its pro rata share of the post-1962 earnings and profits of a controlled foreign corporation[85] which were earned while the United States shareholder owned the stock.[86] Recognized gain attributable to pre-1963 earnings and profits or unrealized appreciation remains taxable at capital gains rates.

Generally, individual taxpayers are most adversely affected by the application of Section 1248. The provision has not proved to be a detriment to corporate shareholders, unless foreign earnings are subject to taxation in the foreign jurisdiction at very low rates, because the dividend portion of the proceeds is eligible for the deemed-paid foreign tax credit.[87] However, if Section 1248 is a problem for a United States corporate shareholder, a transfer of intangible property can be employed to reduce the amount of potential ordinary income dividend. For example, assume a patent is about to be sold by a United States parent corporation, *P*, at a substantial loss which would be a capital loss which *P* cannot use. Assume also that *P*'s foreign subsidiary, *S*, has substantial accumulated earnings and profits which eventually will have to be taken into account by *P* as ordinary income under the provisions of Section 1248. If the transfer of the property by *P* to *S* is tax free under Sections 351 and 367, *S* will take the same basis as *P* and will realize the loss on the sale of the property, thus decreasing the accumulated earnings and profits eventually subject to Section 1248 treatment.[88]

¶ 6.4b Liquidation of Foreign Corporations

A United States shareholder may decide to liquidate a foreign subsidiary for a variety of reasons, possibly as a preference to the sale of the subsidiary's stock or because it may be more profitable to operate the foreign venture as a branch. For United States taxa-

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[85] During the preceding five-year period, the foreign subsidiary must have been a controlled foreign corporation within the meaning of Section 957. See I.R.C. § 1248(a)(2).

[86] I.R.C. § 1248(a).

[87] Reg. § 1.1248-1(d). Note, pursuant to Section 902 a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation is entitled to a credit against its United States tax liability for the foreign income taxes paid by the foreign corporation on its accumulated profits, in the year in which the domestic corporation receives a dividend from the foreign corporation. Also, if the foreign corporation in turn owns at least 10 percent of the voting stock of another foreign corporation, the domestic corporation can obtain a credit under Section 902(b) for the income taxes paid by a second- or third-tier foreign corporation. See discussion ¶ 7.3a[2] *infra*.

[88] See Landis & Currier, "The Future of Section 367," 25 The Tax Lawyer 253, 257 (1972).

of the accumulated earnings and profits for all the foreign subsidiary's taxable years which are properly attributable to the parent's stock in the subsidiary.[97] However, the toll charge does not apply to any earnings and profits of the foreign subsidiary that were previously subject to United States income taxation because the earnings were considered to be from United States sources. Additionally, any accumulated earnings and profits which represent Subpart F income previously taxed to the United States shareholder will not again be subjected to United States taxation upon liquidation.[98] The measure of a foreign subsidiary's earnings and profits that are to be included in the United States shareholder's gross income under the guidelines are computed in accordance with (1) Revenue Ruling 63-6 [99] for taxable years beginning before January 1, 1963, and (2) Section 1248(c),(d) for taxable years beginning after December 31, 1962.

The requirement that the subsidiary's earnings and profits be included in income as a "dividend deemed paid in money" is apparently included to prevent the United States shareholder from selecting assets, such as patents, that will constitute the dividend and thereby obtain a stepped-up basis. However, if the subsidiary does not have enough cash to provide the required dividend, the Internal Revenue Service will ordinarily permit the distribution of other property as part of the dividend with an appropriate adjustment to basis. Otherwise, the other property received by the United States shareholder will have a carryover basis.[100]

Where intangible property constitutes a substantial part of the total assets of a foreign subsidiary, the decision regarding the form of liquidation is dependent upon a variety of factors. Some of the more important factors are as follows:

(1) If the earnings of the foreign subsidiary are taxed at fairly high rates, the United States shareholder may well prefer a plan which produces the maximum dividend income inasmuch as that portion of the sales or liquidation proceeds is eligible for the deemed paid foreign tax credit.[101] In such a situation, if the parent intends to eventually dispose of an intangible asset, such as a foreign patent, at a substantial gain, it may be preferable for the foreign subsidiary to make the sale prior to liquidation. Advantage may thus be taken

[97] Guidelines, § 3.01.
[98] Guidelines, § 4.01.
[99] 1963-1 C.B. 126.
[100] I.R.C. § 334(b)(1).
[101] Note 82 *supra*.

CHAPTER 7

Taxation of Foreign Licensing Income

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of the source rules. The following material deals with source-of-income considerations peculiar to the exploitation of intellectual intangible property abroad.

¶ 7.1a United States Source-of-Gross-Income Rules

[1] Licensing Transactions as Sales of Personal Property. Section 862(a)(6) provides that income from the "purchase [by the taxpayer] of personal property within the United States and its sale without the United States" shall be treated as income from foreign sources. Nothing is said about income from property which is both purchased and sold within or without the United States. This occurrence was apparently too obvious to require a statutory statement, since the implication is clear that the place of purchase is immaterial in determining the origin of income.[5] Specifically, therefore, income from a purchase of intangible property (patents, copyrights, trademarks, and know-how) in the United States or abroad and its sale abroad constitutes foreign-source income. By contract, the source-of-income criteria for allocating income derived from the sale of intangible property which was not purchased by the taxpayer are much less certain. Section 863(b)(2) provides that property, "produced (in whole or in part) by the taxpayer within the United States and sold without the United States," shall be treated as derived partly from both domestic and foreign sources, and shall be apportioned as prescribed by the Secretary.[6]

As the term "produced" is defined by Section 864(a) to include "created," an inventor's or author's gain would seem apportionable under Section 863(b)(2). Yet, there exists a much commented upon, although unresolved, question as to where a patent or copyright is "created" or "produced" for Section 863(b)(2) purposes.[7] It would seem that at least some of the underlying property resulting in protectable works is produced or created where the author or inventor does the work which results in the invention or literary product.[8]

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[5] See Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939); Reg. § 1.861-7(a) (1972); Carding Gill, Ltd., 38 B.T.A. 669 (1938). Apparently, most countries do not attribute any income to the country of purchase. See Carroll, "Methods of Allocating Taxable Income," IV *Taxation of Foreign & National Enterprises* 117, 129 (League of Nations Doc. ch. 425(b), M. 217(b) (1933).

[6] See Reg. § 1.863-3 (1961) which specifies alternative methods for apportionment of such income.

[7] E.g., Pugh, "Sales and Exchanges of Foreign Patents," N.Y.U. 20th Inst. on Fed. Tax. 1305, 1316 (1962).

[8] Duke, "Foreign Authors, Inventors and the Income Tax," 72 Yale L.J. 1093, 1139 (1963).

may seek to avoid the problem by specific allocation in the sales contract.

On the other hand, it may be advantageous for an individual or corporate inventor or author to produce intellectual property in return for which payment is made as "compensation for personal services" within the structure of the source rules.[16] The entire work is then attributable to the country where the work is created. By contrast, if the producer retains title and sells or licenses his efforts, under the source-of-income rules the resulting income may be attributable to entirely different countries.

Finally, the Code furnishes no criteria for determination of whether a sale of property is "within" or "without" the United States. This has resulted in a number of Treasury and judicial pronouncements which focus primarily on the place of the sale of tangible goods sold in international trade by manufacturers and merchandisers.[17] As a consequence, the place in which title passes, as evidence of the place of sale, has thus become the controlling factor in determining income source for United States taxation purposes.

Transfers of property such as know-how, which has been reduced to tangible form, would appear to fit comfortably within the title-passage rule if the risk of economic loss, an important criterion in operation of the title passage rule,[18] remains in the transferor until title passes. However, the propriety of the title-passage rule where transfers of intangible property such as patents, trademarks, and copyrights are involved is much less certain.[19] In such cases, the courts and Internal Revenue Service appear to have recognized the irrelevance of the title-passage test and as an alternative employed a place-of-contract standard.[20]

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[16] For instance, it has been reported that a domestic United States corporation employed United States authors living abroad, providing them with a salary and fringe benefits (pension and insurance plans, tax advice, and accounting services) in return for their manuscripts and publication rights. Stockholders of the corporation were reportedly "friends" of a large publishing company, which made advances to the employer-company to enable it to acquire manuscripts in which it was interested. New York Times, April 2, 1962, p. 33.

[17] See, e.g., Comm'r v. Pfaudler Inter-American Corp., 330 F.2d 471 (2d Cir. 1964); Rev. Rul. 64-198, 1964-2 C.B. 189; Comm'r v. East Coast Oil Co., 85 F.2d 322 (5th Cir. 1936), *aff'g* 31 B.T.A. 558 (1934), *cert. denied,* 299 U.S. 608 (1936).

[18] "[T]he sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss." Reg. § 1.861-7(c).

[19] If the location of property where title passes is to be determinative for income source purposes, a highly technical controversy ensues regarding the "situs" of intangible property.

[20] See cases discussed in ¶ 4.2c *supra.*

¶ 7.1b Allocation and Apportionment of Expenses to Licensing Income

[1] Statutory Pattern. Expenses directly related to foreign licensing include such items as the legal and accounting costs incurred with respect to licensing activities. By contrast, research and development as well as overhead expenses often have a more indirect bearing on licensing income. Yet, the manner in which expenses, direct or indirect, are allocated or apportioned to licensing activities may be of great significance to a United States taxpayer especially with regard to the foreign tax credit limitation which restricts the credit to that part of the United States tax which is treated as having been imposed on foreign-source income.[23] Moreover, the matter of licensing expense allocation is also important to the foreign corporate taxpayer engaged in a United States trade or business which must compute its "taxable income . . . effectively connected with the conduct of a trade or business within the United States."[24] This requires a marshalling of the foreign corporate taxpayer's deductions, since those that are allocable to foreign-source income that is not "effectively connected" with the United States business will not be reflected in the tax base.

As indicated in the previous subsection, Section 861(a) and its counterpart, Section 862(a) define the items of gross income that shall be treated as income from sources both within and without the United States. The enumerated items are (1) interest, (2) dividends, (3) compensation for personal services, (4) rentals and royalties, and (5) sales of personal property. What meager statutory authority exists for defining "taxable income" from sources within (without) the United States is found in Sections 861(b), 862(b) and 863 which directs that from the items of gross income specified in Sections 861(a) and 862(a) there shall be deducted:

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[23] I.R.C. §§ 904(a)(1), (2). For example, a taxpayer may have numerous items of gross income and deductions. In order to determine its United States-source taxable income and its foreign-source taxable income, it will have to put each item of gross income and each deduction either in the domestic category or in the foreign category. Although the rules are reasonably well settled as to the category (foreign-source or United States-source) into which items of gross income fall, until recently little attention has been paid to the classification of deductions. Yet, the classification of deductions may have substantial effects upon the availability of the United States foreign tax credit.

[24] I.R.C. § 882(a). See also discussion ¶ 4.3d *supra*.

the taxpayer was a holding company which received dividends from foreign subsidiaries, as well as foreign-source sales income, royalties, and contract fees (principally earned with respect to distributorship agreements and patent licensing agreements with two unrelated United States corporations) and United States-source interest income. The expenses involved were United States home office expenses for management services and technical assistance, royalties and fees paid to the unrelated United States corporations under the agreements, bad debts, foreign exchange losses, and interest on funded and unfunded debts incurred for unspecified purposes. The taxpayer argued that none of the described expenses should be allocated to foreign-source "passive" income (dividends, royalties, and interest) to reduce the available United States foreign tax credit, inasmuch as the foreign withholding taxes on such income took no account of expenses and also because such income was received without expense to the taxpayer.

The Tax Court rejected the taxpayer's contention, upholding the Commissioner's determination that all of the expenses, including the royalty expense, were to be treated as unidentifiable expenses subject to ratable part apportionment pursuant to Section 863. In its opinion the court noted:

> "As in the case of foreign corporations deriving such income from sources within and without the United States, cf. *Third Scottish American Trust Co., Ltd. v. United States*, 37 F. Supp. 279, Congress has prescribed the substitution of the ratable portion of expenses for a difficult or inconvenient method of computing a more exact deduction. This provides for no exceptions in cases where the ratable amount seems at variance with the probable accurate expenses and other deductions. Since the foreign tax credit is within the legislative discretion, the prescribed method of computing it must be followed. The Commissioner's determination of the foreign tax credit must be sustained." [31]

On appeal, the Second Circuit sustained the Tax Court as to its basic proposition of statutory interpretation, but reversed the lower court decision with respect to the taxpayer's contention that its deduction for royalties and fees paid to the unrelated United States companies, which resulted in the receipt by it of income from royalties, contract

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denied 323 U.S. 803 (1944). See also South Puerto Rico Sugar Co., 2 T.C. 738 (1943).

[31] 1 T.C. at 1158–59.

Hence, the Proposed Regulations proceed on the general assumption that most deductions are "definitely related" to gross income, and so are not subject to ratable apportionment.[35] The following discussion deals with the Proposed Regulations in relation to expenses which may be allocable to licensing income.

Research and development expenditures. The Proposed Regulations provide the following special rules for the allocation and apportionment of research and development expenditures:

"(i) Allocation. Expenditures for research and development which a taxpayer deducts under section 174 shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class. Where research and development is intended to create, or is reasonably expected to result in the creation of, specific intangible properties or processes, or is intended or reasonably expected to result in the improvement of specific property or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably expected to give rise. Experience in the past with research and development shall be considered in determining reasonable expectations. In other cases, as in the case of most basic research, research and development shall generally be considered definitely related and therefore allocable to all gross income of the current taxable year which is likely to benefit from the research and development. The gross income of the current taxable year which can reasonably be assumed to have benefited from similar research and development in the past is ordinarily acceptable as an indication of likely benefits from current research and development. The types of gross income to which deductions for research and development expenses are generally allocable include, but are not limited to, gross income from—

(A) The sale or rental of tangible property or the performance of services with respect to which intangible property is used,
(B) The lump-sum sale of intangible property,
(C) The licensing or other use of intangible property, and
(D) The receipt of dividends from a corporation the stock of which was acquired for intangible property in a tax-free

[35] Prop. Reg. § 1.861-8(a)(2).

eventual income.[38] Yet, pursuant to the Proposed Regulations, such costs, which are ordinarily neither reimbursable nor deductible by foreign countries, must be allocated to current foreign-source income from sales of existing products, royalties, and dividends.

The Proposed Regulations do not specify methods of apportionment of research costs allocated to gross income. Instead, the regulations merely state that, where the classes of gross income derived from such research are disparate, such as sales and royalty income, allocation on a gross income or gross receipt basis will generally not be acceptable.[39] This view is contrary to the approach taken in *International Standard Electric Corp.*[40] where the court apportioned purchased research costs to the disparate gross income therefrom on a gross income basis. Nevertheless, when the relevant examples attached to the Proposed Regulations[41] are examined, it would appear the preferred and perhaps the only acceptable method of apportionment is consolidated worldwide sales, on a unit or dollar basis.

Example (1) considers the case of *X*, a domestic corporation, engaged in the manufacture of gasoline engines in the United States. *X* also has manufacturing plants (branches) in foreign countries *A*

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to mean that if the taxpayer can, for instance, demonstrate that 90 percent of past research was unproductive, 90 percent of the current research expenditures will not be considered related to any item or class of gross income. However, the examples accompanying the Proposed Regulations appear inconsistent with the foregoing interpretation. In Prop. Reg. § 1.861-8(g) Ex. (5), a taxpayer conducting a feasibility study looking to a foreign acquisition, which it abandoned, is required to allocate costs to the class of income which would have resulted had the acquisition been made, i.e., dividends from foreign subsidiaries. See also Prop. Reg. § 1.861-8(e)(7). Hence, it appears likely that the costs of unsuccessful research will be attributed to the classes of income which would have arisen if it were successful.

[38] In the case of successful research, an allocation to the class of income that results is warranted, assuming that satisfactory identification of the expenses is possible. In such circumstances, if the product in question is licensed to or used by a related person, such as foreign subsidiary, the Section 482 regulations require an arm's length consideration to be charged, usually in the form of a royalty. From such royalties, an allocable portion of the current expenses for that product can be recouped and should also be taken into account for foreign tax credit purposes. However, it is not possible to recover the cost of unsuccessful research which produces no salable product and no intangible property which can be sold or licensed. Hence, in the past, the practice has been to allocate such costs to United States-source income as a cost of doing business or staying in business. In the few instances where research costs have been allocated, the allocation has been made on the basis of the traditional gross-to-gross formula instead of on the basis of direct allocation to foreign sales and royalty income.

[39] Prop. Reg. § 1.861-8(e)(3)(ii).

[40] 1 T.C. 1153 (1943).

[41] Prop. Reg. § 1.861-8(g).

a gross income basis, $1,800 would be apportioned to the Y royalty payment and $2,200 would be apportioned to the Z royalty payment. However, as the income is of disparate types, the example dictates that apportionment on a gross income basis would not be appropriate. Instead, apportionment is suggested on a unit sales basis, which allocates $12,500 of the research expenses to each of the royalty payments (30,000/240,000 × 100,000 = 12,500). Both amounts exceed the royalties received and *X* gets no foreign tax credit. Hence, although the Proposed Regulations proceed to apportion the research expense on a consolidated sales basis, no amount of the research expense is apportioned to the sales income which Y and Z earned and retained in their own manufacturing operations abroad.[44]

Since their issuance, the Proposed Regulations regarding the allocation and apportionment of research and development expenses have engendered substantial difficulty between taxpayers and the Treasury. This is so because it has not been the practice of some corporations to reflect the cost of most research and development, especially where there is no immediate application, in royalties charged to related and unrelated foreign licensees, except where a cost sharing arrangement is in effect with related corporations. From this fact and based on the theory that the focus of most research and development is aimed at the United States market, it may be argued that only the costs of research and development undertaken for a specific foreign purpose should be treated as related to foreign-source gross income, especially since most foreign countries are unlikely to permit increased deductions.

Another consequence of the Proposed Regnlations may be the promotion of research by foreign subsidiaries and the consequent discouragement of it in the United States parent corporation, since a deduction in computing foreign taxes will then be obtained without eliminating or impairing the United States foreign tax credit. By contrast, the Proposed Regulations strongly encourage research on the part of foreign corporations engaged in a United States trade or business inasmuch as apportionment of the costs will directly diminish

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[44] Example (13) follows the same approach with respect to unrelated foreign licensees. There, *X*, a domestic corporation both manufactures and licenses the manufacture of a product to *Y*, an unrelated foreign corporation. The Proposed Regulations suggest an apportionment of *X*'s research expenses on the basis of the consolidated sales of *X* and *Y*, even though *X* will never receive or report *Y*'s manufacturing income. As *X*'s only foreign-source income is the royalty income itself, *X* must recoup all its costs, including research, from its own sales income and from the royalty income.

of the corporation attributable to the rendering of such services are considered definitely related to the fees received by the United States corporation and allocable to such amounts under the Proposed Regulations. Moreover, if a United States corporation has a foreign or international department which exercises stewardship or overseeing functions with respect to related foreign corporations and, in addition, the department has other functions which are attributable to other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations or foreign royalty income) to which its deductions are also to be allocated, some part of the deductions with respect to that department are considered definitely related to such foreign-source income.

The remainder of the foregoing expenses, characterized as expenses of stewardship or overseeing functions undertaken for the parent corporation's own benefit, are presumed to be incurred as a result of, or incident to, the ownership of the related corporation and, thus, are considered definitely related and allocable to dividends received or to be received from the related corporation.[48] Therefore, the matter of the apportionment or allocation of home office expenses may be of substantial importance to both licensors and taxpayers which have transferred intangible property to a foreign corporation in return for equity participation.

Although the method of apportionment is not specifically discussed in the text of the Proposed Regnlations, Example (8)[49] following the text indicates that the preferred method is the gross receipts of each subsidiary approach, without regard to whether or not dividends were declared. There the taxpayer, an international pharmaceutical company, has $40 million of gross income, of which $32 million is United States sales income, $3 million domestic dividend income, $3 million foreign dividend income from two subsidiaries (a third subsidiary pays no dividend), $1 million from foreign royalties, and $1 million from reimbursed foreign service fees. The total expenses of the taxpayer's management department or division are $1.6 million of which $1 million represents costs directly associated with an equal amount of the fee income. Of the remainder, $60,000 represents costs

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under (§ 1.482-2(b)), the expenses are directly allocated to the fees received, and are excluded from further allocation under the Section 861 proposed regulations. See discussion ¶ 7.4c *infra*.

[48] Note 46 *supra*. The courts have held that the expenses attributable to activities of this type do not require reimbursement under Section 482. Columbian Rope Co., 42 T.C. 800 (1965), *acq.* 1965-1 C.B. 4; Young & Rubicam Inc., 410 F.2d 1233 (Ct. Cl. 1969); see Reg. § 1.482-2(b)(2)(ii).

[49] Prop. Reg. § 1.861-8(g).

this test, the Tax Court determined that (1) the foreign related subsidiaries were autonomous and had independent operations, (2) only 4 percent of the executive office and other expenses were allocable, on the Service's theory, to foreign-source income, and (3) the expenses were not incurred "in material part" for the benefit of foreign-source income, but primarily for the benefit of the taxpayer's domestic operations.[54]

Significantly, in the *Woolworth* case the Commissioner had the burden of proof because the foreign tax credit issue was raised by the amended answer. Nevertheless, the *Woolworth* decision is the only case to consider the expenses allocation problem in the context of a large United States international operating company; and it is plainly at odds with the new Regulations as well as the Section 861(b) rationale of earlier cases.[55] On the other hand, the "material part" language has been omitted from the current Proposed Regulations, which indicates an intent by the Treasury to discontinue the use of factual criteria as a method for specific allocation of expenses in favor of a presumption that home office expenses, unless attributable to a specific income item, are allocable to United States gross income and foreign-source dividend income.

Legal and accounting fees. The Regulations propose that expenses for legal accounting services should ordinarily be allocated to specific classes of the taxpayer's gross income, or to all gross income of the taxpayer as a class, depending on the nature of the services rendered.[56] An example of direct allocation is provided where an accounting cost study is undertaken for the manufacture of a specific product, and the expenses are allocated to the class of income derived from the product. Similarly, there should be little difficulty in allocating such expenses where they are direct costs of foreign licensing. However, an attempt to identify all professional fees with respect to specific activities, such as licensing, sales of intangible property, or its transfer to foreign related corporations in return for equity participation, may raise substantial practical difficulties. Yet, the Proposed Regulations make it clear that the taxpayer is not relieved of the responsibility for making allocations despite inadequate or broad statements or designations for services, although the Treasury does not indicate what the penalty is for the inability of the taxpayer to do so. Thus, it is advisable to set up separate records of direct and, to the greatest extent possible, indirect professional fees, otherwise it is possible that

[54] 54 T.C. at 1270.

[55] Note 51 *supra.*

[56] Prop. Reg. § 1.861-8(e)(5).

The mitigating effect of tax treaties where the direct sale of intangible property such as patents, trademarks, copyrights, and know-how is concerned often depends upon the divergent source-of-income rules and the tax outlooks of the countries involved. Some treaties, like that with Austria,[61] contain no source rules similar to Section 862(a)(6) relating to the sale of personal property inasmuch as Austria does not agree that the country of sale controls source.[62] Therefore the treaty is silent as to the source of income. Instead, it is implicit in the treaty that each contracting state may tax income from sources within that state, but each state will determine for itself the source of income from the purchase and sale of personal property. Under such circumstances, or similarly if no treaty exists with the country to which the intangible property is transferred, the United States taxpayer must be intimately acquainted with the divergent source rules of each country in order to avoid double taxation while at the same time realizing the maximum advantage from the divergent source-of-income approaches.

More recent treaties, such as the ones with Japan, Trinidad and Tobago, and Brazil, either partially or totally incorporate the United States source-of-income rules.[63] Except where a foreign country has not previously enacted source-of-income rules, total incorporation often leaves the United States vendor of intangible property in almost the same situation as the "silent" treaty produces. By contrast, partial incorporation generates an almost endless array of interpretive questions. For instance, the tax treaty with Trinidad and Tobago and the proposed tax treaty with Brazil provide that "income from the purchase and sale of personal (movable) property shall be treated as income from sources within the State in which such property is sold."[64] Should inclusion of the term "movable" be properly construed to restrict title-passage rule application to tangible property? Apparently it does not, especially in light of Article 5(5) of the treaties which governs income source from the rental of *tangible* personal (movable) property. As the tangible restriction is not used at all in relation to purchased and sold personal (movable) property,

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[61] Treaty with Austria, Oct. 25, 1956, CCH Tax Treaties ¶ 505.

[62] See Report of the Senate Comm. on Foreign Relations, S. Ex. A. 85th Cong., 1st Sess. (1957).

[63] Proposed Treaty with Brazil, March 13, 1967, Art. 5, CCH Tax Treaties ¶ 808; Treaty with Japan, March 8, 1971, Art. 6, CCH Tax Treaties ¶ 4393F; Treaty with Trinidad and Tobago, Jan. 9, 1970, Art. 5, CCH Tax Treaties ¶ 7613.

[64] Proposed Treaty with Brazil, March 13, 1967, Art. 5(7), CCH Tax Treaties ¶ 808; Treaty with Trinidad and Tobago, Jan. 9, 1970, Art. 5(7), CCH Tax Treaties ¶ 7613.

United States residents from the United Kingdom tax on gains accruing to him on the disposal of assets. On the other hand, the proposed treaty with Thailand sets sales of technology apart for source-of-income purposes.[70] Pursuant to Article 19(1)(g), income from such a sale is treated as income from within the contracting state if either of two conditions are met: (1) the sale takes place within that contracting state; or (2) the sale is a sale of rights to use such property or information within a contracting state, and such rights are acquired by a resident or corporation of that contracting state or out of the funds of a permanent establishment located within that contracting state.

