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International Income Taxation

Supplemental Reading Materials

Spring Semester 2020
Chapter Two

Page 37-38 Delete this from the casebook:

Question: In the above example, 90% of XYZ Co.’s gross income earned over the past three years was active foreign business income. Under the Code, what is the source of interest paid by XYZ Co.’s branch to the Mexican bank if the Mexican bank owns 15% of XYZ Co.? (See section 861(c)(2)(A)).

Caveat: Note that the 80/20 test was used differently in the case of dividends as compared to interest. In the dividend context, dividends paid by an 80/20 corporation were still U.S. source, it was just that they could avoid some U.S. withholding tax, depending on the percentage of foreign source income earned. In contrast, interest paid by an 80/20 corporation was not U.S. source, thus it became unnecessary to seek a special exception to the withholding tax generally imposed on foreign lenders receiving dividends or from U.S. debtors. See how the net tax effect for foreign persons receiving dividends or interest from an 80/20 corporation was typically the same (the approaches were different for reasons related to the subtleties of dividend taxation of U.S. persons that were not at issue here). Why did Congress effectively eliminate the 80/20 rule for interest and dividends? Could Congress have achieved its goals without so comprehensively eliminating the 80/20 rules?

Rev. Rul. 60-55

Advice has been requested whether commissions received by a corporation, organized and operating in a foreign country, from a domestic corporation constitute income from sources without the United States within the meaning of section 862 of the Internal Revenue Code of 1954.

The taxpayer corporation, organized under the laws of a foreign country, is engaged in the purchase in the United States and sale in foreign countries of various types of machinery manufactured by a domestic company of the United States.

The foreign corporation maintains its sales and servicing personnel permanently outside the United States. Such sales personnel travel throughout other foreign countries taking orders for and promoting the sale of the items manufactured by the domestic corporation.

In some instances, for various reasons, foreign customers order merchandise directly from the domestic corporation and require shipment directly to themselves, thus depriving the taxpayer of the sale. In such instances, the domestic corporation has obligated itself, by contract, to pay a commission to the foreign corporation in recognition of the fact that the sale would not have been made except for the promotional work done by the latter in foreign countries.

Section 862 of the Code provides, in part, as follows:

(a) GROSS INCOME FROM SOURCES WITHOUT UNITED STATES.—The following items of gross income shall be treated as income sources without the United States:
(3) compensation for labor or personal services performed without the United States:

*In British Timken Limited v. Commissioner*, 12 T.C. 880, acquiescence, C.B. 1949-2, 1, a foreign corporation entered into an agreement with an American associate for the latter to supply the foreign customers of the former with a product previously sold through the foreign corporation. Under such agreement, the American firm paid the foreign corporation a commission on such sales. The court, in determining that such commissions constituted income from sources without the United States, stated as follows:

> * * * we do not regard the fact that the situs of the sales was within the United States as determinative of the source of petitioner’s income. * * * It is the situs of the activity or property which constitutes the source of the compensation paid and not the situs of the sales by which it is measured that is of critical importance. * * *

It has been repeatedly held that the place where the services are performed, and not where the compensation is paid, controls in determining the source of income derived from the performance of labor or personal services. See *Appeal of George H. Salmon*, 3 B.T.A. 838, acquiescence, C.B. V-1, 5 (1926); I.T. 1438, C.B. I-2, 229 (1922); S.M. 5488, C.B. V-1, 51 (1926); and I.T. 3804, C.B. 1946-1, 151.

The facts of the instant case appear to bring it within the rationale of the *British Timken Limited* and *Salmon* cases, inasmuch as the commissions were paid to the taxpayer by the domestic corporation in recognition of the fact that the sales would not have been made except through the services of the taxpayer. Such services consisted of promotion of the products of the domestic corporation by the taxpayer exclusively in foreign countries.

Accordingly, it is held that commissions received by a corporation operating exclusively in a foreign country from a domestic corporation for securing purchase orders from foreign customers constitute income from sources without the United States within the meaning of section 862 of the Code to the extent that they constitute a reasonable allowance for services actually rendered.

**Rev. Rul. 68-443**

Advice has been requested whether the place of initial sale of a product that bears a trademark is the controlling factor in the determination of the source of the royalties paid for the use of the trademark under the circumstances described.

X, a resident foreign corporation, owns a trademark for certain products in many foreign countries. X corporation entered into a license agreement with Y, a domestic corporation, pursuant to which Y was given the right to place the foreign trademark owned by X on Y’s products and sell the trademarked products. The United States trademark for these products is owned by Z, an unrelated party. The license agreement between X and Y is a conventional trademark license agreement for a limited period of time and includes customary provisions to identify and protect the licensor’s proprietorship of this mark. Under the terms of the license, Y corporation pays X corporation a royalty measured by a percentage of the initial sales price of the trademarked products.

Y manufactures the trademarked products in the United States and sells them to foreign buyers in the United States for resale and consumption in foreign countries; all rights, title, and interest of Y in the products pass to the foreign buyers within the United States. Thus, the initial sale of the trademarked products is regarded as having taken place in the United States.

The specific question presented is whether, by reason of the initial sale of the products to the foreign buyers in the United States, Y corporation has ‘used’ the foreign trademark in the United States and the royalties paid by Y to X are income from sources within the United States.

Section 861(a)(4) of the Internal Revenue Code of 1954 states, in part, that royalties for the use of or for the privilege of using in the United States trademarks and other like property shall be treated as income from sources within the United States.
Section 862(a)(4) of the Code states, in part, that royalties for the use of or for the privilege of using without the United States trademarks and other like properties shall be treated as income from sources without the United States.

The gist of a trademark is its association in the public mind with the product, it being the identifying mark of the trade. Ambrosia Chocolate Co. v. Ambrosia Cake Bakery, Inc., 165 F.2d 693, at 697 (1947).

The function of a trademark is to designate the goods as the product of a particular trader and to protect his goodwill against the sale of another’s product as his. J. S. Tyree Chemist, Inc. v. Thomo Borine Laboratory, 151 F.2d 621, at 623 (1945).

In the instant case the character of X corporation’s income is royalty income measured by a percentage of the sales of the foreign trademarked products. The initial sale of the trademarked products to foreign shippers is a means of placing the products in the avenues of commerce with a view towards their ultimate consumption outside the United States. Although the amount of the royalty income is measured by the sales of the trademarked products, the place of sale does not necessarily determine the source of such royalty income.

Since Z owns the United States trademark to these products, the products manufactured by Y and identified by the trademark under the license from X cannot be sold in the United States for consumption in the United States. Moreover, the foreign countries do not protect the foreign trademarks in the United States. It is concluded, therefore, that the royalties paid by Y to X are paid for the use of the trademarks in the foreign countries and that the place of initial sale of the trademarked products is not the controlling factor in the determination of the source of income.

Accordingly, in the instant case, where products are ultimately used in the foreign country where their trademark is protected, a royalty, received by X for the use of the foreign trademark, is income from sources outside the United States despite the fact that the initial sale of the trademarked articles took place in the United States.

SERGIO GARCIA V. COMMISSIONER
140 T.C. No. 6 (2013)

JUDGES: GOEKE, Judge

[T]he issues for decision are:

(1) the extent to which payments made by TaylorMade under the endorsement agreement are compensation for the performance of petitioner's personal services and the extent to which the payments are royalties for the use of petitioner's image rights. We hold that the payments made by TaylorMade are allocated 65% to royalties and 35% to personal services;

(2) whether the U.S. source royalty compensation is income to petitioner or to Long Drive Srl, LLC (Long Drive). Because we hold that even if the U.S. source royalty compensation was income to petitioner, he is not taxable in the United States on any of this income, we need not address this issue.

(3) whether the U.S. source royalty compensation and a portion of the U.S. source personal service compensation are taxable to petitioner in the United States. We hold that no royalty compensation is taxable to petitioner in the United States, but that all U.S. source personal service compensation is taxable to petitioner in the United States.

FINDINGS OF FACT

At the time the petition was filed petitioner was a Spanish citizen residing in Switzerland.

1. Background

Petitioner is a professional golfer, having turned professional in 1999 after a highly successful amateur golf career. Since 1999 he has played golf around the world, on both the Professional Golfers' Association of America Tour (PGA Tour) and the European Tour. From 1999 to 2004 his world golf ranking was: 12th at the end of 1999; 16th at the end of 2000; 6th at
the end of 2001; 4th at the end of 2002; 36th at the end of 2003; and 7th at the end of 2004.

Petitioner was born in Spain, and his skill at golf and dynamic character attributes have made him a fan favorite and a world-famous celebrity. Nicknamed "El Nino" in his early years as a professional, petitioner is notable for his charismatic and fiery personality which differentiates him from most others who play "the gentleman's game" for a living. Petitioner's personality and his athletic image have helped to make him one of the most marketable golfers in the world, even more marketable than many of those golfers who rank ahead of him or who have won one of golf's four "Major" tournaments. Taken together, petitioner's personality, image, and golf skill make up his personal brand.

* * *

On October 8, 2002, petitioner entered into a seven-year endorsement agreement (commencing January 1, 2003, and ending December 31, 2009) with TaylorMade under which he would become a TaylorMade "Global Icon", around whom TaylorMade would build its brand. At the time the endorsement agreement was signed TaylorMade had endorsements and/or use agreements with nearly 200 professional golfers, but petitioner was the only one who held the Global Icon title. Under the endorsement agreement petitioner would exclusively use certain TaylorMade products, both on and off the golf course. TaylorMade also received the right to "fully exploit the Endorsement" and to use petitioner's image rights in doing so (without making a royalty payment each time it used petitioner's image rights). Petition had certain other obligations, including: encouraging cross-promotion of TaylorMade products with his other corporate sponsors; playing in at least 20 professional golf events each year; acting in a courteous and professional manner, including not breaking the law, using performance-enhancing drugs, or committing an act "violating public morality or decency"; completing at least 12 combined service and personal appearance days each year; using "diligent efforts" to be available to test TaylorMade products; and generally supporting TaylorMade products and promoting goodwill toward the TaylorMade brand. There were many other minor obligations petitioner had under the endorsement agreement, such as using reasonable efforts to ensure his TaylorMade trademarks were visible.

* * *

Petitioner's base remuneration for years 2003 through 2005 was $7 million, after which time his base remuneration depended on his average world ranking at the end of the year, from a high of $9 million for a 1st place rank to a low of $3 million should he be ranked 21st or lower. Petitioner's base remuneration for years 2004 through 2009 could also be calculated under an alternative method (more favorable to petitioner) if TaylorMade's products sold well during the years 2003 through 2009. He could also earn bonuses for each Major tournament he won while using the products which he was required to endorse. [Editor Note: The endorsement agreement was subsequently amended twice due to Sergio Garcia’s unwillingness to use the MaxFli ball in tournaments]

* * *

TaylorMade did not fully use petitioner's service or personal appearance days in either 2003 or 2004. It is unclear from the evidence and testimony exactly how many service, personal appearance, and product-testing days
TaylorMade used each year. However, it appears that petitioner participated in a total of 10 service, personal appearance, and product-testing days in 2003 and a total of 9 such days in 2004. The personal appearances involved playing golf with TaylorMade clientele, attending certain company events (such as dinners), and visiting stores. These events took place in several countries, including Ireland, the United States, Japan, Spain, and Portugal.

* * * [T]he first amended endorsement agreement (but not the original) contained a provision assigning 85% of the payments... for TaylorMade's use of petitioner's image rights, both within and outside the United States) to Even Par [a Swiss entity controlled by Sergio Garcia] and 15% to petitioner (for his personal services, both within and outside the United States).

* * * The parties have stipulated that during 2003, 69% of petitioner's personal service income was derived from sources within the United States and the remaining 31% was derived from sources outside the United States. The parties have also stipulated that during 2004, 68% of petitioner's personal service income was derived from sources within the United States and the remaining 32% was derived from sources outside the United States. Finally, the parties have stipulated that any portion of the TaylorMade payments which we determine to be royalties paid for the use of petitioner's image rights shall be treated as 50% U.S. source income and 50% foreign source income.

In his notice of deficiency respondent took the position that all payments made by TaylorMade under the endorsement agreement were compensation for petitioner's personal services. Respondent has since abandoned that position and instead argues that "The vast majority of the remuneration * * * is attributable to the personal services Petitioner rendered to Taylor Made." Petitioner claims that the first amended endorsement agreement's 85%-15% allocation between royalty and personal service payments, if anything, understated the royalty allocation.

One of petitioner's arguments is that we should respect the 85%-15% allocation in the first amended endorsement agreement as the product of an arm's-length negotiation between two unrelated parties with adverse tax interests. Petitioner claims that he and TaylorMade had adverse tax interests because he wished to have a higher percentage of his pay consist of royalties (on which he would pay taxes only in Switzerland), and TaylorMade wished to satisfy its legal withholding requirements and not damage its reputation by using an allocation which was indefensible. However, TaylorMade's CEO testified that "it was irrelevant to me whether it was 85/15 or 50/50." Similarly, TaylorMade's outside counsel testified that petitioner's team took the lead [*21] on the allocation issue and that TaylorMade did not put "a whole lot of effort" into it. In addition, after reviewing the facts of this case, we conclude that the 85%-15% allocation does not comport with the economic reality of the endorsement agreement (discussed further infra). As a result, we will not adopt the 85%-15% allocation stated in the first amended endorsement agreement.

* * *

"Courts have repeatedly characterized payments for the right to use a person's name and likeness as royalties because the person has an ownership interest in the right." Goosen v. Commissioner, 136 T.C. 547, 559 (2011) (citing Cepeda v. Swift & Co., 415 F.2d 1205 (8th Cir. 1969), Haelan Lab., Inc. v. Topps Chewing Gum, Inc., 202 F.2d 866 (2d Cir. 1953), Boulez v. Commissioner, 83 T.C. 584 (1984), Kramer v. Commissioner, 80 T.C. 768 (1983), and Uhlaender v. Henricksen, 316 F. Supp. 1277 (D. Minn. 1970)). In Goosen v. Commissioner, 136 T.C. at 560, we further stated that--

The characterization of * * * [a taxpayer's] endorsement fees and bonuses depends on whether the sponsors primarily paid for * * * [the taxpayer's] services, for the use of * * * [the taxpayer's] name and likeness, or for both. We must divine the intent of the sponsors and of * * * [the taxpayer] from the entire record, including the terms of the specific endorsement agreement. [Citations omitted.]
The facts of this case are well established. Under the endorsement agreement petitioner would receive compensation for performing certain personal services and also for allowing TaylorMade to use his image rights to sell products. Petitioner became TaylorMade's only Global Icon, and his name and/or likeness were prominently featured in TaylorMade's advertisements around the world.

Multiple witnesses, familiar with the sports advertising industry as a whole and with the practices of TaylorMade specifically, have clearly and credibly testified that both the use of petitioner's image rights and the personal services petitioner provided (especially his use of the TaylorMade products while playing in professional golf events) were crucial elements of petitioner's endorsement agreement. For example, TaylorMade's chief marketing director, Robert Maggiore, testified that under the endorsement agreement TaylorMade received petitioner's "brand and image and license. He then wears and plays our products, and then we tell the story about all the equipment he has in play. So if you pull one of those pieces out, like the house of cards kind of falls."

***

We have previously decided cases involving sports stars where allocation of payments for personal services and royalties was at issue. In Kramer v. Commissioner, 80 T.C. 768, involving an endorsement agreement between a retired tennis champion and Wilson Sporting Goods Co. during 1975 and 1976, we allocated 70% of payments to royalties and 30% of payments to personal services. However, given the somewhat different facts of that case, combined with its age, we do not give much weight to the 70%-30% allocation reached. In addition, we have a recent case involving a factual situation much more similar to petitioner's which makes for a better comparison.

Goosen v. Commissioner, 136 T.C. at 562 (citing Kramer v. Commissioner, 80 T.C. 768, DeMink v. United States, 448 F.2d 867, 870 (9th Cir. 1971), Commissioner v. Ferrer, 302 F.2d 481, 488 (2d Cir. 1962), rev’g T.C. Memo. 1961-105). Considering all the surrounding facts and circumstances, we find that 65% of the endorsement fees petitioner received represented royalty compensation and 35% represented personal service compensation.

III. Effect of Swiss Tax Treaty

The parties agree that petitioner is a resident of Switzerland and that the Convention for the Avoidance of Double Taxation With Respect to Taxes on Income, U.S.-Switz., Oct. 2, 1996, Tax Treaties (CCH) para. 9101.001 (Swiss Tax Treaty) applies to him. * * * Article 12(1) of the Swiss Tax Treaty, Tax Treaties (CCH) para. 9101.12, at 185,019, provides that "Royalties derived and beneficially owned by a resident of a
The Contracting State shall be taxable only in that State. Article 12(2) provides that--

The term "royalties" as used in this Convention means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (but not including motion pictures, or films, tapes or other means of reproduction for use in radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof. [Id.; emphasis supplied.]

Petitioner argues that the payments he received from TaylorMade for use of his image rights are royalties as defined by article 12(2) and are therefore taxable only in Switzerland under article 12(1).

Respondent disagrees with petitioner that article 12 governs the taxability of the image right payments. Instead, respondent contends that those payments are governed by Article 17, Artistes and Sportsmen. Article 17(1) provides that "income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State may be taxed in that other State."

In support of his argument, respondent cites the Department of the Treasury Technical Explanation of the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation With Respect to Taxes on Income (Oct. 2, 1996), Tax Treaties (CCH) para. 9145 (Treasury Technical Explanation). Petitioner agrees with respondent that the Treasury Technical Explanation is useful in interpreting the Swiss Tax Treaty, and we concur. See Klovrat v. Oregon, 366 U.S. 187, 194, 81 S. Ct. 922, 6 L. Ed. 2d 218 (1961) ("While courts interpret treaties for themselves, the meaning given them by the departments of government particularly charged with their negotiation and enforcement is given great weight."); see also N.W. Life Assur. Co. of Can. v. Commissioner, 107 T.C. 363, 385 (1996) (finding the Treasury Technical Explanation to another tax treaty to be "persuasive"). Regarding article 17, the Treasury Technical Explanation, Tax Treaties (CCH) para. 9145, at 185,242, states that "In determining whether income falls under Article 17 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or other activities or property rights." (Emphasis supplied.) It further states that--

Article 17 applies to all income connected with a performance by an entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, as appropriate, such as Article 12 (Royalties) * * *. For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be exempt from source country tax under Article 12, even if the performance was conducted in the source country, although he could be taxed in the source country with respect to income from the performance itself under * * * [Article 17]. [Id.; emphasis supplied.]

The parties agree that the Treasury Technical Explanation does not define the term "predominantly attributable". Both parties have made arguments regarding how we should interpret that phrase, but we need not delve into them because we find the example involving a sale of live recordings to be highly illustrative of the intent of the Swiss Tax Treaty. Even given the
relationship between a live performance and a recording of that performance, the Treasury Technical Explanation states that proceeds from the sale of such a recording may be royalties not taxable in the source country under article 12. In a similar vein, we believe that even though petitioner's golf play and personal services performed in the United States has some connection to his U.S. image rights, income from the sale of such image rights is not predominantly attributable to his performance in the United States. Rather, the image rights are a separate intangible that generated royalties (as defined by article 12(2)) for petitioner when TaylorMade paid him for their use.

We thus find that the income petitioner received from TaylorMade for use of his U.S. image rights was royalty income not taxable in the United States under article 12(1).

B. Personal Service Income for Services Other Than Wearing TaylorMade Products While Golfing

In the first amended endorsement agreement, petitioner and TaylorMade allocated 85% of payments to royalties and 15% to personal services. On his 2003 and 2004 tax returns petitioner included 100% of his U.S. source personal service income under the endorsement agreement in his U.S. taxable income. Petitioner did not raise in the petition the issue that he may have included too much of his personal service income in his U.S. taxable income.

Neither party raised any argument regarding the Swiss Tax Treaty until nearly a year and a half after the petition was filed. Respondent first raised issues regarding the Swiss Tax Treaty, but contended only that (1) petitioner was not a Swiss resident to whom the treaty applied, and (2) if the treaty did apply to petitioner, then amounts paid to petitioner for use of his U.S. image rights were taxable in the United States under article 17 of the treaty. Respondent later conceded that his first argument was incorrect and that petitioner was a Swiss resident to whom the treaty applied.

Neither before or during trial did either party raise the possibility that petitioner's personal service income for services other than wearing TaylorMade products while golfing might not be taxable in the United States under the Swiss Tax Treaty. In fact, petitioner's pretrial memorandum concedes that "Garcia was subject to tax in the U.S. on his U.S.-source personal service income under either U.S. federal income tax law or under Article 17 of the U.S.-Swiss Tax Treaty."

* * *

In his posttrial opening brief petitioner for the first time raised the issue that a portion of his U.S. source personal service income might not be taxable in the United States. Respondent did not address the issue in his posttrial opening brief but noted in his reply brief that petitioner had previously conceded that all U.S. source personal service income was taxable in the United States.

We agree with respondent that petitioner previously conceded the issue. By raising the issue when and in the manner he did, petitioner prejudiced respondent in that respondent was unable to introduce testimony and/or other evidence that could have supported his position that all U.S. source personal service income was taxable in the United States. Respondent was also unable to introduce testimony and/or other evidence regarding the allocation of U.S. source personal service income attributable to petitioner's wearing TaylorMade products while playing golf (which petitioner concedes is taxable in the United States) and other U.S. source personal service income (which petitioner now claims is not taxable in the United States). We find that petitioner raised the issue too late, and we will not consider it. See DiLeo v. Commissioner, 96 T.C. 858, 891 (1991), aff'd, 959 F.2d 16 (2d Cir. 1992). As a result, petitioner is liable for U.S. tax on all U.S. source personal service income he received.

IV. Conclusion

We hold that the compensation paid by TaylorMade under the endorsement agreement is allocated 65% to royalties and 35% to personal services. We further hold that none of the royalty compensation is taxable to petitioner in the United States but that all of the U.S. source personal service compensation is taxable to petitioner in the United States.
In reaching our holdings herein, we have considered all arguments made, and, to the extent not mentioned above, we conclude they are moot, irrelevant, or without merit.

To reflect the foregoing, Decision will be entered under Rule 155.

Rev. Rul. 79-388

ISSUES

(1) To what extent are the pension payments from a United States trust to a nonresident alien subject to Federal income and withholding taxes, under the facts below?

(2) What is the proper allocation of income between United States and foreign sources of pension payments received by a nonresident alien individual, under the circumstances described below?

FACTS

A, a nonresident alien individual, began employment with a foreign branch of domestic corporation X in the foreign country of which A was a citizen. Subsequently, A was transferred to X’s office in the United States and remained in such employment until retirement on December 31, 1978. During A’s employment in the United States, A remained a citizen of the foreign country and A’s status in the United States during such period was that of a resident alien individual. Immediately upon retirement A returned to the foreign country and A’s status changed to that of a nonresident alien individual. Pension payments from X’s retirement plan, which included credit for services performed by A for X’s foreign branch, commenced in January 1979.

While employed in X’s branch in the foreign country, A was a participant in the United States retirement plan that X established and contributed to for all employees of X. The retirement plan invested the contributions and received income from such investments.

X’s retirement plan is a noncontributory arrangement with respect to employees that qualifies, under section 401(a) of the Internal Revenue Code, as a self-administered trustee plan, and is exempt from taxation under section 501(a). Section 871(f), relating to an exclusion from gross income for amounts received from certain qualified pension plans, does not apply to any amounts received by A from X’s retirement plan.

LAW AND ANALYSIS

Section 871(a)(1)(A) of the Code imposes a tax of 30 percent of the amount received by a nonresident alien individual as, among other items, interest, dividends, salaries, wages, annuities, and other fixed or determinable annual or periodical gains, profits, and income, to the extent the amount so received is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States.

Section 871(f) of the Code provides an exclusion from gross income for amounts received as an annuity from certain qualified pension plans.

Section 861(a)(3) of the Code provides that compensation for labor or personal services performed in the United States shall be treated as income from sources within the United States and section 862(a)(3) provides that compensation for labor or personal services performed without the United States shall be treated as income from sources without the United States.

Section 1.861-4(a) of the Income Tax Regulations provides that gross income from sources within the United States includes compensation for labor or personal services performed in the United States regardless of the residence of the payer, the place where the contract for service was made, or the place of payment.
Section 1.861-4(b)(1)(i) of the regulations provides, with respect to taxable years beginning after December 31, 1975, that when labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

Section 1.864-4(c)(6)(ii) of the regulations provides that pensions and retirement pay received by a nonresident alien individual attributable to personal services that constitute engaging in a trade or business in the United States constitute income that is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if the individual is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

Section 1441(a) of the Code provides, in general, for the withholding of tax at a 30 percent rate on certain income from sources within the United States of nonresident alien individuals.

Section 1441(b) of the Code lists salaries, wages, annuities or other fixed or determinable periodical gains as items of income subject to the withholding of tax under section 1441(a).

Employer contributions to an annuity or pension plan represent compensation for personal services. See Rev. Rul. 56-82, 1956-1 C.B. 59. An employer’s contributions to a pension plan with respect to wages earned abroad by a taxpayer is compensation for labor or personal services performed without the United States and are treated as derived from sources without the United States. See Rev. Rul. 72-149, 1972-1 C.B. 8.

S. Rep. No. 1707, 89th Cong., 2nd Sess. (1966), 1966-2 C.B. 1059 at 1077, relating to section 871(f) of the Code, states that, in cases to which 871(f) does not apply, a nonresident alien receiving pension income from a plan located in the United States is subject to United States tax on the interest portion of the pension income notwithstanding that employer contributions are wholly in respect of services performed abroad. See also Rev. Rul. 56-125, 1956-1 C.B. 627, which indicates that distributions to a citizen of the United States from a qualified pension trust are income from sources within the United States, to the extent such distributions represent earnings and accretions to contributions of either the employer or the employee.

HOLDINGS

(1) Because A is a nonresident alien who is not engaged in a trade or business in the United States in 1979, the year A received the pension payments under consideration, the portion of the payments that is from United States sources is not effectively connected with the conduct of a trade or business within the United States and therefore is subject to the imposition of tax under section 871(a)(1)(A) of the Code, and to the withholding holding of tax under section 1441(a).

(2) (a) The part of each pension payment received by A from X’s United States pension plan that represents the earnings of the pension plan is income from sources within the United States.

(b) The part of each payment received by A under X’s plan that is attributable to X’s contributions with respect to services rendered by A outside the United States is income from foreign sources and the part received by A under X’s plan attributable to X’s contributions with respect to services rendered by A within the United States is income from sources within the United States.
INTERNATIONAL MULTIFOODS CORPORATION v. COMMISSIONER
108 T.C. 25 (1997)

[The taxpayer was in the business of franchising the right to operate Mister Donut shops in the United States and abroad. On Jan. 31, 1989, International Multifoods sold its Asian and Pacific Mister Donut business operations for $2,050,000. Pursuant to the agreement, P transferred its franchise agreements, trademarks, Mister Donut System, and goodwill for each of the Asian and Pacific countries in which International Multifoods had existing franchise agreements, as well as its trademarks and Mister Donut System for those Asian and Pacific countries in which it had registered trademarks but did not have franchise agreements. In the purchase agreement, International Multifoods allocated $1,930,000 of the sale price to goodwill and a covenant not to compete. On its 1989 Federal income tax return, P reported the income allocated to these assets as foreign source income for purposes of computing P’s foreign tax credit limitation under sec. 904(a), I.R.C. The Commissioner determined that the goodwill and covenant not to compete were inherent in P’s franchisor’s interest. The Commissioner further determined that the sale of International Multifoods franchisor’s interest produced U.S. source income under sec. 865(d)(1).]

RUWE, Judge: ***

We must determine what portion, if any, of the gain on petitioner’s sale of its Asian and Pacific Mister Donut operations constitutes foreign source income for purposes of computing petitioner’s foreign tax credit limitation under section 904(a). We begin with the sourcing of income rules under section 865. Section 865(a)(1) provides that income from the sale of personal property by a U.S. resident is generally sourced in the United States. Section 865(d) provides that in the case of any sale of an intangible, the general rule applies only to the extent that the payments in consideration of such sale are not contingent on the productivity, use, or disposition of the intangible. Sec. 865(d)(1)(A). Section 865(d)(2) defines “intangible” to mean any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property. Section 865(d)(3) carves out a special sourcing rule for goodwill. Payments received in consideration of the sale of goodwill are treated as received from sources in the country in which the goodwill was generated.

1. Goodwill
Petitioner allocated $1,110,000 of the sale price to goodwill. On brief, petitioner maintains that the franchisor’s interest it conveyed to Duskin consisted exclusively of intangible assets in the nature of goodwill; i.e., franchises, trademarks, and the Mister Donut System. Petitioner contends that the income attributable to the sale of this goodwill constitutes foreign source income pursuant to section 865(d)(3).

