangible is treated as property that is depreciable under § 167.[47]

Trademarks and goodwill are intangible assets, amortizable under § 197.[48] Trademarks include "any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others."[49] "[T]rade name includes any name used to identify or designate a particular trade or business or the name or title used by a person or organization engaged in a trade or business."[50] "A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract."[51]

would be intangible assets, amortizable under § 197 and treated as depreciable under § 167.[52] As such, the would be excluded from the definition of capital asset.[53]

Because would not be a capital asset if acquired by , § 1234A is inapplicable.[54]

<u>CONCLUSION</u>

For the reasons discussed above and, subject to review of , we believe Exam should treat the as ordinary royalty income.

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[45] IRC § 1221(a).
[46] IRC § 1221(a)(2).
[47] IRC § 197(f)(7).
[48] IRC § 197(a), (c), (d)(1)(A), (F); Treas. Reg. § 1.197-2(d)(1).
[49] Treas. Reg. § 1.197-2(b)(10)(i).
[50] *Id*.
[51] *Id*.
[52] The are amortizable § 197 intangibles, because they meet the definition in Treas. Reg. § 1.197-2 . See IRC § 197(a), (c), (f)(7); Treas. Reg. § 1.197-2(d)(1). As such, the amortizable § 197 intangibles are treated as property that is depreciable under § 167. IRC § 197(d)(1)(F).
[53] IRC § 1221(a)(2).
[54] Property subject to § 1231 includes property depreciable under § 167 and held by the taxpayer for more than one year. IRC § 1231(b)(1). Thus, the is § 1231 property. Section 1231 property is a different character than capital assets, and § 1234A does not apply to characterize gain from § 1231 property. *CRI-Leslie, LLC v. Commissioner*, 147 T.C. 217 (2016), *aff'd*, 882 F.3d 1026 (11th Cir. 2018). As § 1231 property, § 1234A does not apply to the .

No opinion is being expressed on other aspects of this transaction at this time, including on or any other provision not discussed above.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.

cc:

Addendum

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[60] *Id.*

[61] *Id.*

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[63] *Id.*

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