United States licensors must also be cognizant of tax treaty source-of-income rules. Most tax treaties treat royalty income as income from sources within the country in which the property or right is used.[71] Hence, the tax exemption granted by the source country in many tax treaties represents a material revenue loss. However, a few treaty countries continue to tax royalties at the source on the theory that it will be many years before they can begin to receive royalties from the United States that are equivalent to the royalties paid to United States licensors.[72] Such countries generally cast both their treaty and domestic source-of-income rules for royalties in either of two forms: where the source of the royalty is (1) the country of residence of the person paying the royalty,[73] or (2) the source country if the payor is a nonresident to the extent that the royalty expense was incurred in carrying on a trade or business, or resulted from an asset located in the source country.[74]

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will not be subject to tax in the United Kingdom on their *capital gains.*" (Emphasis added)

[70] Proposed Treaty with Thailand, March 1, 1954, Art. 19(1)(f), CCH Tax Treaties ¶ 7522.

[71] E.g., Treaty with Belgium, July 9, 1970, Art. 12, CCH Tax Treaties ¶ 588E.

[72] For instance, as the tax treaty with Australia is silent regarding royalty source rules, the Australian domestic source rule structure is controlling for royalty payments emanating from Australia. Under the current domestic Australian source rules (effective July 1, 1968), royalties paid to a nonresident are deemed to have been derived from a source in Australia where the payer is (1) an Australian resident, unless the expense was incurred in carrying on a non-Australian business, or (2) a nonresident of Australia to the extent that the royalty expense was incurred in the course of carrying on a business in Australia.

[73] See, e.g., Proposed Treaty with Brazil, March 13, 1967, Art. 5(3), CCH Tax Treaties ¶ 808.

[74] See, e.g., Proposed Treaty with India, Nov. 10, 1959, Art. XI(2)(e), CCH Tax Treaties ¶ 3814; Proposed Treaty with Israel, June 29, 1965, Art.

gross income from royalties be invested in ten-year Turkish Government Savings Bonds on Royalty. When the earliest bonds approached maturity, Turkey decided to exchange the outstanding 1961–1967 bonds for new registered bonds to prevent their speculative sale and purchase on the market below par.

Generally, foreign-source royalty income is subject to current United States taxation even though the licensor does not have full control over its convertibility or remittance.[76] Some judicial authority exists for the view that if foreign currency is restricted to the point where a United States taxpayer cannot even use it within the foreign country, then nothing of value has been realized which is subject to current United States tax liability.[77] However, if the royalty income cannot be remitted due to exchange control regulations, but can be fully used in the country where earned, the United States licensor will be taxed upon its receipt.[78]

Administratively, however, the Internal Revenue Service has recognized the difficulties of valuation and payment that the receipt of income in restricted foreign currency creates for United States taxpayers. If royalty payments are subject to foreign currency restrictions which prevent their free convertibility into dollars, so that the United States licensor is unable to receive payment or cannot effectively utilize the funds abroad, the Service provides the United States licensor with the option of deferring the payment of the tax until the income is freed of the restrictions or is utilized abroad. The option is exercised by attaching to the United States income tax return an additional form noted "Report of Deferable Foreign Income, pursuant to Mimeograph No. 6475" [79] setting forth

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[76] Moreover, the United States tax is payable in dollars even though the royalties are not freely convertible into dollars.

[77] International Mortgage & Inv. Corp., 36 B.T.A. 187 (1937); United Artists Corp., 3 T.C.M. 574 (1944); cf. Credit & Inv. Corp., 47 B.T.A. 673 (1942).

[78] Eder v. Comm'r, 138 F.2d 27 (2d Cir. 1943). There the court stated: "We do not agree with the taxpayer's argument that inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability. In a variety of circumstances it has been held that the fact that the distribution of income is prevented by operation of law, or by agreement among private parties, is no bar to its taxability." (138 F.2d at 29.) See also Max Freudmann, 10 T.C. 775 (1948); Weil, Inc. v. Comm'r, 150 F.2d 950 (2d Cir. 1945).

[79] 1950-1 C.B. 50, *amended by* Mim. 6494, 1950-1 C.B. 54. As to other aspects of Mim. 6475 see Rev. Rul. 57-166, 1957-1 C.B. 191, precluding the deferral of capital losses which have no direct relation to the production of deferrable income.

currency problems are nonexistent. For instance, a typical payment clause in a foreign licensing agreement might provide as follows:

> All royalty payments required to be made by the licensee to the licensor under this agreement shall be made in United States dollars and shall be converted to United States dollars at the rate of exchange at which United States dollars may be legally obtainable for such purposes at the time payment becomes due, and shall be paid in United States dollars in New York, New York, United States of America, or such other Place as licensor may reasonably designate.

When a payment is made the question arises as to whether a withholding tax in local currency, if an obligation of the licensor, obtains a different rate. Moreover, it is not clear when and at what rate the withholding tax on royalties is to be taken into account for United States foreign tax credit purposes in the situation where the royalty income has been accrued, but the royalty and the withholding tax have not yet in fact been paid. Probably, for purposes of consistency the tax should be accrued at the same time and rate as the royalty income, with appropriate adjustments being made later.[84] If a royalty payment is made prior to the due date the exchange rate at the time of actual payment must be used.

¶ 7.3 AVOIDANCE OF DOUBLE TAXATION—THE FOREIGN TAX CREDIT AND TAX TREATIES

¶ 7.3a The Foreign Tax Credit

[1] The Direct Credit. The United States has unilaterally adopted a policy to protect its taxpayers from international double taxation by allowing them the opportunity to credit (offset) against their United States tax liability foreign income, war profits, and excess profits taxes derived from foreign-source income.[85] An an alternative there is also available a deduction for foreign taxes,[86] but the taxpayer must either deduct or credit all such foreign taxes [87]—selective

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[84] See Auderieth, "Overseas Licensing of Patents and Other Intangible Property," P-H Tax Ideas ¶ 24,012. (1971).

[85] I.R.C. § 901(a).

[86] The deduction is allowable under Section 164.

[87] Reg. § 1.901-1(c),(h)(2); I.R.C. § 275(a)(4). To initiate a valid foreign tax credit election the taxpayer must: (1) claim the credit on the appropriate return, and (2) complete and file the appropriate Internal Revenue

bility, a tax credit would be of no benefit. On the other hand, a deduction of the foreign royalty withholding tax could result in an increased net operating loss with a consequent increase in net operating loss carrybacks and carryovers and recovery of United States taxes paid in other years.[90] Another situation in which it may be more profitable to elect a deduction instead of a credit exists where the effective foreign tax rate exceeds 100 percent of the foreign taxable income. This problem may arise where the foreign withholding rate on gross royalty income is exceptionally high. However, the situation is more likely to occur where the computation of taxable income for imposition of the foreign tax differs from the method employed in computing the United States taxable income. A foreign jurisdiction may include certain imputed income as part of its taxable income or it may not allow the same deductions as those allowed in the United States. On the other hand, in conformance with recently proposed regulations, the United States may require allocation of research and development costs, home office expenses, and certain other expenses that are not allowed in the foreign country.[91] Finally, the United States taxpayer must be cognizant of the following limitations which are placed on the direct foreign tax credit.

Identifying the taxpayer. Section 901, which sets forth the foreign tax credit election, does not explicitly state that the credit shall be taken by the person who actually paid the foreign tax. Yet, the limitation found in Section 901(b) that citizens, residents, or domestic corporations may credit taxes paid or accrued, indicates that in the absence of a statutory exception the credit may be taken only by the "technical taxpayer"—the person upon whom the tax is imposed by foreign law and who has paid or accrued such tax. Indeed, this is the conclusion reached in an early landmark case, *Biddle v. Comm'r.*[92] There, the Supreme Court held that an individual share-

[90] Determining whether or not to deduct rather than credit foreign taxes also depends on other factors such as the availability of a foreign tax credit carryover or carrybacks to other years pursuant to Section 904(d) and (e). As the election to take the foreign tax credit is made yearly, the possibility of utilizing or changing the election exists as long as the statute of limitations remains open with respect to the year in question. Accordingly, in some situations it may be possible to utilize foreign taxes as a deduction for purposes of obtaining a refund of prior taxes paid since there is still a possibility of using the taxes as a credit for purposes of a carryover to future years if this should subsequently be advisable.

[91] See discussion ¶ 7.1b[2] *supra.*

[92] 302 U.S. 573 (1938). As a consequence of the *Biddle* decision, earlier

The first patent royalty case to consider the issue was *Trico Products Corp. v. Comm'r.*[98] There, an agreement between the United States corporation which owned the patent and the British licensee provided that royalties be paid, per unit of sales, "as shall after deduction therefrom of English Income Tax . . . be equal to 10 cents United States currency."[99] The Board viewed the issue as indistinguishable from the *Biddle* case inasmuch as the British payment licensee in *Trico Products* was, under applicable British law,[100] merely given the option but was not required to deduct the tax from its payments to the licensor. By contrast, in *Crawford* the withholding of the tax was mandatory.[101] A subsequent case, *Irving Air Chute Co. v. Comm'r,*[102] presented essentially the same factual context as the *Trico Products* case. However, the taxpayer maintained that the record in *Trico Products* was incomplete because there the board had before it only the British statute. By contrast, in *Irving Air Chute* the taxpayer introduced numerous United Kingdom decisions into evidence. Yet, the Tax Court pointed out that no British case was offered which held that in paying the tax under Rule 19 the British licensee was acting as the agent for the Crown in collecting the tax from another taxpayer, the licensor.[103] Instead, British law indicated that the tax on royalties was a tax paid by the licensee on its own account and not a tax withheld from the payee of the royalty.

On appeal, the Court of Appeals for the Second Circuit affirmed the Tax Court decision stating:

"It is whether Congress intended in the credit section . . . to

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[98] 46 B.T.A. 346 (1942).

[99] *Id.* at 365.

[100] The court viewed the applicable statute as being General Rule 19 of the English Income Tax which provided:

> "Where any royalty or other sum is paid in respect of the user of a patent, wholly out of the profits or gains brought into charge to tax, the person paying the royalty or sum *shall be entitled,* on making the payment, to *deduct* and retain thereout a sum representing the amount of tax thereon at the rate or rates of tax in force during the period through which the royalty or sum was accruing due." [Emphasis supplied.]

Income Tax Act, 1918, 8 & 9 Geo. 5, c. 40, Rule 19(2).

[101] Note 96 *supra.*

[102] 1 T.C. 880 (1943), *aff'd* 143 F.2d 256 (2d Cir. 1944), *cert. denied* 323 U.S. 773 (1944). See also O.K Tool Co., 4 T.C. 539 (1945); Cleveland Bronze Co. v. Comm'r, 10 T.C. 974 (1948), *aff'd per curiam* 177 F.2d 200 (6th Cir. 1949).

[103] The Tax Court stated, however, that this might be true with respect to taxes withheld under Rule 21, citing In re Lang Propeller, Ltd., [1927] 1 Ch. 120 (C.A.), *aff'g* (1926) 1 Ch. 585 (Ch. D.), for the proposition that under Rule 21 the paying company must account to the Crown for the amount it is required to withhold as a debtor of the Crown and not as a taxpayer.

In many factual contexts the technical taxpayer restriction is not critical for purposes of determining the availability of the foreign tax credit. For example, when an ordinary withholding tax is imposed by a foreign country on nonresidents of that country for royalty payments remitted to them, the payee of the royalty is without question the technical taxpayer and therefore entitled to a foreign tax credit.[110] On the other hand, under a net licensing arrangement, a foreign licensee will sometimes agree to pay the tax imposed by his country and pay a net (or tax-free) royalty to the United States licensor. Most licensors add the tax paid by the licensee to the net royalty,[111] report the resulting sum, and take the tax paid by the foreign licensee as a foreign tax credit. Although no specific authorization for this method exists in the Treasury Regulations or judicial decisions it would appear to be an acceptable practice in light of several revenue rulings which are closely related. In Revenue Ruling 57-106,[112] a foreign income tax was assumed by a foreign corporation on the sale to it by an American company of assets in the foreign country. It was ruled that the foreign tax assumed was part of the purchase price and that the domestic corporation could take a foreign tax credit for it.[113] A similar result is found in Revenue Ruling 54-600,[114] where the lessee of mining property agreed to pay the property tax on the load. The Internal Revenue Service ruled that the tax was deductible by the lessee as additional royalties or rent and that the amount so paid was additional income to the lessor, from which he could deduct the property tax paid by the lessee. The rationale of these rulings would seem to lend strong support for a foreign tax credit for licensors under net royalty arrangements. Yet, some cautious American licensors employ a gross royalty-tax deduc-

[110] For rulings permitting ordinary withholding taxes on royalties to be credited by the recipient of the royalties, see I.T. 2964, XV-1 C.B. 138 (1936); Rev. Rul. 273, 1953-2 C.B. 58.

[111] This process known as "gross up" is similar to the gross up required under Section 902 for indirect income taxes attributable to foreign dividend income received by domestic corporate shareholders.

[112] 1957-1 C.B. 242.

[113] The Service analogized the situation to one in which a landlord includes the tax paid by a tenant in his income and is permitted to deduct the tax. However, under the facts presented in the ruling the United States corporate taxpayer was held to be entitled to the foreign tax credit for taxes for which it was the technical taxpayer, despite a "subsidy (granted to the purchaser) by its country equivalent to 100% of the taxes . . ." which the purchaser paid. Thus, a credit was allowed even though no tax burden was actually borne by anyone. See Owens & Forry, "Can the foreign tax credit benefit be shifted by agreement?," 31 J. Taxation 160 (1969).

[114] 1954-2 C.B. 164.

income, is allowed only for foreign income or profits taxes paid with respect to such royalties or a tax paid in lieu of an income tax.[117] In order to qualify as an income tax either the foreign statutory scheme of taxation must qualify as a foreign income tax, or the specific aspect of the foreign tax system in question can qualify for the credit even though the overall tax system is not an income tax. Hence, the foreign tax law as a whole must be examined to determine whether it falls within the concept of an "income tax" as that term is generally used under United States tax law. If the foreign tax is a unified tax, the credit will be denied or allowed for the entire tax payment, depending on the predominant character of the tax.[118] If the foreign tax law is predominantly an income tax, then it is generally immaterial, except for purposes of the limitations on the amount of the credit, that some nonincome items are taxed.[119] However, if the foreign tax as a whole is a tax on estimated or presumed income that does not fall within the United States concept of an income tax, the tax paid is not allowed as a credit against the United States income tax even though part of the tax is imposed on income items as determined by United States standards.[120] The following table indicates the foreign royalty withholding taxes upon which the Treasury has expressed an opinion with regard to their availability for foreign tax credit purposes.

For American licensors, perhaps the most important tax on royalties which is not creditable, inasmuch as it is basically an excise tax by nature, is the turnover tax which predominates in European countries. Turnover taxes, whether of the cascading type (based on the gross value, including the tax itself, of each product or service) or of the added value variety (based on the net after-tax value added by

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[117] I.R.C. §§ 901(a), 903. Section 903 which includes taxes imposed in lieu of income taxes within the group of foreign taxes eligible for the foreign tax credit, reflects the fact that foreign taxing jurisdictions may not be comparable to the United States structure. Authority as to what taxes will qualify as "in lieu of" taxes is sparce, presumably because few such taxes have been imposed by foreign jurisdictions. Pursuant to the Regulations, and "in lieu of" tax qualifies for the foreign tax credit if three requirements are met: (1) the foreign country must have a general income tax law in force, (2) the taxpayer claiming the credit should in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and (3) such general income tax must not be imposed on the taxpayer who pays the substituted tax. Reg. § 1.903-1. See also Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961).

[118] Rev. Rul. 56-51, 1956-1 C.B. 320; Rev. Rul. 64-260, 1964-2 C.B. 187.

[119] Rev. Rul. 55-505, 1955-2 C.B. 578.

[120] Rev. Rul. 64-260, note 118 *supra*.

qualify as the "inventor." [124] Nevertheless, similar problems continue to exist in the Federal Republic of Germany, the Netherlands, Belgium, and other countries where turnover and other such taxes (not strictly income taxes) are imposed on royalty payments.[125] In such situations the licensing agreement should contain a "tax clause," similar to the one set out in the preceding subsection, which requires the licensee to either actually or in effect, through a reimbursement procedure, gross-up the royalty to include the amount of the applicable turnover taxes as well as other noncreditable taxes.[126] Alternatively, the royalty fee itself can be set in advance to reflect the addition of these taxes; but this is a less flexible arrangement. Finally, in countries where technical assistance services rendered by a resident to a foreign customer are exempt from the turnover tax, it may be desirable to allocate a portion of the payment under the licensing agreement to such exempt services.[127]

[2] The Indirect Credit. Pursuant to Section 902, a United States licensor-parent may receive an indirect or deemed-paid foreign tax credit for qualifying foreign taxes paid or accrued on certain royalty income of a foreign licensee-subsidiary. Under the general rule, if a United States corporation owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the United States corporation is deemed to have paid a proportion of any foreign taxes paid or deemed to have been paid by the foreign corporation on or with respect to the profits out of which the dividends have been paid.[128] Under this rule, the United States shareholder, licensor, or contributor of intangible

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[124] However, to qualify as an inventor the American licensor has to prove that it or an affiliate had developed the patent, trademark, or process.

[125] For instance, in Rev. Rul. 56-635, 1956-2 C.B. 501, the Service ruled that a German turnover tax imposed on royalties received by United States licensors did not qualify for the foreign tax credit. They rejected the argument that the exemption of the royalties from the general income tax by virtue of the Tax Convention with the Federal Republic of Germany converted the turnover tax, which was not covered by the treaty, into a tax "in lieu" of an income tax under Section 903. See note 117 *supra*.

[126] It would seem preferable for the foreign licensee to bear the burden of noncreditable foreign taxes imposed on royalty payments, such as turnover taxes or net worth taxes inasmuch as such taxes would only be available to the United States licensor as a deduction if withheld from the royalty payment. Note, the added value tax is considered "paid" by the purchaser of the goods or the payer of the royalties.

[127] Auderieth, "Overseas Licensing of Patents and Other Intangible Property," P-H Tax Ideas ¶ 24,012.

[128] I.R.C. § 902(a).

well as a determination of the amount of foreign taxes paid with respect to those earnings and profits. Finally, the method of calculating the deemed-paid credit and the accumulated profits out of which the dividend is paid depends upon whether or not the foreign corporation falls within the less-developed-country corporation classification.[133]

If the foreign corporation paying the dividend is not a less-developed-country corporation, the domestic corporation receiving the dividend must gross the dividend up by including in the domestic corporation's income the amount of the foreign tax deemed paid.[134] Under the gross-up method the amount of foreign tax deemed paid may be determined as follows:

$$\frac{\text{actual dividend}}{\text{accumulated after-tax profits}} \times \text{foreign corporation's foreign income taxes} = \text{foreign tax deemed paid}$$

By requiring the amount of foreign tax deemed paid as computed above to be added to the amount of the dividend required to be included in the shareholder's gross income for United States taxation purposes, the result is that the domestic corporation is taxed for United States purposes on its proportionate share of the foreign corporation's pretax profits while obtaining a credit for its proportionate share of the foreign tax paid by the foreign corporation. By contrast, when a domestic corporation receives a dividend from a less-developed-country corporation the dividend is not grossed up by the amount of the deemed-paid credit. Where the tax rate in the less developed country is lower than the United States tax rate, the

graphs (d) and (e) of that section) Reg. § 1.902-3(c)(5). Yet, such determination may become an extremely complicated affair. See de Kosmian & Chapman, "The Derivative Foreign Tax Credit: The Complex Problems and Planning Possibilities," 23 J. Taxation 46 (1965).

[133] In general, the "less developed country corporation" is defined in Section 955(c) as a foreign corporation engaged in the active conduct of a trade or business, and 80 percent or more of the gross income of which is derived from sources within less developed countries, and 80 percent or more in value of the assets of which on each day of the taxable year consists of property used in such trade or business and located in less developed countries; money and deposits with persons carrying on the banking business; stock and obligations of other less developed country corporations; obligations of less developed countries; investments required because of restrictions imposed by a less developed country, and certain United States property. For foreign tax credit purposes, the term "less-developed-country corporation" also applies to a foreign corporation which has a 10 percent voting interest in a less-developed-country corporation, and which meets the 80 percent income and assets test. I.R.C. § 902(d)(2).

[134] I.R.C. § 902(a)(1).

taxpayer's taxable income from all sources.[137] The limitation may be determined as follows:

$$\frac{\text{total foreign-source taxable income}}{\text{worldwide taxable income}} \times \text{United States tax before credits} = \text{per-country limitation}$$

The per-country limitation has only limited appeal because it prevents excess credits from sources in foreign countries having a higher effective tax rate than the United States from being balanced against the United States tax liability on income from foreign countries whose tax rate is lower than the United States tax rate. Hence, the per-country limitation is generally of benefit only if a taxpayer anticipates continuing losses in some countries.[138] In this latter situation, use of the per-country limitation prevents such losses from being offset against other taxable foreign-source income from other countries, thereby diminishing the amount of foreign tax credit allowable with respect to income from sources in the profit countries.

Overall limitation: statutory pattern. Under the overall limitation, the credit for foreign income taxes paid or accrued may not exceed the proportion of the tax against which the credit is taken that the taxpayer's income from foreign sources (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.[139] The limitation may be determined as follows:

$$\frac{\text{total foreign-source taxable income}}{\text{worldwide taxable income}} \times \text{United States tax before credits} = \text{Overall limitation}$$

The overall limitation can be used only if an election is made by the taxpayer,[140] otherwise the per-country limitation is applicable.[141] The initial election may be revoked by filing an amended return or claim for refund,[142] however, a change to the per-country limitation in a succeeding taxable year may not be made without the con-

[137] I.R.C. § 904(a)(1).

[138] Losses are most likely to be present in cases in which a taxpayer initially operates abroad through branches instead of foreign related corporations. However, losses on foreign investments may also occur due to expense allocations.

[139] I.R.C. § 904(a)(2).

[140] I.R.C. § 904(b). The election is made on Form 1116 in the case of an individual or on Form 1118 in the case of a corporation.

[141] I.R.C. § 904(a)(1).

[142] I.R.C. § 904(b)(3).

niques are the regulations under Sections 861 and 863 of the Code which provide for reduction of foreign-source income by allocating thereto known applicable expenses and apportioning to such income the balance of expenses.[148] An unfavorable direct allocation or apportionment of a United States taxpayer's expenses to gross foreign-source income can diminish foreign-source taxable income and the availability of the foreign tax credit. One method of easing this problem where foreign licensing is involved is to provide that a United States licensee pay the royalty directly to the United States licenser with respect to the foreign intangible property. Thus, the United States licenser would be receiving royalties for the use of foreign patents, copyrights, trademarks, or know-how, i.e., foreign-source income, without bearing foreign withholding tax for which credit must be claimed. The foreign tax credit problem would then be the problem of the parent United States licensee in its own sub-licensing program with its foreign subsidiaries.

Finally, technical assistance agreements raise important tax questions with regard to proper allocation of the resulting income and the rate at which differing types of income are taxed in foreign countries. For instance, assume a technical assistance agreement provides for the design, construction, and initial operation of an electrical generation plant in Brazil. The agreement also requires training of the licensee's technical personnel for ultimate operation of the plant. Some of the training is to be provided in the United States and the remainder of it is to be provided on the site of the power plant in Brazil. In this situation an allocation of the compensation for the technical assistance should be made on some reasonable basis in the agreement between the two places where the work is done because only the portion allocable to the foreign country can qualify as foreign-source income for purposes of the foreign tax credit.[149] Additionally, the effective tax rates imposed by the licensee's country on differing types of income must be considered. At times, it may be advantageous to have as much of the service as possible performed in the United States when, for instance, the licensee is in a country such as India that taxes personal services at a higher rate than the United States resulting in a potentially unusable excess foreign tax credit. On the other hand, it may be advantageous to distinguish between technical assistance and other types of payments. In some countries, the former is taxed at a lower rate than royalties for the

[148] See ¶ 7.1b *supra.*

[149] I.R.C. § 862(a)(3).

Earnings after tax	48	48	
Dividend paid	48	48	
Gross-up[B] $\frac{48}{48} \times 32$			
$\frac{48}{68} \times 32$		22.59	
Dividend for United States tax	80.00	70.59	
United States tax at 48%	38.40	33.88	
Foreign tax credit	32.00	22.59	
Net United States tax	6.40	11.29	
Tax on Royalty at 48%	9.60	—	
Total United States tax on dividends and royalties	16.00	11.29	
Foreign tax	32.00	32.00	
Total United States and foreign taxes	48.00	43.29	
Funds retained in the United States			
Net dividend	41.60	36.71	
Net Royalty	10.40		
Funds retained abroad		20.00	
Consolidated funds retained	52.00	56.71	4.71
United States tax if stock amortization distributed and treated as dividend under United States concepts[C]			4.71
Dividend paid	20.00		
Gross-up $\frac{20}{68} \times 32$	9.41		
Total dividend	29.41		
United States tax at 48%	14.12		
Foreign tax credit	9.41		
Net United States tax	4.71		
Net to United States corporate shareholder			
100% payout—United States concept of amortization		52	52

¶ 7.3b Tax Treaties

As the foreign tax credit is restricted to foreign taxes imposed on income, as determined by United States concepts, and with a source the United States considers foreign, this unilateral mechanism does not necessarily alleviate all international double taxation problems. As the following examples indicate, continuing difficulties for United States taxpayers exporting intangible property exist where there are conflicting concepts of taxable income, conflicting rules on the timing of income and deductions, or conflicting source rules:

Example 1: The United States concept of taxable income provides that under certain circumstances only one-half of long-term capital gain from the sale of intangible property is includable in computing net income. Although the full amount of the gain may be taxable by foreign countries, only one-half of the gain may be included in determining foreign-source income for foreign tax credit purposes.[155] The result is that there is an insufficient United States tax generated by the foreign-source income to absorb the available foreign tax credit.

Example 2: Variations in taxing concepts may also occur with regard to deductions. For instance, the United Kingdom permits a current deduction for capital expenditures incurred on scientific research in connection with a trade or business, while the United States requires such expenses, if of a capital nature, to be amortized over a five-year period.[156] As a consequence, too little foreign tax may be incurred in relation to foreign-source income as determined by the United States concepts. Although the problem is mitigated by the foreign tax credit carryover provisions,[157] it is not entirely eliminated if it is of a continuing nature.