This argument mistakes goodwill for the intangible assets which embody it. Goodwill represents an expectancy that “old customers will resort to the old place” of business. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247 (5th Cir. 1973); Canterbury v. Commissioner, 99 T.C. 223, 247 (1992). The essence of goodwill exists in a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely. Canterbury v. Commissioner, supra at 247; Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 233 (1975). The Supreme Court has explained that “The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage [i.e., to goodwill].” Newark Morning Ledger Co. v. United States, 507 U.S. 546, 556 (1993). An asset does not constitute goodwill, however, simply because it contributes to this expectancy of continued patronage.

Section 865(d)(1) provides that income from the sale of an intangible asset by a U.S. resident will generally be sourced in the United States. Section 865(d)(2) defines “intangible” to include, among other things, secret processes or formulas, goodwill, trademarks, and franchises. Section 865(d)(3) then provides a special rule for goodwill, sourcing it in the country in which it was generated.
Petitioner’s argument equates goodwill with the other assets listed in the definition of “intangible” in section 865(d)(2). This Court has recognized that intangible assets such as trademarks and franchises are “inextricably related” to goodwill. *Canterbury v. Commissioner*, supra at 249-251; see also *Philip Morris, Inc. v. Commissioner*, 96 T.C. 606, 634 (1991), aff’d without published opinion 970 F.2d 897 (2d Cir. 1992). However, we believe that Congress’ enumeration of goodwill in section 865(d)(2) as a separate intangible asset necessarily indicates that the special sourcing rule contained in section 865(d)(3) is applicable only where goodwill is separate from the other intangible assets that are specifically listed in section 865(d)(2). If the sourcing provision contained in section 865(d)(3) also extended to the goodwill element embodied in the other intangible assets enumerated in section 865(d)(2), the exception would swallow the rule. Such an interpretation would nullify the general rule that income from the sale of an intangible asset by a U.S. resident is to be sourced in the United States.10 See *Torres v. McDermott Inc.*, 12 F.3d 521, 526 (5th Cir. 1994); *Israel-British Bank (London), Ltd. v. FDIC*, 536 F.2d 509, 512-513 (2d Cir. 1976); *Edward B. Marks Music Corp. v. Colorado Magnetics, Inc.*, 497 F.2d 285, 288 (10th Cir. 1974).17

Respondent contends that, although not so denominated as such, what Duskin acquired from petitioner was a territorial franchise for the operating and nonoperating countries. Petitioner, on the other hand, argues that it did not sell Duskin a franchise, but, rather, the entire Mister Donut franchising business in Asia and the Pacific. Petitioner maintains that the sale of a franchise requires the franchisor to retain an interest in the business and that petitioner failed to retain the requisite interest in this case following the sale to Duskin. Petitioner contends that section 1253(a) and our opinion in *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. 435 (1992), aff’d 995 F.2d 530 (4th Cir. 1993), support its interpretation of “franchise”.

Although section 865 does not provide a definition of franchise, section 1253(b)(1) defines it for purposes of section 1253(a) to include “an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.” We have found this definition to be consistent with the common understanding of the term. *Jefferson-Pilot Corp. v. Commissioner*, supra at 440-441. When Congress uses a term that has accumulated a settled meaning under equity or the common law, courts must infer that Congress intended to incorporate the established meaning of the term, unless the statute otherwise dictates. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981); see also *Jefferson-Pilot Corp. v. Commissioner*, supra at 442 n.8. Since we find no indication that Congress intended “franchise” to carry a different meaning in the context of section 865, we adopt this definition for purposes of this section.

Pursuant to section 1253(a), the transfer of a franchise, trademark, or trade name shall not be treated as the sale or exchange of a capital asset if the transferor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name. Prior to its amendment in the Omnibus Budget Reconciliation Act of 1993 (OBRA), Pub. L. 103-66, sec. 13261(c), 107 Stat. 312, 539,18 section 1253(d)(2)(A) provided that if a transfer of a franchise, trademark, or trade name is not treated as the sale or exchange of a capital asset, then any single payment in discharge of a principal sum agreed upon in the transfer agreement shall be deducted ratably by the payor over a period of 10 years or the period of the transfer agreement, whichever is shorter.

In *Jefferson-Pilot*, the taxpayer’s subsidiary purchased three radio stations, and the taxpayer sought a deduction under section 1253(d)(2) for a portion of the purchase price, which it claimed was attributable to Federal Communications Commission (FCC) broadcast licenses transferred pursuant to the sale. We concluded that the FCC licenses constituted franchises under section 1253, and a ratable portion of the purchase price attributable to the licenses was deductible under section 1253(d)(2). We found that the FCC had retained the right to disapprove of any assignment of the licenses, as well as the right to prescribe standards of quality for broadcasting services and for the equipment used to broadcast. *Jefferson-Pilot*.
Neither the language of section 1253(a) nor our opinion in *Jefferson-Pilot* supports petitioner’s position. Section 1253(a) provides that the transfer of a franchise will not be treated as the sale or exchange of a capital asset so long as the transferor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise. The necessary implication is that a franchise can be transferred without the retention by the transferor of any significant degree of control. In such a case, the transfer will be treated as the sale or exchange of a capital asset, and the transferee will not be permitted to amortize any portion of the purchase price. See sec. 1253(d)(2) (prior to amendment by OBRA sec. 13261(c)). Indeed, if petitioner’s argument were correct, section 1253(a) would have been altogether unnecessary, as the sale of a franchise would only occur where the transferor retained a significant interest in the franchise. However, as we explained in *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. at 441-442 n.7:

Section 1253 requires a two-step analysis. First, we must determine if the interest transferred was a “franchise” as defined in section 1253(b)(1); then we determine whether a significant power was retained. Limiting the definition of “franchise” based on inferences from the retained powers requirement begs the question of whether the interest transferred is a “franchise” in the first place. [Citation omitted.]

Petitioner’s sale of its Mister Donut operations to Duskin constituted the sale of a “franchise” for purposes of section 865(d)(2). Petitioner transferred to Duskin its existing franchise agreements, trademarks, and Mister Donut System in each of the operating countries, as well as its trademarks and Mister Donut System in the nonoperating countries. Petitioner’s Mister Donut operation utilized franchisees to prepare and merchandise distinctive quality doughnuts. This system included methods of preparation, serving, and merchandising doughnuts. In the purchase agreement, petitioner not only sold Duskin petitioner’s rights as franchisor in the existing franchise agreements in the operating countries, but also all its rights to exclusive use in the designated Asian and Pacific territories of its secret formulas, processes, trademarks, and supplier agreements; i.e., its entire Mister Donut System. Duskin received petitioner’s existing rights as franchisor, as well as the right to enter franchise agreements in the nonoperating countries.

Respondent argues that any goodwill associated with the Asian and Pacific franchise business was part of, and inseverable from, the franchisor’s rights and trademarks acquired by Duskin. Respondent maintains that any gain attributable to the sale of franchises or the trademarks produces U.S. source income, as section 865 generally sources income in the residence of the seller. See sec. 865(a), (d)(1).

While there are no cases on point under section 865, case law interpreting other provisions of the Code supports respondent’s position. In *Canterbury v. Commissioner*, 99 T.C. 223 (1992), we considered whether the excess of a franchisee’s purchase price of an existing McDonald’s franchise over the value of the franchise’s tangible assets was allocable to the franchise or to goodwill for purposes of amortization pursuant to section 1253(d)(2)(A). We recognized that McDonald’s franchises encompass attributes that have traditionally been viewed as goodwill. The issue, therefore, was whether these attributes were embodied in the McDonald’s franchise, trademarks, and trade name, which would make their cost amortizable pursuant to section 1253(d)(2)(A), or whether the franchisee acquired intangible assets, such as goodwill, which were not encompassed by, or otherwise attributable to, the franchise and which were nonamortizable.

We found that the expectancy of continued patronage which McDonald’s enjoys “is created by and flows from the implementation of the McDonald’s system and association with the McDonald’s name and trademark.” *Id.* at 248 (fn. ref. omitted). In addition, we stated:

The right to use the McDonald’s system, trade name, and trademarks is the essence of the McDonald’s franchise. *** Respondent did not identify, and we cannot discern, any quantifiable
goodwill that is not attributable to the franchise. We find that petitioners acquired no goodwill that was separate and apart from the goodwill inherent in the McDonald’s franchise.

The franchise acts as the repository for goodwill * * * [Id. at 249; fn. ref. omitted; emphasis added.]

We concluded that the goodwill produced by the McDonald’s system was embodied in, and inseverable from, the McDonald’s franchise that the taxpayer received.20

Similarly, in Montgomery Coca-Cola Bottling Co. v. United States, 222 Ct. Cl. 356, 381-382, 615 F.2d 1318, 1331-1332 (1980), the Court of Claims, in valuing a Coca-Cola franchise, explained:

Defendant’s expert has testified that there is no goodwill in a Coca-Cola bottling operation. Anything resembling goodwill attaches solely to the national company and the name of the product * * *. Customers buy Coca-Cola because of * * * the product, not because of who bottles it. Since goodwill is considered to be the value of the habit of customers to return to purchase a product at the same location, the absence of the product would destroy the value of the habit; and since only one entity has the perpetual right to distribute Coca-Cola in a territory, the value of goodwill, and the franchise are so interrelated as to be indistinguishable, all the value should then be assigned to the franchise. * * * [Emphasis added; fn. ref. omitted.]

In Zorniger v. Commissioner, 62 T.C. 435 (1974), we addressed the issue of whether the taxpayer’s shares of stock in a Chevrolet dealership possessed goodwill that should have been reflected in the valuation of the stock for purposes of the gift tax. We held that no goodwill existed in the stock, since the dealership agreement required Chevrolet’s prior approval of any transfer of the taxpayer’s interest therein. Id. at 444-445. We relied principally on our decision in Akers v. Commissioner, 6 T.C. 693, 700 (1946), where we determined that no goodwill existed in a General Motors’ dealership upon liquidation, as the taxpayer had a nontransferable, personal services contract, which could have been divested from the taxpayer under circumstances outside his control. In Zorniger v. Commissioner, supra at 444-445 (quoting Akers v. Commissioner, supra at 700), we stated:

“The franchises were not assignable and by their terms were made personal contracts between the parties. Such good will or going-concern value as the corporation might have created during its existence was subject at all times to be divested by termination of the franchises without action by the corporation.” [Citation omitted.]

It is also well established that trademarks embody goodwill. Renziehausen v. Lucas, 280 U.S. 387, 388 (1930); Stokely USA, Inc. v. Commissioner, 100 T.C. 439, 447 (1993); Canterbury v. Commissioner, supra at 252; Philip Morris Inc. v. Commissioner, 96 T.C. at 636. Consumers associate the Mister Donut trademark with their pleasurable experience at Mister Donut shops. As a result, goodwill is also embodied in the trademarks, which Duskin acquired and which cause customers to return to Mister Donut shops in the future and patronize them.

Petitioner’s business in the operating countries was conducted by granting Mister Donut franchises. Under the purchase agreement, Duskin received petitioner’s rights as franchisor under the existing franchise agreements in the operating countries. The franchisees in the operating countries possessed the exclusive right to open stores pursuant to established conditions and at locations approved by the franchisor. In order to ensure that the distinguishing characteristics of Mister Donut were uniformly maintained, the franchise agreements had established standards for furnishings, equipment, product mixes, and supplies, which the franchisees were required to meet. The franchise agreements also required that franchisees operate their shops in accordance with uniform standards of quality, preparation, appearance, cleanliness, and service. The agreements provided that the franchisor could not
Supplement Problems 2 through 14 @ 2.8:

2. Southcal, a U.S. corporation, borrows $10 million from the Brussels office of a Belgian bank. During each of the preceding five years, 85 percent of the income of Southcal was from sources outside the United States and was attributable to the active conduct of business in Belgium. The remaining 15 percent of Southcal’s income was from U.S. sources. Interests payments are made in U.S. dollars to the account of the Belgium lender maintained in a bank in New York. What is the source of the interest paid to the Belgium bank? How, if at all, would your answer change if all interest payments were made directly to the Brussels office of the lender? How, if at all, would your answer change if all of the shares of Southcal were owned by residents of Belgium?

3. Labelle, a French corporation, is engaged in the cosmetic business in France and the United States. The U.S. business is conducted through a branch. During each of the preceding four years, 35 percent of the gross income of Labelle was effectively connected with its U.S. business. If
Labelle pays a dividend to its sole shareholder, a French holding company, is there any basis for characterizing all or a portion as U.S.-source income?

4. Galaxy, a U.S. corporation engaged in the engineering business, performed services under a contract with a Canadian corporation. The employee of Galaxy who performed the services spent 25 working days in Canada and 50 working days in the United States. Because the work in the United States was largely routine supervision of drafting of plans while the work in Canada demanded a high degree of creativity and presence above the Arctic Circle, Galaxy charged $50,000 for the work in Canada and $50,000 for the work in the United States. Assume that Galaxy would like to maximize the amount of income treated as foreign-source because the income will be exempt from Canadian tax, and Galaxy has other income that generates excess foreign tax credits (see ¶ 5230). How much of the gross income for services can Galaxy treat as foreign-source gross income?

5. Cosmos, a U.S. corporation engaged in the manufacture, sale and leasing of computer equipment, has a Paris branch office engaged in marketing its computers in Europe. The Paris branch leases a computer to the Paris branch office of a German company. What is the source of the rental income?

6. Bolivar, a Panamanian corporation, owns a U.S. patent. Bolivar grants a nonexclusive license under the patent to Trimingham, a Bermuda corporation, in exchange for a royalty equal to three percent of the net sales by Trimingham of products incorporating the patented invention. What is the source of the royalty paid by Trimingham to Bolivar?

7. Suncare, a wholly owned U.S. sales subsidiary of Soin de Soleil, a French corporation, purchases a variety of skin care products from unrelated U.S. suppliers and sells them at a profit to unrelated distributors in Europe. Suncare also manufactures cosmetics in the United States and sells them to unrelated distributors in Europe. Finally, Suncare purchases a computer from an unrelated U.S. supplier and resells it at a profit to Soin de Soleil, which will use the computer in its treasurer’s office in Paris. Title on all of the sales passes from Suncare to the purchaser at the international airport in France when the goods arrive. What is the source of the income realized by Suncare from these transactions?

8. Fabulous, a U.S. corporation, sells all of its rights to a German patent to Erfurt A.G. (‘‘Erfurt’’), a German corporation, for $1 million, payable in ten equal annual installments with interest at ten percent on the deferred payments. Title is passed to Erfurt in Germany. The patent had an original cost basis of $400,000 and had been subject to total amortization adjustments of $200,000, all of which had been deducted in calculating German-source taxable income. What is the source of the gross income realized? If the sales price is cast in the form of a ‘‘royalty’’ of five percent of the net sales by Erfurt of products incorporating the patented invention, what is the result? Suppose Fabulous sells its German trademark ‘‘Fabulair’’ and associated goodwill to Erfurt for $5 million payable in five equal annual installments with interest of ten percent on the deferred payments. What is the source of the income realized?

9. Assume the same facts as in the first three sentences of Problem 8, except that the German patent is one of many foreign patents the exploitation of which is handled by a licensing branch office of Fabulous located in Frankfurt, Germany. The gain on the sale of the German patent to Erfurt is exempt from German tax. What is the source of the income realized? If the patent sold were inventory property, would the result change? If the patent were sold for a royalty-like price, would the result change?
9. Suppose that Fabulous had purchased trucks for $400,000 which were used solely in the transportation of inventory purchased in different parts of the United States to U.S. customers. All transportation expenses, including depreciation deductions of $200,000 in respect of the trucks, were applied to reduce U.S.-source income. Fabulous then resells the used trucks for $410,000, thereby realizing income of $210,000, to a foreign purchaser that took title to the trucks in Peru. What is the source of the income realized on the sale of the trucks?

10. United States Tool Corp., a U.S. corporation, sells all of the stock of its wholly owned German subsidiary, Modern Tool A.G., to an unrelated German corporation for $50 million cash, which produces a gain of $40 million. All negotiations occur and the sale contract is executed in Germany. Title to the stock passes to the purchaser in Germany, and the purchase price is paid in Germany. Modern Tool A.G. has been actively engaged in business in Germany and France for the last 10 years and has received approximately 60 percent of its gross income from France and 40 percent from Germany each year. Is the gain foreign-source income?

11. Jackson, a U.S. citizen, took the grand tour of Europe. While in Paris, Jackson used his card, issued by a New York banking corporation, to get $1,000 in cash from an ATM on the Left Bank. The New York bank had no French branch. However, pursuant to a standard contract, the ATM was operated by a French bank that was in turn reimbursed by the New York bank. The New York bank charged a “service fee” of $10 for the transaction. What is the source of the service fee to the New York bank?

12. U.S. Systems, a U.S. corporation, produces electronic toys in the United States. A portion of the production is sold through a branch in Europe to retailers for $300 per unit. The cost of production is $100 per unit. Some of the toys are sold directly by U.S. Systems to independent distributors for $250 per unit. How much of the income from each unit sold to a European retailer will be treated as foreign-source income? How, if at all, would your answer change if sales were made directly to distributors at $150?

13. HiTech, a U.S. corporation, owns the copyright in a computer program for “All Out War,” a popular realistic game. HiTech copies the program onto disks that are inserted into boxes covered with a wrapper containing a “shrink-wrap license.” The license is stated to be perpetual, but no modification of the program is permitted. The programs are sold extensively throughout Europe. Purchasers are allowed to use the program on their own computers, and may make and sell one copy of the program subject to the same limitations. After HiTech receives an order by telephone or electronic mail, the computer programs are shipped directly to customers from warehouses maintained by HiTech in New York and Ireland. Does HiTech realize U.S.- or foreign-source income from the transactions? How, if at all, would your answer change if the computer programs were transmitted electronically to purchasers after HiTech receives payment effected electronically by charging a credit card?

14. Consider the case of a nonresident alien who is planning to write a book in his home office and hopes to reach the U.S. market by concluding a contract with a U.S. publisher. At least three arrangements would be possible:

—The author could agree to write the book in return for royalties geared to U.S. sales and allow the publisher to obtain the U.S. copyright.
—The author could write the book, obtain the U.S. copyright and license it to the publisher in return for royalties geared to U.S. sales.

—The author could write the book, obtain the U.S. copyright and sell it to the publisher for a fixed price.

What is the characterization of the payments that would be received under each of these alternatives? What is the source of income under each?
Chapter 3

Replace the casebook’s case of Black & Decker v. Commissioner, TC Memo 1991-557 (1991) at Section 3.2 ALLOCATION OF DEDUCTIONS with the below case:

INTERNATIONAL MULTIFOODS v. COMMISSIONER
108 T.C. 579 (1997)

Opinion

RUWE, Judge:

In International Multifoods Corp. v. Commissioner, 108 T.C. 25, (1997), we disposed of several issues in this case. In an order accompanying the release of our opinion, we granted respondent’s motion to sever and hold the sole remaining issue in abeyance. This remaining issue requires us to decide whether the loss realized by petitioner on its sale of the stock of Paty S.A.-Produtos Alimenticios, Ltda., on March 31, 1987, is to be sourced in the United States for purposes of computing petitioner’s foreign tax credit limitation under section 904(a).

We severed this issue because the Department of the Treasury (Treasury) issued proposed regulations on July 8, 1996, involving the allocation of losses realized on the disposition of stock (the stock loss regulations). The summary to the proposed regulations stated that “The regulations are necessary to modify existing guidance with respect to stock losses.” 61 Fed.Reg. 35696 (July 8, 1996). Pursuant to the proposed regulations, losses realized on the disposition of stock of a corporation in which the taxpayer owns a 10–percent or greater interest generally would be sourced in the residence of the seller. Sec. 1.865–2(a)(1), Proposed Income Tax Regs., 61 Fed.Reg. 35698 (July 8, 1996). With respect to losses realized on the disposition of all other personal property, the proposed regulations provide that section 1.861–8, Income Tax Regs., or other administrative pronouncements will continue to apply. Sec. 1.865–1, Proposed Income Tax Regs., 61 Fed.Reg. 35698 (July 8, 1996). If the proposed regulations are finalized in their current form, petitioner would be permitted to elect retroactively to source its Paty stock loss in the United States. See sec. 1.865–2(a)(1), (e)(2)(i), Proposed Income Tax Regs., 61 Fed.Reg. 35698–35700 (July 8, 1996).

In his motion to sever issue, filed on July 19, 1996, respondent stated: “At this time, respondent is hopeful that the proposed regulations will be finalized during the beginning of the 1997 calendar year.” On March 3, 1997, respondent filed a status report, which indicated that the stock loss regulations had not yet been finalized. On March 5, 1997, we ordered respondent to file, on or before May 12, 1997, an additional status report with respect to the finalization of these regulations.

On March 13, 1997, petitioner filed a Motion for Court to Decide Paty Loss Issue. In its motion, petitioner stated that on the basis of respondent’s March 3, 1997, status report, “it does not appear that there is any specific date by which the proposed regulations are targeted to be issued as a Treasury Decision.” Petitioner also argued that despite respondent’s acknowledgment that the adoption of the proposed regulations in their current form would decide the Paty stock loss issue in petitioner’s favor, “Respondent continues to decline confessing error. The only purpose for not doing so is to preserve the ability to contest the petitioner’s treatment of the loss.” Petitioner maintained that “The prejudice is compounded by the fact that the Petitioner has not only paid the full amount of the determined deficiencies and interest thereon in the present case, it has overpaid the
deficiencies and interest based upon the settlement of other issues.” On April 29, 1997, respondent filed a Notice of Objection to Petitioner’s Motion for Court to Decide Paty Loss Issue, in which respondent contended that “It is in the interest of judicial economy for the Court to continue to hold the PATY stock loss issue in abeyance pending a further status report by the respondent regarding the finalization of the stock loss regulations.” In a status report filed May 12, 1997, respondent informed the Court that the proposed regulations were still not finalized.

We agree with petitioner that the time has come to decide this issue. In granting respondent’s motion to sever, we relied, in large part, upon respondent’s statement that he was “hopeful” that the proposed regulations would be finalized by the beginning of 1997. It is now over 10 years since the enactment of section 865(j)(1) directing the Secretary to promulgate regulations regarding this issue. However, as of the date of issuance of this opinion, the regulations still remain in proposed form. Petitioner has already paid the deficiencies determined in the notice of deficiency and is entitled to a decision on the merits.

FINDINGS OF FACT
Some of the facts have been stipulated and are so found. At the time its petition was filed, petitioner maintained its principal place of business in Minneapolis, Minnesota. Damca International Corp. (Damca) was a wholly owned subsidiary of petitioner and joined in the filing of petitioner’s consolidated Federal income tax return for the taxable year ended February 29, 1988.

Petitioner and Damca owned 100 percent of the outstanding stock of Multifoods Alimentos, Ltda. (MAL). On February 22, 1979, MAL acquired 85 percent of the outstanding stock of Paty. MAL and Paty were Brazilian “limitadas” organized under the laws of the Federal Republic of Brazil.

Paty was a regional pasta manufacturer, which marketed its products in the greater Rio de Janeiro area. Petitioner acquired an indirect interest in Paty, because it believed Paty would be a profitable investment. Through that investment, petitioner sought to expand its presence in Latin America and provide its stock with more appeal to the stockholding community.

By February 1982, petitioner and MAL had acquired the remaining 15 percent of the stock outstanding in Paty. On February 29, 1984, the Paty stock which MAL held was distributed to petitioner and Damca upon MAL’s liquidation. During its fiscal year 1986, petitioner transferred all but one share of its Paty stock to Damca.


Petitioner sold Paty because it proved to be an unprofitable investment, principally due to price controls imposed by the Brazilian Government. With the exception of the taxable year ended February 29, 1980, Paty never generated net income for any year subsequent to MAL’s acquisition of an interest in Paty. At the time of sale, Paty had a net deficit in earnings of $5,053,076. Neither petitioner nor Damca received any dividends from Paty.

Damca realized a loss of $3,922,310 upon the sale of its Paty stock. Of that amount, petitioner reported only $3,772,310 as a loss due to a $150,000 error in calculating losses. On its U.S. Corporation Income Tax Return (Form 1120) for the taxable year ended February 29, 1988, petitioner reported the loss as a U.S. source loss in computing its foreign tax credit limitation. Respondent determined that the loss from the sale of the Paty stock must be sourced outside the United States.

OPINION
The sole issue for decision is whether the loss realized by petitioner on the sale of its Paty stock is to be sourced in the United States for purposes of determining petitioner’s foreign tax credit limitation under section 904(a).
Enacted as part of the Tax Reform Act of 1986, Pub.L. 99–514, sec. 1211(a); 100 Stat. 2085, 2533, section 865 provides that income from the sale of noninventory personal property generally will be sourced at the residence of the seller. In explaining the purpose behind the passage of section 865, the House report stated:

Source rules for sales of personal property should reflect the location of the economic activity generating the income at issue or the place of utilization of the assets generating that income. In addition, source rules should operate clearly without the necessity for burdensome factual determinations, limit erosion of the U.S. tax base and, in connection with the foreign tax credit limitation, generally not treat as foreign income any income that foreign countries do not or should not tax.

Although the title passage rule operates clearly, it is manipulable. It allows taxpayers to treat sales income as foreign source income simply by passing title to the property sold offshore even though the sales activities may have taken place in the United States. In such cases, the foreign tax credit limitation may be artificially inflated. In addition, foreign countries are unlikely to tax income on a title passage basis. Thus, the title passage rule gives U.S. persons the ability to create foreign source income that is not subject to any foreign tax, and that may ultimately be sheltered from U.S. tax with unrelated excess foreign tax credits. In addition, it gives foreign persons the ability to generate income that should be subject to U.S. tax.

Because the residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property, the committee believes that sales income generally should be sourced there. * * * [H. Rept. 99–426, at 360 (1985), 1986–3 C.B. (Vol.2) 1, 360.]

Congress created several exceptions to the application of the general rule in sec. 865(a). *** Respondent does not argue that any of the exceptions to the general rule of sec. 865(a) are applicable in the instant case.

Section 865(j)(1) provides that “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section, including regulations relating to the treatment of losses from sales of personal property”. There is no dispute that the Paty stock sold by petitioner constitutes personal property under section 865(a).

Petitioner contends that section 865 compels symmetrical treatment for gains and losses. Since it is a U.S. resident, petitioner argues that its loss from the sale of the Paty stock must be sourced in the United States. See sec. 865(a)(1), (g)(1)(A)(ii). Respondent, on the other hand, contends that section 865 applies solely to the sourcing of income from the sale of personal property. The rules governing the allocation of losses, respondent maintains, remain those contained in regulations promulgated under sections 861(b) and 862(b). Respondent argues that the Tax Reform Act of 1986 did not modify the preexisting regulatory rules respecting the allocation of losses from the sale of personal property.

Section 861(a) provides rules for sourcing gross income within the United States, and section 862(a) provides similar rules for sourcing gross income from sources without the United States. Section 863(a) authorizes the Secretary to prescribe regulations specifying the methods of allocation for expenses, losses, and deductions that are derived from domestic and foreign sources. Section 1.861–8(b), Income Tax Regs., provides that deductions are allocated to the class of gross income to which they are definitely related. Section 1.861–8(e)(7), Income Tax Regs., provides rules for the allocation of losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b). Pursuant to its provisions, such losses are considered definitely related and allocable to the class of gross income to which the property ordinarily gives rise in the hands of the taxpayer.

Respondent argues that petitioner’s investment in Paty would ordinarily give rise to foreign source dividend income, and, therefore, petitioner’s loss on the disposition of its Paty stock constitutes a foreign source loss. See Black & Decker Corp. v.
Respondent’s reliance upon sections 861 and 862 to justify application of section 1.861–8(e)(7), Income Tax Regs., is misplaced, as these sections are inapplicable in the instant case. The Tax Reform Act of 1986 amended these sections to eliminate their applicability to the sale of noninventory personal property. See Tax Reform Act of 1986, sec. 1211(b)(1)(B) and (C), 100 Stat. 2536. The impact of these changes becomes evident when current section 861(a) is read in the context of section 861(b), which provides: “From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto.” Following its amendment in the Tax Reform Act of 1986, section 861(a) no longer “specifies” gross income that is derived from the sale of noninventory personal property. Section 862(a) and (b) provides a substantially identical provision with respect to income received from sources outside the United States and related losses. Consequently, the pre–1987 versions of sections 861 and 862 are no longer applicable to determine the source of gain or loss from the sale of noninventory personal property.

