Tax Issues for Royalty Issuers and Investors

A royalty is a contractual obligation resulting in the sale of an agreed percentage of the royalty issuer's revenues for an agreed period of time.

The IRS allows the royalty issuer to deduct the payments of royalties if the funds received for the royalty are used for constructive operational purposes by the company malking the royalty payments.

The royalty issuer's contractual obligation can be secured by the transfer or encumbering of the company's critical assets.

The writers of securities put and call options receive a premium as consideration for the right to buy from the writer or sell to the writer an agreed number of shares at an agreed price. Because the writer has no way of knowing if the written option will be exercised or expire the premium is held in suspense for tax calculation purposes until it is known if the option will be exercised. If the option is exercised the premium is used to adjust the cost basis of the writer and if the option expires the premium is ordinary income to the writer.

Therefore, if the issuer of a royalty provides the purchaser with a 5 year, Continental style put, exercisable only at maturity, to purchase, for the purchaser's cost, less the royalty payments received, the decision of whether or not to exercise the put option is totally beyond the control of the issuer and the amount received for the royalty should be held in suspense until it can be known as to how it should be treated.

As the royalty is a purchase of a percentage of the issuer's revenue it is an asset, which has been sold by the issuer, if the put is exercised and the issuer is required to refund the purchase price, effectively a rescission, there is no tax effect,

as there simply will be a refund. The question, which should be addressed, is what if the put expires unexercised.

In the case of an unexercised put, which is not within the control of the issuer, the cost of the asset sold will have to be determined as there will be a profit on the sale if the cost of the asset sold is less than the price received for it. Assuming a gain there will be reflected in the issuer's tax filing as soon as the issuer knew if the put was going to be exercised.

Any assertion by the IRS that the full amount of the royalty payment would be taxable is wrong and ignores the sale of an asset, a fixed percentage of revenues.

It is well established that the royalty owner treats royalty payments as return of capital, until such time as the cost of the royalty has been recaptured. Thereafter, all royalty payments received are ordinary income to the royalty owner.

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