Example 3: An important problem concerning income concept variation arises when two countries prescribe different methods for allocating income to each country from licensing transactions between related enterprises such as a parent corporation in the United States and a subsidiary in Brazil. The result may be that a segment of income is taxed in both countries with

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[155] Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961).

[156] See C.A.A. 1968, ss. 90-95 and Sch. 10 Section 94(I) defines "scientific research" as including any activities in the fields of natural or applied science for the extension of knowledge, but expenditure on the acquisition of rights in, or arising out of, scientific research is excluded. Such latter expenditure may qualify, however, for the allowance for patent rights under I.C.T.A. 1970, s. 378. I.R.C. § 174; See also ¶ 5.3 *supra.*

[157] I.R.C. § 904(d),(e).

A Comparison of Treaty and Nontreaty Withholding Tax Rates on Gross Royalties

Country	*Nontreaty Rate* (by percent)	*Treaty Rate* (by percent)	*Treaty Article*
Australia	45	45	X
Austria	22.3	None	VIII (1)
Belgium	17	None	12 (3)
Brazil	25	15	14
Canada	15	15	XIII C
Denmark	None	None	VIII
Finland	43	None	14 (1)
France	19.2	5	II
Germany	25	None	VIII
Greece	15	None	VII
Honduras	10	None	VIII
India	70	70	XI (2)(e)
Ireland	35	None	VIII
Israel	47.5	15	15
Italy	18	None	VIII
Japan	20	10	14 (2)
Luxembourg	12	None	VII
Netherlands	None	None	IX
New Zealand	15	15	VII
Norway	None	None	VII
Pakistan	60	None	VIII
Philippines	35	35	
Romania	20	15, 10	14
Sweden	40	None	VI
Switzerland	None	None	VIII
Thailand	20	15	II
Trinidad & Tobago	30	15	14
Union of South Africa	30	30	
Union of Soviet Socialist Republics	30	None	III
United Arab Republic	17	None	VII
United Kingdom	41.25	None	VIII

visions are generally broadly construed, especially those provisions relating to treaty exemptions for the result of a denial may well be the imposition of a double tax.[164]

Royalty income from licensing. As previously noted, tax treaties normally provide that "royalties" derived from within a treaty country by a resident or corporation of the United States are exempt from taxation in the source country or taxable at substantially reduced rates, provided the recipient of the royalty does not have a permanent establishment in the treaty country. However, significant differences may exist between treaties concerning the issue of what particular property or rights generate the type of income that qualifies as a "royalty" payment for treaty purposes. Most treaties consider "royalties" as payments of any kind for the use of, or the right to use, "copyrights, patents, secret processes and formulas, trademarks and other analogous rights." [165] Many older treaties also include motion picture rentals.[166] On the other hand, recent treaties treat film royalties as business profits, and accordingly exempt such payments from source country taxing jurisdiction unless they are attributable to a permanent establishment which the recipient maintains in the source country.[167] Further, some treaties either extend the exemption only to copyrights derived from artistic works [168] or provide for a greater reduction in withholding rates with respect to payments attributable to such property than for other types of intangible property.[169]

The all too familiar question of the outer boundaries of the term "property" is also present where royalty payments are made under a treaty. Most older treaties incorporate the Treasury's view of the

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[164] Maximov v. United States, 373 U.S. 49 (1963).

[165] See, e.g., Treaty with Sweden, March 23, 1939, Art. VI, CCH Tax Treaties ¶ 7311; Treaty with Switzerland, May 24, 1951, Art. VIII, CCH Tax Treaties ¶ 7411; Treaty with the United Kingdom, June 1, 1946, Art. VIII, CCH Tax Treaties ¶ 8113.

[166] However, Australia, Austria, Canada, Greece, and Pakistan exclude motion picture rentals.

[167] See, e.g., Treaty with France, July 28, 1967, Art. 6(1), CCH Tax Treaties ¶ 2809; Treaty with Norway, Dec. 3, 1971, Art. 5(6)(a), CCH Tax Treaties ¶ 6058.

[168] See Treaty with Australia, May 14, 1953, Art. X, CCH Tax Treaties ¶ 413; Treaty with Canada, March 4, 1942, Art. XIII C, CCH Tax Treaties ¶ 1222.

[169] For instance, under the new United States-Romania tax treaty each country agrees to reduce its withholding taxes on cultural royalties derived by residents of the other country to not more than 10 percent. However, the maximum rate on industrial royalties is 15 percent. Art. 12, CCH Tax Treaties ¶ 7266.

know-how payments made to a United States licensor are treated as industrial royalties, deemed to have generally arisen in Australia and therefore taxable as income in the ordinary way.[176]

Sales of Technology, Copyrights, and Trademarks. Additional definitional problems may be encountered in determining whether a particular payment falls within the scope of a "royalty" or "sale" as intended by a treaty inasmuch as most older treaties grant no exclusion by the source country for capital gains,[177] and often simply refer to royalties without distinguishing them from those to be treated as capital gains.[178] As a consequence, the United States licensor is frequently left in a quandary as to the status of most capital gain-type royalties.

Under at least one treaty, that with Luxembourg, it appears that capital gain royalties definitely do not fall within the scope of the term "royalty" for treaty purposes. The exemption for royalties will therefore not be construed to exclude payments for the sale or exchange of the intangible property or rights from source country taxing jurisdiction.[179] On the other hand, some newer treaties expressly include within the term "royalties" income derived from the alienation of any right or property described in the article dealing with royalties.[180] For example, in the treaty with the Federal Republic of Germany it is understood that the exemption accorded to royalties

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Protocol only clarified, instead of changed, the meaning of Article VII of the original United States-Germany tax treaty by holding that know-how royalties paid to United States licensors are exempt under that provision. The decision also held that the German income tax, under local law, is limited to royalty payments which define the period of time during which the know-how is to be rendered. However, a German Federal Fiscal Conrt decision has ruled that the know-how must be reduced to a specific formula or process.

[176] See discussion accompanying note 72 *supra.*

[177] Moreover, as pointed out in ¶¶ 1.2c, 2.2, pursuant to Sections 1231 and 1235 certain payments received for the transfer of all substantial rights in patents, copyrights, and similar property rights are considered to be from the sale or exchange of a capital asset and, therefore, afforded capital gain treatment.

[178] E.g., Treaty with New Zealand, March 16, 1948, Art. VII, CCH Tax Treaties ¶ 5910.

[179] S. Exec. Rep. No. 10, note 174 *supra* (referring to Article VII of the Luxembourg treaty). Although the statement definitely restricts capital gain royalties, it appears that the main thrust of the statement was aimed specifically at know-how transfers.

[180] E.g., Proposed Treaty with Thailand, March 1, 1965, Art. 11(3), CCH Tax Treaties ¶ 7514. The effect created for capital gain royalties in the proposed Thailand treaty results from the unique treaty source-of-income rules relating to the sale of technology. See discussion note 70 *supra.*

mains with respect to lump-sum sales of noncapital assets such as patents or copyrights used in trade or business which are accorded capital gain treatment under the Internal Revenue Code.[184] In another context, the foregoing clause may in some instances extend an exemption from source country taxation for what might otherwise be classified as service income attributable to a permanent establishment.

Technical assistance. Tax treaties are generally not clear regarding the treatment of compensation for services rendered abroad under technical assistance agreements. However, such income should ordinarily be classified as industrial and commercial profits subject to taxation by the source country if a permanent establishment is also present, unless the income is denominated as "royalties" pursuant to the treaty. Thus, in view of the wider scope of the "royalties" exemption in more recent treaties, a close review of the royalties article may prove beneficial, especially where a licensing agreement involves the transfer of know-how which includes a service component.[185]

In the case of officers and employees of United States businesses, compensation for personal services rendered abroad pursuant to technical assistance agreements is usually exempted pursuant to a tax treaty if the United States citizen is temporarily present in the treaty country for a period of not more than 183 days during the taxable year.[186] Moreover, a limit of from $3,000 to $10,000 is frequently placed on the amount of compensation exempt from source country taxation.[187]

Planning prospectives. As previously noted, the current high rates of corporate taxation in both developed and developing countries (when coupled with a dividend withholding tax) frequently generate excess amounts of foreign tax in relation to the foreign-source income against which such foreign taxes can be offset for foreign tax credit purposes under the overall foreign tax credit limitation.[188]

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[184] See ¶ 1.3a *supra.* See Pearson, "The OECD Draft Double Taxation Convention and Recent U.S. Treaties," 48 Taxes 426 (1970).

[185] See discussion ¶ 7.3b[2] *supra.*

[186] The length of presence may vary from 180 to 183 days depending upon the particular treaty. See, e.g., Protocol to the Treaty with the Federal Republic of Germany, Sept. 17, 1965, Art. X(2)(a), CCH Tax Treaties ¶ 3025; Treaty with Belgium, July 9, 1970, Art. 14(2), CCH Tax Treaties ¶ 589.

[187] *Id.*

[188] See ¶ 7.3a[3] *supra.*

American parent. By contrast, the withholding rate on royalty paycent. The royalty to the United States parent is subject to a 10 percent value added tax on the portion of the payment allocable to technical services, but no withholding tax pursuant to Article VIII of the United States-United Kingdom tax treaty.

¶ 7.4 REALLOCATION OF INCOME—SECTION 482

¶ 7.4a Background

Section 482 of the Internal Revenue Code authorizes the Commissioner, with respect to commonly controlled entities, to

> "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." [189]

The provision is deeply embedded in United States fiscal history. Its earliest predecessor was Section 240(d) of the Revenue Act of 1921 [190] which, as amended, initially permitted the taxpayer as well as the Commissioner of Internal Revenue to invoke the section.[191] However, for many years Section 482 was thought to be of very limited significance in regard to the taxation of international income. As a consequence, an inducement for abuse by taxpayers existed. For instance, a United States parent corporation might grant licenses to a controlled foreign corporation in a low tax country, followed by extensive foreign sublicensing. The royalty paid to the United States parent was kept low to avoid the high United States rates, while the bulk of the royalties were retained at little or no tax costs for subsequent reinvestment abroad.[192]

Increased attention by the Treasury Department concerning international income allocation began in 1961 with initiation of an aggres-

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[189] I.R.C. § 482.

[190] Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227.

[191] Revenue Act of 1924, ch. 234, § 240(d), 43 Stat. 253. However, Congress removed the taxpayer's privilege in 1928 when it changed the section into nearly its present form. Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791.

[192] Similar potential tax avoidance situations led to the enactment of Section 1249. See ¶ 6.2 *supra*.

of intangible property to a foreign corporation which is not subject to the provisions of Section 1249,[200] inasmuch as the United States transferor owns 50 percent or less of the voting stock, would still be exposed to income reallocation under Section 482 if actual control exists. Additionally, Section 482 applies to commonly controlled corporations irrespective of their place of incorporation. Therefore, although controlled foreign corporations are not themselves subject to taxation, their transactions with the United States parent corporation are affected, so that not only the parent's income, but also the foreign subsidiary's tax attributes can be significantly altered as a result of Section 482 adjustments.

The Regulations provide that the general purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The standard applied in every case, including the transfer or use of intangible property, is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[201]

¶ 7.4c Considerations Relating to the Transfer or Use of Intangible Property

[1] Intangible Property. The relevant regulations under Section 482 dealing with transfers of patents, copyrights, trademarks, and know-how treat such transfers in a broader classification known as "intangible property." Intangible property is divided into various categories for definitional purposes which include:

(1) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(2) Copyrights, literary, musical, or other artistic compositions, and other similar items;

(3) Trademarks, trade names, brand names, and other similar items;

(4) Franchises, licenses, contracts, and other similar items; and

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

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[200] See ¶ 6.2 *supra*.

[201] Reg. § 1.482-1(b) (1968). See also T.D. 6952, 1968-1 C.B. 218.

States parent. To avoid such difficulties, precise listings should be made of all property, including intangible property, being transferred abroad to controlled foreign corporations or other business entities.

Finally, it should also be noted that Section 482 will be applicable if any transfer, exchange, or use occurs which involves any type of intangible property or any interest therein. Such an occasion will provoke an adjustment if the appropriate charge is not made. Obvious examples which invite scrutiny include interests in patents, license arrangements, and exchanges of information relating to technical competence in a given area. However, a transfer or use of intangible property does not occur during the development stages of the property, but only when the property has been developed and made available by the developer to other affiliates. Notwithstanding this rule, assistance provided by an affiliate to a developer of intangibles in any form must be recognized by an appropriate charge.[208]

[2] Arm's Length Consideration. The Section 482 regulations attempt to delineate "arm's length" consideration through broad guidelines as to the form and amount of the consideration.[209] Where transfers of intangible property are concerned, the arm's length charge made by the transferor may, under the Regulations,[210] take any of the following forms:

(1) Royalties based on the transferee's output, sales, profits, or any other appropriate measure;

(2) Lump-sum payments; [211] or

(3) Reciprocal licensing rights which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish the existence of an actual cross-licensing arrangement between them.

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[208] Reg. § 1.482-2(d)(1)(ii)(b). Hammer, "Section 482 – Apportionment and Allocation Guidelines," 26 N.Y.U. Inst. on Fed. Tax. 693, 704 (1968).

[209] Reg. § 1.482-2(d).

[210] Reg. § 1.482-2(d)(2)(i).

[211] However, Reg. § 1.482-2(d)(2)(i) creates a presumption that a lump-sum form of payment allocation does not occur when the transferor retains a substantial interest in the transferred property and the transferee pays either a nominal consideration or nothing at all. This restriction may have been inserted to prevent the transferor from avoiding reallocation by ascribing a lump-sum payment to a prior closed year. A lump-sum (or installment) payment must be reasonable in any case where the parties themselves use this form of consideration.

left open by the addition of a twelfth and final factor, that being "any other fact or circumstance" which might be considered by unrelated parties in setting a price.[216] It is, therefore, within the discretion of the taxpayer to initially determine what third parties may do under the circumstances. Although such a burden may not be too difficult to meet in industries where licensing and cross-licensing agreements are common, it may prove of little use to transferors who either license esoteric intangible property or are members of an industry which does not normally engage in such practices. In such situations, it appears that the only suitable standard available to provide some assurance that the transferor is within the Section 482 regulatory standards in setting an arm's length price is reliance on the industry practice.[217]

The form which an arm's length consideration for the transfer of intangible property would normally take is also of great significance since the Regulations provide that the same form is to be employed for allocation purposes.[218] Thus, if a royalty based on sales would normally be the consideration for the grant of a license in a particular industry, the Commissioner will allocate a royalty payment on this basis to the transferor in order to reflect an arm's length transaction. By contrast, if a lump-sum payment is the typical form of consideration for the transfer, the allocation will take that form. Hence, it would seem that if a lump-sum allocation would have been appropriate and the transfer of the intangible property took place in a year now closed for taxation purposes, the Commissioner would now be precluded from making an allocation under Section 482. On the other hand, if a royalty was the appropriate form of payment at the time of the initial transfer, the Commissioner may still possess the discretion to allocate a royalty payment for all open years. In this regard, the Regulations provide a presumption that where a transferee has paid either nominal or no consideration for the property or interest therein (i.e., a license) and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment. In all other cases, the form of the consideration will depend upon the facts and circumstances.[219]

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[216] *Id.*

[217] Kalish, "Treatment of Intercompany Transaction When Doing Business Abroad (Avoiding Double Taxation): Section 482," 27 N.Y.U. Inst. on Fed. Tax. 1023, 1041 (1969).

[218] Reg. § 1.482-2(d)(2)(i).

[219] *Id.*

When a developer makes intangible property available to another member of a related group, he must be compensated at that time on an arm's length basis in order to prevent reallocation.[226] If another member of a related group assisted the developer by providing services, know-how, cash, or other property, an allocation between the two will be made at the time the property is transferred or deemed transferred, if the transferee is not charged an arm's length consideration for the property.[227] However, if developed intangible property is later transferred to a member of a related group and no prior allocation was made for assistance rendered by such member in the development of the property, the value of the assistance may be taken as an offset against any allocation made as a result of the transfer.[228]

For instance, if a Belgian subsidiary makes equipment and personnel of its own available to a United States parent corporation which engages in the development of a particular process, the consideration furnished by the Belgian subsidiary must be taken into account as an offsetting item to the intercompany charge for intangible property.[229] In this singular situation it appears the taxpayer may invoke Section 482 for his own benefit, because even if the district director fails to exercise discretion in making an offsetting allocation, he is required by the Regulations to take into account the value of the assistance rendered in determining the proper intercompany income allocation.[230]

[4] Cost-Sharing Agreements. An alternative designed to provide a safe harbor to the arm's length price in the intangible property transfer area is the cost-sharing concept.[231] The concept applies in situations where related entities share the costs of a project for the initial development of certain intangible property. Essentially, all

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ber of the group who can make the most advantageous use of the research and development deductions to develop the property and another member, who can best afford to report the income, obtain the patent, copyright, or other evidence of ownership and claim that it is, in effect, the developer of the property.

[226] See Reg. § 1.482-2(d)(1)(ii)(a).

[227] See Reg. § 1.482-2(d)(1)(ii)(b).

[228] *Id.*

[229] Reg. § 1.482-2(d)(1)(ii)(d), Ex. 3.

[230] See Bischel, "Exportation of American Technology and the Federal Income Tax Part II: Indirect Transfers," 23 Syracuse L. Rev. 1, 17 (1972).

[231] See Cohen, "How the IRS Intends to Administer the New Regulations Under Section 482," 28 J. Taxation 75 (1968); Surrey, "Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482," 28 J. Taxation 75 (1968).

research and development, a cost-sharing agreement has the singular advantage of avoidance of ordinary income treatment under Sections 367 or 1249.[234]

[5] Services Rendered in Connection With the Transfer of Intangible Property. As a general rule, where one member of a group of related entities performs technical or other services for the benefit of, or on behalf of, another member of the group without charge, the district director may make appropriate allocations to reflect an arm's length charge. If a charge is made, but does not equal the arm's length charge, an allocation of the difference is required by the Regulations.[235] By contrast, it should be noted that if a transferor of intangible property renders services to the transferee affiliate which are directly related to the transfer of intangible property, such services are considered in arriving at an arm's length charge for the transfer or use of the property. However, they are not subject to a separate charge or allocation under the rules applicable to the performance of services by one member of a controlled group for another.[236]

An example in the Regulations indicates that where an employee of one member of a group reveals to a related entity a valuable secret process owned by his employer, and at the same time supervises the integration of the process into a manufacturing operation of the related entity, such services are considered to be rendered in connection with the transfer of the secret process and are a factor in determining the amount of the arm's length consideration for the transfer of the intangible property. However, the services are not the basis for a separate allocation. On the other hand, if the employee continues to render services by supervising the manufacturing operation after the secret has been integrated, a separate allocation may be made under the performance-of-services rules.[237]

¶ 7.4d Mitigation of International Double Taxation

As applied to two or more related domestic licensor-licensees, or transferor-transferees of intangible property, Section 482 ordinarily produces correlative adjustments, i.e., an increase in one taxpayer's

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[234] Bischel, note 230 *supra* at 16.

[235] Reg. § 1.482-2(b)(1).

[236] Reg. § 1.482-2(b)(8).

[237] *Id.*

of a Section 482 adjustment. Yet, limitations on the amount of foreign tax credit available to a taxpayer might preclude its total effectiveness in avoiding international double taxation where intangible property transfer adjustments are concerned.[243] For example, by the terms of the generally more favorable "overall limitation," the foreign tax credit is limited to that percentage of the United States tax which a corporation's foreign-source income bears to its total taxable income.[244] Thus, if foreign-source income totals 50 percent of worldwide income, the credit may not exceed 50 percent of the United States tax computed before the credit. Additionally, the foreign tax credit may not exceed the effective United States rate.[245] Finally, to receive a credit for foreign income tax paid by a foreign subsidiary, a United States domestic corporation must own at least a 10 percent interest in the subsidiary, and the credit may not exceed the dividends received by the parent from the subsidiary in the year of the credit.[246]

[1] Administrative Relief. In light of increased Section 482 activity in foreign operations and the inherent limitations of the foreign tax credit, the Treasury Department in 1964 promulgated a temporary measure to unilaterally diminish the prospect of international double taxation arising from income reallocation adjustments. Revenue Procedure 64-54[247] attempted to deal with the double taxation problem by providing an offset against the increased United States tax resulting from adjustments involving the transfer of intangible property. The offset is equal to the amount by which the controlled foreign entity's foreign income tax liability (as actually determined)

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claims. Income Tax Act § 164(1); Federal Republic of Germany, one year, AO §§ 151, 152(3), 153.

[243] I.R.C. § 904.

[244] I.R.C. § 904(a)(2). Originally, the foreign tax credit provisions placed no limitations on the amount of credit allowable. Hence, a taxpayer operating in a foreign country having a substantially higher tax rate than the United States could utilize the credit to reduce the United States tax on his domestic-source income. However, this provision was ultimately eliminated. See Revenue Act of 1921, ch. 136, § 222(a)(5), 42 Stat. 249, 258; Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 169.

[245] Thus, if the effective foreign tax rate after a Section 482 adjustment exceeds the United States rate, the foreign tax attributable to the income will not be completely creditable.

[246] I.R.C. § 902(a). The indirect foreign tax credit is further limited to first through third-tier foreign subsidiaries. I.R.C. § 902(b)(1), (2).

[247] 1964-2 C.B. 1008, 1009-10. Note that Rev. Proc. 72-22, 1972-1 C.B. 747-48, provided that Rev. Proc. 64-54 relief is available where the United States taxpayer is a shareholder in a controlled foreign corporation.

able by Revenue Procedure 65-17 is available for any year in which taxable income is increased by the Internal Revenue Service under the authority of Section 482. For years beginning after December 31, 1964, however, the relief is available only if the Internal Revenue Service determined that the transactions or arrangements upon which the allocation is based did not have as one of the principal purposes the avoidance of federal income taxes.[254]

[2] Tax Treaties.

Substantive treaty provisions. Almost all income tax conventions of the United States include a provison corresponding to Article 9 of the OECD Model Convention dealing with the correction of profits reported by related or associated enterprises in the United States and the other treaty country.[255] Article 11 of the Treaty with Japan is typical:

> "(1) Where a resident of a Contracting State and any other person are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, then any income, deductions, credits, or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income (or loss) of, or the tax payable by, one of such persons may be allocated and utilized in computing the amount of the income subject to tax and the taxes payable by such resident of that Contracting State.
>
> "(2) A person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons owns or controls directly or indirectly both. For this purpose, the term 'control' includes any kind of control,

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[254] Rev. Proc. 65-17, *as amended* Rev. Proc. 65-17 amend. I, 1966-2 C.B. 1211. Among the factors considered by the Internal Revenue Service in making its determination are the amount of dividends received from the corporation which was a party to the transaction giving rise to the allocation; whether there was a good faith effort to comply with the regulations promulgated under Section 482; the extent to which the transaction contravened these regulations; and the amount of income taxes (in both countries) which resulted from the transaction. The relative weight given any one factor depends on the facts of each case. Rev. Proc. 65-17, § 3.02, 1965-1 C.B. 833, 834.

[255] The only exception is the recent treaty with the Soviet Union. Apparently, a reallocation provision was not included and source income exemption favored whenever feasible, because as a practical matter it would be impossible for the Internal Revenue Service to obtain profit and loss statements of Soviet state trading corporations.

nue Service will not adjust the income of one of its taxpayers on the strength of a treaty provision alone without support for such action in the Internal Revenue Code. As a practical matter, the problem does not exist because of the extremely wide discretionary authority given the Commissioner under Section 482 and the far-reaching regulations implementing this authorization. On the basis of these rules, the Commissioner has authority to adjust the income of enterprises under common control even though one of the enterprises is located in a country whose treaty with the United States provides for such corrections only between parent and subsidiary companies. Conversely, it would seem that a treaty country in which a subsidiary of a United States corporation is residenced would be justified in denying recognition to payments made to the parent for royalties or service fees only if and to the extent that such action is supported by the local law of that country.[260]

The competent authority procedure. Almost all United States tax treaties include an article providing that in cases of double taxation contrary to the rules of the treaty, the taxpayer may seek remedial action, via a "competent authority" procedure by the two governments.[261] Under the provisions, the competent authorities of the treaty partners are authorized to communicate directly with each other to implement the provisions of the treaty and by mutual agreement to settle any differences or doubts that may arise in connection therewith. Although the competent authorities are authorized to consider any instance of double taxation, recent treaties specifically authorize the competent authorities to endeavor to agree in the areas of income source and income allocation between affiliated enterprises or units of the same business enterprise operating in both countries.[262]

Prior to 1970, however, taxpayers rarely invoked the competent authority procedure, primarily because taxpayers were not aware

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[260] Although no specific authority exists for this view, it appears unlikely that the United States would question a decision made by another treaty country as being without foundation in the law of that country, or in direct conflict with it, although a taxpayer's complaint to that effect might be submitted by the United States to the other treaty country under the mutual agreement procedures discussed in the following subsections.

[261] E.g., Treaty with Finland, March 6, 1970, Art. 28, CCH Tax Treaties ¶ 2679; Treaty with Federal Republic of Germany (Protocol), Sept. 17, 1965, Art. XVII(1), CCH Tax Treaties ¶ 3025.

[262] E.g., Treaty with France, July 28, 1967, Art. 25(2), CCH Tax Treaties ¶ 2828.