Respondent’s reliance upon our decision in Black & Decker Corp. v. Commissioner, supra, is similarly misplaced. In Black & Decker Corp., we determined that the taxpayer’s worthless stock loss from its investment in a foreign subsidiary was to be allocated against foreign source dividend income and, therefore, constituted a foreign source loss for purposes of computing the taxpayer’s foreign tax credit limitation. In affirming our decision, the Court of Appeals for the Fourth Circuit noted that the relevant transaction was governed by the Internal Revenue Code of 1954. See Black & Decker Corp. v. Commissioner, 986 F.2d at 62 n. 1. The Court of Appeals stated: “we will discuss and cite to that act [the 1954 Act] although the Internal Revenue Code of 1986 now supersedes it.” Id.

Section 865, which is applicable to the Paty transaction, provides that income realized from the sale of noninventory personal property generally will be sourced at the residence of the seller. Section 865(j)(1) provides that “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section, including regulations * * * relating to the treatment of losses.” Nevertheless, respondent contends that nothing in section 865 requires the Treasury to promulgate “any particular rule” with respect to the allocation of losses on the disposition of personal property. We disagree. Through the enactment of section 865(j)(1) directing the Secretary to promulgate regulations necessary to carry out the purpose of this section (i.e., residence-based sourcing), Congress intended to change the rules regarding the allocation of losses realized on the sale of noninventory personal property. Otherwise, section 865(j)(1) would be unnecessary and, indeed, meaningless. The regulations that respondent would have us apply were already in place prior to the Tax Reform Act of 1986. If Congress intended those existing regulations to apply, section 865(j)(1) is a nullity.

The purpose behind section 865(j)(1) is reflected in The General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation, which provides as follows:

The Act provides that regulations are to be prescribed by the Secretary carrying out the purposes of the Act’s source rule provisions, including the application of the provisions to losses from sales of personal property * * *. It is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary. * * * [Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 922–923 (J. Comm. Print 1987)
When Congress directs that regulations be promulgated to carry out a statutory purpose, the fact that regulations are not forthcoming cannot be a basis for thwarting the legislative objective. It is well established that the absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a section of the Internal Revenue Code. See, e.g., Estate of Neumann v. Commissioner, 106 T.C. 216, 221, 1996 WL 162936 (1996); H Enters. Intl., Inc. v. Commissioner, 105 T.C. 71, 82, 1995 WL 447974 (1995); First Chicago Corp. v. Commissioner, 88 T.C. 663, 669, 1987 WL 49293 (1987), affd. 842 F.2d 180 (7th Cir.1988); Occidental Petroleum Corp. v. Commissioner, 82 T.C. 819, 829, 1984 WL 15576 (1984). In Estate of Neumann v. Commissioner, supra at 221, for instance, we determined that regulations were not a prerequisite to applying the generation-skipping tax to certain transfers when the relevant statutory language (sec.7701(f)) provided: “The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title”. We concluded that Congress had not given the Secretary the power to determine section 2663’s application; i.e., whether the general rule of section 2663 applied to cases such as the taxpayer’s. Rather, we explained that Congress had simply authorized the Secretary to provide rules on how the section should apply. Id.

In Occidental Petroleum Corp. v. Commissioner, supra at 829, we considered the effect on the alternative minimum tax of the absence of regulations under section 58(h). We stated: “the failure to promulgate the required regulations can hardly render the new provisions of section 58(h) inoperative. We must therefore do the best we can with these new provisions. Certainly we cannot ignore them.” Id. We held that the absence of regulations did not preclude proper adjustments in respect of the tax benefit rule, and we proceeded to determine those adjustments in that case. We reasoned that Congress had intended section 58(h) to provide a basis for how (as opposed to whether) the alternative minimum tax should be applied in order to take into account the tax benefit rule. See Estate of Neumann v. Commissioner, supra at 220. On brief, respondent argues that our decision in Occidental Petroleum Corp. v. Commissioner, supra, is distinguishable for several reasons. First, respondent contends that section 58(h) explicitly provided that a particular rule (i.e., the tax benefit rule) was to be adopted in the regulations, whereas “section 865(j) merely provides that regulations are to be promulgated with respect to a particular subject matter but does not state or imply what rules are to be adopted with respect thereto.” Second, respondent maintains that the legislative intent underlying section 58(h) was well documented in the committee reports accompanying the enactment of that section, while no reference is made to section 865(j) in the relevant committee reports. Finally, respondent asserts that contrary to the instant case there were no controlling preexisting regulations in Occidental Petroleum Corp.

Respondent’s arguments are unpersuasive. First, we conclude that Congress did intend that regulations promulgated pursuant to section 865(j) would embody a “particular rule”; i.e., residence-based sourcing would generally be used for losses realized on the sale of noninventory personal property. Second, respondent’s reliance on the absence of any mention of section 865(j) in the committee reports is erroneous, since Congress articulated the overall purpose behind section 865 in the legislative history. See supra pp. 8–9. In addition, the General Explanation confirms that it was expected that losses generally would be sourced similarly to gains. Although the General Explanation does not technically rise to the level of legislative history, we have nonetheless stated that “We are not unmindful of the fact that both the Supreme Court, and this Court, have relied upon the General Explanation in analyzing tax statutes * * and that the General Explanation is entitled to great respect”. Rivera v. Commissioner, 89 T.C. 343, 349 n. 7, 1987 WL 43892 (1987).

In the instant case, we must do “the best we can” in applying section 865 and the policy underlying it to a situation involving a loss realized by a U.S. resident on the sale of noninventory personal property. Certainly, we are not free to ignore section 865 simply because the Secretary has
delayed promulgating the appropriate regulations. *Occidental Petroleum Corp. v. Commissioner*, *supra* at 829. In enacting section 865, Congress determined that “the residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property”. H. Rept. 99–426, *supra* at 360, 1986–3 C.B. (Vol.2) at 360. Section 865(j)(1) directs the Secretary to promulgate regulations to carry out the purpose of section 865; i.e., that gains and losses on the sale of noninventory personal property generally are sourced at the residence of the seller.

The Explanation of Provisions accompanying the proposed regulations states that “Section 1.865–2(a) provides the general rule that stock losses are allocated in the same manner as stock gains * * *. Thus, stock loss generally is allocated to the residence of the seller.” 61 Fed.Reg. 35697 (July 8, 1996) (emphasis added). Moreover, the proposed regulations, if adopted in their current form, would source petitioner’s Paty stock loss at the residence of the seller; i.e., in the United States. See sec. 1.865–2(a)(1), (e)(2)(i), Proposed Income Tax Regs., 61 Fed.Reg. 35696, 35697–35700 (July 8, 1996).

Respondent has not provided, nor have we found, any reason that would preclude application of the general rule articulated in section 865(a) to the facts in this case. Applying this general rule of residence-based sourcing, we hold that the loss realized by petitioner on the sale of its Paty stock constitutes a U.S. source loss for purposes of computing petitioner’s foreign tax credit limitation pursuant to section 904(a).

*Decision will be entered under Rule 155.*

**Notes & Questions:**

1. Somewhat anti-climatically, the Treasury Department issued finalized regulations under Reg. 1.865-2 on January 8, 1999.

2. The final regulations issued under Reg. §1.865-2 largely follow the proposed regulations discussed in the Tax Court’s opinion in International Multifoods. Those regulations thus provide as a general rule that a loss on the sale of foreign affiliate’s stock is generally sourced by the residence of the seller. However, if the sale of stock is attributable to a foreign office within the scope of section 865(e)(3), then the loss is treated as a foreign source loss if a gain in that context would have been considered foreign source under that provision. Reg. §1.865-2 has a dividend recapture rule. A dividend recapture amount includes a dividend, an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B) that is included during the 24-month period ending on the date the taxpayer recognized the loss with respect to the foreign stock. Presumably a dividend recapture amount would also include any amounts included in income by reason of section 951A. A recapture period is increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss (or are converted into and held as low-risk investments) with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. In the case of a loss recognized after a dividend is declared but before such dividend is paid, the recapture period is extended through the date on which the dividend is paid.
Further Chapter 3 Problems (Interest Expense & R&E Expense)

3. Global World, a U.S. corporation, has interest expense for the tax year of $200,000, no portion of which is directly allocable to identified property under the regulations. Global World’s worldwide assets have an adjusted basis of $5,000,000 and a value of $10,000,000, of which assets having an adjusted basis of $4,000,000 and a value of $6,000,000 generate U.S.-source income. How much of the interest expense is apportioned to U.S.-source income?

4. [Add problem on R&E Expense Allocation]
Chapter 4

SDI Netherlands B.V. v. Commissioner
107 TC 161 (1996)

TANNENWALD, Judge:

OPINION ***

The issue in dispute is whether petitioner, a corporation organized under the laws of the Kingdom of The Netherlands, is liable for withholding taxes on royalties paid to a Bermuda corporation, and additions to tax for failure to file Forms 1042 for each of the years in issue. All the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Background

Petitioner is a foreign corporation organized in 1974 under the laws of the Kingdom of The Netherlands. Petitioner was formerly known as SDI International B.V. and, prior to that, as Software Design Dervis B.V. Petitioner is the successor in business to Software Design Sebas B.V., a foreign corporation organized in 1972 under the laws of the Kingdom of The Netherlands.

At the time of filing the petition, petitioner maintained its principal office in Rotterdam, The Netherlands. During the years in issue, petitioner was a member of an affiliated group of companies (the SDI Group) whose members designed, manufactured, marketed, and serviced commercial systems software for use on IBM mainframe computers worldwide.

SDI Ltd., a corporation organized under the laws of Bermuda, is the parent company of the SDI Group. During the years in issue, petitioner was a wholly owned subsidiary of SDI Antilles, a Netherlands Antilles corporation, which was a wholly owned subsidiary of SDI Ltd.

The SDI Group also included SDI Bermuda Ltd. (SDI Bermuda), a corporation organized under the laws of Bermuda which, during the years in issue was a wholly owned subsidiary of SDI Ltd. SDI USA, Inc. (SDI USA), a corporation organized under the laws of the State of California was, during the years at issue, a wholly owned subsidiary of petitioner.

Petitioner also had subsidiary corporations in Germany, France, and the United Kingdom. A brochure used by the SDI Group for the years in issue describes SDI Ltd. as the "Corporate Office" of the SDI Group, and petitioner, SDI USA and other members of the SDI Group as "Marketing" offices of the SDI Group.

SDI Ltd. provided management services to certain of its direct and indirect subsidiaries for which such subsidiaries paid it management fees.

Royalty Payments Made By Petitioner

During the years in issue, petitioner licensed from SDI Bermuda, pursuant to a license agreement dated November 28, 1986 (Bermuda license agreement), the worldwide rights to certain commercial systems software for use on IBM mainframe computers (the software). The Bermuda license agreement granted petitioner a nonexclusive license to use or to market the use of, on a worldwide basis, all of the software and any and all industrial and intellectual property rights SDI Ltd. had or would acquire from the effective date of the agreement, in exchange for certain royalty payments. The agreement further provided that petitioner "shall specifically have the right to grant sublicenses and Agents for the
right to use and to market the use of any and all marketing rights granted to [petitioner] under the terms" of the agreement. The agreement was valid for an indefinite period and could be unilaterally terminated by either party on 3 months' written notice.

The Bermuda license agreement contained no express reference to the United States. With respect to royalties, the Bermuda license agreement provided:

8.1 The royalties payable to [SDI Bermuda] by [petitioner] under this Agreement are fixed at 93% of the net amount of all of the royalties due to [petitioner] by all persons, entities and institutions which [petitioner] sublicensed any of the rights licensed to [petitioner] under this Agreement ("Sublicensees"). The aforementioned net amount is the amount that remains after the deduction of the withholding tax on royalties to be withheld when the Sublicensees of [petitioner] or Agents of [petitioner] pay the royalties due to the [petitioner].

***

8.3 All royalties payable to [SDI Bermuda] under this Agreement shall be due within 28 days from the moment that the royalties to be paid by the Sublicensees shall be due to [petitioner]. All royalties payable to [SDI Bermuda] under this Agreement, will be paid by [petitioner] at the option of the [petitioner], in the same currency or in U.S. Dollars in which the royalties due to [petitioner] are payable.

8.4 [Petitioner] shall annually provide [SDI Bermuda] with a survey of all royalties due by the Sub-licensees and pay [SDI Bermuda] in accordance with subsection 8.1 hereof. Any additional payments due to [SDI Bermuda] pursuant to subsection 8.2 shall be made immediately after the approval of the annual accounts of [petitioner]. [SDI Bermuda] has the right to have a representative examine [petitioner's] accounts.

Petitioner made royalty payments to SDI Bermuda, pursuant to the Bermuda license agreement, during the years in issue, in the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Royalty Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$3,583,983</td>
</tr>
<tr>
<td>1988</td>
<td>5,104,781</td>
</tr>
<tr>
<td>1989</td>
<td>5,146,862</td>
</tr>
<tr>
<td>1990</td>
<td>4,768,349</td>
</tr>
</tbody>
</table>

The above payments constituted the following percentages of the total worldwide royalty payments received by petitioner with respect to the software:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
<th>Total Royalty Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>93.89%</td>
<td>$3,817,182</td>
</tr>
<tr>
<td>1988</td>
<td>95.94%</td>
<td>5,320,816</td>
</tr>
<tr>
<td>1989</td>
<td>94.93%</td>
<td>5,421,908</td>
</tr>
<tr>
<td>1990</td>
<td>95.60%</td>
<td>4,987,662</td>
</tr>
</tbody>
</table>

Royalty Payments Received by Petitioner from SDI USA

During the years in issue, petitioner was a party to an exclusive license agreement with SDI USA, dated October 1, 1972, and as modified from time to time, regarding the use and licensing of the software in the United States (the U.S. license agreement). SDI USA was responsible for the direct marketing and sales of the software in the United States.

The U.S. license agreement provided in part:

2.1 In consideration for the payment of the royalties provided hereunder and the performance of the other terms and conditions hereof by [SDI USA], [petitioner] hereby grants and transfers to [SDI USA], upon the terms and subject to the conditions
hereinafter set forth, the exclusive right and license during the Term hereof, to have disclosed to it by [petitioner] and to exploit, use and lease and otherwise obtain the benefit of [the software] within the Territory.

2.2 This Exclusive License shall include, (i) the right to sublicense to others the use and lease of [the software] within the Territory, subject, however, to the terms and conditions of this License; and (ii) this License shall also include the right and, as hereinafter provided, the obligation of [SDI USA], to provide or to provide for the exclusive maintenance, servicing and repair of [the software] within the Territory.

***

2.4 The Territory of this License shall mean and be restricted to the continental United States, Hawaii and Alaska.

Petitioner agreed not to license the software for use or to compete directly or indirectly with SDI USA's exploitation of the software in the United States during the term of its license to SDI USA.

Until February 1987, the agreement provided that SDI USA would pay to petitioner "an annual royalty equal to fifty percent (50%) of the annual gross revenues of [SDI USA] from leasing and sublicensing of [the software], without any deductions therefrom except rebates, discounts and sales or value added taxes."

The U.S. license agreement was modified in February 1987 to provide that SDI USA would pay petitioner "a royalty equal to (50%) fifty percent of the gross billable or invoiced revenues of [SDI USA] with regard to all products licensed herein or further licensed in the future, without any deductions therefrom except rebates, or, sales or value added taxes."

Petitioner received royalty payments pursuant to the U.S. license agreement from SDI USA, during the years in issue, in the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$2,663,401</td>
</tr>
<tr>
<td>1988</td>
<td>$2,936,889</td>
</tr>
<tr>
<td>1989</td>
<td>$3,092,710</td>
</tr>
<tr>
<td>1990</td>
<td>$2,139,458</td>
</tr>
</tbody>
</table>


The parties have stipulated the amounts of royalties received by petitioner from SDI USA and paid by petitioner to SDI Bermuda. As a consequence, it appears that these amounts, if subject to withholding tax, would produce deficiencies greater than those determined in the notices of deficiency for 1987, 1988, and 1990 and a lesser amount for 1989. Respondent has made no specific request for any increased deficiencies.

Discussion ***

Liability for Withholding

Section 881(a) provides that a 30-percent tax shall be imposed on "the amount received from sources within the United States by a foreign corporation" falling within certain categories of income. 12

Section 1442 provides a method for collecting that tax. Central de Gas de Chihuahua, S.A. v. Commissioner, 102 T.C. at 519.

Section 1442 provides in part:

(a) General Rule. - In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. ***

Royalties are among the types of income included in section 1441(b). Sec. 1.1441- 2(a), Income Tax Regs.; see also sec. 1.881-2(b), Income Tax Regs. In addition, section 861(a)(4) provides that U.S.
source income includes:
(4) Rentals and Royalties. - Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.

Section 1441(a) completes the picture of the statutory provisions involved herein. It provides:
all persons *** having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) [which includes "royalties"] (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual or of any foreign partnership shall *** deduct and withhold from such items a tax equal to 30 percent thereof ***

There can be no dispute that the royalty payments received by petitioner from SDI USA constitute U.S. source income and were received by petitioner as such within the meaning of section 1442(a). See Commissioner v. Wodehouse, 337 U.S. 369 [37 AFTR 1363] (1949); see also Estate of Marton v. Commissioner, 47 B.T.A. 184 (1942). However, royalties paid by SDI USA to petitioner are exempt from taxation by virtue of the treaty exemption: (1) Whether the royalties paid by petitioner to SDI Bermuda constitute income "received from sources within the United States by" SDI Bermuda and are thus subject to withholding under section 1441(a); (2) whether petitioner can be considered a "withholding agent"; (3) whether there is a limitations period that has expired in respect of respondent's right to assess a deficiency in withholding tax against petitioner; and (4) whether petitioner is liable for additions to tax under section 6651(a)(1) for failure to file withholding tax returns.

For reasons hereinafter set forth, we resolve the first issue in petitioner's favor with the result that it is unnecessary for us to address the remaining issues. Before proceeding with our analysis of the first issue, however, it is important to note that respondent does not question the existence of petitioner as a valid Netherlands corporation or the application of the treaty exemption insofar as the payments by SDI USA to petitioner are concerned. Similarly, respondent does not attack the arrangements under which petitioner had a license of the worldwide rights and SDI USA had a license of the U.S. rights, although respondent does ask us to take into account the close relationship of the various corporations involved. Compare Gaw v. Commissioner, T.C. Memo. 1995-531 [1995 RIA TC Memo ¶95,531], on appeal (D.C. Cir., May 20, 1996).

Rather, respondent focuses her argument solely on the proposition that, since the royalties paid by SDI USA to petitioner were U.S. source income, they retained that character as part of the royalties paid by petitioner to SDI Bermuda and, as a matter of law, constitute income "received from sources within the United States by" SDI Bermuda under section 881(a). Respondent contends that the fact that such royalties were combined with non-U.S. source royalties received by petitioner to determine the amount of royalties payable by petitioner to SDI Bermuda does not preclude the tracing of the royalties received by petitioner from SDI USA to U.S. sources. To implement such tracing, respondent simply applies the percentage specified in the worldwide
license agreement between petitioner and SDI Bermuda and utilized in computing the amount of the required payment by petitioner to SDI Bermuda. To support her contention that such an allocation is permissible, respondent cites Wodehouse v. Commissioner, 15 T.C. 799 (1950); Rohmer v. Commissioner, 14 T.C. 1467 (1950); Rohmer v. Commissioner, 5 T.C. 183 (1945), affd. 153 F.2d 61 [34 AFTR 826] (2d Cir. 1946); Estate of Marton v. Commissioner, 47 B.T.A. 184 (1942); Molnar v. Commissioner, 156 F.2d 924 [35 AFTR 54] (2d Cir. 1946), affg. a Memorandum Opinion of this Court. In all of these cases, however, the payments, upon which a withholding tax was imposed, were directly from a U.S. payor and the U.S. withholding tax was imposed on that payor. None of them address the situation involved herein, where there is a second licensing step under which royalties are being paid and upon which the U.S. withholding tax is sought to be imposed. Thus, these cases provide no guidance in respect of whether the U.S. source characterization of the royalties paid by SDI USA to petitioner flows through to the royalties paid by petitioner to SDI Bermuda.

Petitioner argues that the royalties paid by SDI USA to petitioner and exempt from tax under the Netherlands treaty became merged with the other royalties received by petitioner from non-U.S. sources and consequently lost their character as U.S. source income. Petitioner submits that, while the royalty payments from SDI USA may be U.S. source income, its royalty payments to SDI Bermuda were made on a separate and independent basis. With respect to the payments to SDI Bermuda, petitioner contends that they were made pursuant to a worldwide licensing agreement between two foreign corporations, and as such do not constitute income "received from sources within the United States" so that no withholding is required under section 1442(a).

Pertinent authority on the issue before us is sparse. Indeed respondent relies solely on Rev. Rul. 80-362, 1980-2 C.B. 208, for her "flow-through" position. In Rev. Rul. 80-362, A, a resident of a country other than the United States and The Netherlands, licensed the rights to a U.S. patent to X, a Netherlands corporation. X agreed to pay a fixed royalty each year to A. X relicenses those rights to Y, a U.S. corporation, for use in the United States. In ruling that X was liable for a withholding tax under section 1441, the ruling states:

In the present factual situation, the royalties from Y to X are exempt from United States tax under Article IX(1) of the Convention. However, the royalties from X to A are not exempt from taxation by the United States because there is no income tax convention between A's country of residence and the United States providing for such an exemption. Since the royalties from X to A are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United States under section 861(a)(4) of the Code and are subject to United States income taxation under section 871(a)(1)(A). [Rev. Rul. 80-362, 1980-2 C.B. at 208-209.]

We are not persuaded that Rev. Rul. 80-362, supra, provides any significant support for respondent's position herein. It fails to reflect any reasoning or supporting legal authority. This circumstance is particularly relevant in applying the usual rule that, in any event, revenue rulings are not entitled to any special deference. See Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341, 350 (1995), on appeal (7th Cir., March 13 and 25, 1996); Halliburton Co. v. Commissioner, 100 T.C. 216, 232 (1993), affd. without published opinion 25 F.3d 1043 (5th Cir. 1994).

At this point, we note that respondent has not argued that petitioner was a mere conduit or agent of SDI USA in paying royalties to SDI Bermuda or that SDI Bermuda was the beneficial owner of the royalties petitioner received from SDI USA so that the U.S. Netherlands treaty exemption should not apply. Compare Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), with Northern Indiana Public Service Co. v. Commissioner, supra; cf. Estate of Petschek v. Commissioner, 81 T.C. 260 (1983), affd. 738 F.2d 67 [54 AFTR 2d 84-5424] (2d Cir. 1984). Presumably such an
argument would have produced a situation where SDI USA rather than petitioner would have been targeted by respondent as the taxpayer liable for the withholding tax under section 1442(a). \textsuperscript{15} See Northern Indiana Public Service Co. v. Commissioner, 105 T.C. at 347.

Given the basis for our disposition of this case, we have no need to deal with the question whether petitioner, even though only a conduit, would meet the statutory requirements of a withholding agent. See sec. 1.1441-7, Income Tax Regs., which provides that a foreign corporation can be a withholding agent. See also Fides v. Commissioner, 137 F.2d 731 [31 AFTR 570] (4th Cir. 1943), affg. 47 B.T.A. 280 (1942); Gaw v. Commissioner, T.C. Memo. 1995-531 [1995 RIA TC Memo ¶95,531], on appeal (D.C. Cir., May 20, 1996).

Although Aiken Industries, Inc. v. Commissioner, supra, and Northern Indiana Public Service Co. v. Commissioner, supra, involved the conduit concept, we think they provide some guidance for our disposition of the instant case. We take this view because the flow-through characterization concept is, in a very real sense, the conduit concept albeit in a somewhat different garb, i.e., whether the U.S. source income is being received as such, because of the status of the paying entity in one case, and the status of the subject matter of the payment in the other.

In Aiken Industries, Inc. v. Commissioner, supra, back-to-back loans, in the identical amounts of principal and rates of interest, were made between a U.S. corporation and a related corporation organized under the laws of the Republic of Honduras, and between the Honduran corporation and its indirect parent. Respondent argued that the Honduran corporation should be disregarded for tax purposes, and that the parent corporation should be deemed the true owner and recipient of the interest payment from the U.S. corporation. We held the Honduran corporation to be a mere conduit for the passage of interest payments and imposed withholding tax liability on the U.S. corporation.

In Northern Indiana Public Service Co. v. Commissioner, supra, the taxpayer, a domestic corporation, organized a finance subsidiary incorporated in Curacao under the Commercial Code of the Netherlands Antilles, (to which the U.S.-Netherlands treaty applied) for the purpose of issuing notes in the Eurobond market. The finance subsidiary borrowed $70 million at 17-1/4 percent interest in that market and lent that amount to the taxpayer at 18-1/4 percent interest. Respondent argued that the finance subsidiary should be ignored and that the taxpayer was liable for withholding taxes under section 1441 on the interest payments to the foreign Eurobond holders. Finding that the finance subsidiary engaged in substantive business activity that resulted in significant earnings, we held that the finance subsidiary was not a mere conduit or agent.

We think the within situation falls more within the ambit of Northern Indiana than Aiken Industries. In the latter case, there was an identity both in terms and timing between the back to back loans, as well as a close relationship between the parties involved. In the former case, although there was a clear connecting purpose between the borrowing and lending transactions, i.e., to obtain the benefit of the exemption from the withholding tax on interest under the U.S.-Netherlands treaty; there were differences in terms, i.e., in the interest rate (albeit not large); and a close relationship between all the parties was not present since the borrowings by the finance subsidiary were from unrelated parties.

In the instant case, there was a close relationship between the parties. However, although respondent asks us, in passing, to take that relationship into account, she does not pursue the matter to the point where she contends that it is a significant factor. Given the fact that respondent recognizes the existence of all of the parties as valid corporate entities and does not attack the bona fides of the license agreements between SDI USA and petitioner, on the one hand, or petitioner and SDI Bermuda, on the other, we are not disposed to allow the close relationship element to control our decision.

The facts of the matter are that the two license agreements had separate and distinct terms and that petitioner had an independent role as the licensee from SDI Bermuda and the licensor of
the other entities, including but not limited to SDI USA. The schedules of royalty payments provided for a spread, not unlike the spread involved in Northern Indiana, which compensated petitioner for its efforts. Like the finance subsidiary in Northern Indiana, petitioner engaged in licensing activities from which it realized substantial earnings. In fact, on a percentage basis, it earned between 5 and 6 percent, compared to the 1 percent earned by that finance subsidiary in Northern Indiana. Under the circumstances herein, we think these arrangements should be accorded separate status with the result that, although the royalties paid by petitioner to SDI Bermuda were derived from the royalties received by petitioner from SDI USA, they were separate payments.

We find support for our conclusion herein in that respondent's view of the law could cause a cascading royalty problem, whereby multiple withholding taxes could be paid on the same royalty payment as it is transferred up a chain of licensors. See, e.g., 1 Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income, par. 7.8, pp. 7:20-7:21 (2d ed. 1996); 2 Kuntz and Peroni, U.S. International Taxation C1-45 - C1-46 (1992); Dale, "Withholding Tax on Payments to Foreign Persons," 36 Tax L. Rev. 49, 66-67 (1980). But for the U.S.-Netherlands treaty, the royalty payments from SDI USA could be subject to withholding tax twice under respondent's reasoning herein.

Respondent argues that only one withholding tax is being sought herein. However, this ignores the fact that, by treaty, the U.S. agreed to forgo taxing royalties and to allow them to be taxed by The Netherlands. Whether or not The Netherlands actually taxed the royalties is irrelevant.

Respondent also infers that she would use her discretion not to apply more than one level of withholding tax on multiple transfers of income that originated as U.S. source income. We think this places an improper exercise of discretion in respondent's hands. To avoid the imposition of interest and additions to tax as determined by respondent herein, each payor in the chain might well feel compelled to file returns and pay withholding taxes. See Glicklich, "Final Regulations on Conduit Financing Arrangements Empower the IRS", 84 J. Taxn. 5, 12 (1996). We are not disposed to conclude, in the absence of any legislative expression on the subject, that Congress intended the statutory provisions to permit "cascading" with the question of relief left to the mercy of respondent.

We hold that the payments by petitioner with respect to which respondent seeks to impose liability for the 30 percent withholding tax herein were not "received from sources within the United States by" SDI Bermuda under sections 881(a), 1441(a), and 1442(a).

Decision will be entered for petitioner.

CENTRAL DE GAS DE CHIHUAHUA, S.A. v. Commissioner

TANNENWALD, Judge:

After making a jeopardy assessment, respondent determined a deficiency of $696,240 in petitioner's Federal income tax for its 1990 taxable year under section 881. The case comes before us on cross-motions for summary judgment on the issue of whether the 30 percent tax imposed by section 881 applies in the absence of an actual payment of the income item, in this case rent.

As will subsequently appear, issues remain to be decided after we have disposed of the contentions of the parties herein, see infra p. 3, so that the cross-motions are more properly characterized as motions for partial summary judgment. However, the facts upon which the cross-motions are based are not in dispute so that the necessary conditions for partial summary judgment have been met. Rule 121(b); Blanton v. Commissioner, 94 T.C. 491, 494 (1990).

During 1990, petitioner (a Mexican corporation) rented a fleet of tractors and trailers to another Mexican corporation, Hidro Gas de Juarez, S.A.
(hereinafter Hidro). Hidro did not pay rent for the equipment. Petitioner and Hidro were under common control within the meaning of section 482. The rented equipment was used to transport liquified petroleum gas from points within the United States to the Mexican border area where it was sold to Pemex, the Mexican Government-operated oil company, for distribution in Mexico.

Petitioner did not file a Federal income tax return for 1990. Respondent, acting under section 482, allocated to petitioner the amount of $2,320,800 as the fair rental value of the equipment for 1990 (which the parties now agree should be $1,125,000) and determined that petitioner was liable for the 30-percent tax imposed by section 881 on that amount, which is the primary position respondent asserts herein. Respondent also asserted in the deficiency notice and asserts herein, as an alternative position in the event that we should grant petitioner's motion, i.e., hold that the section 881 tax does not apply, that petitioner is liable for tax under section 882 on income effectively connected with the conduct of trade or business within the United States. Similarly, petitioner has reserved the right, in the event that we grant respondent's motion, i.e., hold that the section 881 tax does apply, to contend that only a portion of the agreed rental value should be allocated to the use of the equipment within the United States and other matters relating to the nature of the relationship between petitioner and Hidro. The parties are in agreement that our disposition of the motions herein will facilitate resolution of the matters reserved.

The pertinent provisions of the Code upon which the positions of the parties are based are section 881(a) and section 1442(a), the latter section incorporating a portion of section 1441(a).

Section 881(a) imposes a tax "of 30 percent of the amount received from sources within the United States by a foreign corporation as . . . rents".

Section 1442(a) provides, in pertinent part, that "in the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof."

Section 1441(a) provides, in pertinent part, that "all persons . . . having the control, receipt, custody, disposal or payment of any of the items of income specified in subsection (b) [which includes "rent"] (to the extent that any of such items constitutes gross income from sources within the United States) of any nonresident alien individual or of any foreign partnership shall . . . deduct and withhold from such items a tax equal to 30 percent thereof".

Petitioner argues that, in order for section 881(a) to apply, there must be an actual payment of the income item and that the allocation of rent to petitioner from Hidro under section 482 does not satisfy that requirement. Respondent counters with the assertion that there is no requirement of actual payment under section 882 and that the allocation of rent to petitioner under section 482 provides a sufficient basis for imposing the 30-percent tax under that section. For the reasons hereinafter set forth, we agree with the respondent.

In marshalling support for their positions, the parties have viewed section 881, on one hand, and sections 1441 and 1442, on the other, as being mirror images of each other. In this context and in the absence of authority dealing with the issue whether actual payment is required for section 881 to apply, they have pointed to cases dealing with such requirement under sections 1441 and 1442 and comparable provisions of the Internal Revenue Code of 1939.

Petitioner relies on L.D. Caulk Co. v. United States, 116 F. Supp. 835 [45 AFTR 498] (D. Del. 1953). In that case, the issue was the obligation of the plaintiff to withhold tax, under section 143 of the Internal Revenue Code of 1939 (the predecessor of sections 1441 and 1442) on royalties payable to nonresident aliens at a time when payment of such royalties was blocked under U.S. law. The District Court articulated a thorough analysis of the obligation to withhold under such circumstances and concluded that, at
least where the item of income could not have been legally paid, no such obligation existed. We think Caulk is clearly distinguishable from the situation herein where there was no legal impediment to the payment of rent by Hidro to petitioner. The same caveat was expressed in Southern Pacific Co. v. Commissioner, 21 B.T.A. 990, 994 (1930), also relied upon by petitioner, which likewise involved the obligation to withhold in respect of blocked income and is therefore distinguishable. In a similar vein, we find petitioner's reliance on several of respondent's revenue rulings beside the point. The rulings involve clearly distinguishable circumstances, for the most part the measure of excise taxes on discounted payments, and in any event are not binding upon us. Vulcan Materials Co. v. Commissioner, 96 T.C. 410, 418 (1991), affd. without published opinion 95 F.2d 973 (11th Cir. 1992). Since Air Tour Acquisition Corp. v. United States, 546 F.2d 110, 118 [39 AFTR2d 77-754] (5th Cir. 1977); Casanova Co. v. Commissioner, 87 T.C. 214, 217-218 (1986). Thus, the former section and the latter two sections serve distinctly separate purposes. Consequently, we are not persuaded that, even if actual payment is required for withholding under sections 1441 and 1442 (an issue we expressly do not decide herein), it necessarily follows that the same requirement should apply in determining the import of the word "received" in section 881. Indeed, the District Court, in L.D. Caulk Co. v. United States, 116 F. Supp. at 840 n.9, upon which petitioner heavily relies, indicated a similar view.

Petitioner does not question the broad authority of respondent to allocate income under section 482. Moreover, petitioner does not question the authority of respondent to "create" income by an allocation between related entities - a question which was the subject of conflicting views until resolved in respondent's favor. See Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199 (1977) and cases discussed therein, affd. without published opinion 61 F.2d 100 (4th Cir. 1980). To be sure, the existence of such authority was articulated in the context of provisions in the section 482 regulations for a correlative adjustment to the income of the entity from which the income is allocated. See 1.482-1(d)(4), Income Tax Regs. 3 The fact that such an adjustment may not have any effect on Hidro for the taxable year before us since Hidro is a foreign corporation which does not appear to be subject to U.S. tax for such year is irrelevant; the adjustment is deemed made and conceivably could affect Hidro's U.S. tax liability in a

3. See T. French Co. v. Commissioner, 60 T.C. 836, 856 (1973), where we did not reach the question whether the obligation to withhold attached to a constructive dividend, a question we described as "tantalizing".

We think that the parties' use of the mirror image concept is misguided. Section 881 imposes a liability for tax, and sections 1441 and 1442 provide a method for collecting that tax. See Newman & Co. v. United States, 423 F.2d 49, 51-52 [25 AFTR2d 70-777] (2d Cir. 1970); see also Coastal Chemical Corp. v. United States, 781 F. Supp. 669 (D. Haw. 1991), also relied upon by petitioner, involves excise tax on air transportation, it is also distinguishable.

Respondent relies on Casa de la Jolla Park v. Commissioner, 94 T.C. 384 (1990). That case also involved the obligation to withhold under section 1441(a) in a situation where interest was owed by petitioner therein to a nonresident alien who in turn owed money to a Canadian bank. Petitioner caused the amount of the interest it owed to be remitted to the Canadian bank to be applied against the sums due the bank from the nonresident alien. We held that petitioner in that case had an obligation to withhold. In so doing, we interpreted section 1441(a) as not necessarily requiring payment. We think Casa de la Jolla Park does not furnish respondent the degree of support which she attaches to it. In the first place, there was payment although it was indirect. In the second place, the case dealt with the obligation to withhold and not with the issue of liability for the tax as such, which is the situation we have before us. Under these circumstances, we see no reason for us to pursue that question of how far the obligation to withhold attaches to an item of income allocated by respondent under section 482. See R. T. French Co. v. Commissioner, 60 T.C. 836, 856 (1973), where we did not reach the question whether the obligation to withhold attached to a constructive dividend, a question we described as "tantalizing".
Petitioner asserts that section 482 does not confer upon respondent the authority to "create" a payment. We think this position begs the question to be resolved. There can be no doubt that the authority of respondent to allocate income encompasses the conclusion that such allocation "creates" a deemed payment. Any other view would render such an allocation nugatory in a host of situations implicating the application of section 482 even where only domestic corporations are involved. Indeed, petitioner carefully refrains from pushing its rationale that far, seeking only to apply the requirement of actual payment to the language of section 881. In this context, the question is whether a deemed payment constitutes "an amount received" under section 881. We think it does. A holding that actual payment is required could significantly undermine the effectiveness of section 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under section 881. We are not impressed with petitioner's argument that equating a deemed payment under section 482 with "an amount received" under section 881 would constitute a license to respondent to run wild in the arena of allocations under section 482 between foreign corporations under common control. Although respondent's authority under section 482 is extremely broad, it is not open ended and a taxpayer will always be able to challenge an allocation as not permitted by law and/or not correct in amount.

Similarly, we are not impressed with petitioner's attempt to characterize the allocated fair rental value of the equipment as a constructive dividend to the parent of Hidro and petitioner and a nontaxable contribution of capital to petitioner. Petitioner's reliance on Rev. Rul. 78-83, 1978-1 C.B. 79, is misplaced. Aside from the fact that the ruling is not binding upon us, see supra p. 6, it simply does not apply to the instant situation. The facts of that ruling were that sums due one subsidiary were actually paid to another subsidiary. Thus, there was an actual transfer of property which is the hallmark of cases involving both the allocation of intercorporate payments, and the consequent presence of a constructive dividend. See Sammons v. Commissioner, 472 F.2d 449, 452-453 [31 AFTR2d 73-497] (5th Cir. 1972), aflg. in part, revg. in part, and remanding T.C. Memo. 1971-145 [*71,145 PH Memo TC]; White Tool and Machine Co. v. Commissioner, T.C. Memo. 1980-443 [*80,443 PH Memo TC], affd. 677 F.2d 528 [49 AFTR2d 82-1343] (6th Cir. 1982).

The long and the short of the matter is that we hold that the word "received" in section 881 includes the fair rental value of the equipment even though the amount thereof was not actually received by petitioner from Hidro. We are reinforced in this holding by the fact that Congress has clearly indicated when it wished to refer to actual receipts. See the pre-1993 versions of sections 453 and 453A ("installment payments actually received"); pre-1990 version of section 1402 (income of a corporate director derived in the taxable year when the services were rendered "regardless of when the income is actually paid or received"); section 9701 dealing with coal industry health benefits and defining a "1988 agreement operator" to include "an employer from which contributions were actually received". We reject petitioner's attempt to derive sustenance from the fact that, under sections 881(c) and 871(a)(1)(C), original issue discount element of portfolio interest is generally not subject to the tax until paid or the obligation is sold or exchanged. If anything, the fact that Congress found it necessary to include a payment requirement for original issue discount indicates that such a requirement was not intended to apply to the phrase "amount received" in section 881(a).

Petitioner's motion will be denied and respondent's motion will be granted.

An appropriate order will be issued.
Advice has been requested whether a nonresident alien individual is considered to be engaged in trade or business within the United States during the taxable year, within the meaning of section 871 of the Internal Revenue Code of 1954, under the circumstances described below. Advice has also been requested whether the term "rents," as used in section 871, includes considerations other than the payment of a stipulated rental, i.e., payment of taxes, repairs, etc., by the lessee described below.

The taxpayer, a nonresident alien individual who has not elected to treat real property income as income effectively connected with the conduct of a trade or business within the United States pursuant to section 871(d) of the Code, did not, except as described below, engage in any activity within the United States during the taxable year ended December 31, 1971.

The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Section 871(a)(1) of the Code imposes for each year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as income in the form of items enumerated, but only to the extent that the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Section 871(b)(1) of the Code provides for the imposition of a tax on a nonresident alien individual engaged in trade or business in the United States during the taxable year as provided in section 1 or 1201(b) on his taxable income that is effectively connected with the conduct of a trade or business within the United States.

Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular. Jan Casimir Lewenhaupt 20 T.C. 151 (1953), aff'd per curiam, 221 F. 2d 227 (9th Cir. 1955); Elizabeth Herbert 30 T.C. 26 (1958), acq. 1958-2 C.B. 6; Inez De Amodio 34 T.C. 894 (1960), aff'd 229 F.2d 623 (3rd Cir. 1962).

In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income.
from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable. Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See Evelyn M. L. Neil, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business. Compare Adolph Schwarz, 24 T.C. 733, acq. 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.

With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.

Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, i.e., amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

**Rev. Rul. 91-7, 1991-1 CB 110**

**ISSUES**

(1) May a nonresident alien or a foreign corporation make an election under section 871(d) or 882(d) of the Internal Revenue Code for a taxable year in which the taxpayer does not derive income from U.S. real property.

(2) May a nonresident alien or a foreign corporation make an election under section 266 of the Code to capitalize real estate taxes, mortgage interest, and other carrying charges attributable to unimproved and unproductive real property for a taxable year in which it may not deduct such expenses under section 873(a) or 882(c).

**FACTS**

A, a nonresident alien individual, and FC, a foreign corporation, co-own parcel P, unimproved real estate located in the United States. Parcel P is held for investment purposes. During the 1990 taxable year, A and FC do not derive any income from parcel P. A and FC annually pay real estate taxes, mortgage interest, and other carrying charges connected with parcel P. Neither A nor FC has made an election under section 871(d) or section 882(d) of the Code with respect to parcel P in any previous taxable year.

**LAW AND ANALYSIS**

Nonresident alien individuals and foreign corporations are subject to taxation at a rate of 30 percent on certain types of U.S. source gross income (including rent) which is not effectively connected with the conduct of a trade or business within the United States (ECI). See sections 871(a) and 881(a) of the Code. Nonresident alien individuals or foreign corporations that are engaged in a U.S. trade or business during the taxable year are subject to taxation under sections 871(b) and 882(a) of the Code on their taxable income which is ECI. Sections 873(a) and 882(c) allow deductions to nonresident alien individuals and foreign corporations only if and to the extent that the deductions are connected with the ECI of such persons.

Nonresident alien individuals and foreign corporations that, during a taxable year, derive from U.S. real property gross income which is not ECI may elect for such taxable year to treat such income as if it were ECI. See sections 871(d) and 882(d) of the Code. Income subject to the election is taxable as ECI under
section 871(b) or section 882(a), and is not taxable under section 871(a) or section 881(a). Because A and FC do not derive any income from parcel P during the 1990 taxable year, neither taxpayer can make an election for such year under section 871(d) or section 882(d) of the Code. Sections 1.871-10(a) and 1.882-2(a) of the Income Tax Regulations. Under sections 873(a) and 882(c), A and FC are not allowed any deductions in the 1990 taxable year for the real estate taxes, mortgage interest, or other carrying charges paid during such taxable year, because such amounts are not connected with ECI.

Section 1.1016-(c) of the regulations provides that adjustments to basis shall be made for taxes and other carrying charges which the taxpayer elects, under section 266 of the Code, to treat as chargeable to capital account, rather than as an allowable deduction. Under section 1.266-1(b)-(1)(i) of the regulations, annual taxes, interest on a mortgage, and other carrying charges on unimproved and unproductive real property, which are otherwise expressly deductible under Subtitle A of the Code, may be capitalized at the election of the taxpayer. An item not otherwise deductible may not be capitalized under section 266. See section 1.266-1(b)(2).

Because the real estate taxes and mortgage interest incurred during the 1990 taxable year on parcel P are not allowable deductions for A and FC for such taxable year, those expenses cannot be capitalized under section 266 of the Code by adding the amount of the expenses to the basis of parcel P.

HOLDINGS

(1) A nonresident alien individual or foreign corporation may not make an election under section 871(d) or 882(d) of the Code for a taxable year in which the foreign taxpayer does not derive income from U.S. real property.

(2) A nonresident alien individual or foreign corporation may not make an election under section 266 of the Code to capitalize real estate taxes, mortgage interest, and other carrying charges attributable to unimproved and unproductive U.S. real property if, during the taxable year in which such expenses are incurred, such expenses are not allowable deductions under section 873(a) or 882(c).

Rev. Rul. 70-424, 1970-2 CB 150

M, a foreign corporation, and Q, a domestic corporation, entered into an agreement under which M conveyed to Q the sole agency for the sales of its products in the United States. Q agreed to make sales of such products within the United States and not to make sales of the same kind of products of any other company except on express permission from M. Q further agreed not to make sales of M's products to purchasers domiciled outside the United States or to any competitor of M without consent of M and not to take a financial interest in any competitor of M. It is also provided that Q will secure yearly contracts which will be subject to the approval of M. Q assumes the full responsibility for the sales of M's product and acts as guarantor. However, M agreed to share equally with Q any loss incurred up to a specified amount in any one year during the life of the agreement. Under the agreement Q is to receive a commission based on a graduated percentage of the selling price of the products.

Held, the arrangement is one of ordinary principal and agent through which M carries on its activities in the United States and thus is engaged in trade or business within the United States. M is, therefore, subject to the provisions of section 882 of the Internal Revenue Code of 1954.

G.C.M. 21219, C.B. 1939-1, 201, is hereby superseded, since the position stated therein is set forth under the current statute and regulations in this Revenue Ruling.
Further Chapter 5 Problems (U.S. Trade or Business)

1. African Art Traditions, Ltd. (‘‘Traditions’’) is a long-established, family-owned company organized and operated in a West African country to purchase art objects produced by artists and craftsmen in West Africa and sell them to tourists visiting the country. Traditions has never sold such objects in the United States. However, the scion of the family has recently returned to the home office of Traditions after completing study in the United States that included courses in sales and marketing. He has convinced his family that West African art could generate big volume sales at substantial profit in many of the more chic stores in the United States. Members of the family have invited U.S. department store buyers to the home office to discuss the potential market for West African art in the United States. As a result of these discussions, the family has determined to start exporting art to the United States, aiming at substantial sales to a limited number of stores (20 or 25). They are considering a number of possibilities:
   a. Have no representation in the United States. Sell only to U.S. department store buyers who visit the home office or other countries in the region where Traditions has agents. In addition, sell to U.S. buyers who order by phone, fax, mail or on the Internet.
   b. Have a Traditions officer visit the United States annually for three or four months to travel throughout the country promoting and selling the art to department stores and accepting orders, which would be forwarded for approval to the Traditions home office. Traditions would have no warehouse, office or other fixed place of business in the United States. Art would be shipped from the home office directly to the customer.
   c. Have a permanent sales office, but no warehouse, in the United States staffed with Traditions personnel. Art objects would be shipped from the home office directly to the customer.
   d. Have Traditions set up no sales office in the United States, but retain under contract an independent sales agent that has a U.S. office and employees who will organize marketing efforts and conduct sales campaigns in the United States.
   e. Authorize an independent sales agent, in addition to the activities described in d., to solicit, negotiate and accept orders for art in the name and on behalf of Traditions.
   f. Have Traditions establish a shop on Fifth Avenue in New York that would maintain a modest inventory. The shop would sell directly to customers, fill orders by mail, fax or on the Internet received from customers in certain Central and South American countries and accept orders from customers in Asian countries that would be forwarded to and filled by shipments directly from the home office to the customers. All sales would be under commercial terms prescribed by the home office. However, employees in New York would have the power to decide whether or not to accept and fill all orders.

Traditions would much prefer to operate under method a., but business exigencies may dictate the use of one of the other methods. In each case consider whether it matters to your analysis if title to the art objects passes outside or within the United States. You have been retained primarily to offer U.S. tax advice. The only income taxes imposed in Traditions’ home country are on oil production and mining. The family has become quite accustomed to receiving its income without fiscal erosion and would like to keep it that way. Advise them.

2. How, if at all, would your answers in Problem 1 be modified if Traditions also hired craftsmen as employees to produce art objects for the corporation at its headquarters?
ISSUE
Whether, in the situations described below, securities held by a United States branch of a foreign bank and recorded on its books are attributable to the United States branch or to the home office.

FACTS
P, a foreign corporation whose home office is located in foreign country X, is actively engaged in the conduct of the banking business within the United States within the meaning of section 1.864-4(c)(5)(i) of the Income Tax Regulations through B and C, P's United States branch offices. B has in its possession and has recorded on its books interest bearing securities of related and unrelated United States corporations evidencing funds advanced by B to these borrowers. Typically, the branch offices' participation in the loan acquisition process varies and is described in the situations presented below.

Situation 1: Unrelated Party Loans
B has full-time permanent employees who are account officers. These account officers contact financial officers of medium size United States companies. Through scheduled appointments, the account officers propose terms to prospective customers, and, if a customer is interested in the terms being offered, the customer executes a credit application. B transmits the credit application to C, which is staffed with personnel particularly capable of performing credit analysis, security evaluation, and other research functions. C's findings are forwarded to B. The account officer incorporates C's findings into a loan package which is forwarded to a credit committee composed of officers from B and C. The credit committee generally approves or rejects the loan package. In some cases, the committee will suggest modification of terms, in which case further negotiation by the account officer with the customer is necessary. Once the customer has agreed to terms and those terms are approved by the credit committee, B prepares the loan documentation and forwards it to the customer for signature. After the customer has signed, B funds the loan.

Situation 2: Related Party Loans
P has a wholly-owned United States subsidiary, S, which is actively engaged in equipment leasing and related services. S is in need of additional funding for expansion of its operations. The home office of P reviews S's expansion plans, evaluates the customer orders and the credit worthiness of the customers' future receivables, and approves the loan. P funds the loan through B, by increasing B's capital and having B loan the funds to S. B actually disperses the funds to S. As evidence of the loan, S executes a promissory note in favor of B. B services the loan throughout its term.

Situation 3: Loan Participations
An unrelated foreign multinational corporation, Z, is solicited by P's home office and negotiates with that office for lines of credit that far exceed the funding capability of an individual branch such as B. In cases where P has approved such a large line of credit, it does so in anticipation that its various branches will participate in the funding of the loan. Regarding B's participation, P's home office forwards the loan documentation to B and instructs B, subject to B's normal credit analysis and other loan review procedures, to fund a part of the loan to Z. Z's wholly-owned domestic subsidiary contacts B for purposes of obtaining the designated loan amount. With the benefit of the information contained in the prior loan documentation forwarded from P, an independent global credit analysis is not performed by B. However, an account officer of B negotiates with Z's United States subsidiary for the necessary collateral which is standard under B's loan practices. C performs a thorough credit analysis of Z's domestic subsidiary, evaluates the collateral and confirms to B that the collateral is adequate to secure the loan. B funds the loan.
Section 881(a)(1) of the Internal Revenue Code generally imposes a tax of 30 percent on any interest received by a foreign corporation from United States sources, to the extent the interest is not effectively connected with the conduct of a United States trade or business. Although "portfolio interest" is exempt from the 30% withholding tax under section 881(c), "portfolio interest" does not include interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, unless the interest is paid on an obligation of the United States Government. Section 881(c)(3)(A).

Section 1.864-4(c)(5)(ii) and (iii) of the regulations provides special rules for determining whether income from securities is effectively connected with the active conduct of a banking, financing, or similar business within the United States. Subdivision (ii) requires the securities be acquired in the course of conducting specified activities, or, the securities consist of particular types. In addition, the securities must be considered attributable to a United States office through which the banking, financing, or similar business is carried on.

Subdivision (iii) provides that a security is attributable to a United States office only if such office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the security. However, a United States office need not have been the only active participant in arranging the acquisition of the security.

HOLDING

Situation 1

The activities of B and C are considered to be active and material with respect to the acquisition of the security. B or C solicited and negotiated the loan, performed the credit analysis and loan review, and approved the loan. These factors demonstrate that P's branch office operation had the requisite authority and capability to make the loan and in fact performed all material functions with respect to the making of the loan. Accordingly, the interest income from the security held by B is considered effectively connected with the active conduct of a banking and finance business in the United States.

Situation 2

B did not actively and materially participate in the acquisition of the loan merely because it funded the loan. All essential functions in connection with the loan were performed by P's home office. Therefore, the interest income received with respect to the security evidencing the related party loan to Z is not effectively connected with the active conduct of the banking, financing, or similar business within the United States. The Service will closely scrutinize loans made to related parties to determine whether a United States branch office actively and materially participates in arranging the acquisition of the securities. Absent facts clearly indicating active and material participation by a United States branch office including contemporaneous written evidence documenting such participation, it will be presumed that the office did not actively and materially participate.

Situation 3

B's and C's activities are considered active and material. Although P's home office solicited and negotiated the overall line of credit, B negotiated the collateral for the loan and C performed an independent credit analysis and evaluation of the collateral prior to the granting of the loan. The fact that P's home office also actively and materially participated in the acquisition does not affect this result.
Rev. Rul. 75-253, 1975-1 CB 203

Advice has been requested whether foreign source interest income received by the taxpayer, under the circumstances described below, is effectively connected with the conduct of a trade or business within the United States under section 864(c)(4) of the Internal Revenue Code of 1954.

The taxpayer, a foreign subsidiary of a United States commercial bank, is incorporated in country M, and is in the business of making loans to organizations doing business in less developed countries. The taxpayer has offices in country M and in the United States. The taxpayer's United States office handles the negotiation and acquisition of the securities involved in the loan transactions. The United States office presents interest coupons for payment and presents all securities for payment at maturity. It maintains complete photocopy files of the taxpayer's outstanding loans as well as records indicating dates of maturity of and interest payments on the securities. The only business activities of the taxpayer's office in country M, which had a skeleton staff, consisted of receiving and storing the original securities and giving pro forma approval of the loans.

Section 864(c)(4) of the Code provides, in part, that interest income from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a foreign corporation if such corporation has an office or other fixed place of business within the United States to which such income is attributable and such income is derived in the active conduct of banking, financing, or similar business within the United States.

Section 1.864-5(a) of the Income Tax Regulations provides, in part, that foreign source income realized by a foreign corporation engaged in a trade or business in the United States shall be treated as effectively connected with such trade or business only if the foreign corporation has in the United States an office or other fixed place of business to which such income is attributable in accordance with section 1.864-6.

Section 1.864-6(b)(2)(ii)(b) of the regulations provides, in part, that the determination as to whether foreign source interest income derived by a foreign corporation in the active conduct of a banking, financing, or similar business in the United States shall be treated as effectively connected with the active conduct of that business, shall be made by applying the principles of paragraph (c)(5)(ii) of section 1.864-4.

Section 1.864-4(c)(5)(ii) of the regulations states, in part, that United States source interest income derived by a foreign corporation engaged in a trade or business in the United States shall be treated as effectively connected with the conduct of that business only if the securities giving rise to such interest income are attributable to the United States office through which such business is carried on and were acquired in a certain manner or consist of certain types of securities.

Section 1.864-4(c)(5)(iii)(a)(2) of the regulations states, in part, that for the purposes of section 1.864-4(c)(5)(ii) a security shall be deemed to be attributable to a United States office only if such security is or was held in the United States by or for such office and recorded on its books or records as having been purchased or acquired by such office or for its account.

The reference to the principles of section 1.864-4(c)(5)(ii) of the regulations in section 1.864-6(b)(2)(ii)(b) does not mean that the provisions of section 1.864-4(c)(5)(iii)(a)(2) will determine whether foreign source income is effectively connected with a United States banking, financing, or similar business. Section 1.864-4(c)(5)(iii)(a)(2) provides a standard for determining whether United States source interest income received by foreign banks of financing companies through the efforts of their United States offices will be taxed a flat rate under section 881 of the Code or at graduated rates under section 882 in order to enable such taxpayers to conduct business within the United States with some certainty as to the tax consequences of their activities.

However, in the case of foreign source interest income earned by foreign banks or financing companies in the United States, the question is not whether such interest is to be taxed at ordinary or flat rates, but
whether said interest is to be taxed by the United States at all. Therefore, section 1.864-4(c)(5)(iii)(a)(2) applies only in the case of United States source income that is to be treated as effectively connected with a United States banking, financing, or similar business with the result that foreign source income (interest, dividends, etc.) may be effectively connected with the active conduct of a United States banking, financing, or similar business despite the wording of section 1.864-4(c)(5)(iii)(a)(2). A foreign corporation cannot, for example, avoid the taxation of effectively connected foreign source income simply by holding securities outside the United States.

In the instant case, the taxpayer is engaged in the active conduct of a banking, financing, or similar business in the United States within the meaning of section 864(c)(4) of the Code. Moreover, since the taxpayer's United States office performed all the significant tasks relating to the negotiation and acquisition of the securities, with the sole exception of storage of the securities, the interest income derived from the securities is attributable to the taxpayer's United States office within the meaning of the regulations under section 864. Accordingly, foreign source interest income derived by the taxpayer from the securities is effectively connected with the conduct of a trade or business within the United States under section 864(c)(4) of the Code.

**SWALLOWS HOLDING, LTD. v. COMMISSIONER**

515 F.3d 162 (3rd Cit. 2008)

Judge: ROTH, Circuit Judge

This case, grounded in the principles of administrative law, requires that we review the validity of an Internal Revenue Service (IRS) regulation. *** The IRS has appealed a United States Tax Court decision that held Treas. Reg. 1.882-4(a)(3)(i) to be invalid. Petitioner-appellee Swallows Holdings, Ltd. (Taxpayer) is a Barbados corporation with two principal shareholders, Raimundo Arnaiz-Rosas and Aurora Elsa Arnaiz. On September 14, 1992, Taxpayer filed its first federal income tax return. In its return, Taxpayer reported that it held real property in San Diego, California. Between 1993 and 1996, Taxpayer generated rental income from the San Diego property. It was not until 1999, however, that Taxpayer filed returns for tax years 1993, 1994, 1995 and 1996.