CHAPTER 8

Tax Effect of Foreign Licensing and Technical Assistance Income on Subsidiary and Affiliated Corporations

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¶ 8.1 TAX DEFERRAL AND SURCHARGES: PERSONAL HOLDING COMPANIES AND SUBPART F

¶ 8.1a Foreign Personal Holding Companies

Possibly the greatest danger present in an income reallocation under Section 482 as discussed in the preceding chapter is the loss

or an option to acquire such an option, he is considered to own the stock.[9]

If the income and ownerships requirements are met, the "United States shareholders" of a foreign personal holding company are taxed annually upon their proportionate share of the undistributed foreign personal holding company income.[10] The effect of the provision is to tax the United States shareholder directly on current licensing income as well as other foreign personal holding company income. Therefore, individuals licensing or performing technical assistance services abroad generally cannot use a closely held foreign corporation to defer United States income tax on royalties from foreign sources unless the corporation has sufficient operating income to shield the royalty or technical assistance income.[11]

¶ 8.1b Subpart F—Controlled Foreign Corporations

The foreign personal holding company provisions left gaps which some United States licensors were able to utilize to indefinitely defer United States tax liability on licensing income. In particular, the definitional aspects of a foreign personal holding company were so narrowly drawn that foreign licensing subsidiaries of publicly owned United States corporations were excluded from its coverage. Thus, in many cases United States parent corporations transferred valuable income-producing assets, including patents and know-how, to foreign "tax haven" subsidiaries which were used as conduits to sublicense the technology to operating corporatons in other countries. For instance, a Liechtenstein subsidiary could receive for its services 80 percent of the royalties and fees derived from the use of its United States parent's patents, formulas, trademarks, and know-how by foreign licensees, even though the foreign subsidiary had few, if any, employees, and such transactions were handled as if there were no such foreign company.[12] Foreign licensing income could,

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[9] I.R.C. § 554(a)(3). Stock attributed to an individual through a corporation or by an option may be reattributed to another person, but stock constructively owned through the individual's family or his partner may not again be reattributed. I.R.C. § 554(a)(5).

[10] I.R.C. §§ 551(a),(b). Note, under the deemed distribution device no pass-through (or indirect credit) of the foreign income taxes paid by the corporation is allowed to its shareholders.

[11] Additionally, Sections 367 and 1249 normally operate to require ordinary income treatment on any transfers to such corporations.

[12] See *Tax Effects of Conducting Foreign Business Through Foreign Corporations* 14-15 (1961). (Prepared for the use of the Senate Committee on Finance by the Staff of the Joint Committee on Internal Revenue Taxation.)

laws of which the controlled foreign corporation is created; [18] or

(2) Royalties derived in the active conduct of a trade or business and which are received from a person other than a related person.[19]

The pertinent regulations state that in general the question of whether or not royalties are derived from the active conduct of a trade or business is to be determined from the facts and circumstances of each case.[20] However, royalties are considered to be derived from the active conduct of a trade or business if the licensor meets either of the following tests:

(1) The licensor has developed, created, or produced the property, or has acquired and added substantial value to it, and the licensor is regularly engaged in developing, creating, or producing, and licensing, or in acquiring and adding substantial value to and licensing property of such kind; or

(2) The licensor leases property as a result of the performance of the licensor, and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.[21]

The frequency with which a controlled foreign corporation enters into licensing transactions from which royalty income is derived is not, in itself, indicative of the active conduct of a trade or business

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[18] I.R.C. § 954(c)(4)(C). For example, the French subsidiary of a United States corporation will not generate Subpart F income from the licensing of know-how to a related French corporation.

[19] I.R.C. § 954(c)(3)(A). For these purposes a "related person" includes an individual, partnership, corporation, trust, or estate which controls the controlled foreign corporation, and any corporation which is controlled by the foreign corporation or by the same persons which control the controlled foreign corporation. Moreover, the Section 958 constructive ownership attribution rules are also applicable. I.R.C. § 954(d)(3).

[20] Reg. § 1.954-2(d)(1)(i).

[21] Reg. § 1.954-2(d)(iii)(a)(1),(2). The regulations further state that activities of an independent contractor are not considered activities of the licensor for purposes of the substantial organization test. Reg. § 1.954-2(d)-(1)(iii)(b)(3)(i).

ties for the use of patents which it acquires by purchase. The primary business of *B* Corporation, operated on a regular basis, consists of licensing patents which it has purchased "raw" from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, *B* Corporation, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adoption of the process and, by so doing, substantially increases the value of the patent. Royalties received by *B* Corporation from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A)."[25]

A person is a "related person" with respect to a controlled foreign corporation if "such person is a corporation which controls, or is controlled by, the controlled foreign corporation . . . ."[26] Control is defined as the ownership of more than 50 percent of the total combined voting power of all classes of stock entitled to vote.[27] Thus, a 50 percent owned second-tier foreign operating corporation (joint venture) will not be considered a related person. Royalties received from such a venture are therefore exempted from Subpart F application. Morover, as indicated previously, royalties received by a corporation from the licensing of intangible property to a related person do not constitute Subpart F income if the related person uses the rights in the country in which the foreign corporation is organized.[28] For example, a United States parent of a Swiss subsidiary which licenses technology to an affiliated corporation in Switzerland does not derive Subpart F income from the transaction; but if the affiliated corporation uses the rights in Germany, the German use must be included as Subpart F income, since the rights are not used in the country in which the foreign corporation is organized. It should also be noted that the latter transaction would not be exempted from Subpart F application even if the controlled foreign corporation is engaged in the active conduct of a trade or business because the active trade or business exception only applies to royalties received from a person unrelated to the controlled foreign corporation. Thus, the definition of a "related person" takes on added importance.

[25] Reg. § 1.954-2(d)(iii)(c), Ex. 3.
[26] I.R.C. § 954(d)(3)(B).
[27] I.R.C. § 954(d)(3).
[28] I.R.C. § 954(c)(4)(C).

performance of such contract in that they assist *B* Corporation directly in the execution of the contract and provide *B* Corporation with skills which are a principal element in producing the income from the performance of such contract." [33]

On the other hand, even though technical assistance furnished by a related person to a controlled foreign corporation is not itself considered to be substantial, when combined with similar unsubstantial assistance from another related person, the total assistance furnished may be substantial.[34]

Although the place where services are considered to have been performed depends on all the facts and circumstances, as a general rule, services will be considered performed where the persons performing the services for the controlled foreign corporation, which derives income in connection with their performance, are physically located when they perform their duties in the execution of the service activity resulting in such income.[35] Thus, in many instances, total gross income of a controlled foreign corporation, derived in connection with each service contract or arrangements performed for or on behalf of a related person, must be apportioned between income which is not foreign base company service income and that which is foreign base company service income on a basis of employee time spent without the country, under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little or no value, while services performed by technical, highly skilled, and managerial personnel will be assigned values in relation to the type of function performed by each individual.[36]

Finally, as the following subsections indicate, for some United States licensors who also sell personal property through a controlled foreign corporation, it is important that Subpart F income also includes foreign base company sales income. Roughly speaking, this category consists of income derived by a controlled foreign corporation from selling personal property that it purchased from a related

[33] Reg. § 1.954-4(b)(3).
[34] Reg. § 1.954-4(b)(2)(ii)(d).
[35] Reg. § 1.954-4(c).
[36] *Id.*

as long as it is retained by a controlled foreign corporation in qualified investments in less developed countries.[41] A less developed country is any foreign country or any possession of the United States with respect to which there is in effect an Executive Order by the President designating it as less developed for Subpart F purposes.[42] However, there are certain countries which are not eligible for less developed status under any circumstances.[43] Qualified investments constitute (1) stock of a less-developed-country corporation (LDCC) if a controlled foreign corporation owns 10 percent or more of the combined voting power of the stock of such corporations, (2) an obligation of a less developed country.[44]

To be a LDCC, the principal conditions are that at least 80 percent of the corporation's earnings has its source within a less developed country and 80 percent of its assets consist of property qualifying under the less-developed-country corporation laws.[45] Among the types of foreign corporations qualifying as LDCCs are corporations engaging in the active conduct of a trade or business during the entire taxable year, and holding companies which derive 80 percent or more of their gross income in the form of dividends and interest received from 10 percent-or-more-owned less-developed-country corporations and from gains on the sale or exchange of stock in such less-developed-country corporations.[46]

[3] Planning Prospectives. The foregoing mitigation measures, as well as other aspects of the Subpart F structure can often be effective implements for maintaining United States tax deferral or increasing after-tax income from foreign licensing and other activities. For instance, the Regulations provide that a United States shareholder of multiple-controlled foreign corporations may employ one of three elections in an effort to diminish the variations in foreign tax rates due to required minimum distributions: (1) the single controlled foreign corporation, (2) a chain where the United States corporation controls one or more of the foreign corporations, and (3) a group of controlled foreign corporations which are all owned by a United States shareholder.[47]

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[41] I.R.C. § 955(a), (b).
[42] I.R.C. § 955(c)(3).
[43] *Id.*
[44] I.R.C. § 955(b)(1).
[45] I.R.C. § 955(c)(1).
[46] Reg. §§ 1.955-5(a)(1)(i), 1.955-6(b)(1)(ii).
[47] Reg. § 1.963-4(a)(1)(ii).

(3) An extremely high "supplementary" income tax is imposed on profit repatriation to foreign shareholders which exceeds 12 percent of the foreign shareholder's original investment and reinvestment.[52]

In light of the foregoing provisions, assume a United States parent corporation, *X*, transfers patents [53] to a Brazilian licensing subsidiary, *B*, instead of licensing the patents directly to its Brazilian operating subsidiary, *A*. *A* is allowed a deduction for the royalty payment [54] to *B* and upon subsequent repatriation to *X* the character of the income is converted to dividend income, which is free of exchange control restrictions. Moreover, both *A* and *B* will be allowed to repatriate up to 12 percent of their investment and reinvestment (which includes the royalty income in the case of *B*) wthout being subject to the supplementary tax. On the other hand, if *X* Corporation is not in an excess foreign tax position it may be preferable to grant a royalty-free license directly to *A*. The result would be higher operating profits which could ordinarily be repatriated to *X* Corporation with no further United States tax liability.

Finally, it should be noted that the 30-70 rule permits large amounts of royalty income to flow through foreign operating subsidiaries in developed countries without subjecting their shareholders to Subpart F deemed distributions. The flow-through may occur because up to 30 percent of *gross income*, which may be a far higher percentage of net income, may consist of royalty income without triggering Subpart F application.[55]

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contracts with a Currency and Exchange Control (now the Banco Central de Brazil).

[52] This tax, in addition to a 25 percent withholding tax on all gross-income payments to nonresidents, is assessed at the following graduated rates:

Between 12% and 15%	40%
Between 15% and 25%	50%
Over 25%	60%

[53] The Internal Revenue Service will issue a favorable Section 367 ruling when intangible property is transferred to a foreign corporation which is a less-developed-country corporation holding company. See ¶ 6.3b[2] *supra*.

[54] However, the deduction may not exceed a percentage (not higher than 5 percent of the gross receipts from the sale of the industrial product) established and revised from time to time by the tax authorities for each type of product.

[55] I.R.C. § 954(b)(3)(A). As a further refinement, multiple groups of foreign operating subsidiaries may be used to generate licensing income without violating the 30 percent rule. However, when using a foreign operating subsidiary for licensing purposes a United States parent should also be cognizant

¶ 8.1d Personal Holding Companies

The personal holding company provisions are directed primarily at tax avoidance sought to be accomplished by shifting income from a wealthy or talented individual, where it would be subject to high tax rates, to a corporation with lower tax rates. A penalty tax of 70 percent of undistributed personal holding company income is imposed on any corporation which meets the definition of a personal holding company.[59] As in the case of foreign personal holding companies, a corporation will fall within the "personal holding company" classification if it meets certain gross income and stock ownership requirements.

The gross income test is fulfilled if at least 60 percent of the adjusted gross income of a corporation consists of personal holding company income.[60] The relevant statutes and regulations thereunder define personal holding company income as including "royalties" received for the privilege of using patents, copyrights, secret processes and formulas, trademarks, and other like property.[61] From a practical prospective, the foregoing definition may create difficulties where a licensing agreement combines an intangible property license with an undertaking by the licensor to provide services. Personal services are considered personal holding company income only if a service provides for the designation of a particular individual [62] to perform the services and that individual owns 25 percent or more of the corporation's stock at some time during the taxable year.[63] In the event the service income is not classified as personal holding income, it would be necessary to allocate the income generated by the contract between "royalties" and "compensation" for services.[64] Finally, a classification problem occurs in transactions where it is not clear whether the transferor of intangible property has

(1) Granted a license on which it is receiving royalty payments; or

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[59] I.R.C. § 541.

[60] I.R.C. § 542(a)(1).

[61] I.R.C. § 543(a)(1), Reg. § 1.543-1(b)(3). Moreover, in Rev. Rul. 71-596, 1971-2 C.B. 242, the Service held that payments received for the use of a secret formula were royalties even though the contract referred to such payments as part of rent.

[62] However, the designation must be available to some person other than the corporation. I.R.C. § 543(a)(7)(A), Reg. § 1.543-1(b)(8)(a).

[63] I.R.C. § 543(a)(7).

[64] See Portable Indus., Inc., 24 T.C. 571 (1955).

residents.[70] Thus, a corporation meets the personal holding company stock requirement if five or fewer individuals own more than 50 percent in value of its outstanding stock during the last half of the corporation's taxable year.[71] When the two sets of provisions overlap, however, the foreign personal holding company provisions take precedence.[72] Yet, if applicable, the burden of the personal holding company tax, which is imposed on the corporation rather than on the shareholders, generally falls indiscriminately on foreign as well as domestic shareholders.[73]

¶ 8.2 DOMESTIC TAX INCENTIVE CORPORATIONS WITH FOREIGN INCOME

¶ 8.2a Western Hemisphere Trade Corporations

A corporation which meets the requirements of a Western Hemisphere Trade Corporation (WHTC) is entitled to a special deduction which in effect reduces the United States income tax rate by fourteen percentage points.[74] This lowers the current top corporate tax rate from 48 percent to approximately 34 percent. To qualify for such favored treatment, however, a corporation must (1) be a domestic corporation, (2) conduct all of its business (except for "incidental purchases") in the Western Hemisphere, (3) derive at least 95 percent of its gross income for the three-year period preceding the close of its taxable year from foreign sources (not necessarily, however, from Western Hemisphere sources), and (4) derive at least 90 percent of its gross income for the same period from the active conduct of a trade or business.[75]

The principal advantage of using a WHTC as a licensing affiliate instead of a foreign corporation is the inapplicability of Section 367 to such entities and hence, the possibility of transferring intangible

[70] I.R.C. § 542(a)(2).

[71] *Id.*

[72] I.R.C. § 542(c)(5).

[73] However, Section 542(c)(7) provides a blanket exemption from personal holding company status for foreign corporations wholly owned by nonresident aliens, provided it does not have any personal service contract income for the taxable year. Additionally, Section 5454(a) provides a more limited form of relief for a corporation with more than 90 percent foreign ownership during the last half of the taxable year.

[74] I.R.C. § 922.

[75] I.R.C. § 921. For a definition of countries qualifying under Section 921 see Rev. Rul. 55-105, 1955-1 C.B. 94. Also, note that business must be done in a country. Rev. Rul. 66-340, 1966-2 C.B. 283.

cent. If the effective foreign tax rate exceeds 48 percent, use of a WHTC would be costly if a corporate shareholder could otherwise use the excess foreign taxes against other income had a foreign subsidiary corporation been used for the WHTC operations. Even where the effective foreign tax rate is less than 34 percent, it is essential to compare the WHTC tax benefits with the loss of deferral of United States taxes.

¶ 8.2b Possessions Corporations

A domestic corporation which qualifies as a possessions corporation under Section 931(a) is taxable only on gross income derived from sources within the United States. Thus, it is not subject to United States taxation on its possession or foreign-source income unless such income is received in the United States.[84] To qualify for the possession corporation tax exclusion, a corporation must be a domestic corporation which derives at least 80 percent of its gross income (determined without regard to the Section 931 exclusion) from sources within a United States possession for the three-year period immediately preceding the close of the taxable year or so much of the period for which the corporation was in existence.[85] Moreover, at least 50 percent of its gross income must be derived from the active conduct of a trade or business within a "United States possession for the requisite period." [86]

The use of a possessions corporation for licensing operations abroad would be easier than the use of a WHTC since ony 50 percent of gross income need be from the active conduct of a trade or business within a United States possession. On the other hand, the possession corporation structure is of limited application due to the extreme geographical restrictions on the sources of its income. Also, in reality, the possessions corporation tax incentive is merely a deferral instead of an exclusion from United States taxation since its income may not be included in a consolidated return, nor is a

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[84] I.R.C. § 931(a).

[85] The Regulations construe "possession" to include the Panama Canal Zone, Guam, Samoa, Wake and Midway Islands, and Puerto Rico. Reg. § 1.931-1(a)(1). The Virgin Islands are excluded by statute. I.R.C. § 931(c). In determining the source of income presumably the source-of-income rules contained in Sections 861-63 are applicable, although these provision are directly concerned only with determining whether income is from sources within or without the United States. Reg. § 1.863-3(c)(3) dealing with the reallocation of income between possessions and the United States.

[86] I.R.C. § 931(a)(2).

posed Regulations indicate that although a copyright, such as the copyright on a book, does not constitute export property, a copyrighted article such as a book or other copyrighted property is export property if the other requirements for the qualification of export property are met.[93] From the foregoing regulatory example it appears that the physical embodiment of technical know-how, such as computer programs, also qualifies as export property, if it is held for sale in the ordinary course of business and the rights to the proprietary intangible know-how are not made a part of the sale or lease agreement.[94]

Even though royalty income from the licensing of intangible property may not constitute more than 5 percent of total receipts, significant amounts of royalty income may be partially deferred from current United States taxation through use of the DISC structure without a corporation qualifying as a DISC risking potential loss of its DISC status.

Example: *D*, a corporation qualified as a DISC, receives $50,000 in gross royalty receipts during its taxable year. Additionally, *D* purchases export property from a related supplier and sells it for $1 million. Pursuant to the Section 994 intercompany pricing rules, *D* elects to treat 4 percent of the qualified export receipts of $40,000 as that part of the income allocable to the DISC on the sale of the export property.[95] At the end of the year, *D*'s *net* income is $90,000, of which more than one-half is attributable to the royalty income. United States taxation can be deferred on up to one-half of the $50,000 royalty income.

Additionally, in closely held corporations the pro-rata stock owner-

[93] Prop. Reg. § 1.993-3(f)(3).

[94] For example, the Proposed Regulations indicate that the preparation of a map of a particular construction site would constitute services, but standard maps prepared for sale to customers generally would not constitute services and would be export property. Prop. Reg. § 1.993-3(b).

[95] Under Section 994(a) any one of the following three methods may be used for determining the profits of a DISC:

(1) Four percent of the gross receipts of the DISC derived from the sale of export property plus 10 percent of the expenses incurred to promote these sales;

(2) Half of the combined income of the DISC and its related supplier from the sale of export property abroad plus 10 percent of the expenses incurred to promote these export sales;

(3) Taxable income based upon the sales price actually charged (but subject to the rules provided in Section 482).

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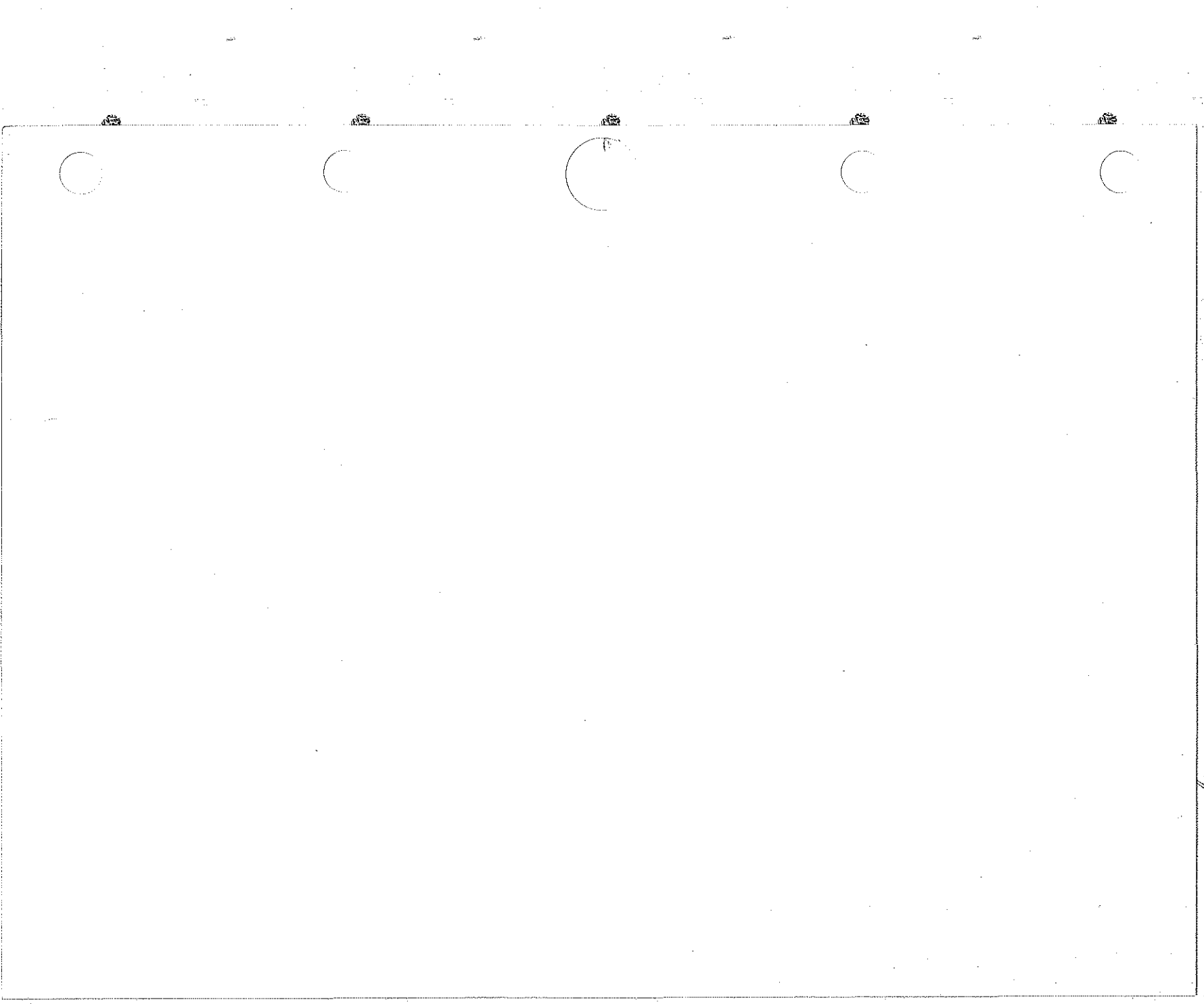

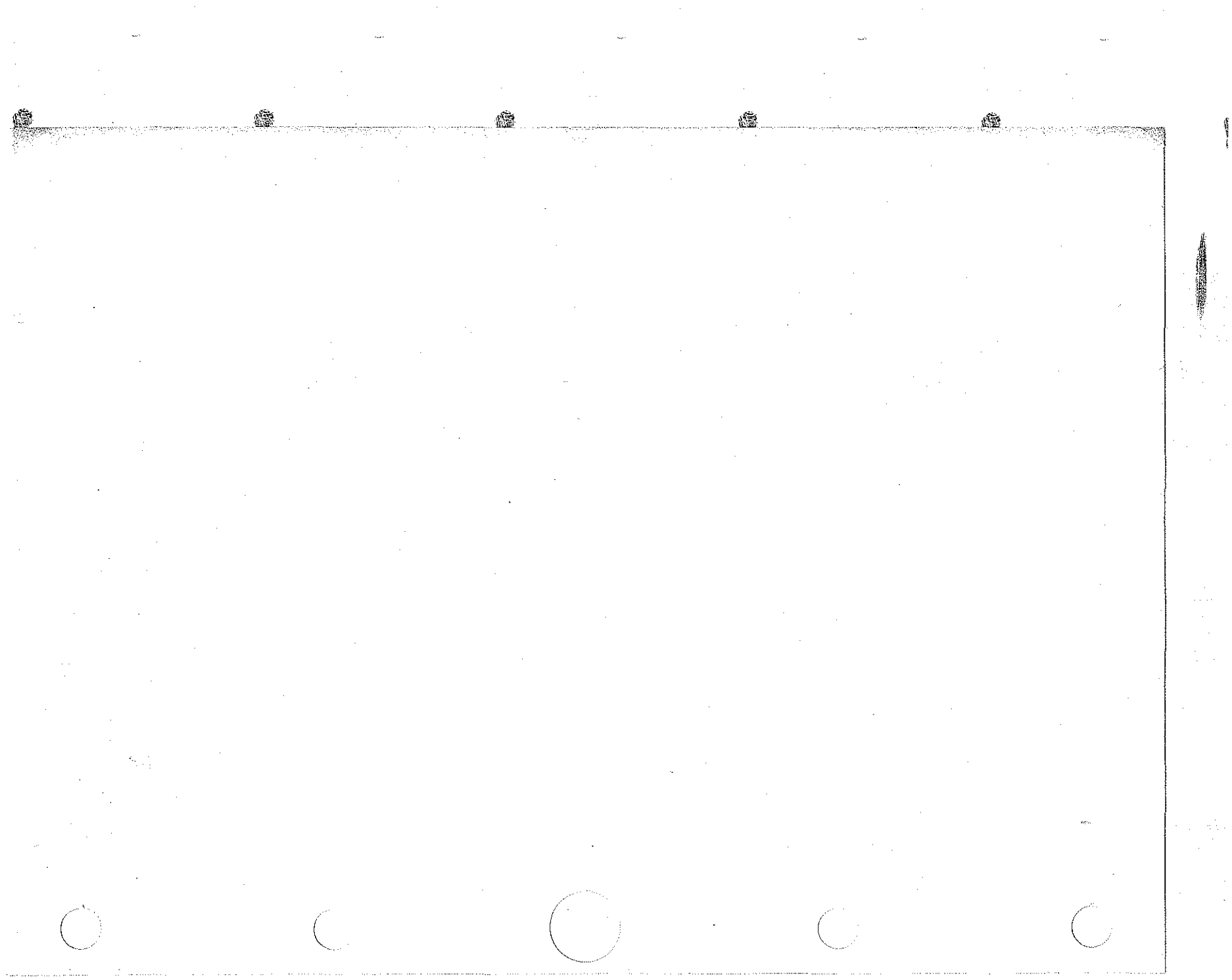

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ship deemed distribution rule coupled with the income flow-through characteristics of a DISC may be used to avoid the corporate tax on royalty income where the principal shareholders of the corporation are also the principal shareholders of the DISC.