A foreign corporation, engaging in trade or business in the United States, is taxed on its taxable income that is connected with the conduct of that trade or business. 26 U.S.C. § 882(a). Deductions from income are allowed only if they are connected with the "income which is effectively connected with the conduct of a trade or business within the United States." Section 882(c)(1)(a). However, foreign corporations that do not engage in a trade or business in the United States are taxed at a flat rate of thirty percent of any amount received from sources within the United States. Section 881(a). The Internal Revenue Code, generally speaking, does not allow these foreign corporations to claim deductions. Section 882(c)(2). Nevertheless, if a foreign corporation conducts real property activity in the United States, the foreign corporation can treat the income derived from the real property activity as income from a "trade or business," thus qualifying the foreign corporation to claim tax deductions (e.g., interest and taxes) that are otherwise unavailable. Section 882(d)(1).

The dispute in this case arises from the filing deadlines set forth in Treas. Reg. 1.882-4(a)(3)(i), which the Secretary of the Treasury promulgated to supplement section 882(c)(2). The regulation requires that a foreign corporation file a return within eighteen months of the filing deadline set in section 6072 in order to claim the real property activity tax deductions. Here, Taxpayer filed the tax returns in question well after the expiration of the eighteen-month filing period. The Commissioner assessed tax deficiencies accordingly.

Taxpayer challenged the Commissioner's

II. Discussion

A. Jurisdiction

We have jurisdiction to review the final judgment of the Tax Court pursuant to I.R.C. § 7482(a)(1). ***

As we did in Armstrong World Industries, we will look to Chevron here to determine the validity of Treas. Reg. 1.882-4(a)(3)(i). ***

1. Chevron Step One: Ambiguity of the Statutory Text ***

Under Chevron, if the statutory language is clear and unambiguous, our inquiry ends and the plain meaning of the statute governs the action. 467 U.S. at 842-43. If, however, the statutory provision is ambiguous, such ambiguity is viewed as an implicit congressional delegation of authority to an agency, allowing the agency to fill the gap with a reasonable regulation. MCI Telecomm. Corp. v. Bell Atlantic-Pa., 271 F.3d 491, 515-16 (3d Cir. 2001). The inquiry into the ambiguity of a statutory provision must begin with the text of the statute. The text of I.R.C. § 882(c)(2) reads in pertinent part:

A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all information which the Secretary may deem necessary for the calculation of such deductions and credits.

Our inquiry focuses on the requirement that foreign companies file "with the Secretary a true and accurate return, in the manner prescribed in subtitle F." Taxpayer argues that the word "manner" does not by its nature include a timing element, thus indicating that Congress did not intend for a filing deadline to exist. This is an overly narrow interpretation of "manner." Courts that have interpreted "manner" as used in I.R.C. § 882(c)(2) and its predecessors have struggled over whether "manner" includes a timing element, which indicates that the language is not clear and unambiguous. Compare Anglo-American Tea Trading Co. v. C.I.R., 38 B.T.A. 711, 714 (1938) (discussing divergent conclusions and adopting interpretation that excludes a "timing" element), with Espinosa v. Comm'r, 107 T.C. 146, 156 (1996) (reasoning that provision embodied some "cut-off" period, even if not expressly stated).

Moreover, Congress uses "manner" without "time" in other sections of the Code, and, in some of these situations, "manner" has been interpreted to implicitly include a timing element. See I.R.C. §§ 179(c), 835(c)(2). In these provisions, Congress did not use the phrase "time and manner," yet the Secretary promulgated valid regulations that include temporal components. See Treas. Reg. §§ 1.179-5(a), 1.826-1(a)(3)(i). Thus, Congress does not uniformly use the phrase "time and manner," when it desires a particular Code provision to embody a timing element. Rather, we find "manner," depending on the context, may be a comprehensive term. As used in this instance, the word "manner" may be defined as "a characteristic or customary way of acting." Webster's Dictionary 724 (9th Ed. 1986). Under this definition, the provision is not a clear and unambiguous expression of congressional intent, as one's "customary way of acting" may include an element of timeliness. Further, Congress's use of "manner" in I.R.C. § 882(c)(2) prompts contextual ambiguity. We could read "manner" to refer to subtitle F, which itself includes timing elements. Alternatively, we could read this provision as indicating that Congress did not wish the timing requirements of subtitle F to apply. Reading the statute this way would not foreclose the Secretary from promulgating a regulation that sets a filing deadline. Instead, it would only restrict the Secretary from promulgating a regulation that would embody the
2. Chevron Step 2 - Reasonableness of the Secretary's Action

Our inquiry is not yet at its end, as we will only defer to the Secretary's action if it is a permissible construction of I.R.C. § 882(c)(2). See Woodall, 432 F.3d at 248 (citing Chevron, 467 U.S. at 842-43). We "need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question had arisen in a judicial proceeding." Chevron, 467 U.S. at 843 n.11. Often, a promulgated rule is the culmination of intense debate between the agency, Congress, other members of the Executive Branch and the public. Rules represent important policy decisions, and should not be disturbed if ""this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute ...."" Id. at 845 (quoting United States v. Shimer, 367 U.S. 374, 382-83 (1961)). Further, Chevron deference is ""even more appropriate in cases"" that involve a ""complex and highly technical regulatory program ...."" Robert Wood, 297 F.3d at 282 (quoting Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994)). The Code is indisputably complex and technical, and we will adjust our inquiry accordingly.

In this case, the Secretary has promulgated a rule that creates an eighteen-month window within which foreign companies must file a federal tax return in order to claim rental activity tax deductions. Taxpayer argues that previous cases upholding the disallowance of deductions under I.R.C. § 882(c)(2) involved filing deadlines that permitted at least a two year window within which foreign corporations could have filed timely tax returns. From this, Taxpayer draws the conclusion that it is unreasonable for the Secretary to promulgate a rule with a filing period of less than two years. We find Taxpayer's argument to be unpersuasive. The Secretary will, under the current regulation, allow a foreign company to file eighteen months after the filing was originally due. Moreover, because I.R.C. § 6072(c) already provides for a five and one-half month filing period, foreign companies have, in practice, twenty-three and one-half months to submit a "timely" return. It is not unreasonable for the Secretary to impose such a deadline.

Additionally, we believe that drawing this temporal line is a task properly within the powers and expertise of the IRS. Chevron recognizes the notion that the IRS is in a superior position to make judgments concerning the administration of the ambiguities in its enabling statute. In this case, the IRS found that eighteen months served as a balance between its desire for compliance with the federal tax laws and a foreign corporation's desire to obtain valuable tax deductions. Therefore, we hold that the eighteen-month filing window created by Treas. Reg. 1.882-4(a)(3)(i) is a reasonable exercise of the Secretary's authority.

III. Conclusion

For the forgoing reasons, we will vacate the judgment of the Tax Court and remand this case for further proceedings in accordance with this opinion.
Further Review Problem on Branch Profits Taxation (page 191)

6. Suppose that the U.S. branch of FC had paid interest of $20,000 during the year to various unrelated creditors but that it properly deducted interest of $25,000 in determining its effectively connected income on the basis of the interest allocation rules. Would there be an additional branch profits tax? How much?

7. How, if at all, would your answers to the Problems 1 through 5 in the casebook and Problem 6 be affected if the U.S. Model Treaty were in force between the United States and FC’s country of residence?

Further Review Problems after Completing Chapter 5 (Review of Chapter 4 and 5 Concepts) (page 202)

The Problems that follow are intended to bring together many of the considerations raised by the materials in this and the prior two chapters. In each instance analyze the result under the usual sources of U.S. income tax law; then, consider whether your answer would be modified if the U.S. Model Treaty were in force with respect to the transaction.

1. Dickens, a citizen and resident of the United Kingdom, occasionally purchases and sells securities on the New York and American Stock Exchanges. He effects his transactions through a stockbroker in New York City, who is instructed by telephone from London. During the tax year, Dickens made 20 purchases and 15 sales. He received dividends during the year of $30,000 from his shares. He realized gains of $200,000 and losses of $100,000 from transactions involving the shares. Dickens wishes to know the extent of any U.S. income tax liability. Advise him.

2. In Problem 1 would Dickens’ U.S. taxes be reduced if he had realized losses of $230,000?

3. The broker in Problem 1 has recently suggested that Dickens give him discretionary authority to buy and sell “to exploit fast-breaking market conditions.” Would such an arrangement affect your earlier responses?

4. Carlson, a citizen and resident of Denmark, is a commodities dealer operating in Copenhagen. During the tax year, Carlson, by e-mail from her home office, purchased several carloads of wheat. She took title to the wheat in Minneapolis. The wheat was sold to the government of India, FOB New York City, where the wheat was placed aboard a Liberian flag vessel. Carlson has never been to the United States. While she has occasionally purchased U.S. commodities in the past, this is her sole transaction in the United States during the current year. Does she have any potential U.S. income tax liability?

5. Rosario, a corporation organized in Argentina, sells consumer products to retailers in the main cities of that country. Rosario has no office in the United States. Rosario sales representatives in Argentina send orders to a purchasing agent in New York. The purchasing agent purchases the products from U.S. manufacturers in Rosario’s name. The products are shipped to Miami and delivered to vessels bound for Argentina. Orders are accepted in Argentina. Title to the goods is transferred to customers at the port of destination. However, the customers have agreed contractually to insure against all losses attributable to shipwreck, fire and accident while the goods are in transit. The Argentine customers make payment to an account maintained by Rosario in
Switzerland. Does Rosario have any liability for U.S. taxes? Would your answer differ if the purchasing agent is properly characterized as an “independent agent”? 

6. Empire, Ltd. (‘‘Empire’’), is a German corporation engaged in the sale of machinery parts to various customers throughout Europe. For many years Empire purchased the parts from Colonial Ohio Corp. (‘‘Colonial’’), an Ohio corporation, in Youngstown, Ohio. Although Empire has no U.S. office, it took title to the parts in Youngstown, transported the parts to Europe and made delivery to its European customers. The two companies are each wholly owned by a Swiss holding company. Does Empire have any U.S. income tax liability? Should the relationship between Empire and Colonial affect the analysis?

7. The method of operation in Problem 6 has recently changed. Empire now arranges sales between Colonial and the European customers. The parts are delivered FOB Youngstown where title passes to the customers, who then pay all shipping costs. Empire receives a 20–percent commission from Colonial whenever customer payments are received. Does Empire have any U.S. income tax liability? Should the prior arrangement between the corporations affect the analysis?

8. Mimi Manon is a well-known soprano from France. While visiting Los Angeles for one week several years ago, Manon made a highly acclaimed recording which broke sales records around the world. Manon has returned to her home in France, where she receives monthly checks equal to ten percent of the gross revenues produced by worldwide record sales in accordance with a written contract between Manon and the U.S. recording company. The contract describes such payments as ‘‘royalties.’’ Does Manon have any U.S. income tax liability? Does the recording company have any obligation to withhold?

9. Horatio, a citizen and resident of Ireland, is an equal partner with Imogene, a U.S. citizen, in a consulting firm operating out of a Miami office and serving clients located in Florida. Under the terms of the partnership agreement, Horatio and Imogene are to share equally in profits and losses. During the course of the year, Horatio devotes 100 days to the venture, but works primarily at home in Dublin and communicates with his partner and his clients by telephone, fax and Internet. In fact Horatio is actually in the United States only ten days during the year. During the year the partnership earns net income of $200,000, all of which derives from the provision of consulting services by the partnership to clients in the United States. All of the partnership income is reinvested in the business and none is distributed to the partners. Horatio has no other economic involvement in the United States. To what extent, if at all, will Horatio be subject to U.S. income taxes for the year?

10. Leonardo and Verdi, citizens and residents of Italy, purchased some undeveloped farm land in Iowa for $1 million. They have leased the land to a tenant farmer who completely manages the agricultural use of the land, pays all real estate taxes (which amount to $80,000 annually) and pays an annual rental of $100,000. How should Leonardo and Verdi minimize their U.S. income tax liabilities in respect of the leasehold arrangements?

11. After a number of years Leonardo and Verdi have decided to sell the land and are delighted to have received an offer of $10 million for the property. Will they be taxed on the gain realized from the sale? Could they have avoided U.S. tax on the gain if they had not elected to minimize U.S. taxes in Problem 12?

12. Romano, a citizen and resident of Colombia, invested $6 million in Knickerbocker, a wholly owned U.S. corporation. Knickerbocker acquired an apartment building in New York for $2
million, purchased $2 million of stock in small holdings of publicly traded U.S. companies and
invested $2 million in a fancy art gallery operated in rented space on Fifth Avenue that produced no
U.S. real property income. Although the art gallery has been subject to an annual lease with no right
of renewal, it has been operated at the same location since its establishment. After only five years,
Knickerbocker was worth $100 million and Romano has decided to sell the company. Determine
how much, if any, of Romano’s gain will be subject to U.S. income taxes in the circumstances
described below. Assume that the property values indicated in each case represent the maximum
values during the five years since Knickerbocker was organized.

a. The apartment building is worth $60 million; the stock is worth $20 million; the
gallery assets are worth $20 million.
b. The apartment building is worth $40 million; the stock is worth $40 million; the
gallery assets are worth $20 million.
c. The apartment building is worth $40 million; the stock is worth $20 million; the
gallery assets are worth $40 million.
d. The apartment building is worth $100 million, but is subject to a mortgage of $80
million which secures loans to Knickerbocker used to finance art inventory
purchases and executive bonuses; the stock is worth $40 million; the gallery assets
are worth $40 million.

13. If Knickerbocker were a corporation organized in the Cayman Islands, in which of the
circumstances described in Problem 14 would Romano be subject to U.S. income tax on the sale of
stock in the corporation?

14. Blue Water Resorts Inc. (“Blue Water”), a U.S. corporation whose shares are not publicly
traded, operates resort hotels in many countries of the Caribbean, but does not operate in the United
States. By the end of Year 1, Blue Water owned real property in various other countries with an
adjusted basis of $10,000,000 and a value of $30,000,000. In Year 2, Blue Water acquired
American Paradise Co. (“Paradise”), a Bahamas corporation that operated resort properties in
Florida. In fact all of the assets of Paradise consisted of real property in the United States. The value
of the Paradise real property, which was also the purchase price paid by Blue Water for the stock,
was $40,000,000, but the adjusted basis of the real property to Paradise was only $5,000,000. In
early Year 3, Casino, a nonresident alien of the United States, realized a profit of $1,000,000 from
the sale of shares in Blue Water. Is the gain realized by Casino subject to U.S. income tax?
Chapter 6
Rev. Rul. 87-71, 1987-2 CB 148

ISSUE

How is the arm's length price of iron ore determined under section 482 of the Internal Revenue Code under the circumstances described below?

FACTS

S, a wholly owned foreign mining subsidiary of domestic corporation P, operates an iron ore mine in a foreign country. The ore is extracted from the ground and loaded at the mine for shipment by rail to a seaport. The ore is a direct shipping grade ore suitable for blast furnace feed and needs no concentration. After nonmining transportation, the ore is unloaded from rail cars at the seaport and loaded on seagoing vessels for shipment to purchasers.

All of the ore is sold at the port to various purchasers, including P and unrelated purchasers in geographic market A and unrelated persons in geographic market B. The ore is processed in the geographic market of each purchaser. All sales prices include the cost of transportation to the purchasers in both geographic markets. The cost of transportation to the purchasers in both geographic markets is the same. Due to economic conditions existing in each marketplace, S is able to sell its ore to unrelated purchasers in geographic market B at a price which is substantially higher than the price at which the ore is sold to unrelated purchasers located in market A. The economic conditions have a definite but not reasonably ascertainable effect on the price of ore in each market.

The price charged by S for the sale of ore to P is substantially higher than the price charged for the sale of ore to unrelated purchasers located in geographic market A.

LAW AND ANALYSIS

Section 1.482-2(e)(1) of the Income Tax Regulations provides that, where one member of a group of controlled entities sells or otherwise disposes of tangible property to another member of such group at other than an arm's length price, the district director may make appropriate allocations to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid for the property under the same circumstances. Section 1.482-2(e)(1)(v) of the regulations provides that the selling price, for purposes of section 482 of the Code, of mineral products (other than oil and gas) sold to related parties at the stage at which mining ends will be determined under the provisions of section 1.613-4.

Section 1.613-4 provides rules for the determination of gross income from minerals (other than oil and gas) at the stage at which mining ends.

Under the facts of this case, the direct shipping grade ore was extracted and shipped by rail to the seaport. The only processes applied at the mine were extraction and loading for shipment to the port. Therefore, mining ended when the ore was loaded for shipment to the port. This was followed by nonmining transportation to the port prior to sale. Since a nonmining process involving transportation occurred before the sale in the case of both related and unrelated party sales, the special rule in section 1.482-2(e)(1)(v) of the regulations does not apply.

The determination of an arm's length selling price under section 1.482-2(e)(2) of the regulations is primarily factual. Section 1.482-2(e)(2)(ii) provides that uncontrolled sales are considered comparable to controlled sales if the circumstances involved in the uncontrolled sales are so nearly identical to the controlled sales that
any differences can be reflected by a reasonable number of adjustments to the price of the uncontrolled sales. Differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. One difference which may affect the price of property is a difference in the geographic market in which the sale takes place.

In this case, the economic conditions present in geographic market $B$ have a definite effect on the price of ore sold in that marketplace. However, the amount of the adjustment in price to reflect the difference in economic conditions cannot be reasonably ascertained. Thus, the price of ore sold to unrelated purchasers in geographic market $B$ cannot be adjusted to account for differences in economic conditions in the two geographic markets and, therefore, cannot be considered to be comparable to the arm's length price charged for ore in geographic market $A$.

In *Paccar, Inc. and Subsidiaries v. Commissioner*, 85 T.C. 754 (1985), Tax Court held that the comparable uncontrolled price method was not applicable due, in part, to the fact that the controlled sales and uncontrolled sales were made into different geographic markets and the adjustments needed to account for the differences in the geographic markets had not been established.

The uncontrolled sales by $S$ to purchasers in geographic market $A$, in which $P$ is located, are comparable to the sales $S$ made to $P$. The price $S$ charged $P$ for ore is substantially higher than the price charged to unrelated purchasers located in the same market. Accordingly, the price $S$ charged $P$ for ore is not an arm's length price.

**HOLDING**

The provisions of section 1.482-2(e)(2) of the regulations are applicable under the circumstances described, and only the uncontrolled sales made to the purchasers located in geographic market $A$ are considered in establishing an arm's length selling price for purposes of section 482 of the Code.

**Chapter 6—Note to Students**

Under the “one-sided” transfer pricing methodologies, one party is “tested” and a routine profit is given to that tested party. The following methods should be put under the descriptive category” of a “one-sided” transfer pricing methodology: (i) the uncontrolled price method, (ii) the resale price method, (iii) the cost plus method, and (iv) the comparable profits method. Each of these transfer pricing methods seek to isolate one or more (but not all) of the related party entities and identifies this sub-group of affiliates as “tested parties” leaving aside one (or more than one) affiliate as an “untested party.” The underlying reasoning for each of these “one-sided” transfer pricing methodologies is that if the tested party’s share of the combined income meets the arm’s length standard, then as a matter of logic the untested party’s income by inference must also meet this standard even though it remains untested. Thus, the impact of using a “one-sided” transfer pricing methodology is that the “tested party” is allocated a routine profit based on an analysis of what unrelated companies would routinely earn for their identified functions while the untested party keeps all of the residual income (i.e., the combined income less the routine profits allocated to the tested party).

A “one-sided” transfer pricing methodology may work well when there are only routine profits to be divided among affiliates. However, when residual profits exist, a “one-sided” transfer pricing methodology does not explain why residual profits should reside with any particular entity
and simply assumes that the untested party should be the recipient without further explanation. This is the essential paradigm that allows the base erosion and profit shifting problem to exist. “One-sided” transfer pricing methodologies simply accept this outcome.

“One-sided” transfer pricing methodologies consequently put strong emphasis on the foundational question of which party should be the “tested party” and which party should not be tested, as it is only the “tested party” whose profits are benchmarked. The section 482 regulations answer this crucial, outcome dispositive question by stating that the “tested party” should be the controlled party whose operating profit can be verified using the most reliable data and requires the fewest and most reliable adjustments. Therefore, the “tested party” should be the least complex of the controlled taxpayers and should lend itself to comparison with uncontrolled comparable taxpayers. Once agreement is reached on the risk-function responsibilities between the pertinent affiliates and which party should be the “tested party,” the profit allocations are no longer controversial because the routine profits attributable to routine functions are common knowledge among those experienced in transfer pricing matters—both for the taxpayer and the taxing authority.

However, what is controversial, and what has made a decided impact on the outcome of the section 482 transfer pricing controversies, is the foundational question of which affiliate is framed as the complex “untested party” and which affiliate is framed as the straightforward “tested party.” In a potential base erosion context where there is more than routine income on a combined basis, taxpayers will understandably desire to frame their U.S. affiliate as the straightforward “tested party” entitled to only a routine profit margin and frame their low-taxed foreign affiliate as the complex “untested party” entitled to all the residual profits without further explanation.

It is with respect to this critical dispositive framing game where “one-sided” transfer pricing methodologies make a significant difference in the ultimate outcome of a transfer pricing dispute. In this regard, a taxpayer can designate one or more affiliates of its group to be the risk taker with respect to a particular trading pattern. The risk taker is often located in a low-tax jurisdiction and given the “complex profit picture” through intercompany agreements executed among and with other parties. The U.S. affiliate assumes the role of non-risk taker providing only routine functions.

If the U.S. affiliate provides “straightforward” service-related functions, then it would be allocated a routine profit (typically using the comparable profits or cost plus methods). If the U.S. affiliate were to provide “straightforward” manufacturing-related activities, then it would be allocated a routine profit for those activities as well (typically using a resale profit methodology). To make such a planning structure effective, all non-routine intangibles must be owned by the offshore affiliate (via qualified cost sharing agreements, developed by the foreign affiliate itself with its own personnel, or acquired through some other form of transfer or contribution).

Again, the desired transfer pricing result is to frame the non-risk taking U.S. affiliate as the “tested party,” whereas the risk taking tax haven affiliate is factually presented as “complex” and thus entitled to be framed as the “untested party” receiving all residual profits without explanation. Thus, through active advance tax planning and the use of a “one-sided” transfer pricing methodology, the groundwork is in place to create significant amounts of homeless income in tax haven jurisdictions that is blessed by the section 482 regulations and need not be explained to anyone.

The result of this framing game lying at the heart of “one-sided” transfer pricing methodologies is an ad hoc, “all or nothing” scorecard with respect to the holdings of cases involving the IRS’s efforts to tax residual profits of a multinational enterprise. The transfer pricing dispute in cases
utilizing “one-sided” transfer pricing methodologies is not over the routine profit; it is typically over the residual profits.

The holding in U.S. Steel, discussed in the casebook, is (in)famous because it moved the Venezuelan location advantage out of the company conducting business in Venezuela and into a tax haven subsidiary that was neither located in the country of origin or in the country where the product was shipped. The critical lesson from U.S. Steel and its progeny is that a significant number of transfer pricing cases can be explained by the dispositive question of which party should be isolated as the “tested party” and which party should be left untested. However, few present the framing game as dramatically as in U.S. Steel due to the fact that residual profits in that case were allocated entirely to a tax haven subsidiary that served solely a risk taking function. The risk-taker determination is, of course, a factual question upon which a taxpayer and tax authority can have dramatically different views. The cumbersome process of resolving such factual disputes is also well illustrated by U.S. Steel, in which the essential facts related to the taxpayer’s 1957 through 1960 tax returns, while the case was ultimately resolved in 1980.

In an effort to achieve better results for the federal budget, the IRS began to formulate a variety of theories upon which to argue that the tested party and the untested party should be switched. When the IRS argued simply that it would seek to reformulate the internal economic arrangements and risk-assignment put into place by the taxpayer, so as to place the reconstructed arrangement in a light more favorable to the government, the argument was soundly rejected. Courts consistently upheld the economic and contractual relationships existing among related parties when those arrangements were legitimate business transactions put into place before the risks and rewards were determined. Thus, courts have rejected the idea that section 482 permitted “substance over form” arguments. On the contrary, so long as the internal multinational enterprise’s agreements allocated true economic risks and rewards, the IRS’s authority under section 482 was solely to apply the arm’s length standard to the economic fact pattern presented by the taxpayer.

However, the IRS has had success where it could demonstrate as fact that the “tested parties” proffered by the taxpayer were themselves “complex” and incapable of being benchmarked with routine external comparable companies. For example, when the U.S. affiliate was the entity that engaged in manufacturing, the IRS argued that non-routine manufacturing know-how created and developed by the U.S. manufacturing affiliate entitled the U.S. affiliate to more than a routine manufacturing margin. When the posture changes such that the offshore affiliate is the manufacturer and the U.S. affiliate is the distributing entity, then the IRS seeks to argue that the U.S. distributor affiliate had developed its own “marketing intangible,” entitling the U.S. distributor affiliate to more than a routine distribution margin. The evolution of the concept of a “marketing intangible” is interesting and deserves further analysis. Courts have held that marketing intangibles can include customer lists, trademarks, trade names, brand names, and related customer goodwill, and the IRS has asserted an even more expansive list of situations where a marketing intangible might exist in its litigating positions with mixed success.

As matters stand, the path is clear for the government: if residual profits exist, then it must find some non-routine intangible in the hands of the U.S. affiliate, such as manufacturing know-how or a marketing intangible, that distinguishes the tested U.S. affiliate from the comparable data set of companies proffered by the taxpayer to support its use of a “one-sided” transfer pricing methodology. If the comparable data is materially and economically distinguishable, then the U.S. affiliate can be defrocked of its “sole tested party” status due to the fact that it owns non-routine intangibles that
contribute significantly to the residual profits of the combined entity.

In stark contrast to a “one-side” transfer pricing methodology, a “two-sided” transfer pricing methodology (comparable profit split and a residual profit split methods in the nomenclature of the section 482 regulations) evaluates the overall income of the affiliates and determines how to allocate the combined profits between them with all parties treated as tested parties. The residual profits are divided between those affiliates that contribute to their creation in contrast to the “all or nothing” result generally prevailing in cases decided with a “one-sided” transfer pricing methodology.

Furthermore, in contrast to the transfer pricing result achieved under a “one-sided” transfer pricing methodology, the use of a “two-sided” transfer pricing methodology requires that a profit allocation to a tax haven subsidiary be affirmatively explained as a precondition for any allocation. In other words, in a “two-sided” transfer pricing methodology, no allocation of residual profits is made unless it can be affirmatively demonstrated that the affiliate’s activities made a significant contribution to the creation of the residual profits (see Reg. §1.482-6(b) for analysis of residual profit allocations). The IRS and taxpayer, a court, or competent authorities, must determine the functions that contribute significantly to the overall residual profits and then must split the residual profits based on their relative weighting of functional importance. Although these weightings may not have been clearly understood in previous years, the current reality is that advanced pricing agreement (the “APA” process) and the treaty mutual agreement (competent authority) processes have provided a defined pathway for resolving these disputes.

Stated differently, when a “two-sided” transfer pricing methodology is used to resolve a transfer pricing dispute, the taxpayer has the burden of showing that its allocation of residual profits follows the substantive functions that created the multinational enterprise’s residual profits. If the taxpayer cannot explain how a tax haven’s activities functionally contributed to the creation of residual profits, it would receive a zero allocation. Nothing is left unexplained in a profit-split approach that employs a “two-sided” transfer pricing methodology because the contributions of the various affiliates must be demonstrated as a condition precedent for an allocation of income. As the income allocation tracks the functions that create the income in a “two-sided” transfer pricing methodology, an allocation of homeless income that is divorced from those substantive functions is unachievable.