> Example: Export-oriented corporation *P* forms a Disc, *D*, and during its first year of operation assigns to *D* the right to receive $300,000 in patent licensing income. In addition, *D* receives $700,000 in qualified export receipts from the sale of export property of which *D* elects to treat 4 percent as that part of the income allocable to the DISC. Although *D* is required to make a qualifying distribution equal to the non-qualified receipts, or $300,000,[96] in order to retain its DISC status, the income distributed will not have been subjected to United States corporate income tax.[97]

Finally, it should be noted that the DISC deferral incentive may have an effect on the amount of patent and proprietary know-how licensing income derived outside of the DISC structure. For instance, foreign licensing agreements often contain a clause requiring the licensee to purchase from the licensor certain component parts essential to the manufacture of a licensed product.[98] Where these sales of component parts can be flowed through a DISC, it may, to varying degrees, be possible to reduce or eliminate the royalty in return for an adjustment in the sales price of the components subject to DISC tax deferral incentives.

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[96] Such qualifying distributions may be made pursuant to Section 993(c) if a DISC has reasonable cause for not meeting the 95 percent gross receipts test. However, a qualifying distribution made within eight and one-half months after the end of the DISC's taxable year is deemed to be for reasonable cause if at least 70 percent of the gross receipts of the DISC for the year in question were qualified export receipts. I.R.C. § 993(c)(3).

[97] For other examples, see generally Bischel, "Proposed DISC Regs: Planning for deemed and actual distributions in qualified years," 38 J. Taxation 178 (1973).

[98] Such clauses are frequently inserted to insure the quality of the licensed product.

Section 243 deduction for dividend distributions available to corporate shareholders.[87]

¶ 8.2c Domestic International Sales Corporations

A Domestic International Sales Corporation (DISC) is a domestic corporation which enjoys favorable tax treatment since the Internal Revenue Code views it as a flow-through for taxation pusposes and therefore generally not subject to United States taxation.[88] Further, although a DISC shareholder must currently include DISC income in its returns on a pro rata basis computed on the percentage of stock ownership, the shareholder is entitled to defer taxation on up to one-half of the DISC income.[89] To qualify as a DISC, however, a domestic corporation, in addition to certain other requirements, must derive at least 95 percent of its gross receipts from "qualified export receipts" (usually from the sale or lease of export property), and at least 95 percent of the adjusted basis of its assets at the close of the taxable year must consist of "qualified export assets."[90]

Since the primary purpose of the DISC legislation is the encouragement of United States exports, it is not surprising that the term "export property" does not include patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), trademarks, trade brands, franchises, or other like property.[91] Thus, the sale or lease of such property cannot constitute a qualified export receipt because qualified export receipts can generally be generated only by the sale, lease, or rental of export property.[92] However, the sale or lease of the physical embodiment of an intangible property may qualify as export property. The Pro-

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[87] See Rev. Rul. 65-293, 1965-2 C.B. 323. However, dividends from a possessions corporation to its 10 percent or more domestic corporate shareholders qualify for the indirect foreign tax credit.

[88] I.R.C. § 991. The only exception to a DISC's tax exemption is in the case of Section 1491 transfers.

[89] Pursuant to Section 995(a), a DISC shareholder is in effect entitled to defer taxation on DISC income which is the subject of neither an actual nor a deemed distribution. Distributions of dividend income are deemed to occur in relation to each of the following: (1) interest of producer's loans, (2) recognized gain on disposition of certain nonqualified expert assets, (3) depreciation recapture and other income recognized on sales or exchanges of export assets, (4) 50 percent of the remaining taxable income, and (5) foreign investment attributable to producer's loans.

[90] I.R.C. § 992(a)(1).

[91] I.R.C. § 993(c)(2)(B).

[92] I.R.C. § 993(a)(1)(A).

property to a WHTC without any recognition of gain.[76] Yet, the active trade or business requirement strongly discourages the use of the WHTC for licensing purposes because the Internal Revenue Service has indicated that licensing will not be regarded as the active conduct of a trade or business.[77] On the other hand, gains from the sale of property used in a trade or business, which are treated as capital gains,[78] constitute income derived from the active conduct of a trade or business.[79] Moreover, in licensing a patent or know-how, the accompanying technical assistance may constitute by far the most valuable part of the transfer, especially in developing countries. Clearly, the performance of such services must be considered an active business.[80] Finally, it would appear that a research corporation, actively engaged in developing patents, deriving its income by administering licenses and furnishing services to licenses should be considered engaged in the active conduct of a trade or business.

In evaluating the desirability of utilizing a WHTC in the foregoing contexts it is important to consider the effects of the loss of tax deferral and the foreign tax credit. Although dividends paid by a WHTC to its shareholders qualify for the Section 243 deduction (or for elimination in a consolidated return if the affiliated group to which a WHTC belongs elects to be taxed under Section 1501),[81] the indirect foreign tax credit does not apply to dividends received from a WHTC since it is a domestic corporation.[82] Further, as the foreign tax credit available to the WHTC is limited to the amount of income tax paid to the United States,[83] the tax benefits realized by the use of a WHTC are proportionately reduced as the effective foreign tax rate on income, such as foreign-source service income which is also taxable currently by the United States, exceeds 34 per-

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[76] I.T. 3757, 1945 C.B. 200.

[77] Rev. Rul. 56-512, 1956-2 C.B. 173.

[78] I.R.C. § 1231.

[79] Rev. Rul. 58-56. 1958-1 C.B. 335. However, the ruling states that gains from the sale or exchange of capital assets do not constitute income derived from the active conduct of a trade or business.

[80] In particular, transfers of technical know-how to developing countries may consist primarily of technical assistance, which is generally given a rate preference over royalty income for taxation purposes.

[81] I.R.C. § 1504(b). See generally Tillinghast, "The Western Hemisphere Trade Corporation: Comparison with Locally Incorporated Entities; Its Utility: Its Future," 28 N.Y.U. Inst. on Fed. Tax. 437 (1970).

[82] I.R.C. § 902(a).

[83] I.R.C. § 904.

(2) Has sold the property and is receiving installment payments on the purchase price; [65] or

(3) Is receiving a payment of profits as a participant in a joint venture.[66]

Even though copyright royalties constitute personal holding company income, publishers and other active business firms are exempted from the application of the personal holding company provisions. To qualify for the exemption, the corporation's copyright royalties (except for shareholder-created works) must constitute 50 percent or more of its ordinary gross income; its other personal holding company income must not exceed 10 percent of its ordinary gross income; and its Section 162 deductions allocable to its copyright royalties (other than personal services rendered by shareholders and certain other items) must meet a complex test designed to insure a substantial level of business activity.[67] Rentals from film properties acquired before substantial completion of production are subject to a special treatment accorded to rents,[68] whereas income from film properties acquired after substantial completion of production is treated as copyright royalty income.[69]

The application of the personal holding company provisions to foreign as well as domestic licensing corporations proceeds from the broader ownership definition requirement for personal holding companies when compared to foreign personal holding companies. The stock ownership requirement for personal holding companies differs from the requirement for foreign personal holding companies in that the controlling group need not consist of United States citizens or

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[65] See discussion ¶ 1.3a *supra*. Note, if a contract fails to allocate payments between royalties and proceeds from the sale of property or the performance of services, the entire amount may be treated as royalty income in the event the taxpayer cannot demonstrate that a portion is other than royalty income. See, e.g., Lane-Wells Co. v. Comm'r, 134 F.2d 977 (9th Cir. 1943), *rev'd on other grounds* 321 U.S. 219 (1944); John C. O'Conner, 16 T.C.M. 213 (1957), *aff'd on other grounds* 260 F.2d 358 (6th Cir. 1958), *cert. denied* 359 U.S. 910 (1959). On the other hand, if a taxpayer receives a payment with respect to a patent in which it has no interest, the amount will not be classed as royalty income. See Hopag S.A. Holding de Participation et de Gestion de Brevets Industriels, 14 T.C. 38 (1950), *acq.* 1953-1 C.B. 4.

[66] E.g., William J. Lemp Brewing Co., 18 T.C. 586 (1952).

[67] I.R.C. § 543(a)(4). See Cohen, "Personal Holding Companies – Entertainment Industries," 1962 S. Cal. Tax Inst. 651. Note, in Irving Berlin Music Corp. v. United States, 487 F.2d 540 (Ct. Cl. 1973), the active business exemption was strictly construed in relation to copyright royalties.

[68] I.R.C. § 543(a)(5).

[69] Note 66 *supra*.

¶ 8.1c Disregard of Corporation as a Separate Entity

A large body of federal income tax litigation turns on the disregard, in whole or in part, of the separate existence of a corporation and the closely related question of whether a transaction is, in fact, the act of a corporation or its shareholders.[56] Moreover, Section 269 provides that if a taxpayer's principal purpose in acquiring control of a corporation is the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which he would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. Thus, in a few instances, it has been determined that the separate entity of the foreign subsidiary may be disregarded if the arrangement is a sham.[57]

Application of Section 269 or a disregard of the corporate entity by the Internal Revenue Service will, in the case of a United States corporate parent, result in a loss of the deferral of United States tax liability and current taxation of the foreign subsidiary's income as though it were a branch operation. Such possibilities exist where foreign licensing and technical assistance subsidiaries are nothing more than paper operations dependent primarily upon a parent corporation's technical personnel whose services are loaned or subcontracted to the subsidiary. To foreclose a disregard of the corporate entity of a licensing or technical assistance subsidiary it should be provided with as much substance as possible. For instance, it is advisable to transfer to the subsidiary the full-time personnel administrating the foreign licensing and technical assistance. Although the administrative personnel need not necessarily be located in the country where the foreign subsidiary is organized, it is helpful if some foreign office be maintained.[58]

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of the possible consequences of a Section 482 reallocation of income. See O'Conner, "Side Effects of Section 482 Can Be More Serious than Original Allocation," 31 J. Taxation 194 (1969); Farber, "The Less Developed Area of Correlative Adjustments Under Section 482," 45 Taxes 811 (1967).

[56] Siegal v. Comm'r, 45 T.C. 566 (1966); Comm'r v. Consolidated Premium Iron Ores Ltd., 265 F.2d 320 (6th Cir. 1959); Comm'r v. Spermacet Whaling & Shipping Co., 281 F.2d 646 (6th Cir. 1960); Kaspare Cohn Co., Ltd. v. Comm'r, 35 B.T.A. 646 (1937); Ross Glove Co. v. Comm'r, 60 T.C. 569 (1973). In general, see also Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 2–23, 24 (3d ed. 1971).

[57] E.g., United States v. Klein, 247 F.2d. 908 (2d Cir. 1957), *cert. denied*, 355 U.S. 924 (1958). In *Klein* the taxpayer's fear that certain foreign corporations would not be respected by the Internal Revenue Service, partly because their operations were directed from the United States, led to a series of intercorporate manipulations that culminated in criminal convictions.

[58] See Gibbons, *Tax Factors in Basing International Business Abroad* 19–22 (1957).

The chain election has generally proved to be most beneficial inasmuch as a United States shareholder may elect to include any controlled foreign corporation, or as many as desired, as long as all the second-tier, or possibly third-tier corporations, in the chain of corporations are included in calculating the pro rata minimum distribution. Thus, a Swiss licensing subsidiary with a 15 percent effective tax rate might be mixed with a German paying an effective rate of 55 percent. Together the two rates might average out to an effective tax rate of between 36 and 39 percent so that the minimum distribution would be only 51 percent. Thus, by establishing controlled foreign licensing corporations in low tax rate countries, many United States companies are assured of building up some Subpart F income not currently taxable by the United States as long as the minimum distribution requirements are met.[48]

Before 1963, a typical base company sales operation involved the use of a wholly owned Swiss subsidiary to sell the French-made goods of another subsidiary to other European countries. The resulting income would bear a minor tax in Switzerland, but no French tax and no United States tax until the profits were repatriated to the United States parent. At present, a United States parent corporation, if it is not in an excess foreign tax credit position, may wish to have its Swiss subsidiary purchase products manufactured by an unrelated French licensee of the United States parent company instead of its own French subsidiary. Sales would still be made by the Swiss subsidiary to related parties in other European countries.[49]

By contrast, a United States corporation, which is in an excess foreign tax credit position, may find it desirable to utilize a foreign licensing holding company in less developed countries, such as Brazil, where:

(1) Deductions are not permitted for royalties and payments for technical services when made to a parent corporation; [50]

(2) In many cases the payment of royalties to a foreign licensor in United States dollars will not be permitted for foreign exchange control purposes; [51] or

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[48] See Diamond, "How U.S. Business Has Handled the 1962 Revenue Act: Escape Hatches Uncovered," 26 J. Taxation 363, 367 (1967).

[49] The Domestic International Sales Corporation provisions (I.R.C. §§ 991-97) have generally eliminated much of the tax usefulness of such sales structures where the goods sold originate in the United States. See discussion ¶ 8.3 *infra*.

[50] Brazil Law 4131 of Sept. 3, 1962, Art. 174, Sole paragraphs d, f.

[51] Brazil Law 3470 of Nov. 28, 1958, provides for the registration of licensing

person (e.g., a domestic parent engaged in manufacturing) or from buying personal property (e.g., raw materials) for sale to a related person, if the property is both produced and sold for use outside the country in which the controlled foreign corporation is incorporated.[37]

[2] Measures Mitigating Subpart F Treatment. Subpart F contains a number of mechanisms designed to limit its application primarily to sales and service affiliates of United States enterprises and to foreign holding companies located in countries with low effective income tax rates. One of the most important of these mechanisms is the so-called 30-70 rule whereby if foreign base company income is less than 30 percent of the controlled foreign corporation's gross income, none of its income is treated as foreign base company income; if the foreign base company income is more than 70 percent of gross income, its entire gross income is treated as foreign base company income and if the percentage is between 30 and 70, only the actual amount is treated as foreign base company income.[38]

If a shareholder of a controlled foreign corporation is a United States corporation, it may elect to exclude from income its pro rata share of the controlled foreign corporation's Subpart F income provided the shareholder had received a minimum distribution of the controlled foreign corporation's earnings and profits for the taxable year.[39] The amount which must have been distributed is prescribed by statute and is dependent upon the effective foreign tax rate (commencing with 83 percent of earnings and profits if the foreign tax rate is under 9 percent, and declining to zero if the foreign tax rate is 43 percent or more). Essentially, the minimum distribution provision acknowledges that, if the foreign taxes paid by the controlled foreign corporation plus the United States tax paid by the shareholder on the amounts actually distributed are equal to 90 percent or more of the taxes which would have been paid had the business been operated as a foreign branch of the domestic shareholder, the tax avoidance resulting from the use of a foreign corporation is de minimis.[40]

Subpart F income remains deferred from United States taxation

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[37] I.R.C. §§ 954(a)(2), (d).

[38] I.R.C. § 954(b)(3). However, in some circumstances the income is reduced by deductions properly allocable to it under the Regulations. See Reg. § 1.954-1(c).

[39] I.R.C. § 963(a).

[40] See generally Friedman & Silbert, "Minimum Distributions Under Section 963—What Is Left of Subpart F?," 23 N.Y.U. Inst. on Fed. Tax. 955 (1965).

Subpart F income also includes income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are both performed for or on behalf of a related person and performed outside the country under the laws of which the controlled foreign corporation is created or organized.[29] However, the Regulations restrict the operation of the statute to situations in which a related person furnishes "substantial assistance" to the performance of the technical assistance or other services performed by the controlled foreign corporation.[30] A related person's assistance in the form of direction, supervision, services, or know-how is not considered substantial unless either (1) the assistance provides the controlled foreign corporation with skills which are a principal element in producing the income from the performance of the services, or (2) the cost to the controlled foreign corporation of the related person's assistance is 50 percent or more of the total cost to the controlled foreign corporation of performing the services.[31] Moreover, technical assistance furnished by a related person to a controlled foreign corporation is not taken into account in determining the substantiality of assistance unless the assistance so furnished assists the controlled foreign corporation directly in the performance of the services performed by such corporation.[32]

"*Example* (2): Controlled foreign corporation *B* enters into a contract with an unrelated person to drill an oil well in a foreign country. Domestic corporation *M* owns all of the outstanding stock of *B* Corporation. Corporation *B* employs a relatively small clerical and administrative staff and owns all the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well by *B* Corporation are regular employees of *M* Corporation who are temporarily employed by *B* Corporation. In addition, *B* Corporation hires on the open market unskilled and semiskilled laborers to work on the drilling project. The services performed by *B* Corporation under the well-drilling contract are performed for, or on behalf of, a related person for purposes of section 954(e) because the services of the technical and supervisory personnel which are provided by *M* Corporation are of substantial assistance in the

[29] I.R.C. § 954(e).
[30] Reg. § 1.954-4(b)(1)(iv).
[31] Reg. § 1.954-4(b)(2)(ii)(b).
[32] Reg. § 1.954-4(b)(2)(ii)(e).

from which royalties are derived.[22] Rather, as the following example indicates, the Service will look to the substantiality of the value added to the intangible property through development or marketing by the controlled foreign corporation prior to or at the time of the licensing of such property.

> "*Example* (*1*): Controlled foreign corporation *A*, through its own staff of employees maintains and operates a research facility in a foreign country *X*. At the research facility owned by *A* Corporation, employees of such corporation who are full time scientists, engineers, and technicians regularly perform experiments, tests, . . . which ultimately result in the issuance of patents. Royalties received by *A* Corporation for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of Section 954(c)(3)(A)."[23]

The "developed, created, or produced" test clearly indicates that a foreign corporation operating its own research facilities, employing full-time scientists, engineers, and technicians, performing experiments, tests, and related activities, which ultimately result in the creation of patentable technology is engaged in an active trade or business. By contrast, a foreign corporation doing nothing more than acting as a depository of royalties is not carrying on business activities. In between these extremes, however, there are instances in which the Regulations tend to obfuscate or extend the purpose and intent of the statute. For example, if a foreign corporation finances independent research carried on abroad in return for a percentage of royalty income derived from any rights produced thereon, the Regulations take the position that such income is not excludable even though the foreign corporation, through its own efforts, contributes to the effective and profitable exploitation of such rights.[24]

By contrast, if a foreign corporation has purchased instead of created technology, its activities will fall within the active trade or business exception if it makes a substantial contribution to the value of the rights which it licenses. The Regulations contain the following example:

> "*Example* (*3*): Controlled foreign corporation *B* receives royal-

[22] *Id.*

[23] Reg. § 1.954-2(d)(iii)(c).

[24] Reg. § 1.954-2(d)(iii)(c), Ex. 4. For other examples see Duffy, "Foreign Base Company Licensing and Technical Service Activities Under Revenue Act of 1962," 21 N.Y.U. Inst. on Fed. Tax. 859, 872 (1963).

therefore, be accumulated with little or no tax incidence and reinvested in foreign subsidiaries. Subpart F was enacted in 1962 to end the tax deferral privilege for such corporations.

[1] Statutory Framework. The focal point of Subpart F is the "controlled foreign corporation." Essentially, a foreign corporate entity will be deemed a controlled foreign corporation if more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by "United States shareholders" on any day of the corporations's taxable year.[13] A United States shareholder is defined as any citizen or resident of the United States or any domestic partnership, corporation, trust, or estate who owns 10 percent or more of the corporation's combined voting power.[14] If a foreign corporation is a controlled foreign corporation for at least an uninterrupted thirty-day period during the taxable year, under certain conditions, part or all of its Subpart F income is taxable to its United States shareholders on a pro rata basis via a deemed distribution mechanism.[15] Note that distributions pursuant to this mechanism are treated as a dividend for purposes of the indirect foreign tax credit.[16]

Pursuant to Section 952(a), Subpart F income is defined to consist primarily of "foreign base company income" which in turn is defined to include foreign personal company income as one of its components.[17] Thus, in most instances royalty income received by a controlled foreign corporation from licenses or sublicenses granted by it to others is includable in determining the amount of Subpart F income which may be attributed to United States shareholders. However, two important exceptions to the inclusion of royalty income were placed in Section 954 in order to make the Subpart F provisions coincide with congressional intent that they not extend to foreign active operating subsidiaries of United States corporations. For Subpart F purposes, foreign personal holding company income (and hence Subpart F income) does not include:

(1) Royalties received from a related person for the use or privilege of using property within the foreign country under the

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[13] I.R.C. § 957(a).
[14] I.R.C. §§ 951(b), 957(d), 7701(a)(30).
[15] I.R.C. § 951(a)(1).
[16] I.R.C. § 960; Reg. § 1.960-1(a).
[17] I.R.C. § 954(a)(1).

of the privilege of deferring United States taxes on the income generated by a foreign subsidiary or affiliated corporation. Such loss is a direct result of the foreign subsidiary or affiliated corporation being classified as either a Subpart F controlled foreign corporation or a foreign personal holding company.

Initially, a foreign corporation is deemed to be a foreign personal holding company if 60 percent or more of its gross income for the taxable year is "foreign personal holding company income."[1] In subsequent years (with certain exceptions) the required percentage is only 50 percent.[2] Section 553 defines foreign personal holding company income as including all types of interest, royalties, rents (unless rent is 50 percent or more of gross income), and gains on securities and commodities.[3] As this definition indicates, the foreign personal holding company classification is clearly intended to apply to foreign corporations used solely or primarily for the licensing of intangible property such as patents, copyrights, trademarks, and know-how.[4] On the other hand, compensation for services, such as technical assistance, is considered to be foreign personal holding company income only where the person performing the service owns, directly or indirectly, 25 percent or more of the stock of the foreign corporation.[5] In some instances these definitions produce difficult allocation problems where an agreement provides for both the licensing of property and performing of services.

In addition to meeting the foregoing income requirements, a foreign corporation will be classified as a foreign personal holding company only if "at any time during the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States . . . ."[6] Constructive ownership rules as set forth in Section 554 attribute stock owned, directly or indirectly, by a corporation as being owned proportionately by its shareholders.[7] Further, stock owned by an individual's family or his partner is also attributable to him.[8] If an individual has an option to acquire stock

[1] I.R.C. §§ 552(a)(1), 555(a).

[2] *Id.*

[3] I.R.C. § 553.

[4] I.R.C. § 553(a)(1); Reg. § 1.553-I(b)(1). Note, a classification problem occurs in transactions where it is not clear whether the licensor has licensed or sold the property. See discussion ¶ 4.2d *supra.*

[5] I.R.C. § 543(a)(7).

[6] I.R.C. § 552(a)(2).

[7] I.R.C. § 554(a)(1).

[8] I.R.C. § 554(a)(2).

of who the competent authority was or how to utilize his services. Thus, the Internal Revenue Service, in Revenue Procedure 70-18[263] designated the Assistant Commissioner (Compliance) as the competent authority for purposes of obtaining mutual agreements in connection with the allocation of income, and the Assistant Commissioner (Technical) as the competent authority for the purpose of interpreting tax treaties. The procedure also set forth the mechanics whereby a taxpayer may obtain competent authority assistance.[264]

Nevertheless, remaining difficulties limit the practical utility of the competent authority procedure. For instance, the competent authority to which a claim is made has to determine whether the request merits consideration. If the determination is negative, the taxpayer has no further recourse for avoidance of double taxation. Also, no remedy exists if the competent authorities disagree. Most importantly, in some cases the competent authority procedure is totally ineffective where, prior to a proposed reallocation of royalty income between treaty countries, the statute of limitations for refund or claims has expired in the treaty country to which the tax was originally paid.[265] In this regard, it should be noted that in recent treaties the competent authority provision authorizes the competent authorities, if they reach agreement on an income allocation question, to arrange for the adjustment of income and a refund or credit of taxes, notwithstanding (in the opinion of the Treasury Department) the running of the statute of limitations.[266]

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[263] 1970-2 C.B. 493.

[264] For a discussion of the mechanics see Pergament & Auderieth, "The 'competent authority' rules for Section 482 relief: an analysis of Rev. Proc. 70-18," 35 J. Taxation 2 (1971).

[265] See O'Donnell, *"A provision-by-provision analysis of Rev. Proc. 70-18: Many questions remain,"* 35 J. Taxation 12 (1971).

[266] U.S. Treasury, *Technical Explanation by Treasury Department on the Convention Between the United States and Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Signed July 9, 1970, CCH Tax Treaties* ¶ 596, at 703-27 (entered into force October 13, 1972).

whether or not legally enforceable, and however exercised or exercisable." [256]

At present, however, a majority of the treaties do not define control in such broad terms as the Japan treaty and limit the application of the foregoing provision to enterprises of which one controls the other.[257] Nevertheless, the Japan Treaty represents a growing trend to permit such adjustments where the enterprises concerned are under common control.[258]

Similarly, a number of United States tax treaties include a provision corresponding to Article 12(4) of the OECD Model Convention which refers to the treatment of excessive royalty payments between related enterprises. The language of the treaties which include this provision differs to some extent, but the wording of Article 11(7) of the treaty with France dealing with a reduction of the withholding rate on royalties is representative:

"Where, owing to a special relationship between the payer and the recipient, or between both of them and some other person, the amount of the royalties paid exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention." [259]

In accordance with the practices of most nations, the United States follows the principle that a tax treaty should only mitigate a taxpayer's burden, and not add to his obligations as they would exist under the unilateral law in the absence of a treaty. Consequently, treaty provisions similar to the foregoing provisions are viewed as instruments for the removal of restrictions on the application of unilateral reallocation measures, such as Section 482, and not as substitutes for such provisions where none exist under the local law, or as limitations on existing provisions. It follows that the Internal Reve-

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[256] March 8, 1971, CCH Tax Treaties ¶ 4393K.

[257] E.g., Treaty with Austria, October 25, 1956, Art. IV, CCH Tax Treaties ¶ 507; Treaty with Canada, March 4, 1942, Art. IV, CCH Tax Treaties ¶ 1208.

[258] E.g., Treaty with France, July 28, 1967, Art. 8, CCH Tax Treaties ¶ 2811; Treaty with Luxembourg, Dec. 18, 1962, Art. IV, CCH Tax Treaties ¶ 5307.

[259] Treaty with France, July 28, 1967, Art. 11(7), CCH Tax Treaties ¶ 2814.

exceeds the amount which would have been determined to be such liability if the controlled foreign entity had originally treated the transactions giving rise to the Section 482 allocations in a manner consistent with Section 482.[248]

The substantive effects of Revenue Procedure 64-54 are somewhat limited in scope, because its application is subject to several limitations and conditions. The first condition is a written statement by the taxpayer alleging that economic double taxation has resulted from the Section 482 reallocation. The taxpayer must then execute a closing agreement, as a part of which it agrees to forgo claiming a foreign tax credit for the amount of the tax allowed as an offset and to pay the United States any recovery of taxes attributable to the Section 482 reallocation.[249] However, by far the most important limitation concerning Revenue Procedure 64-54 relates to the duration of its applicability. Relief under the revenue procedure applies only to years before 1965.[250] No direct relief is available for subsequent taxable years; however, limited indirect relief remains available where funds are transferred between entities.

Revenue Procedure 65-17 [251] grants a taxpayer that has been a party to a Section 482 allocation the option of treating any dividends received from a foreign entity and which it included in gross income for the year of adjustment as a payment attributable to the allocation.[252] Nevertheless, the amount of current gross income excluded under such election may not exceed the increase in gross income that resulted from the allocation, less the amount of offset allowed under Revenue Procedure 64-54.[253] Finally, the relief made avail-

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[248] Rev. Proc. 64-54, § 3.01, 1964-2 C.B. 1008-09. Note that although such offset might exceed the United States tax liability in some instances, no refund would be available. See Rev. Proc. 65-31, 1965-2 C.B. 1024, setting forth the method of computing the offset.

[249] Rev. Proc. 64-54, § 3.02, 1964-2 C.B. 1009-10.

[250] Originally, the Revenue Procedure applied to years beginning before 1963. However, taxpayer contentions that relief ought to be extended until issuance of regulations met with some Treasury response in Rev. Proc. 66-33, 1966-2 C.B. 1231, which extended most of Rev. Proc. 64-54 to taxable years beginning before 1965.

[251] 1965-1 C.B. 833.

[252] The procedure requires (in the year of the Section 482 adjustment) the creation of an account receivable equal to the amount of the allocation, less any offset under Section 3 of Rev. Proc. 64-54 and any dividend adjustment made for the year of allocation, plus interest accrued on such account receivable. Rev. Proc. 65-17, § 4.02, 1965-1 C.B. 833, 835.

[253] Rev. Proc. 65-17, § 4.01(2), 1965-1 C.B. 833, 835. Additionally, the excluded amount may not be considered a dividend for any federal income tax purpose.

income is matched by a decrease in the other taxpayer's income.[238] When the statute is applied to a domestic-foreign pair of taxpayers, however, the tax result may well be the prospect of international double taxation for the United States taxpayer. For instance, on a unilateral basis, the foreign country concerned often has enacted substantive income source or allocation rules which conflict with the United States rules reflected in the Section 482 reallocation.[239] Even where international income allocation rules are not in conflict, the foreign country may simply agree with the taxpayer's initial interpretation of the rules.[240] Moreover, even if the foreign country is amenable to a reallocation, the time lag between the adjustment and the year in which the transaction occurred may prove fatal.[241] By the time the Internal Revenue Service raises the issue of a Section 482 intangible property transfer adjustment on audit, or makes a final determination of United States liability, the time period during which a foreign subsidiary may seek a refund or adjustment of its foreign tax for the taxable year involved may be expired.[242]

To a certain extent, the foreign tax credit may mitigate the effects

[238] In some circumstances, there may be no change in aggregate tax liability, but more frequently the result is a net increase in the taxes due because income is shifted to a higher bracket taxpayer or, most recently, because of the creation of imputed income. See, e.g., B. Forman Co. v. United States, 453 F.2d 1144 (2d Cir. 1972).

[239] For a discussion of the problems of international income allocation see Schipper, *The Liability To Tax of Non-Resident Companies: A Comparative Study in Fiscal Law* (1958).

[240] See Kalish, "Treatment of Intercompany Transaction When Doing Business Abroad (Avoiding Double Taxation): Section 482," 27 N.Y.U. Inst. on Fed. Tax. 1023, 1078–1079 (1969), for an example of a United States corporation which granted to its Swiss subsidiary the right to use certain trademarks, patents, and other intangible property relative to the manufacture of chemical products. The license was royalty free on a nonexclusive basis for a twenty-five-year period. The Swiss subsidiary sublicensed the intangibles to related foreign corporations. Under Section 482, the Internal Revenue Service reallocated from the Swiss subsidiary to the United States parent company an amount equal to 30 percent of the gross technical assistance fees which the Swiss subsidiary received from its sublicensees. The Swiss tax authorities took the position that the allocated royalty for the years under audit in the United States would not be deductible by the Swiss subsidiary for Swiss federal and cantonal tax purposes. Additionally, the Swiss authorities refused to recognize a new licensing agreement providing for a royalty in accordance with the Service settlement, and indicated future royalty payments not deductible for Swiss tax purposes, but upon which the 5 percent withholding rate on dividend payments under Article VI of the United States-Swiss tax treaty would be imposed.

[241] The time lag often results from agreements extending the regular three-year statute of limitations for audit and subsequent upper-level review of the taxpayer's return by the Internal Revenue Service. See I.R.C. §§ 6501(a), 6503(a)(1).

[242] For example, Canada has a four-year statute of limitations for refund

parties sharing the costs are treated as developers of portions of the intangible property which results. As a consequence, no allocation may be made by a district director if a related party uses the intangible property for which it is considered the developer.[232]

> Example: A United States parent, its French subsidiary, and its Brazilian subsidiary agree in writing to share the costs and risks of developing a new process for manufacturing latex paints in return for specific interests in any intangible property which might be produced (i.e., the North American rights to the United States parent, the Eastern Hemisphere rights to the French subsidiary, and the South American rights to the Brazilian subsidiary). Each related party would, in effect, be considered a developer of its portion of the resulting intangible property. Assuming the division of the interests are porportionate to the costs and risks, no further allocation could be made.

As the example indicates, a bona fide cost-sharing agreement must be a written agreement between two or more members of a controlled group which provides for the sharing of costs and risks of the initial development of certain intangible property in return for a specified interest in that property. Moreover, the agreement must reflect a good faith attempt by the parties to share costs on an arm's length basis and, of course, must be comparable to that which unrelated parties would have adopted under similar conditions.[233]

Cost-sharing agreements have an important advantage over the arm's length transfer method in that they enable a research and development corporation to grant royalty-free licenses to other members of a controlled group for use in their manufacturing enterprises. In fact, such an agreement can eliminate the need for licenses or other agreements if the parties desire to avoid them. On the other hand, members of a group of controlled entities may be reluctant to enter into a written cost-sharing agreement at a time when the prospective intangible property is unknown and unproved. Furthermore, unless carefuly drafted, a cost-sharing agreement, once adopted, may not prove broad enough to cover the unexpected and unintentional byproducts of the technology being developed. On balance, however, a cost-sharing agreement may prove indispensable as the only means of negating the potential for reallocating a considerable amount of income to research corporations. Because no taxable benefit occurs when members of a group receive the benefits of the

[232] Reg. § 1.482-2(d)(4).

[233] *Id.*

[3] The Developer-Assister Rules. The Section 482 regulations place great emphasis on the "developer-assister" rule in the determination of who is the owner of intangible property to be transferred and, consequently, who is entitled to receive compensation with respect to such property.[220] However, as among members of a group of related entities, great weight is given to the relative amounts of the costs of development and corresponding risks of development borne by the various members of the group. The member who bears the greatest percentage of the costs and risks is considered to be the developer.[221] The Regulations provide the following example:

> "*Example (1).* *X*, at the request of *Y*, undertakes to develop a new machine which will function effectively in the climate in which *Y*'s factory is located. *Y* agrees to bear all the direct and indirect costs of the project whether or not *X* successfully develops the machine. Assume that *X* does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and *Y* obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances stated, *Y* shall be considered to be the developer of the intangible property. . . ." [222]

Other examples indicate that when *Y* is obligated to pay the development costs only if something productive results from the project, then *X* will be considered the developer and later use by *Y* would be considered the time at which the arm's length charge will be made.[223] Moreover, it is not essential that the developer and owner of the intangible property necessarily be the same member of the related group who obtained a patent or copyright.[224] Should a member of a related group, other than the developer, obtain a patent or copyright on property or a right to use the property, that member will be deemed to have received the property in a transfer from the developer subject to the provisions of the Regulations relating to transfers of intangible property and, thus, required to pay an arm's length amount for the property.[225]

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[220] Reg. § 1.482-2(d)(1)(ii)(a).

[221] *Id.*

[222] Reg. § 1.482-2(d)(1)(ii)(d), Ex. 1.

[223] Reg. § 1.482-2(d)(1)(ii)(d), Ex. 2.

[224] Note 220 *supra.*

[225] Note 220 *supra.* Apparently, the Regulation is aimed at attempts by related groups to advantageously structure such situations by allowing the mem-

The best indication of the proper amount of arm's length consideration is generally determined by reference to transfers between unrelated persons of the same or similar intangible property under the same or similar circumstances.[212] In the absence of sufficiently similar transactions, eleven factors, which would normally be considered by unrelated parties in establishing a proper rate of compensation for the transfer of intangible property, are used to arrive at the proper arm's length consideration: [213]

(1) Prevailing rates in the same industry or for similar property;

(2) The offers of competing transferors or the bids of competing transferees;

(3) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted;

(4) The uniqueness of the property and the period for which it is likely to remain unique;

(5) The degree and duration of protection afforded to the property under the laws of the relevant country;

(6) Value of services rendered by the transferor to the transferee in connection with the transfer; [214]

(7) Prospective profits to be realized or costs to be saved by the transferee through the use or subsequent transfer of the property;

(8) The capital investment and starting-up expenses required of the transferee;

(9) The availability of substitutes for the property transferred;

(10) The arm's length rate and prices paid by unrelated parties, where the property is resold or sublicensed to such parties; and

(11) The cost incurred by the transferor in developing the property.

These factors consider the type of property transferred and the form of the transfer in order to arrive at the amount of the arm's length consideration.[215] However, the Regulations give no indication as to the relative importance of the various factors. Indeed, the field is

[212] Reg. § 1.482-2(d)(2)(ii).
[213] Reg. § 1.482-2(d)(2)(iii).
[214] See Reg. § 1.482-2(b)(8).
[215] Note 213 *supra*.

The definition of "intangible property" is as broad for Section 482 purposes as the outer boundaries of property are narrow for purposes of Section 351.[202] For example, although there may be insufficient know-how to qualify as property for purposes of receiving a tax-free ruling under Section 351 or 367, there may be more than enough know-how to warrant a reallocation of income from intangible property under Section 482. Additionally, an item classified as services under Section 351 may be considered "intangible property" for Section 482 purposes.[203]

If an item is deemed to be intangible property under Section 482, the consideration charged the transferee will be based on an arm's length consideration, including a profit element. By contrast, if the intangible is deemed to be a service it may be transferred at cost.[204] Finally, the determination of what constitutes intangible property is relevant in ascribing an arm's length price to the sale of tangible property affixed.[205]

A problem which is accentuated by the broad definition of intangible property for Section 482 purposes occurs when a taxpayer makes no formal transfer of technology or trademarks. For instance, in *Johnson Bronze Co.*[206] the Tax Court had to deal with the income allocation problems created by a United States manufacturer who transferred to a Panamanian subsidiary, without any consideration or written instrument, its goodwill, know-how, trade name, trademarks, and similar intangibles for use in foreign countries.[207] Although the court did not specifically allocate any consideration to the intangible properties, it did consider the fact of the transfer in determining an arm's length price for the sale of goods from the parent to the subsidiary. Hence, the informality of a transfer may increase the taxpayer's exposure to a claim that no adequate consideration has been given by the subsidiary for the use of intangible property because the taxpayer's records do not reflect any such consideration. The result may well be that a disturbing amount of intangible property transfers will result in taxability to the United

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[202] Rev. Rul. 64-56, 1964-1 C.B. (Part I) 133. See also ¶ 1.2a[3] *supra.*

[203] Rev. Rul. 64-56, note 202 *supra;* Reg. § 1.482-2(b)(7). Cf. Reg. § 1.482-2(d)(3)(i).

[204] Reg. § 1.492-2(b)(3). But see Reg. § 1.482-2(b)(7) which provides for an arm's length charge other than cost where the services constitute "an integral part of the business activity. . . ."

[205] Reg. § 1.482-2(e)(3)(ii)(d).

[206] 24 T.C.M. 1542 (1965).

[207] *Id.* at 1545.

sive international enforcement program.[193] The Kennedy Administration, in conjunction with the Treasury Department enforcement program, proposed extensive changes in the substantive law affecting United States taxpayers with foreign affiliates, which included the amendment of Section 482 as well as removal of United States tax deferral for all American-owned foreign subsidiaries.[194] In partial response, the House of Representatives enacted legislation amending Section 482 to authorize a formula allocation of income between a domestic corporation and its foreign subsidiaries in proportion to the assets, payrolls, and selling expenses attributable to domestic and foreign activities. Although the Senate rejected the proposal, the conferees recommended that the Treasury Department "explore the possibility of developing and promulgating regulations under this authority [Section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income." [195] The Treasury Department veiwed the foregoing recommendation as though it were a mandate. Proposed regulations were issued in 1965.[196] In 1966 the proposed regulations were withdrawn [197] and final regulations were issued in 1968 providing extensive guidelines for applying Section 482 to a variety of circumstances, one of which includes income resulting from the transfer or use of intangible property.[198]

¶ 7.4b Structure of Section 482

Section 482 applies to all transactions between members of a group of controlled taxpayers. In defining "commonly controlled" the Regulations have adopted a standard of actual control instead of a percentage of voting stock requirement.[199] For instance, a transfer

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[193] The Program was called the International Enforcement Program or the Coordinated Examination Program. Its purpose was to increase the level of voluntary compliance with international tax rules by an extensive audit procedure. See Thrower, "Recent Developments in International Tax Administration and Enforcement," 1 Tax Advisor 479, 482 (1970).

[194] Federal Tax System – Message from the President, 107 Cong. Rec. 6456, 6458 (1961).

[195] Conf. Rep. No. 2508, 87th Cong., 2d Sess. 18–19 (1962), reprinted in 1962-3 C.B. 1129, 1147. See also Treasury Memoranda in "Hearings on President's 1961 Tax Recommendations Before House Comm. on Ways and Means," 87th Cong., 1st Sess., vol. 4, at 3534, 3545 (1961).

[196] Treas. Dep't Rel. 30 Fed. Reg. 4256 (1965).

[197] Treas. Dep't Rel. 31 Fed. Reg. 10394 (1966).

[198] T.D. 6952, 1968-1 C.B. 218.

[199] Reg. § 1.482-1(a)(3).

The consequence is the production of excess foreign tax credits. Where such excess credits are a recurring problem, the existence of foreign-source royalty income which is exempt from foreign taxation pursuant to a treaty may provide a valuable mechanism for the use of otherwise unavailable foreign taxes as a credit (or offset) against United States tax liability on such royalty income.

In generating the needed tax-exempt or low-tax-rate foreign-source royalty income, the United States licensor may employ not only the United States tax treaty system, but also under certain conditions the foreign tax treaty systems. Armed with a thorough knowledge of tax treaty systems it may often be profitable for United States licensors to route nonbusiness royalty income circuitously before reaching its destination in order to take advantage of low tax treaty withholding rates. For example, royalty income arising in Country *A* may be routed through Country *B* before it reaches the United States if Country *A* levies a high withholding tax on payments to the United States, but a low rate in relation to Country *B* with whom it has a tax treaty; and Country *B* has a tax treaty with the United States. For instance, the United States has no concluded treaty with Spain, whereas the Federal Republic of Germany does have such a treaty. Pursuant to the Germany-Spain treaty, taxpayers who are "residenced" in Germany are entitled to a favorable Spanish withholding rate of 5 percent on royalties derived from Spain. Hence, instead of licensing directly to an unrelated Spanish licensee, a United States taxpayer may wish to license patent rights to a German subsidiary for sublicensing to the Spanish licensee. Alternatively, an American subsidiary corporation residenced in Germany will achieve the same result. Under either method the United States licensor will be exempted from withholding tax on the resulting German income under the United States-Germany income tax treaty. The overall tax cost, the 5 percent withholding rate under the Germany-Spain treaty, will be far less than the 14 percent withholding rate on patent royalty payments that direct licensing would have produced. Moreover, for United States foreign tax credit purposes the result will be tax-exempt foreign-source income.

Even if the United States has a tax treaty with the country in which a licensee is located it may still be advantageous to route royalty income through a second country. Perhaps the best illustration might be the routing or royalties from an Australian affiliate to a United Kingdom affiliate and then on to the United States parent corporation in order to avoid the 47½ percent Australian withholding tax on royalties passing directly from an Australian affiliate to the

applies to gains derived from the outright sale of intangible property or rights. Additionally, it applies to arrangements for the licensing of such property or rights which, for United States taxation purposes, are considered gains from the sale of capital assets.[181]

The most recent United States treaties, of which the treaty with Norway is typical, contain a clause which provides as follows:

> "The term 'royalties' as used in this article means—
>
> "(a) Payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (but not including copyrights of motion picture films or films or tapes used for radio or television broadcasting), patents, designs models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), and
>
> "(b) Gains derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such sale, exchange, or other disposition for consideration are contingent on the productivity, use, or disposition of such property or rights." [182]

Coupled with the foregoing provision is a clause which, in conformance with the OECD Draft Treaty restricts taxation of gains from the sale, exchange, or other disposition of capital to the country of residence of the recipient, except in the case of property of a permanent establishment or a sufficient presence by an individual occurs in the country of source.[183] Hence, income derived from the sale of intangible property, which either constitutes a capital asset or is measured by the productivity or use of the property rights, is exempted from source country taxation. However, uncertainty re-

[181] "Hearings on S. Exec. Docs. G & I Before a Subcomm. of the Senate Comm. on Foreign Relations," 89th Cong., 1st Sess. 33 (1965). Much of the above result relating to the capital gain royalty exemption can be traced to the divergent taxation philosophies of the United States and the Federal Republic of Germany. There is no exact counterpart in German tax law of the capital gain concept applied in the United States. Instead, a distinction is drawn between business property and nonbusiness property. Gain from the sale of property which forms part of a resident business is taxed as business income. Gain from the disposition of nonbusiness property is either taxed at the full individual rate or not taxed at all, depending solely on the holding period. See Gumpel, "Revision of the Tax Convention Between the United States and the Federal Republic of Germany," 44 Taxes 383 (1966).

[182] Treaty with Norway, Dec. 3, 1971, Art. 10, CCH Tax Treaties ¶ 6063.

[183] *Id.* at Art. 12, CCH Tax Treaties ¶ 6065; O.E.C.D. Draft Double Taxation Convention on Income and Capital, Art. 13(3), Doc. No. C(63)87 (1963).

United States domestic tax structure; that only intangible technology which possesses the quality of exclusivity falls within the scope of the term "property" [170] by specifically exempting income from "patents, designs, secret processes, formulas and other like property." [171] However, the term "other property" created conflicting views under past treaties as to whether nonsecret know-how was within its purview. As a consequence, some more recent treaties include additional items such as "scientific works, plans and models" which are not necessarily protectable by either foreign law or secrecy.[172] Other treaties have gone further and expressly exempted "industrial, commercial, or scientific equipment, knowledge, experience, skill or know-how," [173] including therein items which constitute services rather than property.[174] This broadened exemption of know-how under royalty tax treaty provisions can produce varying results. For instance, a United States licensor can benefit under the German treaty provision exempting know-how royalty payments from taxation at the source.[175] By contrast, under Australian internal law,

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[170] See ¶ 1.2a *supra*.

[171] See, e.g., Treaty with Denmark, May 6, 1948, Art. VIII, CCH Tax Treaties ¶ 2112; Treaty with Italy, March 30, 1955, Art. VIII, CCH Tax Treaties ¶ 4311.

[172] Treaty with Austria, Oct. 25, 1956, Art. VIII(1), CCH Tax Treaties ¶ 511; Treaty with the Federal Republic of Germany, July 22, 1954, Art. VIII-(3)(a), CCH Tax Treaties ¶ 3011; Treaty with Japan, March 8, 1971, Art. 14, CCH Tax Treaties ¶ 4393N.

[173] Treaty with the Union of Soviet Socialist Republics, June 20, 1973, Art. III, CCH Tax Treaties ¶ 8002E; Treaty with Luxembourg, Dec. 18, 1962, Art. VII(b), CCH Tax Treaties ¶ 5310; See also Treaty with the Federal Republic of Germany, July 22, 1954, Art. VIII(3)(a), CCH Tax Treaties ¶ 3011; Proposed Treaty with Israel, June 29, 1965, Art. 15(2)(B), CCH Tax Treaties ¶ 4218; Proposed Treaty with Thailand, March 1, 1965, Art. 11(2)(b), CCH Tax Treaties ¶ 7514.

[174] See S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 21 (1964); "Hearings on S. Exec. Docs. G & I Before a Subcomm. of the Senate Comm. on Foreign Relations," 89th Cong., Ist Sess. 33 (1965).

[175] A 1965 Protocol between the United States and the Federal Republic of Germany amended and broadened the definition of royalties exempted under the treaty to specifically include payments for know-how, whether they are patent-like property rights, or attributable to services or other non-proprietary know-how rendered to the licensee. Moreover, industrial or commercial profits changed to include income derived "from the furnishing of services of employees or other personnel." (Protocol modifying the Tax Treaty with the Federal Republic of Germany, Sept. 17, 1965, Art. III(5), CCH Tax Treaties ¶ 3025). Hence, know-how payments, whether characterized as royalties or services, are exempt from German taxation as they are not effectively connected with a permanent establishment.

Further, in a 1970 decision the German Supreme Tax Court (Bundesfinanzhof) supported the view of the United States Treasury that the 1965

[1] The Permanent Establishment Limitation. Except for the tax treaties with Sweden and the Soviet Union which grant an unqualified exemption for royalty income,[161] all treaties provide that an exemption or reduction in the withholding rate on royalty remittances shall not apply if the licensor maintains a permanent establishment in the royalty payee's country.[162] However, even the permanent establishment concept has been modified to some extent. For instance, more recently negotiated treaties which are reflective of the OECD Draft Double Taxation Convention on Income and Capital provide that only royalty income "effectively connected" with a business carried on by the licensor through a permanent establishment are not exempted from source taxation, hence taxable on a net income basis as industrial or commercial profits.[163] Therefore, the reduction or elimination of the withholding tax on gross royalty receipts is applicable only to nonbusiness (investment) type royalty income.

[2] Income From Intangible Property Not Effectively Connected With a Permanent Establishment. The overall format of United States taxation treaties with regard to the taxation of royalty investment income is fairly similar, yet there are important differences among the various provisions of the treaties. Technical variations arise from the dissimilarity of taxing systems. Substantive differences are produced as a result of varying economic climates. However, even when identical provisions do exist in United States income tax treaties, each treaty should be carefully interpreted unless identical provisions in other treaties have received interpretation in a comparable situation. On the other hand, specific tax treaty pro-

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[161] Treaty with Sweden, March 23, 1939, Art. VI, CCH Tax Treaties ¶ 7311; Treaty with the Union of Soviet Socialist Republics, June 20, 1973, Art. III, CCH Tax Treaties, ¶ 8002E.

[162] As previously indicated, a resident of one country is generally deemed to have a permanent establishment in the other country if he has (1) Any fixed place of business in the foreign country through which he is engaged in industrial or commercial activity, or (2) An agent in that country who habitually exercises a general power to enter into contracts, or maintains substantial equipment or machinery in that country for at least one year. See, e.g., Article 4 of the income tax convention between France and the United States, July 28, 1967, CCH Tax Treaties ¶ 2807. This definition of permanent establishment is based on the OECD model convention and other United States tax treaties.

[163] E.g., Treaty with Japan, March 8, 1971, Art. 8, CCH Tax Treaties ¶ 4393H; Treaty with Norway, Dec. 3, 1971, Art. 5, CCH Tax Treaties ¶ 6058.

neither giving any recognition to the tax imposed by the other.

Example 4: Finally, there can be conflicts regarding source-of-income concepts. One country may regard the source of income from the sale of intangible property as the place where the substance of the sale occurred. Other countries, such as the United States, use a title-passage test.[158] Again the unilateral foreign tax credit mechanism does not adequately solve this international double taxation problem.

Tax treaties approach these problems by attempting to set forth mutually acceptable rules for the source and allocation of income. Moreover, tax treaties deal with a major problem which the foreign tax credit mechanism does not solve—taxation on a gross income instead of net income basis. The United States withholds a tax of 30 percent on the amount of gross outgoing royalties. Many other countries impose withholding rates of 15 to 25 percent on royalty remittances. These rates on gross income may produce a considerably higher tax than the approximately 50 percent tax on the net income of corporations common in most countries.[159] Hence, the foreign tax credit may not absorb the excess foreign tax. As the "Tax Rates on Gross Royalties" table indicates, some treaties approach the problem by reducing the foreign withholding tax rate on royalty payments to a level that at least approximates the foreign countries' corporate tax rate.[160] Many countries, aware that the burden of a royalty withholding tax is frequently passed forward to the licensee, are willing by treaty to mutually exempt royalty remittances totally from source taxation.

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[158] Reg. § 1.861-7(c).