The IRS’s first significant success in getting a court to utilize a “two-sided” transfer pricing methodology was the landmark case of 

Eli Lilly & Co. v. Commissioner. 84 T.C. 996 (1985), aff’d in part and rev’d in part, 856 F.2d 855 (7th Cir. 1988). Since Eli Lilly, the government has been able to convince courts that a two-sided transfer pricing methodology (a profit split or residual profit split) is appropriate if both parties are complex. The following case of 

Bausch & Lomb v. Commissioner, 92 T.C. 525 (1989), aff’d, 933 F.2d 1084 (2d Cir. 1991) is an important case in this line of authority, and the Tax Court’s decision in that case is excerpted below.
BAUSCH & LOMB, INC. v. COMMISSIONER
92 TC 525 (1991)

Official Tax Court Syllabus

Petitioner and its subsidiaries engaged in the manufacture, marketing and sale of soft contact lenses and related products in the United States and abroad. B&L Ireland was organized on Feb. 1, 1980, under the laws of the Republic of Ireland as a third tier, wholly owned subsidiary of petitioner. B&L Ireland was organized for valid business reasons and to take advantage of certain tax and other incentives offered by the Republic of Ireland. Pursuant to an agreement dated Jan. 1, 1981, petitioner granted to B&L Ireland a nonexclusive license to use its patented and unpatented manufacturing technology to manufacture soft contact lenses in Ireland and a nonexclusive license to use certain of its trademarks in the sale of soft contact lenses produced through use of the licensed technology worldwide. In return, B&L Ireland agreed to pay petitioner a royalty equal to 5 percent of sales. In 1981 and 1982, B&L Ireland engaged in the manufacture and sale of soft contact lenses in the Republic of Ireland. All of B&L Ireland's sales were made either to petitioner or certain of petitioner's wholly owned foreign sales affiliates at a price of $7.50 per lens. Held, respondent abused his discretion under sec. 482, I.R.C. 1954, when he determined that the $7.50 sales price did not constitute an arm's-length consideration for the soft contact lenses sold by B&L Ireland to petitioner. Held, further: The royalty contained in the Jan. 1, 1981 license agreement did not constitute an arm's-length consideration for the use by B&L Ireland of petitioner's intangibles. However, respondent's adjustment to the royalty rate was unreasonable. Sec. 1.482-2(d), Income Tax Regs., applied to determine an arm's-length consideration for use by B&L Ireland of petitioner's intangible property.

Köörner, Judge:

*** After concessions, the issues for determination are: (1) Whether respondent's allocations of gross income from Bausch & Lomb Ireland, Ltd., to Bausch & Lomb Inc. were arbitrary, capricious, or unreasonable; and (2) whether an allocation under section 482 is required to clearly reflect petitioners' income.

***

Section 482 authorizes respondent to allocate income between controlled enterprises if he determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect the true income of the controlled enterprises. The purpose of section 482 is to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers. Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972); see W. Braun Co. v. Commissioner, 396 F.2d 264, 266 (2d Cir. 1968), revg. and remanding T.C. Memo. 1967-66; sec. 1.482-1(b)(1), Income Tax Regs.

Respondent's authority to make allocations under section 482 is broad. Edwards v. Commissioner, 67 T.C. 224, 230 (1976); PPG Industries v. Commissioner, 55 T.C. 928, 990-991 (1970). Respondent's section 482 determination must be sustained absent a showing that he has abused his discretion. Paccar Inc. v. Commissioner, 85 T.C. 754, 787 (1985), affd. 849 F.2d 393 (9th Cir. 1988). The taxpayer thus bears the heavier than normal burden of proving that respondent's section 482 allocations are arbitrary, capricious, or unreasonable in order for us to redetermine the deficiency. Your Host, Inc. v. Commissioner, 489 F.2d 957 (2d Cir. 1973); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 359 (1987).

Whether respondent has exceeded his discretion is a question of fact. American Terrazzo Strip Co. v. Commissioner, 56 T.C. 961, 971 (1971). In reviewing the reasonableness of respondent's allocation under section 482, we focus on the reasonableness of the result, not the details of the methodology employed. Eli Lilly & Co. v. United States, 178 Ct. Cl. 666, 676, 372 F.2d 990, 997 (1967).

For purposes of section 482, the terms "tax avoidance" and "tax evasion" are
interchangeable. *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234, 236 (2d Cir. 1935). Respondent's determinations have been upheld where the challenged transactions were arranged solely to avoid taxes and without a valid business purpose. *Asiatic Petroleum Co. v. Commissioner*, supra.

Even in the absence of tax avoidance motives, respondent may make allocations under section 482 in order to clearly reflect the respective incomes of members of the controlled group. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 215-216 (2d Cir. 1952), revg. and remanding on this issue 16 T.C. 882 (1951). Thus establishment of a business purpose for a transaction does not necessarily insulate the taxpayer from a section 482 allocation. *Eli Lilly & Co. v. United States*, 372 F.2d at 998-999.

We have found as fact that petitioners had sound business reasons for the establishment of B&L Ireland. Petitioners had reason to believe that manufacturing capacity at its Rochester facility was inadequate to meet expected increases in soft contact lens demand. Petitioner determined that it was prudent to establish additional manufacturing capacity overseas in order to minimize regulatory delays, establish an alternative supply source to the Rochester facility, and to have a facility capable of more efficiently servicing the increasingly important European markets. Ireland was determined to be the location at which these objectives could be realized most cost effectively due to the incentives offered by the Republic of Ireland to induce the location of manufacturing facilities within the Republic. Since a non-Irish company could not receive section 84 financing, there were sound business reasons for incorporating an Irish manufacturing facility rather than merely operating the facility as a division of B&L. Although it is possible that B&L could have established the Irish facility in a manner which resulted in a greater United States tax, it is axiomatic that a taxpayer is not obligated to arrange his affairs in a manner which maximizes his tax burden. *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215, 1235 (1945). Thus respondent's determination must stand or fall based on the "clear reflection of income" prong of section 482.

As a preliminary matter, we must first address respondent's contention that it is inappropriate to analyze the transfer price and royalty rate used by B&L separately, on the theory that B&L and B&L Ireland would have constructed their relationship in a different manner had they been conducting their affairs at arm's length. Respondent argues that B&L would never have agreed to license its spin cast technology which allowed it to produce soft contact lenses for approximately $1.50 per lens and then purchase lenses from the licensee for $7.50 per lens. Respondent argues that B&L would have been unwilling to pay an independent third party much more than its costs would have been had it chosen to produce the contact lenses itself. He is indifferent as to whether the royalty is increased or the transfer price is decreased as long as the result is that B&L Ireland receives only its costs of production and a reasonable mark up. In essence, respondent argues that B&L Ireland was little more than a contract manufacturer the sale of whose total production was assured and who thus was not entitled to the return normally associated with an enterprise which bears the risk as to the volume of its product it will be able to sell and at what price.

Respondent's argument would have some merit had we found that B&L was required to purchase B&L Ireland's production of soft contact lenses. In such a case, B&L Ireland would indeed have been a contract manufacturer in substance despite the fact that ostensibly the license agreement and product purchases were not interdependent. However, we have found as fact that no such purchase requirement existed. All of the documents generated by B&L in evaluating the feasibility of the Irish lens facility indicate that it was intended to serve the foreign market with limited possible importation of Irish lenses into the United States in the event of production problems at the Rochester facility. That B&L would import substantial quantities of Irish lenses into the United States should worldwide demand not meet expectations was not guaranteed. Nor did B&L Ireland have a guarantee that the transfer price it received for its
lenses would remain at $7.50 per lens. In actuality, the transfer price was reduced to $6.50 in 1983 due to market pressures. The most that can be said is that B&L Ireland had certain expectations as to the volume and price of lenses it could anticipate selling to B&L or its affiliates. However, such expectations are no different than those which any supplier has with regard to the business of a major customer and do not constitute a guarantee which effectively insulated B&L Ireland from market risks. In a case where the license of intangibles and sale of the product manufactured to the licensor were interdependent, then the separate royalty rate and transfer price would be unimportant as long as the net result is satisfactory. The same cannot be said in this instance where both the volume and price of sales to the licensor are subject to variation. The transfer price and the royalty rate each has independent significance and will thus be examined separately.

A. Determination of Arm's-Length Prices Between Petitioner and B&L Ireland for Soft Contact Lenses.

[Editor’s Note: The Tax Court found as fact that B&L functioned as a distributor with respect to lenses it purchased from B&L Ireland and that the comparable-uncontrolled-price method of determining an arm's-length price was the best method to determine the arm’s length pricing as to this arrangement and that the third-party transactions identified by the taxpayer provided ample evidence that the $7.50 per-lens price charged by B&L Ireland is equal or below prices which would be charged for similar lenses in uncontrolled transactions, thus providing the taxpayer a victory on that front. But, the Tax Court then proceeded to analyze the royalty arrangement, and the opinion on that front follows]

B. Determination of Arm's-Length Royalty Payable by B&L Ireland for Use of B&L's Intangibles

We next address the adequacy of the royalty charged by B&L to B&L Ireland for use of its patent rights, technology and trademarks as they relate to the production and sale of soft contact lenses. The license agreement entered into by B&L and B&L Ireland, effective January 1, 1981, requires B&L Ireland to pay to B&L 5 percent of the net sales proceeds from the sale of any products manufactured by B&L Ireland using any of B&L's patent rights or technology, or marketed under B&L's trademarks. None of the experts were of the opinion that the license agreement as written constitutes arm's-length consideration to B&L for license of its intangibles. Petitioners maintain that 5 percent is the proper royalty percentage, but now contend that the 5 percent should be applied to the average realized price (ARP) of B&L and its subsidiaries from the sale of B&L Ireland contact lenses to third parties (contended to be $16.74 in 1981 and $15.25 in 1982 for domestic sales, and $22.43 in 1981 and $18.10 in 1982 for foreign sales). ** *

Petitioners primarily rely on the expert testimony of Professor Irving H. Plotkin as support for their position that a royalty of five percent of ARP constitutes an arm’s-length consideration to B&L for the license of its intangibles. Professor Plotkin's report relies upon and is supplemented by the expert report of petitioner's contact lens industry expert, Dr. Irving J. Arons, and pro forma financial statements of B&L and B&L Ireland prepared for 1981 and 1982 by the public accounting firm of Price Waterhouse.

Professor Plotkin concurs with Dr. Arons' conclusion that a royalty rate of five percent of ARP was the standard licensing rate for licensing technology in the contact lens industry during the relevant years. Petitioners place great reliance on Dr. Arons' identification of the Vertical Spin Cast License Agreement between CAS and NPDC, and the 1979 CooperVision Agreement pursuant to which NPDC granted CooperVision a coexclusive license to use the ILC Cast Molding Process of soft contact lens production as comparable uncontrolled transactions which support a royalty of five percent of net sales as an appropriate royalty rate for the intangibles licensed to B&L Ireland. Professor Plotkin also conducted a rate of return analysis in which he calculated B&L Ireland's rate of return on investment for production of contact lenses, and B&L's rate of...
return on the marketing and sale of Irish produced lenses. Using the pro forma financial data compiled by Price Waterhouse, Professor Plotkin determined that B&L Ireland earned a rate of return of 106 percent in 1982 compared to 66 percent for B&L with respect to their respective activities involving Irish lenses. He concluded that such a profit split accurately reflected the relative risks borne by each entity and further supported a royalty rate of five percent of ARP.

Respondent primarily relies on the expert reports of Dr. David Bradford and Dr. Clark Chandler to support his position that a royalty rate of between 27 and 33 percent of ARP would be necessary to adequately compensate B&L for the use of its intangibles by B&L Ireland.

Dr. Bradford first determined that B&L could have produced the lenses produced for it by B&L Ireland itself for $1.50 per lens. He then determined that an independent manufacturer would require a markup of between 50-100 percent to profitably produce lenses using the spin cast technology. He thus determined that B&L would have paid a maximum of $2.25 to $3 for lenses from an independent manufacturer using its spin cast technology. He then determined the appropriate royalty by subtracting this maximum lens price from the $7.50 actually paid by B&L to arrive at a royalty of between $4.50 and $5.25 per lens.

Dr. Chandler's approach was to identify each of the discrete intangibles which he alleged B&L Ireland gained access to through the B&L License Agreement, and based on transactions involving similar intangibles and other criteria, determine what an independent contact lens manufacturer would be willing to pay, expressed as a percentage of ARP, for use of such an intangible. Dr. Chandler determined that the maximum royalties arrived at by his estimates were obviously unrealistic given the $7.50 per lens transfer price utilized in 1981 and 1982, he therefore reduced his high end royalty rate to 33 percent of ARP.

We have closely examined the expert's reports and the clarifying testimony given at trial by each expert as to his respective report. We are not bound by the opinion of any expert when the opinion is contrary to our own judgment. We may embrace or reject expert testimony, whichever in our judgment is most appropriate. Helvering v. National Grocery Co., 304 U.S. 282, 295 [20 AFTR 1260] (1938); Silverman v. Commissioner, 538 F.2d 927, 933 [38 AFTR2d 76-6258] (2d Cir. 1976), affg. a Memorandum Opinion of this Court. We are not restricted to choosing the opinion of one expert over another, but may extract relevant findings from each in drawing our own conclusions. Chiu v. Commissioner, 84 T.C. 722, 734 (1985).

For the reasons stated below, we do not completely embrace the approach or results arrived at by any of the experts. We think, however, that petitioners have adequately demonstrated the unreasonableness of the royalty espoused by respondent. However, we are not required to approve or disapprove of respondent's allocation in toto. G.D. Searle v. Commissioner, 88 T.C. at 367; Ach v. Commissioner, 42 T.C. 114, 126-127 (1964); Nat Harrison Associates Inc. v. Commissioner, 42 T.C. 601, 617 (1964).

We think the record also establishes that B&L would have received greater consideration for the license of its intangibles had B&L and B&L Ireland been independent and the royalty arrived at through arm's-length bargaining. We therefore draw upon elements of the expert reports and record as a whole to determine the royalty the parties would have negotiated under these circumstances.

We first must determine whether the record contains a sufficiently similar transaction to the B&L License Agreement involving an unrelated party. The royalty paid by an unrelated party for the same intangible property under the same circumstances should be the best indication of an arm's-length consideration. Ciba-Geigy Corp. v. Commissioner, 85 T.C. at 223; sec. 1.482-2(d)(2)(ii), Income Tax Regs. [Editor's Note: The Tax Court then considered several royalty arrangements but did not believe they were comparable transactions].

We thus conclude that the intangible property
embodied in the 1979 CooperVision Agreement and the Vertical Spin Cast Licensing Agreement differed from that embodied in the B&L Ireland License Agreement. Additionally, the circumstances under which the former two agreements were negotiated differed significantly from the circumstances of B&L and B&L Ireland at the time they entered their license agreement. See section 1.482-2(d)(2)(ii), Income Tax Regs. We thus refuse to rely on either agreement as evidence of an arm's-length consideration for the intangibles licensed by B&L to B&L Ireland.

Having found that the record does not contain a sufficiently similar transaction involving an unrelated party, we must attempt to construct an arm's-length royalty. In doing so, we look to the relevant factors identified by section 1.482-2(d)(2)(iii), Income Tax Regs., for guidance.

Section 1.482-2(d)(2)(iii)(g) and (h), Income Tax Regs., provides that we may consider the "prospective profits to be realized *** by the transferee through its use "

*** of the property" and "the capital investment and starting up expenses required of the transferee." The best indication of the prospective profits to be anticipated through use of the spin cast technology by an Irish manufacturing facility and the capital investment required to generate these profits are the projections actually prepared by B&L for the purpose of determining the feasibility of such a facility, as well as the actual proposals submitted to the IDA. Unlike both respondent and petitioners' experts, we find little relevance in B&L Ireland's actual results of operations during 1981 and 1982. Such information would not have been available in 1980 to a potential licensee negotiating a license agreement which was entered on January 1, 1981. The arm's-length nature of an agreement is determined by reference only to facts in existence at the time of the agreement. *R.T. French Co. v. Commissioner, 60 T.C. 836, 852 (1973). Rather, we place heavy reliance on the Special Expenditure Application (SEA) dated October 15, 1980, the various documents prepared by B&L to determine the feasibility of the proposed Irish lens manufacturing facility, and the actual proposal submitted to the IDA. These documents all contain various projections of earnings to be generated by the Irish lens manufacturing facility. These projections were intended to serve as financial justification to B&L management and the IDA of the capital investment to be made in development of the facility. ***

The best indication in the record of the earnings such a hypothetical investor would hope to generate are the 10-year earnings and cash-flow projections contained in the October 15, 1980 Special Expenditure Application. This document was generated closest in time to the license agreement and would thus appear to be the most up-to-date information available prior to the date of the license. However, we feel that a prudent investor would have adjusted these projections in several important respects before using them as a basis for determining the price at which he would be willing to enter into a royalty arrangement with B&L for use of its intangibles. ***

The purpose of the license agreement is to divide the income earned through exploitation of the licensed intangibles between the licensor and licensee. In this case, the income earned through exploitation of the licensed intangibles is the price B&L Ireland received from the sale of products produced using the licensed technology. The fact that the purchaser of the product also happens to be the licensor of the technology used to produce the product is irrelevant as long as the purchaser pays a market price. Therefore the price realized by B&L on its resale of lenses to nonaffiliates is of no consequence. We think an arm's-length royalty would be based on the price which the licensee is able to realize through sale of products produced using the licensed technology. Basing the royalty rate on this amount has the effect of varying the amount of royalty payable based on the amount of income the licensee is able to generate through use of the license and thus more accurately effectuates the parties' purpose in entering into the agreement. We will thus construct a royalty rate which is a percentage of the price B&L Ireland could expect to earn from lens sales. ***
Our rejection of the royalty rate advocated by respondent does not, however, require that we accept that proposed by petitioners. *G.D. Searle v. Commissioner*, 88 T.C. at 367. ***

In his expert report and at trial, Dr. Plotkin testified that as a rule of thumb a royalty rate generally divides net profits before royalties 25 to 75 percent between the licensor and licensee, respectively. See also *Ciba-Ceigy Corp. v. Commissioner*, 85 T.C. 172, 229 (1985). Even accepting this generalization, we think the B&L Ireland license agreement was unique and would have been an exception to the general rule had it been negotiated at arm's length. In the normal licensing situation, each party possesses something unique which is necessary for exploitation of a particular project. For example, one party may possess the production technology and the other possesses the capital and marketing expertise. A license agreement is negotiated since neither party possesses all of the attributes needed to exploit the product on its own. Here in contrast, B&L possessed both the production technology and the marketing network necessary to produce and sell soft contact lenses. B&L Ireland merely had the capital, a nonproprietary asset which theoretically could have been supplied by any number of entities. Thus, B&L Ireland would have found itself in a weaker bargaining position vis a vis B&L and would have had to cede more of the profits from plant operations to B&L than the customary 25 percent. Using our best judgment, we find that at arm's length B&L Ireland would have been willing to invest in the lens production facility even if required to share approximately 50 percent of the profits therefrom with B&L as consideration for use of its intangibles. As illustrated in Schedule D, this equates to a royalty rate of 20 percent of net sales.

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<td>Operating Earnings Projection</td>
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<td>20% Royalty</td>
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As Schedule D indicates, at a royalty rate of 20 percent of net sales an investor in the Irish lens facility could expect to generate sufficient net earnings to cover his $8,363,000 investment by early in his 4th year of operations. Over the course of the project, he could expect to generate an internal rate of return on this investment of approximately 27 percent. We can assume that the 12-percent rate used to discount future cash-flows in the SEA projections constituted petitioner's estimate of the acceptable rate of return on a relatively riskless venture. The additional 15 percentage points earned by the investor can thus be viewed as compensation for assuming the risks involved in the venture. Considering the proven, low-cost production technology to which B&L Ireland gained access via the licensing agreement, and its access to worldwide markets through its relationship with B&L, we consider the risks assumed by B&L Ireland to be moderate in comparison to those of other manufacturing ventures and the 15-percent premium to be wholly adequate to compensate B&L Ireland for assumption of these risks.

We thus hold that a royalty of 20 percent of B&L Ireland's sales price for soft contact lenses...
constitutes arm’s-length consideration for use of B&L’s intangibles. At arm’s length B&L would thus have received royalties of $1,674,000 and $5,541,000 from B&L Ireland in 1981 and 1982, respectively.\footnote{FN26 1981: 1,116,000 units x $7.50 x 20% = $1,674,000 1982: 3,694,000 units x $7.50 x 20% = $5,541,000}

To give effect to the foregoing,

Decision will be entered under Rule 155.

NOTES & QUESTIONS:

4. The Tax Court’s analysis looks to operating profits of the combined profits and then seeks to allocate them. What was the ultimate approximate profit split among the related parties?

5. Bausch & Lomb is important, or at least should be important, due to the manner in which the funding party was treated in terms of the profit split. The Tax Court did not consider funding as especially important. The Tax Court stated as follows:

We can assume that the 12-percent rate used to discount future cash-flows in the SEA projections constituted petitioner’s estimate of the acceptable rate of return on a relatively riskless venture. The additional 15 percentage points earned by the investor can thus be viewed as compensation for assuming the risks involved in the venture. Considering the proven, low-cost production technology to which B&L Ireland gained access via the licensing agreement, and its access to worldwide markets through its relationship with B&L, we consider the risks assumed by B&L Ireland to be moderate in comparison to those of other manufacturing ventures and the 15-percent premium to be wholly adequate to compensate B&L Ireland for assumption of these risks.

The above excerpt calls into question the idea that a funding party among related parties is entitled to some excessive or sole “entrepreneurial” profit simply because it is the funding party. Funding the development among affiliated companies not a significant function that should entitle a party to participate in a split of residual profits. The funding party should be entitled to receive a reasonable return on its invested capital, but the residual profits should be split among the parties that that possessed the functions that substantively contributed to the creation of the non-routine intangible. The Tax Court’s decision in Bausch & Lomb can be read as supportive of that thesis.

Rev. Rul. 78-83, 1978-1 CB 79

Advice has been requested whether income of X corporation diverted to Y corporation will be treated as a distribution taxable as a dividend to P corporation to the extent of the earnings and profits of X and a capital contribution by P to Y, under the circumstances described below.

The taxpayer, P, a domestic corporation, owned all of the stock of X, a foreign corporation incorporated in country M. X produces and exports fiber for sale on the world market, but due to monetary restrictions, X has had difficulty in securing dollars needed to pay refunds to foreign customers and to pay travel expenses of its employees outside country M. P, therefore, formed Y, a wholly owned foreign corporation incorporated in country T to act on behalf of X to receive part of the sales price charged by X. Thereafter, some of these dollars accumulated by Y were used to pay the above-mentioned refunds and expenses, as well as certain promotion expenses in connection with the fiber sales. P provided incidental services for X in connection with these disbursements, but performed no services in connection with the fiber sales. The funds diverted from X to Y were in excess of the amounts necessary to provide Y with reasonable compensation for its services to X and to reimburse Y for the expenses it incurred on behalf of X.
Section 301(a) of the Internal Revenue Code of 1954 provides that except as otherwise provided in subchapter C of the Code, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

Section 301(c) of the Code provides, in part, that in the case of a distribution to which subsection (a) applies, that portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

Section 1.301-1(c) of the Income Tax Regulations provides that section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such. A distribution to a shareholder in his capacity as such, need not be formally declared and paid but may take the form of a constructive dividend.

Section 482 of the Code provides authority to distribute, apportion or allocate gross income, deductions, and credits among related organizations, trades, or businesses if it is necessary in order to clearly reflect the income of such entities or to prevent the evasion of taxes.

Section 482 of the Code applies to transactions between brother-sister corporations involving the performance of services by one for the benefit of the other that result in significant shifting of income.

Where an allocation is made under section 482 as a result of an excessive charge for services rendered between brother-sister corporations, the amount of the allocation will be treated as a distribution to the controlling shareholder with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder to the other entity involved in the transaction. See Rev. Rul. 69-630, 1969-2 C.B. 112, relating to a bargain sale between brother-sister controlled corporations.

A constructive dividend is paid when a corporation diverts property, directly or indirectly, to the use of a shareholder without expectation of repayment, even though no formal dividend has been declared.

Generally, in those cases involving corporations controlled by the same persons, the courts have found a constructive dividend to have been distributed to the common shareholders where one of the corporations was used as a device for siphoning off the earnings and profits. See Helvering v. Gordon, 87 F.2d 663 [18 AFTR 791] (8th Cir. 1937); Commissioner v. Greenspun, 156 F.2d 917 [35 AFTR 48] (5th Cir. 1946); Biltmore Homes, Inc. v. Commissioner, 288 F.2d 336 [7 AFTR 2d 1035] (4th Cir. 1961).

However, a constructive dividend is a diversion of the property, not of the income. Income is a characterization which tax law attributes to certain receipts of property, whereas a constructive distribution is that of property itself. Thus, where property is transferred from one affiliate to a sister corporation without adequate consideration therefor, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate income or deductions between the corporations.

However, any amount diverted to Y for disbursements on behalf of X, or as reasonable compensation for services rendered to X, would not be considered as constructive dividend income to P.

Accordingly, the income of X diverted to Y in excess of the disbursements on behalf of X and reasonable compensation for services of Y will be treated as a distribution taxable as a dividend to P to the extent of the earnings and profits of X, and a capital contribution by P to Y.
Chapter 7

When the anti-deferral regimes of subpart F (per section 951) or global intangible low-taxed income (per section 951A) are subject to immediate US taxation, what is the appropriate analogy? Early IRS efforts to prevent deferral had used arguments of assignment of income to prevent the deflection of income away to a non-US affiliate, but those efforts were largely unsuccessful. Congress enacted the subpart F regime as a backstop to prevent the inappropriate shifting of income out of the US tax base as the transfer pricing regime was seen as inadequate to address the potential profit shifting efforts of US taxpayers.

At the time of its enactment, dividends were taxed at the same ordinary income rates as was active business income. So, at that time it was not critical to determine whether an anti-deferral regime was premised on an acceleration of the repatriation (a deemed dividend) or was instead premised on the idea of bolstering the assignment of income principles. That parity changed in 2004 when Congress provided that qualified dividends were eligible for preferential capital gains rates and provided that a qualified foreign corporation could remit dividends that would entitle the shareholder to claim preferential capital gains rates. So, is a subpart F inclusion simply an assignment of business income to a US controlling shareholder or is the subpart F inclusion a “deemed dividend.” If a deemed dividend, would a subpart F inclusion to an individual US shareholder entitle that shareholder to claim the preferential rates under section 1(h)(11) if the controlled foreign corporation meet the requirements for a qualified foreign corporation as defined in section 1(h)(11)(C)?

When the subpart F regime was enacted in 1962, there was no rate difference between dividend income and the taxation of ordinary business profits. Thus, the question of whether an anti-deferral regime is more like an extension of the assignment of income doctrine (imputed foreign profits to the US person that assigned those excess profits to controlled entities) or whether the ant-deferral regime represented an acceleration of dividend income was not a critical question. However, almost immediately upon the enactment of preferential rates for qualified dividends, the Treasury Department made it clear that its view was that the preferential rates applicable to qualified dividends did not extend to deemed inclusions by reason of subpart F by issuing Notice 2004-70, 2004-2 C.B. 724. Of course, one could have expected that this issue would be addressed at some point in the courts. In the below case, the Fifth Circuit agreed with the government that a subpart F income is not analogous to an actual dividend distribution that would have been eligible for preferential rates.

**RODRIGUEZ v. COMMISSIONER**

722 F.3d 306 (5th Cir. 2013)

Judge: PRADO

Osvaldo Rodriguez and Ana M. Rodriguez ("Appellants") challenge a determination of tax deficiency made by the IRS. The IRS determined that, for 2003 and 2004, the gross income Appellants reported based on their ownership of a controlled foreign corporation should have been taxed at the rate of Appellants' ordinary income rather than the lower tax rate Appellants had claimed. Appellants challenged the IRS's determination before the Tax Court and lost. This appeal followed. For the reasons that follow, we
affirm the Tax Court's determination.

I

Appellants are Mexican citizens and permanent residents of the United States who, during the relevant time periods, owned all of the stock of Editora Paso del Norte, S.A. de C.V. ("Editora"), a company that is incorporated in Mexico. Editora has a branch in the United States called Editora Paso del Norte, S.A. de C.V., Inc. Editora is a controlled foreign corporation ("CFC").

On October 15, 2005, Appellants amended their 2003 tax return to include an additional $1,585,527 of gross income attributable to their ownership of Editora's shares. At the same time, Appellants also filed their 2004 tax returns, in which they included $1,478,202 in gross income attributable to Editora. They reported both amounts as qualified dividend income, which was taxed at a rate of 15%, rather than the 35% at which their other income was taxed. On March 20, 2008, the IRS issued a notice of deficiency to Appellants. The notice indicated that Appellants' income tax payments for 2003 and 2004 were deficient in the amounts of $316,950 and $295,530, respectively, based on the IRS's determination that Appellants' Editora-attributable income should have been taxed as ordinary income rather than as qualified dividend income.

Appellants challenged the deficiency, and the case was submitted to the Tax Court on a fully stipulated record. The only issue for the Tax Court was one of statutory interpretation: whether Appellants' income attributable to Editora constituted qualified dividend income subject to a lower tax rate than Appellants' ordinary income. The Tax Court ruled in favor of the IRS. After unsuccessfully seeking a revision of the Tax Court's determination, Appellants filed this appeal. ***

The issue in this case is whether amounts included in Appellants' gross income for 2003 and 2004 pursuant to 26 U.S.C. §§ 951(a)(1)(B) and 956 (collectively, "§ 951 inclusions") constitute qualified dividend income under 26 U.S.C. § 1(h)(11). The § 951 inclusions would be subject to a lower tax rate if they constitute qualified dividend income. Ordinary income is taxed at a higher rate.

Sections 951 and 956 are provisions of the tax code intended to limit the deferral of taxes that would otherwise be owed to the United States. See Elec. Arts., Inc. v. Comm'r, 118 T.C. 226, 272 (2002). These sections require that CFC shareholders include CFC-owned United States property as part of the shareholder's gross income. 26 U.S.C. §§ 951(a)(1), 956(a). Tax deferrals are thus minimized because CFC shareholders lose the ability to defer United States tax obligations by keeping the CFC's earnings abroad or by investing in property instead of repatriating income through the payment of dividends.

Section 951(a)(1)(B) requires that United States shareholders of CFCs "shall include in [their] gross income ... the amount determined under section 956 with respect to such shareholder for such year ..." 26 U.S.C. § 951(a)(1)(B). Section 956 describes how to determine a shareholder's pro rata share of United States property held by the CFC for inclusion as gross income. Id. § 956(a). The parties do not dispute the amount calculated pursuant to § 956. Their only dispute is whether the amount determined by § 956 and included as income pursuant to § 951 constitutes "qualified dividend income" under § 1(h)(11). Section 1(h)(11)(B)(i)(II) defines qualified dividend income as including "dividends received during the taxable year from ... qualified foreign corporations." Id. § 1(h)(11)(B)(i)(II). A dividend is "any distribution of property made by a corporation to its shareholders" out of its earnings and profits. Id. § 316(a).

There are also instances where a statute specifically states that certain income is to be treated as if it were a dividend. See infra Part III.C. These "deemed dividend" provisions operate by legislative fiat. Appellants argue that their § 951 inclusions constitute either actual dividends or deemed dividends. As explained below, Appellants' § 951 inclusions
do not qualify as either.

Section 951 inclusions do not constitute actual dividends because actual dividends require a distribution by a corporation and receipt by the shareholder; there must be a change in ownership of something of value. Since these § 951 inclusions involve no distribution or change in ownership, they do not constitute qualified dividend income.

Section 316(a) defines a dividend as "any distribution of property made by a corporation to its shareholders ...." 26 U.S.C. § 316(a) (emphasis added). In the same vein, § 1(h)(11)(B)(i) defines "qualified dividend income" as "dividends received during the taxable year ...." 26 U.S.C. § 1(h)(11)(B)(i) (emphasis added). These statutory provisions illustrate what case law explicitly states: in determining when a dividend has issued, "[t]he question is not whether a shareholder ends up with "more" but whether the change in the form of his ownership represents a transfer to him, by the corporation." Comm'r v. Gordon, 391 U.S. 83, 91 [21 AFTR 2d 1329] n.5 (1968) (emphasis added); see also Jack's Maint. Contractors, Inc. v. Comm'r, 703 F.2d 154, 156 [51 AFTR 2d 83-1130] (5th Cir. 1983) ("[A]ll that is necessary [for a dividend] is that the corporation confer an economic benefit on a shareholder without expectation of repayment and that the primary advantage of the transaction be to the shareholder's personal interests rather than to the corporation's business interests." (emphasis added)).

Section 951 inclusions do not qualify as actual dividends because no transfer occurs. Indeed, these statutory provisions exist specifically to account for instances where CFCs do not make transfers of value to shareholders. Under the statutes at issue here, ownership of the CFC's property does not change. On this basis alone, § 951 inclusions do not constitute actual dividends. Section 951 inclusions are calculated purely on the basis of CFC-owned United States property and the CFC's earnings, without any change of ownership. 26 U.S.C. § 956(a). Shareholders are required to count the CFC's earnings and property as part of their own gross income to ensure that they cannot defer United States tax obligations by keeping earnings abroad or investing in property instead of repatriating income through the payment of dividends. Section 956(a) makes clear that § 951 inclusions involve no transfer of ownership and no distribution to shareholders. Section 951 inclusions are calculated solely on the basis of property owned by the CFC. They thus do not constitute actual dividends.

It is also worth noting that, in the context of this case, Appellants-as Editora's sole shareholders-could have caused a dividend to issue. Had they done so, the income at issue would have unquestionably qualified as dividend income subject to a lower tax rate, a point the IRS concedes. Appellants use this point to decry the outcome reached here. They urge the Court to avoid the "absurd, harsh, and unjust result" of taxing Appellants' § 951 inclusions at a higher rate than qualified dividend income, when Appellants, as Editora's sole shareholders, could have easily caused a dividend to issue, thereby avoiding this issue altogether.

This argument is unavailing. Appellants could have caused a dividend to issue. They could have also paid themselves a salary or invested Editora's earnings elsewhere. Each of these decisions would have carried different tax implications, thereby altering our analysis. Appellants cannot now avoid their tax obligation simply because they regret the specific decision they made.

In the alternative, Appellants claim that their §951 inclusions should be deemed dividends. This argument is unpersuasive, however, because, when Congress decides to treat certain inclusions as dividends, it explicitly states as much, and Congress has not so designated the inclusions at issue here. See, e.g., 26 U.S.C. § 851(b) ("For purposes of paragraph (2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i)
... for the taxable year to the extent that ... there is a distribution out of the earnings and profits of the taxable year ....") (emphasis added); 26 U.S.C. § 904(d)(3)(G) ("For purposes of this paragraph, the term "dividend" includes any amount included in gross income in section 951(a)(1)(B).") (emphasis added); 26 U.S.C. § 959(a)(1) ("For purposes of this chapter, the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not [be included as gross income] when such amounts are distributed to ... such shareholder ....") (emphasis added); 26 U.S.C. § 960(a)(1) ("For purposes of subpart A of this part, if there is included under section 951(a) in the gross income of a domestic corporation any amount attributable to earnings and profits of a foreign corporation ... then, except to the extent provided in regulations, section 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation ....") (emphasis added). Moreover, if all § 951 inclusions constituted qualified dividends, then statutory provisions specifically designating certain inclusions as dividends would amount to surplusage. Cf. Freeman v. Quicken Loans, Inc., 132 S. Ct. 2034, 2042-43 (2012) (statutory interpretations that avoid surplusage are favored); Microsoft Corp. v. i4i Ltd. P'ship, 131 S. Ct. 2238, 2248-49 (2011) (same).

Relatedly, the original version of § 956 specifically stated that Congress did not intend amounts calculated thereunder to constitute dividends. Under the original language of § 956, enacted in 1962, CFC earnings invested in United States property "[a]re the aggregate amount of such property held, directly or indirectly, by the [CFC] ... to the extent such amount would have constituted a dividend ... if it had been distributed." Revenue Act of 1962, Pub. L. No. 87-834, Sec. 12, § 956, 76 Stat. 960, 1015-16 (emphasis added). This language was removed only in 1993 when the entire subpart was rewritten in light of other, new regulations. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, Sec. 13232, § 956, 107 Stat. 312, 501. It does not appear that the omission of this language from the new version of the statute was intended to change the treatment of amounts calculated under § 956. As these examples demonstrate, Congress specifically designates when § 951 inclusions are to be treated as dividends, and Congress has not so stated here.

Appellants' reliance on various non-binding secondary sources does not alter our analysis here because the sources cited are in each instance either nonbinding or inapposite. In the historical sources cited by Appellants, references to a conceptual equivalence between § 951 inclusions and dividend income do not carry the weight Appellants attribute because such comments were made at a time when there was no tax advantage to classifying CFC-owned property as a dividend; the distinction was treated loosely at the time because it did not carry tax implications. Section 1(h)(11), the statute creating the tax disparity between dividend income and ordinary income, was not enacted until 2003. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, Sec. 302, 117 Stat. 752, 760 (enacting §1(h)(11)).

For the reasons discussed above, it is clear that Congress did not intend to deem as dividends the § 951 inclusions at issue here. The statute is completely silent, a fact which carries added weight when compared to the myriad provisions specifically stating that certain income is to be treated as if it were a dividend. Appellants' reliance on other non-binding sources is unavailing. As such, we affirm the Tax Court.

For the foregoing reasons, the judgment of the Tax Court is AFFIRMED.

NOTES & QUESTIONS:
1. Later, we will explore the contours of section 956 which creates a deemed inclusion when a controlled foreign corporation makes an investment in US property. In some respects, section
956 inclusions seem even more analogous to a deemed dividend inclusion that could be eligible for preferential rates for qualified dividends if the controlled foreign corporation to which the section 956 inclusion originated were a qualified foreign corporation, but the government was successful in again beating back that argument with the consequence that section 956 inclusions create ordinary income to individual shareholders. See SIH Partners LLLP v. Commissioner, 923 F.3d 296 (3rd Cir. 2019). The impact of these rules creates an interesting dichotomy. If an individual shareholder incurs a subpart F inclusion (or presumably a section 951A inclusion) with respect to the earnings of its controlled foreign corporation, that income will be subject to regular individual tax rates. However, if those earnings escape taxation by reason of the subpart F regime or GILTI regime of section 951A and are actually remitted to the individual during the year in which they are earned, the individual US shareholder can claim preferential capital gains rates as long as the controlled foreign corporation is a qualified foreign corporation as defined in section 1(h)(11)(C). This divergence creates a permanent rate difference for individual US shareholders with respect to whether the earnings are taxable by reason of the subpart F regime or by reason of an actual dividend distribution.

Chapter 7

Problem Set 1: FC is a non-US corporation with 100 shares of stock outstanding. The stock of FC is owned as follows:

- Individual A, a resident alien, owns 11 shares.
- Individual B, a United States citizen, is the sister of Individual A and owns 9 shares.
- Individual C, a United States citizen, owns 12 shares.
- Individual D, a nonresident alien, is the spouse of Individual C and owns 15 shares.
- Corporation E, a United States corporation, owns 18 shares.
- Corporation F, a foreign corporation, owns 15 shares.
- Partnership G, a foreign partnership, owns 20.

A. Is FC a controlled foreign corporation based on the above known facts?

B. Assume the same facts as stated above except now assume that Individual B owns 10% of the stock of Corporation E. What difference does this additional fact make in the analysis?
C. Assume the same facts as stated above except now assume that Individual B owns 7% of the stock of Corporation F. What difference does this additional fact make in the analysis?

D. Assume the same facts as stated in A above except now assume that Individual B owns 5% of the partnership interest in Partnership G. What difference does this additional fact make?

E. Assume the same facts as stated in 1.A. except now assume that the partnership is a US partnership that is owned 40% by Individual H (a US person) and 40% by Individual I (a non-US person).
F. Assume the same facts as 1.A. except that Corporation F owns 51% of Corporation E.

Dover v. Commissioner  
122 TC 324 (2004)

HALPERN, J. OPINION

*** Sale of H&C

On June 30, 1997, Dover UK and petitioner entered into an agreement with Thyssen Industrie Holdings U.K. PLC (Thyssen), a German corporation registered in England and Wales, and its German parent, Thyssen Industrie AG, for the sale by Dover UK to Thyssen of the entire issued share capital of H&C (the agreement or stock sale agreement). The agreement provided that it and other specified documents and agreements relating to the sale were to be held in escrow until the "Escrow Release Date" (July 11, 1997), by which time it was anticipated that the purchaser would have "completed its due diligence inquiries, and . . . determined that it does wish to proceed with . . . [the sale]" (the "escrow condition"). Dover UK, as "Vendor", also agreed to accomplish certain document deliveries and undertakings by July 11, at which time Thyssen, as "Purchaser", was required to "satisfy the consideration for the Shares". Dover UK also agreed to carry on the H&C business "in the normal course without any interruption" between June 30 and July 11, 1997. On July 11, 1997, Thyssen notified Dover UK that the escrow condition had been satisfied, and (we assume, since there is no stipulation) the purchase price was received by Dover.

Petitioner obtained an opinion of UK counsel dated July 3, 2001, that, as a matter of English law, beneficial title to the H&C shares passed from Dover UK to Thyssen on July 11, 1997, when the escrow condition was satisfied.

Retroactive Election To Treat H&C as a Disregarded Entity

By letter dated December 3, 1998, petitioner, on behalf of its (then) former indirect subsidiary, H&C, requested that respondent grant an extension of time, pursuant to sections 301.9100-1(c) and 301.9100-3, Proced. & Admin. Regs., for H&C to file a retroactive election to be a disregarded entity for Federal tax purposes (the request for 9100 relief). Specifically, petitioner requested: "H&C be granted an extension of time to make an election: (a) . . . to be disregarded as an entity
separate from its owner for U.S. tax purposes and (b) effective immediately prior to the sale of stock in H&C by Dover UK to Thyssen UK.” In the request for 9100 relief, petitioner stated that the date of the sale was June 30, 1997, and, on the Form 8832, Entity Classification Election (Form 8832), attached to the request for 9100 relief, it set forth June 30, 1997, as the proposed effective date of the election.

Initially, respondent was reluctant to grant the request for 9100 relief, in large part, because, in respondent's view, petitioner should not be entitled to benefits it might claim resulted from the disregarded entity election; i.e., the avoidance of FPHCI on the deemed sale of the H&C assets. However, after representatives of petitioner and respondent conferred, and petitioner made a supplemental submission, respondent, on March 31, 2000, granted the requested relief. Specifically, respondent granted to H&C "an extension of time for making the election to be disregarded as an entity separate from its owner for federal tax purposes, effective immediately prior to the sale on . . . [June 30, 1997], until 60 days following the date of this letter." Respondent, however, added the following caveat: no inference should be drawn from this letter that any gain from the sale of . . . [H&C's] assets immediately following its election to be disregarded as an entity separate from its owner gives rise to gain that is not foreign personal holding company income as defined in section 954(c)(1)(B)(iii) of the Internal Revenue Code.

On or about October 10, 1999, H&C made an election on Form 8832 to be disregarded as a separate entity. The Form 8832 specifies that the election is to be effective beginning June 30, 1997.

Discussion

I. Introduction

This case presents an issue of first impression and, insofar as we are aware, the first occasion that any court has had to opine on the impact of the so-called check-the-box regulations on the application of a specific provision of the Internal Revenue Code of 1986 (the Code), in this case, section 954(c)(1)(B)(iii) (defining, in part, FPHCI).

II. Code and Regulations

A. The Code

The provision of the Code principally at issue is section 954. Section 954 is found in subpart F of part III, subchapter N, chapter 1, subtitle A of the Code (Subpart F), which encompasses sections 951-964. Subpart F is concerned with controlled foreign corporations (CFCs). Neither party disputes that, in 1997, both Dover UK and H&C (up until it became a disregarded entity) were CFCs, as that term is defined in section 957(a). Section 951 provides that each United States shareholder of a CFC shall include in gross income certain amounts, including "his pro rata share . . . of the . . . [CFC's] subpart F income" for the taxable year. Sec. 951(a)(1)(A)(i). Subpart F income includes "foreign base company income (as determined under section 954)". Sec. 952(a)(2). Pursuant to section 954(a)(1), foreign base company income includes FPHCI, which is defined, in pertinent part, in section 954(e) as follows:

(c) Foreign Personal Holding Company Income.-

(1) In general.-For purposes of subsection (a)(1), the term "foreign personal holding company income" means the portion of the gross income which consists of:

*** (B) Certain property transactions.-The excess of gains over losses from the sale or exchange of property-

*** (iii) which does not give rise to any income.
Section 301.7701-3(a), Proced. & Admin. Regs., sets forth the general rule that "[a] business entity that is not classified as a corporation . . . can elect its classification for federal tax purposes as provided in this section".

In pertinent part, section 301.7701-3(g)(1)(iii), Proced. & Admin. Regs., provides:

(iii) Association to disregarded entity. If an eligible entity classified as an association elects . . . to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

Section 301.7701-2(a), Proced. & Admin. Regs., states that, "if . . . [an] entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner".

Under section 301.7701-3(c)(1)(i), Proced. & Admin. Regs., a classification election, including an election to change classification, is made by filing a Form 8832 with the IRS service center designated on that form. Under subdivision (iii), the election is effective "on the date specified by the entity on Form 8832" if, as in this case, one is specified.

Under section 301.7701-3(g)(3)(i), Proced. & Admin. Regs., an election to change classification "is treated as occurring at the start of the day for which the election is effective", and "[a]ny transactions that are deemed to occur . . . as a result of a change in classification [e.g., in the case of a change in classification from association to disregarded entity, the deemed liquidation] are treated as occurring immediately before the close of the day before the election is effective". For example, if H&C's disregarded entity election is effective as of the start of business on June 30, 1997, the deemed liquidation of H&C is treated as occurring immediately before the close of business on June 29, 1997.

The making of a disregarded entity election "is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation", thereby qualifying the parties to the deemed liquidation for tax-free treatment under sections 332 and 337. Sec. 301.7701-3(g)(2)(ii), Proced. & Admin. Regs.

Lastly, section 301.7701-3(g)(2)(i), Proced. & Admin. Regs., provides:

(2) Effect of elective changes.
   (i) In general. The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

The preamble to the 1997 proposed regulations, which contains the identical provision, explains the purpose of the above quoted provision:

This provision . . . is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the . . . regulations. [REG-105162-97, 62 Fed. Reg. 55768 (Oct. 28, 1997).]

III. Summary of the Parties' Arguments

A. Petitioner's Argument

Petitioner argues that, by permitting a corporate taxpayer to "disregard" the separate entity status of a subsidiary and, instead, treat the subsidiary's business as a hypothetical branch or division of the parent, the check-the-box regulations override the principle, based upon Moline Props., Inc. v. Commissioner, 319 U.S. 436, 438-439 [30 AFTR 1291] (1943), that the separate entity status of a corporation may not be ignored for Federal tax purposes. As a result (as petitioner sees it), Dover UK is deemed not only to sell H&C's assets (rather than its shares in H&C) but is deemed to be engaged in H&C's
business at the time of that sale. Therefore, petitioner argues that the H&C assets are excluded, by section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs., from the definition of property "which does not give rise to any income", with the result that the deemed sale of those assets did not give rise to FPHCI pursuant to section 954(c)(1)(B)(iii).

Alternatively, petitioner argues that, giving effect to the "plain and ordinary meaning" of section 954(c)(1)(B)(iii), Dover UK's deemed sale of the operating assets of H&C "could not possibly have been a sale of property 'which does not give rise to any income' because those assets were components of an active, ongoing commercial enterprise, which did give rise to income." Therefore, petitioner argues that, because the requirement in section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs., that such assets be used in the seller's trade or business goes beyond the narrow statutory mandate that such assets simply not be property "which does not give rise to any income", that regulation is invalid.

B. Respondent's Arguments

Respondent argues that the deemed sale of the H&C operating assets was not a sale of property used or held for use in Dover UK's business. Therefore, respondent continues, that property was not excluded from the definition of property "which does not give rise to any income" pursuant to section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs., and its deemed sale by Dover UK gave rise to FPHCI taxable to petitioner. Secs. 951(a)(1)(A)(i), 952(a)(2), 954(a)(1), (c)(1)(B)(iii).

Based primarily on the statutory language and legislative history of section 954(c)(1)(B), respondent also rejects petitioner's argument that section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs., is invalid.


A. Introduction

Petitioner argues that Dover UK's deemed sale of the H&C assets qualifies as a sale of property used in Dover UK's trade or business. Therefore, pursuant to section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs., that property is not, within the meaning of section 954(c)(1)(B)(iii), property "which does not give rise to any income", and Dover UK's sale does not give rise to FPHCI taxable to petitioner. In support of its argument, petitioner relies upon the check-the-box regulations and revenue rulings previously issued by respondent. Respondent disagrees on the basis of caselaw, which he cites in support of his argument that Dover UK's deemed sale of the H&C operating assets did not constitute a sale of assets "used or held for use" in Dover UK's business within the meaning of section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs.

B. The Relevant Authorities

1. Section 301.7701-2(a), Proced. & Admin. Regs.

Petitioner argues that "the check-the-box regulations . . . impose continuity of business enterprise as a consequence of . . . [a disregarded entity] election", citing section 301.7701-2(a), Proced. & Admin. Regs. In pertinent part, that regulation provides: "If . . . [a business entity with only one owner] is disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner."

Petitioner argues: "As a consequence [of the above-quoted regulation], there was as a matter of law and under respondent's own check-the-box regulations . . . a continuing business use of H&C's assets, which were deemed to be a branch or division of Dover UK."

2. The Revenue Rulings

Petitioner also argues that respondent's position in this case is "wholly inconsistent with" his position contained in published revenue rulings, which, under principles derived from the attribute carryover rules of section 381(c) applicable to section 332 liquidations,
"unequivocally attribute the trade or business of a subsidiary that is liquidated under section 332 to its parent." Therefore, because H&C's disregarded entity election involved a deemed section 332 liquidation of H&C, see sec. 301.7701-3(g)(1)(iii) and (2)(ii), Proced. & Admin. Regs., petitioner concludes that respondent's position violates the principle of Rauenhorst v. Commissioner, 119 T.C. 157, 182-183 (2002), that "taxpayers should be entitled to rely on revenue rulings in structuring their transactions, and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation".

The revenue rulings cited by petitioner involve the question of whether the liquidation of a subsidiary followed by a pro rata distribution of the proceeds of the sale of the subsidiary's assets to the parent's shareholders in partial redemption of the parent's stock may qualify as a partial liquidation of the parent under former section 346(a)(2).

The seminal ruling upon which petitioner relies is Rev. Rul. 75-223, 1975-1 C.B. 109. That ruling describes three situations in which a parent corporation (P) disposes of a wholly owned operating subsidiary (S). In situation 1, P liquidates S in a tax-free section 332 liquidation and sells the S assets for cash. P distributes the cash to P's shareholders in redemption of a portion of their P stock. Situation 2 is the same as situation 1 except that S sells its own assets for cash prior to the section 332 liquidation and subsequent redemption distribution by P. In situation 3, P simply distributes the S stock pro rata to its shareholders in redemption of a portion of their P stock. The issue, as stated in the ruling, is "whether, and to what extent, the fact that a corporation has conducted a portion of its business activities through a subsidiary rather than directly precludes the application of section 346(a)(2) of the Code." 1975-1 C.B. at 110. Under former section 346, a distribution in partial redemption of the stock of a corporation is considered to be made in partial liquidation of the corporation if the distribution is on account of "the [distributing] corporation's ceasing to conduct, or consists of the assets of, a trade or business . . . [actively conducted throughout the prior 5-year period and] not acquired by the corporation within such period in a [taxable] transaction". Former sec. 346(a) and (b)(1). See also sec. 1.346-1(a)(2), Income Tax Regs., stating: "An example of a distribution which will qualify as a partial liquidation under . . . section 346(a) is a distribution resulting from a genuine contraction of the corporate business".

The revenue ruling, after noting that "[t]he business activities of a subsidiary are not generally considered to be business activities of its parent corporation", recognizes that, under a section 332 liquidation (where the carryover basis rules of section 334(b)(1) apply), "[s]ection 381, in effect integrates the past business results of the subsidiary (as represented by its earnings and profits, net operating loss carryover, etc.) with those of the parent corporation." Rev. Rul. 75-223, 1975-1 C.B. at 110. The revenue ruling then states:

For most practical purposes, the parent corporation, after the liquidation of the subsidiary, is viewed as if it has always operated the business of the liquidated subsidiary. Consequently, there is no meaningful distinction, for purposes of section 346(a)(2), between a corporation that distributes the assets of a division, or the proceeds of a sale of those assets, and a parent corporation that distributes assets of a subsidiary, or the proceeds of a sale of such assets, received from the subsidiary in a liquidation governed by sections 332 and 381. [Id.]

Accordingly, the ruling holds that, in situations 1 and 2, "the fact that the distributions . . . were attributable to assets that were used by a subsidiary rather than directly by the parent will not prevent the distribution from qualifying as a `genuine contraction of the corporate business' of the parent within the meaning of section 1.346-1(a)(2) of the regulations." Id.
In Chief Counsel Memorandum (G.C.M.) 37,054 (Mar. 21, 1977), the IRS Chief Counsel described the position taken in Rev. Rul. 75-223 and in G.C.M. 35,246 (Feb. 20, 1973), in which the Chief Counsel gave advance approval to the position taken in Rev. Rul. 75-223, as follows:

Under that Ruling [Rev. Rul. 75-223] and G.C.M. 35246 a distribution by a parent corporation of the assets of a subsidiary (or the proceeds of a sale of such assets) received in a liquidation governed by Code sections 332 and 381 is to be treated no differently than a distribution by a corporation of the assets of a branch or division (or the proceeds of a sale of such assets).

FN1 Although under Treasury regulations G.C.M.s do not establish precedent (see sec. 1.6661-3(b)(2), Income Tax Regs.), they have been described as "an expression of agency policy". Taxation With Representation Fund v. IRS, 646 F.2d 666, 682 [47 AFTR 2d 81-1026] (D.C. Cir. 1981). Moreover, the Court of Appeals for the Second Circuit (the court to which an appeal of this decision most likely would lie) has stated that, under certain circumstances, it may be proper to rely on G.C.M.s for "interpretive guidance". Morganbesser v. United States, 984 F.2d 560, 564 [71 AFTR 2d 93-825] (2d Cir. 1993).


Respondent has also reaffirmed his Rev. Rul. 75-223 position in the context of transactions other than partial liquidations. See, e.g., Priv. Ltr. Rul. 80-19-058 (Feb. 13, 1980), involving an amalgamation of a United States shareholder's Country X CFCs, which qualified as a "corporate acquisition" within the meaning of section 381. Pursuant to the amalgamation, CFC F1 contributed the stock of its subsidiary, F2, to a new CFC, Newco 1, in exchange for Newco 1 stock and debentures, the latter consideration constituting a dividend to F1 under section 356(a)(2). Newco 1 combined with several operating company CFCs, three of which were same country (Country X) subsidiaries of F1, to form Newco II. In the private letter ruling, the Commissioner states that "a surviving corporation carries with it all those characteristics which the merged corporation had prior to the merger . . . [including] the attribute of a predecessor corporation having engaged in a trade or business with respect to the use of its assets", even though that is not an item specifically listed in section 381(c) as carrying over to the surviving corporation. Accordingly, the IRS ruled that the amounts treated as section 356(a)(2) dividends paid to F1 out of the earnings and profits of a party to the Newco II amalgamation which were accumulated when that party (1) was a related person to F1 within the meaning of section 954(d)(3), (2) had been created or organized under the same foreign country laws as F1, and (3) had a "substantial part" of the assets used in its trade or business located in such foreign country would not be includable in FPHCI of F1 for purposes of section 954, by reason of section 954(c)(4)(A) (now section 954(c)(3)(A)(i)), the so-called same country exception to the treatment, as FPHCI, of related party dividends or interest. In other words, the IRS found that Newco II inherited from former operating subsidiaries of F1 collapsed into it in a transaction subject to section 381 the attribute of being "engaged in a trade or business with respect to the use of . . . [those subsidiaries'] assets". Therefore, a
portion of the Newco II dividend to F1 arising out of F1's receipt of the Newco I debentures (which become Newco II debentures) was excluded from FPHCI by the same country exception.

3. The Caselaw

Respondent relies principally upon four cases in support of his argument that the H&C assets were not used in Dover UK's business before their deemed sale by Dover UK: Reese v. Commissioner, 615 F.2d 226 [45 AFTR 2d 80-1248] (5th Cir. 1980), affg. T.C. Memo. 1976-275 [¶76,275 PH Memo TC]; Azar Nut Co. v. Commissioner, 94 T.C. 455 (1990), affd. 931 F.2d 314 [67 AFTR 2d 91-987] (5th Cir. 1991); Aero Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962), affd. 334 F.2d 40 [14 AFTR 2d 5106] (6th Cir. 1964); and Ouderkirk v. Commissioner, T.C. Memo. 1977-120 [¶77,120 PH Memo TC]. In three of those cases (Reese, Azar Nut, and Ouderkirk) the issue is whether an individual's gain or loss on the sale of a parcel of real property is capital or ordinary.

a. Reese v. Commissioner

In Reese, the taxpayer financed the construction of a manufacturing plant, which he intended to sell to investors who would agree to lease the building to a corporation for use in the corporation's manufacturing business. The taxpayer was the chief officer and principal shareholder of the corporation. The partially completed plant was sold at a loss to satisfy a judgment against the taxpayer. The issue was whether the loss was capital or ordinary. The taxpayer argued for ordinary loss treatment on the ground that the plant was either (1) held primarily for sale to customers in the ordinary course of his construction business or (2) used in a trade or business, excludable, in either case, from capital asset status under what, respectively, are now paragraphs (1) and (2) of section 1221(a). The Court of Appeals for the Fifth Circuit found that (1) the taxpayer's activities in financing and acting as builder, developer, and general contractor for the construction of the plant between 1968 and 1970, when the building was sold, constituted "an isolated, non-recurring venture", which did not constitute a trade or business, and (2) the property sold was intended for use by the corporation in its manufacturing business, not by the taxpayer in his business of being a corporate executive. Reese v. Commissioner, 615 F.2d at 231. Therefore, the Court of Appeals held that the property was not excluded from the definition of a capital asset as either property held for sale to customers in the ordinary course of business or as property used in the taxpayer's trade or business. Id.