[159] Assume that proprietary information is licensed in country *X* for a payment of 30 currency units spread over a ten-year period at the rate of 3 units per year. Moreover, assume the costs related to the generation of the proprietary information amount to 20 units. If country *X* imposes a withholding rate of 33-1/3 percent of the amount remitted, the total amount received by the seller will be 20 currency units. Therefore, the net income before imposition of the foreign withholding tax is 10 units and a tax of 10 units will amount to an imposition of tax at a rate of 100 percent of net income – a result that would obviously stifle such transfers of intangible property. For an excellent analysis of the effect of excessively high withholding rates on gross royalty income, see Beaman, "Taxation of Royalty Payments by Licensees in Less Developed Countries," U.N. Doc. No. ST/SG/AC.8/R.24 (1971).

[160] Alternatively, the difficulty may be met by applying the foreign tax to net income rather than gross income.

Assumptions

(A) If, on a 100 percent payout, funds generated through amortization of the value of stock for intangibles are retained abroad as permanent capital or are used to repay loans, there will be a net advantage on a consolidated basis.

(B) Section 78 gross-up adjustment on a United States concept disallowing amortization of the value of stock for intangibles in arriving at accumulated earnings. Formulas for Section 78 adjustment:

$$\frac{\text{Dividends}}{\text{Accumulated Earnings}} \times \text{Foreign Tax}$$

(C) Prior to the Revenue Act of 1962, it would have been possible to return funds provided by stock amortization at the capital gains rate of 25 percent upon liquidation of the company even on a Unted States concept that such funds constituted earnings available for dividends. This is no longer possible with respect to a more-than-50-percent-owned foreign subsidiary. I.R.C. § 1248.

[5] Foreign Taxpayers. Pursuant to Section 906, the United States extends a foreign tax credit to nonresident aliens and foreign corporations for creditable foreign income taxes paid or accrued on foreign-source income, including income from royalties and the sale of intangible property, which is effectively connected with the conduct by the foreign taxpayer of a trade or business within the United States.[152] On the other hand, the credit is not available to the foreign taxpayer for foreign taxes imposed on the United States-source income that would not have been imposed by the foreign country of possession but for the fact that the taxpayer was a citizen or resident of (or if a corporation, domiciled for tax purposes in) the foreign taxing country.[153] Finally, even where the foreign tax credit is available to foreign taxpayers, it is subject to the per-country and overall limitations which apply to United States citizens. In computing the amount of foreign tax credit allowable under such limitations, taxable income is treated as consisting only of the taxable income effectively connected with the conduct of the taxpayer's trade or business within the United States.[154]

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[152] I.R.C. § 906(a).
[153] I.R.C. § 906(b)(1).
[154] I.R.C. § 906(b)(2).

use of patents or know-how. For instance, in Peru technical fees are taxed at an effective rate of 24 percent whereas royalties for the use of patents are taxed on a graduated scale having for its base the ordinary income tax rate, plus a surtax of 30 percent on the balance after calculation of the ordinary income tax.[150] A few countries, such as Venezuela, accord more favorable treatment to royalty payments than to technical services.[151]

[4] Comparison of Equity Participation Versus Licensing. Often, domestic corporations directly license intangible property to foreign related corporations instead of contributing such property in return for further equity participation. Direct licensing precludes the difficult task of obtaining Section 351 and 367 rulings, as well as potential recognition of gain under the rules of some foreign taxing jurisdictions. Yet, as the following calculation indicates, in certain circumstances when the peculiarities of the foreign tax credit are examined, the added difficulty of an exchange of intangible property for stock can produce a larger after-tax return. This factor, together with other elements should receive careful consideration in evaluating the most satisfactory method for the exploitation of intangible property abroad.

Illustration of Advantage of Nontaxable Exchange of Intangibles for Stock Versus Royalty*

(Gross-up country)

	100% Payout		*Advantage*(A) *Stock v. Royalty*
	Royalty	*Stock*	
Income before royalty or stock amortization	100	100	
Royalty or stock amortization	20	20	
Pretax income	80	80	
Foreign tax at 40%	32	32	

[150] Decree Law 17580 of April 15, 1969.

[151] The current administrative interpretation given to the concept of services performed within Venezuela would appear to leave the majority of technical service payments as nondeductible to the payor and nontaxable to the recipient. (Income Tax Bull. No. 50, Jan.–Feb. 1970, pp. 8, 9, 17, 18. Lacey, "Technology and Industrial Property Licensing in Latin America: A Legislative Revolution," 6 The Int'l Lawyer 389, 400 (1972).

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sent of the Commissioner.[143] Usually, permission to change will be granted is the basic nature of the business or the conditions in the foreign countries change.[144]

Overall limitation: planning techniques. The overall limitation possesses an advantage over the per-country limitation; it permits the taxpayer to average differing tax rates in various foreign countries. In effect the taxpayer applies credits for taxes paid to countries have higher effective rates than the United States against the United States tax liability on income from countries having rates lower than the United States rate. Thus, if the overall effective foreign tax rate is equal to or less than the United States rate, a tax credit will be available for the full amount of the foreign taxes even though some of the foreign countries have an effective rate which is higher than the United States rate.[145]

Since the availability of the foreign tax credit under the overall limitation requires the presence of foreign income, the amount of net foreign-source taxable income and the effective rate thereon become decisive factors. With the advent of increased foreign income tax rates, many domestic corporations conducting foreign operations accumulate, on a continuing basis, excessive creditable foreign taxes in relation to net foreign-source income.[146] However, a taxpayer may often be able to utilize the exportation of intangible property to help bring a perennial excessive foreign tax credit problem into balance. For instance, royalties generated for the use of intangible property outside of the United States may produce foreign-source income which is free of foreign taxes if it is derived from a country which exempts royalty income from source taxation under a tax treaty with the United States.[147] Excess income taxes from other foreign countries having a higher effective tax rate than the United States can then be credited against such royalty income. Further, where desirable, foreign-source income may be accelerated by the sale of intangible property abroad with title passing outside the United States.

A possible substantial limitation on the use of the foregoing tech-

[143] I.R.C. § 904(b)(1).

[144] Reg. § 1.904-1(d)(3).

[145] On the other hand, foreign losses will be applied to reduce the total foreign taxable income, possibly limiting the credit for taxes paid to a profit country.

[146] See Chapman & de Kosmian, "Excess Foreign Tax Credit: Some Solutions to the Many Problems," 22 J. Taxation 296 (1965).

[147] See discussion regarding source of income; ¶ 7.1a *supra,* and tax treaties; ¶ 7.3b *infra.*

result of not being required to gross up the dividend by the amount of the deemed-paid tax is to artificially increase the effective foreign tax rate and therefore the amount of foreign tax deemed paid on the dividend for foreign tax credit purposes.[135] Computation of the deemed-paid foreign tax on dividends received from less-developed-country corporations is determined as follows:

$$\frac{\text{actual dividend}}{\text{accumulated pretax profits}} \times \text{foreign corporation's foreign income taxes} = \text{foreign tax deemed paid}$$

[3] Limitations on the Amount of Foreign Tax Credit. As previously indicated, the foreign tax credit provisions are designed to avoid double taxation on foreign-source income earned by United States taxpayers. They are not intended to reduce the United States tax liability on United States-source income. However, if the effective foreign tax rate on foreign income of a United States taxpayer is greater than the effective United States rate, the amount of foreign taxes imposed on the foreign income will be greater than the United States tax imposed on such income and more than sufficient to fully offset the United States liability on the foreign income via the foreign tax credit structure. In the absence of any restriction on the use of the foreign tax credit, the credit could be employed to offset not only the United States tax liability on foreign-source income, but also the tax liability on domestic income. To prevent the use of the foreign tax credit for such a purpose, the Internal Revenue Code provides a choice of two alternative limitations on the amount of foreign tax credit available to the United States taxpayer: the per-country limitation and the overall limitation.[136]

Per-country limitation. Under the per-country limitation, the amount of available tax credit is computed separately with respect to each foreign country. The amount of foreign tax allowable as a credit is limited to that proportion of the United States tax which the taxable income from sources within the foreign country bears to the

[135] The effect is to reduce the overall effective United States rate to less than what it would ordinarily be with regard to such dividends. On the other hand, if the foreign rate is higher than the United States rate, the overall effective rate on the foreign dividend will equal the foreign rate, regardless of whether or not gross up is required. Both formulas will generate an "excess credit" which may be used to offset United States tax liability on other foreign-source income. However, the amount of the excess credit will be higher if the gross-up formula is used.

[136] I.R.C. § 904(a).

property to the foreign corporation becomes entitled to a credit for qualifying foreign income taxes incurred by the foreign corporation when dividends paid out of the foreign profits which had been subject to the foreign taxes are received by the domestic corporation and are taxed in the United States.

The deemed-paid credit is also applicable to qualifying foreign income taxes incurred by second- and third-tier foreign corporations.[129] However, similar stock ownership requirements must be met. The first-tier foreign corporation must own 10 percent or more of the voting stock of the second-tier foreign corporation from which it receives dividends and the second-tier foreign corporation must in turn own 10 percent or more of the voting stock of the third-tier foreign corporation from which it receives dividends.[130] When the stock ownership requirements are met, the second-tier foreign corporation is deemed to have paid the foreign taxes of a third-tier foreign corporation from which it receives dividends. In turn, those foreign taxes become part of that second-tier foreign corporation's foreign taxes that the first-tier corporation is deemed to have paid when dividends are received from the second-tier foreign corporation.

The deemed-paid indirect foreign tax credit is generally available only to domestic corporations, but not their individual shareholders. A foreign corporation may claim the deemed-paid credit if the dividend is from income that is effectively connected with the conduct of its United States trade or business. For this purpose the foreign corporation is treated as a domestic corporation.[131]

The amount of the credit allowable in respect of a dividend distribution requires a determination of the proportionate amount of taxes paid by the foreign corporation with respect to the earnings and profits out of which the dividend is paid. Hence, the calculation, in turn, depends upon a determination of the amount of the dividend and the amount of earnings and profits out of which it is paid,[132] as

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[129] I.R.C. § 902(b).

[130] I.R.C. § 902(b)(1). However, the overall interest of the domestic corporation in the second- or third-tier foreign corporation must be at least 5 percent. If third-tier foreign corporations are involved, the percentage interest of the domestic corporation and of each intervening foreign corporation multiplied together must equal 5 percent or more. I.R.C. § 902(b)(3).

[131] I.R.C. §§ 906(a), (b)(4).

[132] Generally, the determination of earnings and profits of the foreign subsidiary will be made in accordance with usual United States rules including those set forth in Section 312. In appropriate circumstances the domestic parent corporation may elect to compute earnings and profits of the foreign subsidiary in accordance with the rules of Reg. § 1.964-1 (except for para-

FOREIGN TAXES ON ROYALTY INCOME QUALIFYING AS INCOME OR PROFITS TAXES

Country	*Authority*
Austria	
Surcharge on investment income tax (Federal Laws of September 9, 1966, and June 27, 1968)	Revenue Ruling 70-133, 1970-1 Cum. Bull. 159
Brazil	
Royalties, except those withheld under Law No. 1474, Art. 3	Revenue Ruling 59-70, 1959-1 Cum. Bull. 186
Czechoslovakia	
Gross royalties	Revenue Ruling 73-118, 1973-10 I.R.B. 12
German Democratic Republic (East)	
Gross Royalties	Revenue Ruling 73-159, 1973-14 I.R.B. 16
Japan	
Royalties (withholding)	Revenue Ruling 273, 1953-2 Cum. Bull. 58
Mexico	
Gross Royalties	Revenue Ruling 73-106, 1973-9 I.R.B. 9

the seller to each transaction) are not eligible for credit, although they can be deducted for United States tax purposes.[121] In an early decision, *Eitingon-Schild Co., Inc.*[122] it was held that the former French turnover tax imposed on royalties did not qualify as an income tax and was therefore not creditable. This unfavorable development for American licensors in France was subsequently modified by an exchange of letters,[123] supplementing the United States-France Tax Convention whereby the French Government agreed to exempt from the turnover tax royalties for the use of patents, trademarks, and process payable to a United States licensor who could

[121] I.R.C. § 164.

[122] 21 B.T.A. 1163 (1931).

[123] *Process-Verbal* of February 15, 1956 (CCH Tax Treaties ¶ 2,876).

tion clause in licensing agreements of which the following is typical:

> All payments required to be made by the Licensee to the Licensor under this agreement shall be made in gross and without deduction of any taxes or other charges imposed with respect to or based upon such payment by or under the authority of any government, treaty organization, or subdivision of either, other than the United States of America, except income tax which is creditable by Licensor against United States income tax under the foreign tax credit provision of the Internal Revenue Code of the United States of America. Promptly after execution of this agreement, Licensor shall advise Licensee of the portion of "any taxes or other charges" allowable as a credit against Licensor's United States income taxes, such advise to remain in effect until modified by Licensor. Licensee shall furnish Licensor photostatic copies of all official receipts for any such taxes and charges deducted from payments hereunder.

Such a clause provides a solid assurance of the foreign tax credit since it has been determined that the technical taxpayer may make an agreement to have the tax paid by another person as the technical taxpayer's agent, at least when the foreign government accepts the substitution.[115] On the other hand, it is consistent to hold that a person who is not the technical taxpayer cannot obtain the benefit of the credit by an agreement to share the burden of the tax.[116]

Taxes eligible for the credit. The foreign tax credit in the case of royalties derived from licensing abroad as in the case of other foreign

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[115] Singer Mfg. Co. v. United States, 87 F. Supp. 769 (Ct. Cl., 1950). There a United States parent was held to be entitled to the credit for Italian taxes imposed upon it for sales profits in Italy, but paid by an Italian subsidiary acting as its agent or paymaster under an agreement between the subsidiary and the Italian government.

[116] Badger Co., Inc., T.C. Memo. 1967-178. In *Badger* the taxpayer, a United States corporation, entered into an agreement with a foreign corporation under which it provided technical services to licensees of the foreign corporation in return for one-half the royalties received by the foreign corporation less one-half the foreign withholding tax on the royalties. The taxpayer maintained that although the foreign corporation was the technical taxpayer of the foreign taxes, the United States corporation was entitled to a credit for 50 percent of the tax because it bore the burden of that part of the tax. However, citing *Irving Air Chute* the Tax Court held that the economic burden did not determine who should be treated as a taxpayer for purposes of the foreign tax credit. Moreover, it was found that the foreign tax was not imposed on the taxpayer's income, which was merely a payment for services rendered to the royalty recipient. In essence, the withholding tax was imposed on the foreign corporation, which was not merely a trustee through whom the income was funnelled, but an independent recipient of income.

> allow an American taxpayer who has granted patent licenses to foreigners to claim a credit, as for taxes paid or accrued, for the amount of economic burden of taxation which foreign law has permitted a foreign licensee, as distinguished from a foreign government, to compel the taxpayer to bear." [104]

Citing *Biddle*, the court stated that the "taxpayer," for foreign tax credit purposes, is one who is directly liable for the tax. Therefore, it is the *technical* taxpayer and not the person who ultimately bears the economic burden of the tax who is entitled to the credit.[105]

The results of the foregoing decisions were subsequently changed by Article XIII(1) of the United States-United Kingdom Tax Convention which waived the British tax on royalties for American licensors who did not maintain a permanent establishment in the United Kingdom.[106] Complete relief was achieved by a Supplementary Protocol effective October 15, 1958, which applied to accounting periods beginning on or after April 1, 1956, thus extending the exemption from the British tax to American licensors with permanent establishments in the United Kingdom. Congress further fortified the relief with the enactment of Section 905(b) of the Code [107] which permits American licensors to take a foreign tax credit for the British tax for taxable years beginning after December 31, 1949. [108] Nevertheless, it should be noted that a similar problem continues to exist in other countries which have a comparable scheme for the withholding of tax on royalties payable to nonresidents.[109]

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[104] Irving Air Chute Co. v. Comm'r, 143 F.2d 256, 259 (2d Cir. 1944).

[105] The technical taxpayer restriction is desirable from the standpoints of both tax policy and administration. Economic incidence is simply not a feasible test for determining who should be given the credit for a particular tax. The policy of the foreign tax credit system is based upon presumption that creditable taxes are taxes which cannot be shifted by agreement or otherwise from the taxpayer upon whom they are imposed. This presumption dictates that the credit not be denied to a technical taxpayer on the ground that he has not borne the economic burden of the creditable tax. Moreover, from an administrative prospective the technical taxpayer restriction appears to be the only feasible criterion since it would be quite difficult for courts to decide in individual cases where the burden of many taxes falls as well as the addition of uncertainty to the law. For an extensive analysis of the question see Owens, *The Foreign Tax Credit* at 381–389 (1961).

[106] CCH Tax Treaties ¶ 8118 (effective January 1, 1945 with respect to United States tax and April 6, 1945, with respect to United Kingdom tax).

[107] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 103, 72 Stat. 1606.

[108] However, any refund so generated is to be paid without interest. I.R.C. § 905(c).

[109] E.g., India, Ceylon, Australia, Jamaica, and Pakistan.

holder of a British corporation could not credit the British standard (or normal) tax paid by the British corporation and deductible out of dividends paid to the shareholders because the British corporation, rather than the shareholder, was the technical taxpayer. The Court observed that it is United States and not foreign concepts of taxation which are controlling for purposes of the determining the meaning of "taxes paid." [93] As United States tax principles do not recognize the concept that the corporate tax is actually borne by the stockholders, there was no basis for a conclusion that the foreign tax credit "extends to such a stockholder a credit for a tax paid by the corporation—a privilege not granted to stockholders in our own corporations." [94]

The peculiarities of the British tax system have also produced a sequel of cases on the same issue concerning the British tax on royalties. In *Crawford Music Corp.*,[95] the initial case and the only decision in the taxpayer's favor, a United States corporate taxpayer received royalties from a British company on copyrights for songs and sheet music. A tax was withheld from the gross royalty by the British licensee pursuant to a British statute which stated that from the payment of any royalty the licensee must "deduct thereout a sum representing the amount of the tax thereon at the rate of tax in force at the time of payment." [96] The Board of Tax Appeals found that the tax was not assessed against the United States copyright owner, but it stated that "it seems plain . . . that the person who pays the United Kingdom income tax upon the royalties of petitioner pays those as the taxes of the petitioner." [97] Therefore, the United States taxpayer was considered to be actual taxpayer and could credit the British tax.

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rulings allowing a credit were revoked or modified. S.M. 3040, IV-1 C.B. 198 (1925); S.M. 5363, V-1 C.B. 89 (1926); I.T. 2401, VII-1 C.B. 126 (1928), *superceded by* G.C.M. 19902, 1938-1 C.B. 354 and I.T. 3183, 1938-1 C.B. 355.

[93] 302 U.S. at 581.

[94] *Id.*

[95] 40 B.T.A. 284 (1939).

[96] *Id.* at 289. General Rule 21 of the English Income Tax, the relevant statute provided:

> "Upon payment of any interest of money, annuity, or other annual payment charged with tax under Schedule D, or of any royalty or other sum paid in respect of the user of a patent, not payable, or not wholly payable, out of profits or gains brought into charge, the person by or through whom any such payment is made *shall deduct* thereout a sum representing the amount of tax thereon at the rate of tax in force at the time of the payment." [Emphasis supplied.]

Income Tax Act 1918, 8 & 9 Geo. 5, c. 40, Rule 21(1).

[97] Note 95 *supra* at 290.

application of the foreign tax credit is prohibited. Technically, there is no requirement that the taxpayer make an "election" between the credit and deduction; rather he elects to have the benefits of the credit. The method chosen on the return may be changed at any time before the expiration of the statute of limitations for the taxable year.[88] For purposes of the deduction or credit, a foreign tax is considered "paid" when it is withheld from income at the source, even though the foreign government does not receive the tax from the withholding agent until a later taxable year.[89]

As the following example indicates, in most instances the foreign tax credit is more advantageous to the licensor:

> Example: *X*, a United States corporation, derives $100 of royalty income from a foreign country on which it pays foreign withholding tax at the rate of 40 percent. If the foreign tax is treated as a *deduction*, the United States taxable income is $60 on which there is an additional United States tax of $30. The result is a total tax payment of $70 on *X*'s foreign royalty income. By contrast, if *X* elects to treat the foreign tax as a *credit*, there is United States taxable income of $100 (assuming the royalty is not derived from a less developed country) producing a tentative United States tax liability of $50 against which is credited the foreign tax of $30, leaving a balance of $20 due the United States. As a consequence of utilizing the foreign tax credit for its foreign royalty income, *X* nets $50 from the royalty income instead of only $30 if the foreign tax was used as a deduction.

There are, however, a few situations in which a United States licensor would be advised to treat a foreign tax as a deduction rather than a credit. For instance, if the United States taxpayer has an overall net operating loss with no resulting United States tax lia-

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Service computation form. An individual should file Form 1116, while a corporation should file Form 1118. The election is made on an annual basis and must be made for each subsequent year. Reg. § 1.901-1(c).

[88] I.R.C. § 901(a); Reg. §§ 1.901-1(d), 1.905-2. To elect or change a prior election, an amended return should be filed for the year in question. If a claim for refund results from the subsequent election to utilize the foreign tax credit, the taxpayer might use Form 843 to make the claim. Note, the time to elect or change an election cannot be extended by employing one of the special statutory provisions such as the net operating loss carryback (Rev. Rul. 56-196, 1956-1 C.B. 655) or the ten-year period of limitation in which to determine or adjust the proper amount of the foreign tax credit already elected. Rev. Rul. 63-248, 1963-2 C.B. 623. But see Bank of America v. United States, 377 F.2d 575 (Ct. Cl. 1967), where prior to 1960 the election was allowed to be made within the special ten-year limitation period.

[89] Jules D. Lederman, 6 T.C. 991 (1946).

the amount of income to be deferred and the currency restrictions applicable thereto.[80] A separate report must be made for each country in which the taxpayer has blocked income. Costs, deductions, and credits applicable to such income must also be deferred. Deferral terminates, however, when the royalty income (1) becomes readily convertible into dollars, (2) is actually converted to dollars or property readily convertible to dollars, or (3) is used for nondeductible personal expenditures such as gifts, bequests, or payment of dividends.

In at least one factual context, it appears that tax deferral under Mimeograph No. 6475 would be precluded even though payment of a foreign royalty is subject to currency restrictions. This situation arises where the Agency for International Development (AID) has effected a gnaranty against inconvertibility of royalties payable in foreign currencies. If AID discharges its guarantee, the United States licensor will be paid an amount equal to the foreign royalty in dollars and the United States Government will receive the foreign currency obligation in exchange. Such a payment would terminate the licensor's right to deferral of United States tax liability.[81] In the absence of an AID guarantee, when foreign currency is blocked or when a related foreign corporation is financially unable to make a royalty payment and therefore cannot utilize a royalty deduction, it may sometimes be advisable to waive the royalty payment for that period.

If the licensor decided to forgo or does not have available the option to defer taxation under Mimeograph No. 6475 on foreign royalties received in a restricted currency, a difficult problem arises with regard to the determination of the proper exchange rate to use in reporting the income. Usually, there is an official rate and a free rate. As the official rate ordinarily produces more dollars, the taxpayer may be required to explain why such rate should not be applicable.[82] However, the rate at which foreign currency is selling on the free market is ordinarily considered the proper exchange rate.[83]

Difficulties with currency conversion may occur even if blocked

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[80] Mim. 6584, 1951-1 C.B. 19.

[81] Another difficult problem arises where the royalty payment in restricted currency is made in one tax accounting period and realization of the dollars under the guarantee are paid in another period. As the guarantee of the United States Government can be expected to be fulfilled, it would appear deferral under Mimeograph 6475 would not be available. See Kust, 44-3rd T.M. Portfolio, *Licensing and Technical Assistance Abroad*, A-23 (1969).

[82] S.E. Boyer, 9 T.C. 1168 (1947).

[83] Ceska Cooper, 15 T.C. 757 (1950).

¶ 7.2 BLOCKED INCOME AND CURRENCY CONVERSION

United States licensors often find foreign royalty income subject to restrictions on repatriation. For instance, it may be necessary to obtain the approval of an exchange control board or similar governmental agency of a foreign country for remittance of a royalty to a licensor in another country such as the United States. The following examples illustrate other methods of remittance restrictions:

(1) The Central Bank of the Philippines issued exchange control regulations effective February 21, 1970, which provide a royalty ceiling of 5 percent of the wholesale price of the commodity which is manufactured locally under a royalty contract and a 50 percent limitation on the amount which can be remitted.

(2) In Colombia, since 1967 the right to remit foreign currencies in payment of royalties, commissions, trademarks, and patents, as well as technical services, has been directly regulated by Colombia's Momouth Decree Law 444 of March 22, 1967. The law makes a distinction between "royalties, commissions, trademarks, patents and similar payments," and "contracts in foreign currency for the payment of technical, scientific, artistic, or any other type of service." [75] Prior to registration with the exchange office, the former must be submitted to a royalty committee for evaluation and approval. The latter is subject only to registration with the exchange office. Approval of the Royalty Committee is subject to a series of criteria which include (1) the usefulness of the contract in the economic and social development of the country, (2) the possibility of producing the product without a license, (3) treaties to which Colombia is a party and international practice in the area, (4) the effect on the balance of payments, (5) the extent of the market to which the product is destined, and (6) the life of the patent. By contrast, the exchange office will register agreements for technical services if the cost of the services does not exceed the usual price and the services are found socially, economically, technically, or culturally useful for the country.

(3) Beginning in 1961, Turkey has required that 3 percent of the

5(3), CCH Tax Treaties ¶ 4208 (although under Article 15(1), royalties are taxed at a reduced rate of 15 percent of gross income).

[75] Decree Law 444, Art. 101; Decree Law 688 of April 20, 1967, Art. 6, which amends Art. 102 of Decree Law 444. For an extensive discussion see Lacey, "Technology and Industrial Property Licensing in Latin America; A Legislative Revolution," 6 The Int'l Lawyer 388 (1972).

any movable property, tangible or intangible, would apparently fall within the ambit of the provision.[65]

A third tax treaty approach to source of income from sales of intangible property is the capital assets approach as typified by the Swedish treaty.[66] This treaty provides that gains derived in one of the contracting countries from the sale or exchange of capital assets by a resident, a corporation, or other entity of the other contracting country shall be exempt from taxation if it has no permanent establishment in the former country.[67] Initially, use of the terms "capital asset" and "sale or exchange" with regard to sales of intangible property would seem to considerably enlarge the scope of taxing jurisdiction by the United States. However, if the niceties of the United States domestic tax law are applicable, serious practical difficulties are encountered. For instance, should sales or exchanges of property such as copyrights be properly exempted under the treaty as sales or exchanges where, under Section 1231, such gain is treated as capital gain although the property does not qualify as a capital asset? The identical problem is, to an extent, also present in Section 1235 sales or exchanges of patents held by individuals.[68]

Apparently, the only treaty which presently provides a carte blanche exemption of foreign withholding tax on the income arising from the disposition of intangible property is the treaty with the United Kingdom.[69] Article XIV (2) of the treaty simply exempts

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[65] However, in determining whether intangible property is "moved" to or "created" (produced) in a foreign country requires immersion into the academic question concerning the "situs," if any, of an intangible. A variation of the income source approach to intangible property transfers of the Brazilian and Trinidad and Tobago treaties can be found in the proposed treaty with Israel. The source rules of the Israeli treaty are restricted to "moveable" personal property regardless of whether the property is purchased or produced. (Proposed Treaty with Israel, June 29, 1965, Art. 5, CCH Tax Treaties ¶ 4208.) No apparent reason exists for the difference in source rule treatment between the treaties. Although the Israeli treaty contains an article (Article 8) providing for tax deferral for corporate transfers of technical assistance, it seems unlikely that the treaty negotiators would discriminate against direct technology transfers.

[66] Other tax conventions which follow the capital asset approach are those with Belgium, Denmark, Finland, the Federal Republic of Germany, Ireland, and the Netherlands.

[67] Treaty with Sweden, March 23, 1939, Art. IX, CCH Tax Treaties ¶ 7314.

[68] I.R.C. § 1235(a).

[69] Treaty with the United Kingdom, April 16, 1945, Art. XIV, CCH Tax Treaties ¶ 8119. In a statement before the Senate Foreign Relations Subcommittee on Tax Conventions on May 13, 1966, Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy noted: "Under the protocol, the exemption from United States capital gains tax for British residents is generally continued in effect, but the article is now made reciprocal so that Americans

all such expenses will be prorated on the basis of the gross income in the United States and abroad.[57]

¶ 7.1c Effects of Income Taxation Treaties on United States Source-of-Income Rules

Inclusion of geographic source-of-income rules in United States income tax treaties serves two purposes with respect to taxation of income derived from intangible property: (1) the determination of which country shall exercise taxing jurisdiction with respect to certain items or classes of income, and (2) to allow a foreign tax credit for items of income which the Internal Revenue Code might otherwise treat as income from United States sources.[58] The only consistent exception to application of the source-of-income rules is where a permanent establishment is found to exist in either contracting country.[59] Generally, all income "effectively connected" with the conduct of business through a permanent establishment is taxable without regard to its source by the country in which the permanent establishment is located.[60] However, even if a United States taxpayer has a permanent establishment in the treaty country to which income generated from intangible property is effectively connected, the manner in which the tax treaty alters the source-of-income rules of the United States and the treaty country may be of great significance.

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[57] Such apportionment could be made pursuant to the Commissioner's authority to issue regulations under Section 863 dealing with the allocation of expenses which cannot be allocated to some item or class of gross income.

[58] Essentially, geographic source-of-income rules are mechanical devices adapted to the structure of the United States tax treaties which function to accomplish these two objectives. See Gachet, "The Source of Income in United States Tax Treaties," 48 Taxes 608 (1970); Clary, "Income Tax Treaty Source of Income Rules: How They Are Applied," 28 J. Taxation 12 (1968); Bischel, "Exportation of American Technology and The Federal Income Tax, Part I: Direct Transfers," 22 Syracuse L. Rev. 867 (1971), reprinted in 17 Tax Counselor's Qu. 1 (1973).

[59] See discussion ¶ 7.3b[1] *infra*. In general, a resident of one country will be deemed to have a permanent establishment in the other treaty country if he has (1) any fixed place of business in the other country through which he engages in industrial or commercial activity, or (2) an agent in that country who habitually exercises a general power to enter into contracts, or maintains substantial equipment or machinery in that country for at least one year.

See, e.g., Article 4 of the income tax convention between France and the United States of America, July 28, 1967, CCH Tax Treaties ¶ 2807. This definition of permanent establishment is based on the one contained in the OECD (Organization for Economic Cooperation and Development) model convention and other United States income taxation treaties.

[60] See, e.g., I.R.C. §§ 864(c)(2)(A), (B).

"ancillary and subsidiary" to the $1 million foreign royalty and allocable thereto. The balance of the $540,000 is considered "directly related" to dividend income. This amount is apportioned in the ratio of the gross receipts of each subsidiary to the total gross receipts of all subsidiaries. The result is apportionment of $240,000 to the domestic dividends of $3 million and $300,000 to the foreign dividends, of which $90,000 is apportioned to the foreign subsidiary which declared no dividend, and $180,000 and $30,000 to the two subsidiaries which paid $2 million and $1 million dividends respectively. The latter calculation is necessary in determining the per-country foreign tax credit limitation, whereas by applying the overall foreign tax credit limitation the net result is to charge $300,000 to the $3 million foreign dividends received.[50]

The Proposed Regulations are clearly in direct conflict with past court decisions such as *International Standard Electric Corp. v. Comm'r*[51] which held that expenses of this character are not definitely related to any class of gross income and therefore should be ratably apportioned on a total gross income basis. Employing a "ratable apportionment" approach in the above example would result in only 3/40 of the unidentifiable expenses of $540,000, or $40,500, being charged to the foreign dividends received. Moreover, in the only recent case to consider expense apportionment, *F.W. Woolworth Co.*,[52] the Tax Court rejected ratable apportionment on the basis of the 1966 proposed Section 861 regulations, and held that such expenses were directly related to domestic-source income. The expenses involved were executive office salaries and pension costs, director's fees, register and transfer fees, legal fees in federal tax matters, outside accounting fees, and charitable contributions. The Internal Revenue Service allocated the foregoing items to foreign dividend income received by the taxpayer in the ratio that the dividends bore to total gross income. The 1966 Proposed Regulations dealing with expense apportionment provided that "a deduction shall be considered definitely related to one or more items or classes of gross income if it is incurred *in whole or in material part* as a result of, or incident to, the activities from which such gross income is derived. . . ."[53] Applying

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[50] For a discussion of the Section 904 foreign tax credit limitations, see discussion ¶ 7.3a[3] *infra.*

[51] 1 T.C. 1153 (1943), *aff'd in part* 144 F.2d 487 (2d Cir. 1944), *cert. denied* 323 U.S. 803 (1944). See also textual discussion accompanying note 30 *supra.*

[52] 54 T.C. 1233 (1970), *nonacq.* 1971-2 C.B. 4.

[53] Prop. Reg. § 1.861-8(a)(3)(i) (1966) (emphasis added).

the amount of United States-source income subject to United States taxing jurisdiction.

The foregoing effects have prompted one of the principal authors of the Proposed Regulations to comment that the area will require the close attention of the Treasury in developing the final Regulations. Involved will be a balancing of the foreign tax credit and accounting principles, the importance of research and development to the United States economy and the willingness of foreign countries, after discussion, to allow cost sharing or the payment of greater royalties.[45] The Treasury itself has indicated that it intends to repropose the Regulations. Yet, the government is likely not prepared to accede to the view that all research and development expenses are attributable to United States-source income. At the very least, it appears that the Treasury may invoke its statutory authority under Section 863 to apportion all research and development expenses on the basis of current worldwide gross income, while taking into account both United States parent and related foreign subsidiary research and development expenses for apportionment purposes. Moreover, in determining "gross income" under United States taxation concepts it is unlikely that statutory authority exists for taking into account subsidiary sales rather than only subsidiary dividends.

Home office expenses. In allocating and apportioning home office expenses the proposed Regulations distinguish between two types of home office expenses of a United States corporation involving related foreign subsidiaries:

(1) Expenses that benefit and should be charged to foreign subsidiaries and which should be deductible by them; and
(2) Expenses that are in the nature of a stockholder's oversight or stewardship expenses which, under current international practice, cannot be charged to foreign subsidiaries.[46]

If a United States corporation renders services for the benefit of a foreign related corporation and the United States corporation charges the related corporation for such services,[47] the deductions for expenses

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[45] Cole, "Highlights of the Proposed Regs on allocation and apportionment of deductions," 39 J. Taxation 272 (1973).

[46] Prop. Reg. § 1.861-8(e)(4).

[47] The category of services considered directly related are those services which are covered by a Section 482 allocation. To the extent such expenses consist of services rendered for the benefit of foreign related subsidiaries for which charges are made pursuant to Section 482 and the regulations there-

and *B*. The foreign plants manufacture and sell four- and six-cylinder engines in foreign countries. The United States plant manufactures and sells six- and eight-cylinder engines in the United States. For the taxable year, *X* maintains a centralized research facility which incurs general research costs, applicable to all engines, and specific research costs applicable, respectively, to four-, six-, and eight-cylinder engines. Pursuant to the example, the costs applicable to four-cylinder engines are allocable totally to foreign-source income. The costs applicable to eight-cylinder engines are allocated totally to United States-source income. The general research costs and costs applicable to six-cylinder engines are allocable to both foreign- and United States-source income. The recommended apportionment, in computing the limitation on the foreign tax credit, is unit sales. For general research the denominator is all engine sales. For six-cylinder research costs the denominator is all sales of six-cylinder engines.[42]

As all of *X*'s income is subject to immediate United States taxation, due to the factor of foreign branch operations, the result in Example (1) appears correct, assuming the proprietary of any allocation of general research expenses. On the other hand, suppose *X* had created subsidiaries in countries *A* and *B* to manufacture and sell the engines. Moreover, assume that each subsidiary declared a dividend to *X*, in the year under consideration, of 50 percent of its after-tax net income from the sale of engines. Should the amounts of research expense apportioned to *A* and *B* under the unit sales formula then be apportioned totally to the dividends received by *X*? Such an apportionment would not appear appropriate inasmuch as *X* has received and reported for purposes of United States taxation only one-half of the sales income generated by *A* and *B*. Yet, further proposed regulatory examples indicate the Treasury would make such an apportionment.

For instance, in Example (12),[43] *X*, a domestic manufacturer, expends $100,000 for the development of patents it has acquired. It uses such patents in its own manufacturing business and also makes them available to foreign corporations *Y* and *Z* for use in their respective countries for a 5 percent sales royalty. In the taxable year, *X* has sales of $900,000 and gross income of $360,000 from 180,000 units produced. *Y* has sales of $135,000 from 30,000 units and pays $6,750 in royalties to *X*. *Z* has sales of $165,000 from 30,000 units and pays $8,250 in royalties.

If apportionment of the $100,000 development cost were made on

[42] *Id.*

[43] *Id.*

exchange or from a corporation to which intangible property was transferred as a contribution to capital.

"(ii) Apportionment. If the gross income resulting from research and development activity is or is reasonably expected to be of disparate types, such as sales income and royalty income, apportionment of the deductions for research and development expenses allocated thereto on such basis as gross income or gross receipts will not generally be reasonable." [36]

In essence, the Proposed Regulations provide that all expenditures deducted under Section 174 (presumably by current deduction or sixty-month amortization) are subject to allocation. Where the research is intended to create specific intangible property, or to improve specific products or processes, the deductions are considered definitely related to the class of gross income which arises or may reasonably be expected to arise therefrom. Past experience is to be employed in determining reasonable expectations. In other cases, such as basic or general research, the deductions are allocable to all gross income of the current taxable year which is likely to benefit from such research. Current gross income which resulted from past research of a similar character is considered to be the best indication of "likely benefit."

Unquestionably, the Proposed Regulations concerning research expenditures raise issues of great significance inasmuch as, in the absence of judicial authority, the Internal Revenue Service has not previously attempted to allocate research expenditures, or has allocated them primarily to United States-source income. For instance, gross income from sales and royalties is often generated by past research costs which may have been incurred years ago. Yet, pursuant to the Proposed Regulations, a taxpayer would presumably be required to treat a portion of its present research expense as attributable to currrent foreign income from other sources. Moreover, current research expenditures must be allocated to current income on the assumption of likely future benefits, without any notion of a casual relationship between the expense and income items.[37] Finally, it should be observed that most research, whether basic or specific, produces no intangible property or product of value and therefore no

[36] Prop. Reg. § 1.861-8(e)(3).

[37] Possibly the Proposed Regulations can be interpreted to reach a less harsh result than an initial impression might indicate inasmuch as past experience is to be considered in determining the "reasonable expectations" of gross income to be derived from specific research. This criterion could be construed

fees, and export sales income, should be allocated to such income and not ratably apportioned. The appeals court stated:

> "It seems to us fairer to allocate the expenses to the aggregate items of foreign income found by the Tax Court to have resulted from the payment of the royalties and fees, especially when the conclusion was reached that these expenses bore no relation to the receipt of dividends. In doing this, the expenses should be allocated to the percentages of sales, royalties and contract revenues from each foreign country." [32]

The foregoing conclusion does not appear inconsistent with the basic rationale as to unidentified expenses. The payments to obtain technical information were required in order to earn specified income and were obviously directed thereto. The Tax Court's difficulty was with apportionment; it did not think that there was a satisfactory method of attributing the described expenses to sales, royalties and fee income, and therefore included the expenses in the ratable apportionment residue under Section 863. However, the Court of Appeals saw no difficulty in apportioning the expenses on a gross revenue basis, despite the disparate nature of the income.

[2] The Proposed Regulations. On June 18, 1973, the Treasury issued revised Proposed Regulations on the allocation and apportionment of deductions between United States- and foreign-source income.[33] The Proposed Regulations inject a number of principles and assumptions not previously invoked by the Treasury in the matter of indirect expense allocation and apportionment. Moreover, in the Proposed Regulations the Treasury has for the first time considered the question of the allocation of research and development expenditures in regulatory form.

The basic approach of the Proposed Regulations is that almost all deductions should be classified as related to domestic or foreign sources depending on the factual relationship of the deduction to gross income. Each deduction must be examined to determine on a factual basis the gross income to which it is related. A deduction is considered definitely related and therefore allocable to gross income if it is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or can be reasonably expected to generate gross income.[34]

[32] 144 F.2d at 489.

[33] 38 Fed. Reg. 15840 (1973).

[34] See Prop. Reg. § 1.861-8(b) (preamble) (1973).

(1) The expenses, losses, and other deductions properly apportioned or allocated thereto, and

(2) A ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

The remainder, if any, becomes taxable income from sources within or without the United States. Where items of gross income, expenses, losses, and deductions other than those specified in Sections 861(a), 861(b), 862(a), and 862(b) are involved, Section 863 authorizes the Secretary, by regulation, to allocate or apportion such items to sources within or without the United States. Further, Section 863(b) specifies three items of income which are derived from sources partly without the United States, as to which the taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary or his delegate.[25] One such item is income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States.[26] As the term "produced" is defined to include "created," the provision would appear to have application to the sale of intangible property including patents, trade secrets, copyrights, and trademarks,[27] even though the regulations make no specific mention of sales of such property.[28]

The courts have generally followed the foregoing statutory pattern in determining United States-[29] and foreign-source taxable income. In the leading case, *International Standard Electric Corp. v. Comm'r*,[30]

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[25] The specific authority to prescribe regulations of a legislative nature is granted only in Section 863 with respect to items of gross income other than those specified in Sections 861(a) and 862(a), and the designated items of income which are partly within and partly without the United States. Thus, it would appear that the regulations under Sections 861(b) and 862(b), dealing with allocation of expenses to items of income specified in Sections 861(a) and 862(a) are merely interpretive rather legislative in nature. Legislative history reinforces the conclusion that the statutes rather than regulations were to be the controlling authority, except in the special areas described in Section 863. See Revenue Act of 1921, §§ 217(a), (c) and (e), 42 Stat. 227.

[26] I.R.C. § 863(b)(2).

[27] I.R.C. § 864(a).

[28] Reg. § I.863-3(b).

[29] See Standard Marine Ins. Co., Ltd., 4 B.T.A. 853 (1926); Balfour Williamson & Co., Ltd., 1 T.C.M. 852 (1943); Commercial Union Assurance Co., Ltd., 1 T.C. 1166 (1943), *aff'd in part*, 144 F.2d 994 (2d Cir. 1944); G.C.M. 26013, 1949-2 C.B. 76; de Nederlandsche Bank, 35 B.T.A. 53 (1936).

[30] 1 T.C. 1153 (1943), *aff'd in part* 144 F.2d 487 (2d Cir. 1944), *cert.*

[2] Royalty Income—Place of Use. If a licensing transaction does not qualify as a sale, the source of the resulting royalty income is (1) governed by a generally worded statute which fails to distinguish between tangible and intangible property, (2) considers neither the place of production nor where the licensing contract was negotiated or executed, and (3) uses the same criteria whether the taxpayer purchased or produced the licensed property. Section 862(a)(4) merely treats as income from foreign sources:

> "Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or the privilege of using without the United States patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like properties."

Accordingly, where a nonsale licensing of intangible property occurs, the source of the resulting income depends not on the place of contract or where the royalties are paid, but on the geographical area of use or right to use the product. Neither the statute nor the Regulations give any clue regarding the scope of the term "place of use." In the relatively few rulings and decisions which have dealt directly with the issue, however, both the Internal Revenue Service and the courts have attempted to apply some economic common sense to the matter by looking primarily to the markets actually exploited by the licensee.[21] Thus, the place of use of intangible property will generally be considered to be where the intangible property is both protected (either by registration or in the case of know-how by the laws of the country concerned) and exploited.

A closely related problem concerns the determination of where licensed rights are "used" if licenses are granted for both domestic and foreign rights. Early decisions held that where the parties placed no price on foreign and domestic rights, no segregation would be made; all income was attributed to the United States. Subsequently, this rule was relaxed to allow allocation of royalty income from the use of intangible property (provided the taxpayer could show a basis for such apportionment) on the basis of the place where the resulting product incorporating the intangible property right was sold.[22]

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[21] *Id.*

[22] E.g., Wodehouse v. Comm'r, 178 F.2d 987 (4th Cir. 1949).

To date, however, the Internal Revenue Service has not attempted to apply the source apportionment rule to gross receipts arising from patent and copyright transfers.[9] Instead, the Service has attempted to diminish the amount of foreign-source income attributable to patent sales by recently proposing allocation of research and development expenses to such income.[10]

A related issue concerns the allocation of income between property and services in foreign know-how transfers where services relating to the know-how transfer are provided in the United States. Although the source rules specify the place of sale as being determinative where income from the sale of personal property is involved, compensation for labor or personal services is regarded as income from the country in which such labor or personal services was performed.[11] Hence, if a foreign tax is imposed on payments made under a know-how transfer agreement encompassing elements of both property (assuming the know-how in question qualifies as such)[12] and services, the amount of foreign tax available for credit against United States tax liability may be affected by the foregoing source rules.[13] The only guidance concerning the source of such services is Revenue Ruling 55-17[14] in which the Service took the view that service income is deemed to have the same source as the proprietary know-how payments if they have only a nominal value apart from the sale of the know-how. Yet, in light of the Service's more recent emphasis on the substantiality of the service component of know-how transfers,[15] wary taxpayers

[9] Section 863 was apparently intended to serve as a method of allocating those items of income not otherwise specifically covered by Sections 861 and 862. In effect, however, because Section 863 contains no general rules of allocation or apportionment and is effective only through regulations issued under its authority, that section, through its present regulations, deals only with additional specified items of income. For a detailed discussion, see Roberts & Warren, *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens* VI–95 (1968).

[10] Prop. Reg. § 1.861-8(e)(3). See also discussion ¶ 7.1b *infra.*

[11] I.R.C. § 862(a)(3).

[12] Inferentially, the Tax Court has given support to the view that the service component of a foreign know-how will not be considered separately from the proprietary component for income source purposes if its value is insignificant in relation to the total value of the transfer. See United States Mineral Prods. Co., 52 T.C. 177, 200 (1969).

[13] For instauce, a domestic corporation exporting technical know-how to a foreign corporation may agree to provide technical instruction for employees of such corporation in the United States.

[14] 1955-1 C.B. 388.

[15] Rev. Rul. 64-56, 1964-1 C.B. 133, 134; Rev. Proc. 69-19, 1969-2 C.B. 301, 302. See discussion ¶ 1.2a[3] *supra.*

¶ 7.1 TAXING STRUCTURE—DETERMINATION OF INCOME SOURCE

A United States citizen, resident, or domestic corporation is generally subject to United States taxing jurisdiction on a worldwide income basis.[1] Yet, in the case of a domestic owner of intangible property licensing or selling it abroad, or indirectly exploiting the property overseas via a transfer to a foreign corporation, the source of the resulting income may have significant impact upon the owner's ultimate United States tax liability.

For instance, where intangible property is licensed or sold to a foreign transferee, the income derived is usually subject to current foreign taxation as well as United States taxation. To ameliorate the effects of possible economic double taxation, Congress enacted a unilateral credit (or offset) of foreign income taxes against the United States tax liability.[2] Assurance of the United States credit for foreign taxes is of prime importance in many situations involving the sale or transfer of intangible property or services abroad. However, the credit is available only if the taxpayer brings itself within the limitations of the foreign tax credit provisions; one of the most important of which is the limitation of the foreign tax credit to foreign-source income.[3]

Additionally, the Internal Revenue Code contains certain tax incentive and avoidance structures whose operations are dependent directly or indirectly on the source of income received by an entity.[4] Some aspects of the source-of-income rules have been previously discussed in Section 4.2 in relation to licensing payments to nonresident aliens and foreign corporations. That section should be reviewed for a detailed discussion of the background and general application

[1] I.R.C. § 61(a). However, under Section 911, earned income from foreign sources is excluded from the gross income of an individual citizen of the United States if he is a bona fide resident of the foreign country for at least a full taxable year or if the individual is present in a foreign country or countries for 510 days (about seventeen months) out of eighteen consecutive months. The maximum that may be excluded is $20,000 per taxable year (computed on a daily basis if the privileged period is less than the full taxable year), increasing to $25,000 after bona fide foreign residence for an uninterrupted period of three consecutive years.

[2] I.R.C. §§ 901–02.

[3] I.R.C. §§ 904(a)(1), (2). A hypothetical example: A United States corporation transfers foreign patent rights through an exclusive license to an unrelated Canadian corporation. The United States corporation has no other income from foreign countries. If the proceeds of the sale are held not to be foreign-source income, the result would be the loss of the United States foreign tax credit for any Canadian taxing arising from the transaction.

[4] See discussion Chapter 5 *infra*.

of the deemed-paid foreign tax credit for the resulting gain instead of incurring a United States tax on the subsequent capital gain.

(2) If Section 332 applies to a transaction the gain attributable to the unrealized appreciation of the subsidiary's assets will be deferred. By contrast, if Section 1248 is used, the gain will likely be taxable currently as long-term capital gain which is generally not as favorable to a United States corporate shareholder unless the foreign tax rate is relatively low. Additionally, a Section 332 liquidation or at least a dividend prior to liquidation is essential if a foreign subsidiary has substantial pre-1963 earnings and profits.

(3) The tax consequences in the country in which the foreign subsidiary is incorporated or residenced may also have an important effect upon the form of liquidation. For instance, in most foreign countries corporate liquidations are taxable events. Therefore, the foreign subsidiary may be required to recognize gain or loss on the distribution of property to its shareholders. Further, in some situations the United States shareholder may also be taxed by the foreign country on any gain realized.[102]

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[102] If an indirect foreign tax credit is desirable on the resulting dividends, arrangements should be made to pass title to the stock outside of the United States. Moreover, if a tax treaty is applicable to the transaction, it should be examined to determine if the source country grants an exemption from taxation for the gain realized from the liquidation by the United States shareholder.

tion purposes, a corporate liquidation is a taxable event unless a nonrecognition provision such as Section 332 is applicable.

A foreign subsidiary may qualify for Section 332 treatment if it complies with the following statutory requirements:

(1) A plan of liquidation is adopted.

(2) The parent corporation owns, on the date of the adoption of the liquidation plan and until the property is distributed, at least 80 percent of the voting stock of the liquidating subsidiary and at least 80 percent of all other classes of stock (except nonvoting stock that is limited and preferred as to dividends).[89]

(3) The parent corporation must receive at least partial payment for its stock.[90]

(4) There must be a complete liquidation of all of the subsidiary's stock and all of its property must be distributed to the shareholders after creditors' claims are satisfied.[91]

(5) The liquidation must be completed within three years after the taxable year in which the first liquidating distribution is made.[92] If the plan does not provide for an extended period of liquidating distribution, then the actual liquidation must be completed within one taxable year.[93]

(6) Finally, pursuant to Section 367 if the liquidation of a foreign subsidiary is involved, prior to the liquidation the United States shareholder must obtain a ruling that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.[94]

As in the case of transfers to foreign corporations,[95] guidelines for the issuance of Section 367 ruling regarding liquidation of foreign corporations are contained in Revenue Procedure 68-23.[96] Where a foreign subsidiary is to be liquidated into its United States parent via Section 332, the guidelines provide that a favorable Section 367 ruling will be issued if the United States shareholder agrees to include in current income a "toll charge" or dividend equal to all

[89] Reg. § 1.221-2(a).
[90] Reg. § 1.332-2(b).
[91] Reg. § 1.332-2(c).
[92] Reg. § 1.332-4(a)(1).
[93] Reg. § 1.332-3.
[94] I.R.C. § 367.
[95] See discussion ¶ 6.3b *supra*.
[96] 1968-1 C.B. 821 (hereinafter referred to as "Guidelines".)