In support of his argument that Dover UK's deemed holding of the H&C operating assets "for only a moment before the sale" did not transform those assets into assets used in Dover UK's business, respondent relies on the conclusion of the Court of Appeals in Reese that an "isolated, non-recurring venture" cannot amount to the conduct of a trade or business. The facts before the Court of Appeals, and the question it answered, however, are distinguishable from the facts and question before us. In Reese, the Court of Appeals was asked to conclude (and did conclude) that the taxpayer's venture into real property construction never amounted to the conduct of a trade or business. Here, on the deemed liquidation of H&C, Dover UK is deemed to have received the assets of what undeniably was an ongoing business. The question is whether that business was ever conducted by Dover UK. Reese does not answer that question.

b. Ouderkirk v. Commissioner and Azar Nut Co. v. Commissioner

Ouderkirk v. Commissioner, T.C. Memo. 1977-120 [¶77,120 PH Memo TC], involved an individual who, in connection with the liquidation of a corporation, received 7,700 acres of cut-over timberland and an obsolete and inefficient sawmill, both of which the taxpayer contributed to a partnership owned by him and his wife. After refurbishment, the sawmill was placed in operation. Over an 11-year period, approximately 80 percent of the timber processed by the sawmill was acquired
from sources outside the 7,700 acres of timberland owned by the partnership. At the end of that period, the partnership sold the sawmill at a loss (which it reported, and passed through to the taxpayer and his wife, as an ordinary loss from the sale of property used in a trade or business) and sold the timberland at a gain (which it reported, and passed through to the taxpayer and his wife, as a capital gain from the sale of an investment asset). The Commissioner challenged the characterization of the timberland gain as capital gain, arguing that the timberland was not a capital asset because it was property used in the partnership's sawmill and lumber business. We rejected the Commissioner's position and sustained the taxpayer's argument that the property was investment property in the hands of the partnership. In reaching that conclusion, we noted that "[t]he incidental use of this 7,700-acre tract in connection with . . . [the] cutting of scattered timber did not convert the tract from investment property to real property used in the [partnership's] sawmill business within the meaning of section 1231." Id.

In Ouderkirk, as in Reese v. Commissioner, supra, the issue was whether the property in question had a business connection sufficient to require its exclusion from the definition of a capital asset (in Ouderkirk, as property used in a trade or business, and, in Reese, as inventory type property). Therefore, Ouderkirk, like Reese, is distinguishable from this case, where the issue is whether assets undeniably used in a trade or business were used in a trade or business conducted by Dover UK.

In Azar Nut Co. v. Commissioner, supra, the taxpayer, in connection with its termination of an individual's employment, purchased the employee's residence at an appraised fair market value pursuant to the terms of an employment agreement. The taxpayer immediately listed the house for sale at the purchase price paid to its former employee but eventually incurred a substantial loss on the sale, some 22 months later. Because the house was never held for rental by the taxpayer or used or intended for use in the taxpayer's business, we held that it was not exempt from capital asset status as property used in a trade or business and that the loss was, therefore, capital loss. 14 Id. at 463-464. In Azar Nut, as in Ouderkirk v. Commissioner, supra, and Reese v. Commissioner, supra, capital asset status was based upon insufficient (or no) business use, not, as respondent argues in this case, upon the identity of the user of assets undeniably used in a trade or business.

c. Acro Manufacturing Co. v. Commissioner

In Acro Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962), the taxpayer, a manufacturer of precision switches and thermostatic controls, acquired in a tax-free reorganization the stock of Universal Button Company (Button), a manufacturer of metal buttons for work clothes. Some 3 months later, the taxpayer received an offer to buy all of the stock or assets of Button. Because the taxpayer wished to avoid capital loss on a sale of the Button stock, the parties to the transaction negotiated an agreement for the sale of Button's assets whereby the taxpayer would liquidate Button and sell its assets to the purchaser. Pursuant to that agreement, Button adopted a plan of complete liquidation. On the following day, less than 7 months after its acquisition by the taxpayer, Button underwent a tax-free section 332 liquidation, and its assets were sold by the taxpayer to the purchaser for cash plus the purchaser's assumption of the liabilities relating to the business formerly carried on by Button. Button's business continued uninterrupted during the foregoing ownership transfers.

The taxpayer argued that the non-capital asset character of the assets in Button's hands should carry over to the taxpayer after the section 332 liquidation because, under the section 1223(2) holding period "tacking" provisions, the taxpayer is deemed to have held or owned those assets while they were used by Button in the conduct of its business. Acro Manufacturing Co. v. Commissioner, supra at 383.

Respondent, while admitting that the assets distributed to the taxpayer in connection with
the section 332 liquidation of Button were not capital assets in Button's hands, argued that, because the former Button assets were never used in the taxpayer's business, they constituted capital assets in the taxpayer's hands. Id. at 384.

We rejected the taxpayer's arguments and held that the character of the Button assets did not automatically carry over to the taxpayer; rather, we stated that our concern was with the "tax nature" of those assets in the taxpayer's hands. We asked: "Were the assets acquired or used in connection with a business of . . . [the taxpayer]?" Id. We found that the taxpayer "neither acquired nor used the Button assets in its business, neither did . . . [the taxpayer] enter into the button business." Id. at 386. In connection with those findings, we rejected the taxpayer's argument that it used the former button assets in its business "for a short time", between the same-day liquidation of Button and sale of its assets, stating that "ownership for such a minimal, transitory period is insufficient to establish 'use' of the distributed assets in . . . [the taxpayer's] business or to place . . . [the taxpayer] in the button business." Id. at 384. As a result, we found that the former Button assets were capital assets in the taxpayer's hands and the taxpayer's sale of those assets resulted in a capital loss. Id. at 386.

Both the result in Acro Manufacturing Co. v. Commissioner, supra, and our reasoning in reaching that result were affirmed by the Court of Appeals for the Sixth Circuit. Acro Manufacturing Co. v. Commissioner, 334 F.2d 40 [14 AFTR 2d 5106] (6th Cir. 1964). In affirming our decision that the taxpayer's "minimal, transitory" period of actual ownership of assets whose character was non-capital in Button's hands was insufficient to establish their character as non-capital assets in the taxpayer's hands, the Court of Appeals observed that it was "not advised of any showing by the taxpayer's corporate records" that the taxpayer did, in fact, operate the button business for any period of time. Id. at 44.

While the facts of Acro Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962), involve an actual, rather than a deemed, section 332 liquidation, we do not believe that that is a consequential difference. Because the period between the deemed distribution in liquidation of H&C's assets and the deemed sale of those assets can be described as a "minimal, transitory period", we conclude that the facts before us are, as pertinent, not distinguishable from the facts in Acro Manufacturing Co.

C. Analysis and Application of Authorities

Respondent specifically acknowledges that, for tax purposes, H&C's disregarded entity election constituted a deemed section 332 liquidation of H&C into Dover UK, whereby H&C became a branch or division of Dover UK. Respondent refers to the disregarded entity election as a "check-the-box liquidation" and states that there is no difference between it and an actual section 332 liquidation.

Accordingly, the principal question before us is whether, attendant to a section 332 liquidation, the transferee parent corporation succeeds to the business history of its liquidated subsidiary with the result that the subsidiary's assets used in its trade or business constitute assets used in the parent's trade or business upon receipt of those assets by the parent.

Because Dover UK's disregarded entity election is characterized as an actual liquidation of H&C for income tax purposes, among the undisputed tax consequences are the following: (1) Dover UK recognized neither gain nor loss on its deemed receipt of H&C's assets, see sec. 332(a); (2) it succeeded to H&C's basis in those assets, see sec. 334(b); and (3) it would add H&C's holding period to its own (deemed) holding period in those assets, see sec. 1223(2). Moreover, the deemed-received assets did not constitute a single, mass asset with a unitary holding period, but comprised the numerous classes of both tangible and intangible property necessary to constitute a going elevator installation and service business (e.g., tools, spare parts, fixtures, and accounts receivable). Each item deemed received by Dover UK came with a distinct, carryover basis and an existing holding period. Cf. Williams v. McGowan, 152 F.2d 570, 572 [34 AFTR 615] (2d Cir. 1945) (capital asset status of the assets of a business sold
shortly after the partnership conducting the business was terminated must be determined on an asset by asset basis).

Agreeing, as he must, to the foregoing description of the tax consequences resulting to Dover UK from its deemed receipt of H&C's assets, respondent, nevertheless, argues: "Dover UK must . . . use, or hold for use, such assets for the requisite period of time in its trade or business before Dover UK is allowed to exclude from FPHCI the gain from the [deemed] sale of those assets." Respondent refuses to attribute H&C's business history to Dover UK:

Dover UK had a separate identity from H&C and the business of H&C (installing and servicing elevators) was not the business of Dover UK (a holding company). In addition, Dover UK never intended to use the assets in an elevator business. It acquired the assets for the purpose of selling those assets and avoiding FPHCI.

The arguments of the parties concerning whether we must deem Dover UK to have succeeded to H&C's business history center on section 381, which provides that the acquiring corporation in a section 332 liquidation succeeds to the various tax attributes of the distributing corporation described in section 381(c). While section 381(c) does not list among the carryover attributes the distributing corporation's business history, we agree with petitioner that respondent's denial that Dover UK succeeded to H&C's business history is inconsistent with his position in Rev. Rul. 75-223, 1975-1 C.B. 109, Rev. Rul. 77-376, 1977-2 C.B. 107, G.C.M. 37,054 (Mar. 21, 1977), and a number of private letter rulings (discussed supra section V.B.). Respondent argues that the conclusion reached in Rev. Rul. 75-223 (and reaffirmed in subsequent published and private rulings) should be limited to section 346. Respondent further states that "petitioner should not be allowed to argue that the tax attributes of a subsidiary are carried over to the parent in all cases under . . . [section 381]." We disagree.

The crucial finding in all of the rulings discussed supra section V.B., is that, in any corporate amalgamation involving the attribute carryover rules of section 381, the surviving or recipient corporation is viewed as if it had always conducted the business of the formerly separate corporation(s) whose assets are acquired by the surviving corporation. See, e.g., Rev. Rul. 75-223, 1975-1 C.B. at 110. The Chief Counsel has stated unequivocally that the impact of that finding on a distribution by a corporation of assets received by it in a section 332 liquidation is that the distribution "is to be treated no differently than a distribution by a corporation of the assets of a branch or division". G.C.M. 37,054 (Mar. 21, 1977). Although that principle has been applied by the Commissioner in specific contexts (generally, in connection with former section 346 or section 302(c) partial liquidations), it has been stated as a principle of law applicable in any case involving a corporate combination to which section 381 applies. That includes a section 332 liquidation. Moreover, if a parent corporation's distribution to its shareholders of the operating assets of a former subsidiary, immediately after receiving those assets in a section 332 liquidation of the subsidiary, qualifies as "a genuine contraction of the . . . [parent corporation's] business" for purposes of section 1.346-1(a)(2), Income Tax Regs., we fail to see any basis for not applying the same rationale to the parent's sale of the liquidated subsidiary's assets, so that the sale is treated as a sale of assets used in the parent corporation's business for purposes of section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs.

In Rauenhorst v. Commissioner, 119 T.C. 157 (2002), we refused "to allow . . . [IRS] counsel to argue the legal principles of . . . opinions against the principles and public guidance articulated in the Commissioner's currently outstanding revenue rulings." Id. at 170-171. Consistent with our holding in Rauenhorst, we refuse to allow respondent to argue the legal principles of Acro Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962), against the principles subsequently articulated in Rev. Rul. 75-223, 1975-2 C.B. 109, Rev. Rul. 77-376,
1977-2 C.B. 107, and G.C.M. 37,054 (Mar. 21, 1977). We therefore consider respondent to have conceded that, as a direct result of a section 332 liquidation of an operating subsidiary, the surviving parent corporation is considered as having been engaged in the liquidated subsidiary's preliquidation trade or business, with the result that the assets of that trade or business are deemed assets used in the surviving parent's trade or business at the time of receipt. See Rauenhorst v. Commissioner, supra at 170-171, 173. As stated by respondent on brief, pursuant to section 301.7701-3(g)(1)(ii) and (2)(i), Proced. & Admin. Regs., "there is no difference between a check-the-box liquidation and an actual liquidation."

Therefore, notwithstanding our holding in Acro Manufacturing Co. v. Commissioner, supra, we conclude that respondent has conceded that Dover UK's deemed sale of the H&C assets immediately after the check-the-box liquidation of H&C constituted a sale of property used in Dover UK's business within the meaning of section 1.954-2(e)(3)(ii) through (iv), Income Tax Regs. That result is consistent with the conclusion of the Court of Appeals for the Second Circuit in Williams v. McGowan, 152 F.2d 570 [34 AFTR 615] (2d Cir. 1945), that depreciable property and inventory that had been part of a business sold shortly after the partnership conducting the business was terminated retain their status as non-capital assets in the hands of the individual seller. Respondent's acknowledgment that the business history and activities of a subsidiary carry over to its parent in connection with a section 332 liquidation of the subsidiary is also reflected in section 301.7701-2(a), Proced. & Admin. Regs., which provides that "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner". In the context of a business organization, a "branch" is defined as a "division of a business", and a "division" as an "area of . . . corporate activity organized as an administrative or functional unit." American Heritage Dictionary (4th ed. 2000); see also Black's Law Dictionary 188, 479 (6th ed. 1990) (defining a "branch", in relevant part, as a "division, office, or other unit of business located at a different location from main office or headquarters", and a "division" as an "[o]perating or administrative unit of . . . business"). Thus, the plainly understood import of the cited regulation's use of the terms "branch" and "division" to describe the impact of the deemed section 332 liquidation resulting from a disregarded entity election with respect to an operating subsidiary (particularly in light of respondent's ruling position, as set forth supra) is that the activities of the business operation indirectly owned by the parent through its former subsidiary become the activities of a functional or operating business unit directly owned and conducted by the parent. It follows from the language of the regulation that the assets used in the business of the (deemed) liquidated subsidiary retain their status as assets used in the same business by the (deemed) branch or division of the parent.

We interpret our statement in Acro Manufacturing Co. v. Commissioner, 39 T.C. at 386, that the taxpayer "neither acquired nor used the Button assets in its business" as tantamount to a statement that the Button business never became an operating branch or division of the taxpayer. Therefore, the Secretary and the Commissioner, in effect, rejected our position in that case by issuing section 301.7701-2(a), Proced. & Admin. Regs., as well as Rev. Rul. 75-223, Rev. Rul. 77-376, and G.C.M. 37,054.

Finally, we note that, consistent with his admonition in the preamble to the final check-the-box regulations, T.D. 8697, 1997-1 C.B. at 216, that "Treasury and the IRS will continue to monitor carefully the uses of partnerships [and, by extension, disregarded entities] in the international context and will take appropriate action when . . . [such entities] are used to achieve results that are inconsistent with the policies and rules of particular Code provisions", respondent was, of course, free to amend his regulations to require a minimum period of continuous operation of a foreign disregarded entity's business, prior to the disposition of that business, as a condition precedent to treating the owner as having been engaged in the trade or business for purposes of
characterizing the gain or loss. But, in the absence of respondent's exercise of that authority, we must apply the regulation as written. See Exxon Corp. v. United States, 88 F.3d 968, 974-975 [77 AFTR 2d 96-2521] (Fed. Cir. 1996); Woods Inv. Co. v. Commissioner, 85 T.C. 274, 282 (1985); Henry C. Beck Builders, Inc. v. Commissioner, 41 T.C. 616, 628 (1964). As we observed in sustaining the application of a provision of the consolidated return regulations, the fact that the regulation gives rise to a perceived abuse is "a problem of respondent's own making", a problem that respondent has allowed to persist by choosing "not to amend the regulations to correct the problem." CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398, 411 (1994), affd. 62 F.3d 136 [76 AFTR 2d 95-6104] (5th Cir. 1995).

VI. Validity of Section 1.954-2(e)(3), Income Tax Regs.

Because we find that Dover UK's deemed sale of the H&C assets constituted a sale of assets used in Dover UK's business within the meaning of section 1.954- 2(e)(3)(ii) through (iv), Income Tax Regs., we do not address petitioner's argument that section 1.954-2(e)(3), Income Tax Regs., is invalid.

VII. Conclusion

Dover UK's gain on the deemed sale of the H&C assets does not constitute FPHCI to petitioner pursuant to section 954(c)(1)(B)(iii).

Decision will be entered under Rule 155.

Whirlpool v. Commissioner [to come]

Problems Set on Subpart F Rules

1. Suppose that a U.S. corporation has a wholly owned manufacturing subsidiary in the Netherlands and it establishes a branch office in Switzerland. The Swiss branch handles all sales of the products manufactured in the Netherlands to non-Dutch customers. Leaving aside U.S. tax considerations, such an organizational structure could be particularly advantageous because the combined Swiss–Dutch tax burden on the income from non-Dutch sales will be markedly less than if the non-Dutch sales were handled directly by the Dutch manufacturing subsidiary. Assume that the effective Dutch and Swiss corporate income tax rates on manufacturing and sales income are 35 percent and 18 percent, respectively. Under such an organizational structure, does the trading income escape classification as foreign base company sales income because the products have not been purchased from a related person but have been manufactured by the controlled foreign corporation?

2. Consider the classification of sales income in a case in which a controlled foreign corporation incorporated in Switzerland handles non-Swiss sales in Europe through a Swiss office (the sales profit of which is subject to Swiss income tax at the rate of 18 percent). The products sold by the Swiss office are manufactured by a manufacturing branch of the Swiss corporation established in the Netherlands where manufacturing income is taxed at a 35–percent rate. Can the position taken in Reg. § 1.954–3(b)(1)(ii) that a manufacturing branch may, under the prescribed circumstances, be treated as a separate corporation for purposes of applying the definition of foreign base company sales income be justified on the basis of the literal terms of Section 954(d)(2) or the legislative history discussed in the Ashland Oil case? Note that the court’s analysis in Ashland Oil made it unnecessary for it to decide this issue.
3. Precision Marine Corp. (‘‘PM U.S.’’), a U.S. corporation, is engaged in the manufacture and sale of power boats inside and outside the United States. PM U.S. owns 100 percent of the stock of PM Bermuda (‘‘PM Bermuda’’), a corporation organized under Bermuda law. PM Bermuda is engaged in the production of marine electronic navigational and communications equipment (‘‘marine equipment’’) that it sells at a profit to PM U.S., passing title in Bermuda. PM U.S. installs appropriate items of marine equipment it buys from PM Bermuda in power boats PM U.S. sells to its unrelated distributors outside Bermuda. All of the marine equipment is manufactured for PM Bermuda by an unrelated contract manufacturer (‘‘CM’’), located in Monterrey, Mexico. CM buys for the account of PM Bermuda components from unrelated suppliers outside Bermuda and engages in substantial manufacturing activities to produce the marine equipment. Under its contract with CM, PM Bermuda owns throughout CM’s manufacturing process the components, work-in-progress and finished products, and PM Bermuda has the rights (i) to control the acquisition by CM of components used by CM in its manufacturing of the marine equipment, (ii) to exercise oversight and control over CM’s operations involved in its manufacture of the marine equipment and (iii) to supervise and control the use of intangibles that are licensed by PM Bermuda to CM for use in the manufacture by CM of the marine equipment. Because CM has established a record of outstanding efficiency and quality control, PM Bermuda’s employees limit the exercise of their rights of supervision and control to random checks each week of the quality of the finished products manufactured by CM. PM Bermuda pays CM an arm’s length conversion fee for CM’s manufacturing activities based on the type and number of items produced by CM. Is the income realized by PM Bermuda on its sales of marine equipment to PM U.S. foreign base company sales income?

4. Juicer Inc. (‘‘Juicer U.S.’’) is a U.S. corporation that owns all of the outstanding stock of Juicer Singapore PLC (‘‘Juicer Singapore’’), a corporation organized under the laws of Singapore, which is subject to an effective foreign income tax rate of 10 percent. Juicer Singapore sells juicer machines that convert fruits and vegetables to juices to Juicer U.S., which resells them to unrelated distributors in the Western Hemisphere. The machines are manufactured under contract with Juicer Singapore by unrelated contract manufacturers CM–C, CM–J and CM–V, which are incorporated in China, Japan and Vietnam, respectively. Under each of the following sets of circumstances, would Juicer Singapore generate foreign base company sales income upon sale of the juicer machines to Juicer U.S.?
   a. The contract with CM–C specifies that Juicer Singapore provides and owns throughout the manufacturing process the raw materials and components used to manufacture the juicer machines. Juicer Singapore also owns and licenses to CM–C the manufacturing patents needed by CM–C in the manufacture of the juicer machines. Pursuant to the contract, a Juicer Singapore employee visits CM–C quarterly to evaluate the quality of the work process, the effective use of the manufacturing patents and the final products ready for shipment to Juicer U.S. The employee is empowered to require CM–C to remediate promptly any deficiencies in the manufacturing process. Juicer Singapore pays a conversion fee to CM–C related to the quantity of machines produced. Juicer Singapore has the right, which it exercises, to have its employees train CM–C employees at Juicer Singapore’s expense before the involvement of those CM–C employees in the manufacture of juicer machines.
   b. The contract with CM–J specifies that Juicer Singapore is not obligated to provide any raw materials or components, which are selected and purchased by CM–J. The contract
gives Juicer Singapore the right to supervise the manufacturing process and to conduct quality control checks on finished juicers. The CM–J factory is operated entirely by robots that were designed, built, installed and serviced by Juicer U.S. The robots are programmed with tolerance-measuring systems and if juicers are not in accordance with quality standards set forth in the contract, employees of Juicer U.S. are authorized to stop production and adjust the robot or robots involved. Because the robots have consistently demonstrated a high level of accuracy and reliability, the Juicer Singapore employee responsible for supervising the CM–J production only visits the factory once a month to check the robots. While onsite, the Juicer Singapore employee consults with the Juicer U.S. employee who monitors the robots remotely and verifies that the production is within specification. The Juicer Singapore employee also performs a random sampling of the manufacturing process and finished products for quality control purposes at CM–J’s factory every other month.

c. The contract with CM–V specifies that Juicer Singapore provides the raw materials and components used in the manufacture of the juicers by CM–V, and Juicer Singapore is responsible for monitoring quality control on the final products but does not supervise the production process itself. The Juicer Singapore employee responsible for the quality control oversight has chosen to hire an unrelated project manager to monitor quality control. However, the manner in which the project manager carries out its responsibilities is not controlled by Juicer Singapore. The project manager cannot instruct CM–V to make changes to its process based on his findings. Instead, he is obligated to notify the Juicer Singapore employee of quality deficiencies, and the latter is authorized to direct CM–V to make changes to conform to quality standards prescribed in the contract.

d. Assume the same facts as in Problem 4.c., except the project manager makes monthly reports of quality deficiencies to the Juicer Singapore employee. In this case, the Juicer Singapore employee is obligated to exercise his authority to stop production immediately until the deficiencies are eliminated.

5. Consider whether income earned by Matterhorn, S.A. (‘‘Matterhorn’’), a Swiss corporation, of which 100 percent of the total combined voting power of all classes of stock is owned by USM Corp. (‘‘USM’’), a U.S. corporation, would constitute ‘‘foreign base company income’’ under the following circumstances:

a. Matterhorn acquires by license from USM rights to all European patents owned by the latter. Matterhorn sublicenses these patents in return for royalties to 12 independent licensees in countries outside Switzerland.

b. Would your answer in Problem 1.a. change if the patents were acquired originally by Matterhorn covering inventions developed by its own technicians?

c. Matterhorn receives $200,000 of dividends and $100,000 of interest from each of two wholly owned subsidiaries, which are organized under the laws of, and have all of their assets and operations in, Belgium and Switzerland, respectively. Of the gross income of the Belgian subsidiary for the tax year, $800,000 consists of income from the manufacture and sale of machine tools in Belgium and $200,000 consists of passive interest income. Of the gross income of the Swiss subsidiary, $600,000 consists of income from the manufacture and sale of electronic instruments in Switzerland and $400,000 consists of interest income that is foreign personal holding company income.
d. Matterhorn sells gold coins of numismatic value at a gain to an independent dealer in Switzerland. The coins were purchased by Matterhorn in Antwerp, Belgium, ten years before as an investment.

e. Matterhorn sells at a gain all rights to a group of Swiss patents (purchased from USM three years ago) to Eiger, S.A., a Swiss corporation, which is engaged in the manufacture and sale of consumer products in Switzerland, which is also a wholly owned subsidiary of Matterhorn and which had previously paid royalties to Matterhorn for the use of these patents.

f. Matterhorn purchases from USM golf balls manufactured by USM in the United States. Matterhorn packages them and sells them to independent distributors outside of Switzerland.

g. Would it make a difference in Problem 1.f. if Matterhorn sold only to independent distributors in Switzerland?

h. Would it make a difference in Problem 1.f. if Matterhorn bought the golf balls from an independent U.S. manufacturer (instead of USM)?

i. Would it make a difference in Problem 1.f. if Matterhorn bought the component material for the golf balls from USM and used that component material to manufacture the golf balls in Switzerland? What additional facts would you need to know to answer this question?

j. Would it make a difference in Problem 1.i. if Matterhorn bought the component material for the golf balls from USM and had the golf balls manufactured by AB Corporation, an unrelated corporation, under a contract manufacturing arrangement? AB Corporation performs the manufacturing activities with respect to the golf balls outside of Switzerland. Matterhorn’s employees do not engage in any significant oversight or direction of AB Corporation’s manufacturing activities with respect to the golf balls.

k. Would it make a difference in Problem 1.j. if Matterhorn’s employees engage in product design and quality control of the golf balls and control manufacturing logistics with respect to the golf balls? What additional facts would you need to know to answer this question?

l. Matterhorn purchases products manufactured by a German corporation and a Dutch corporation and resells these products to independent customers in European countries other than Switzerland. USM owns 49 percent and 51 percent, respectively, of the value and the total combined voting power of all classes of stock of the German and Dutch corporations. Assume that the applicable corporate income tax rates in Germany would be 40 percent, in the Netherlands would be 38 percent and in Switzerland would be 20 percent. (Does the application of the definition of ‘‘foreign base company sales income’’ in Section 954(d) to these facts imply a broader scope for the provision than is justified by policy considerations?)

m. Would it make a difference in Problem 1.l. if USM owned 50 percent of the voting power and value of the stock of the German corporation?

n. Would it make a difference in Problems 1.l. and 1.m. if, instead of purchasing and reselling for its own account the output of the German and Dutch companies, Matterhorn acted as a sales agent, receiving a commission for its services?

o. Matterhorn renders, in return for fees, technical and engineering services to independent customers in European countries outside Switzerland.
p. Would your answer in Problem 1.o. change if Matterhorn renders the services in Switzerland for a Dutch manufacturing corporation, of which all the voting stock is owned by USM?
q. Matterhorn’s gross income consists of two components—$9.6 million is in the form of services income as described in Problem 1.o., and $400,000 is in the form of fees paid by USM for services rendered to the European customers of USM outside Switzerland.
r. How would your answer in Problem 1.q. change if the amount of Matterhorn’s services income as described in Problem 1.o. totaled $2.5 million and Matterhorn’s income from fees paid by USM for services rendered to European customers of USM outside Switzerland totaled $7.5 million?
s. Would your answers in Problems 1.q. and 1.r. change if Matterhorn’s services income is subject to an effective rate of Swiss and other foreign income taxes of 32 percent?
t. Matterhorn is a 60–percent partner of Partnership X, organized under the laws of Belgium. What result to Matterhorn under Section 954(c) if Partnership X receives interest income that would have met the definition of foreign personal holding company income in Section 954(c)(1)(A) if it had been received directly by Matterhorn?

6. USM sells products it manufactures in the United States to unrelated foreign and U.S. customers who agree in a written installment debt obligation to pay the purchase price in installments over a period of five years. USM sells the installment obligations to Matterhorn for less than the unpaid principal balance on the obligations. Matterhorn either collects the obligations at maturity at face value or sells them to an unrelated party for more than it paid USM for them but less than their face value. What are the tax consequences of these transactions under Sections 864(d), 951(a)(1)(A) and 954(c)?

7. Would your answer in Problem 2 change if Matterhorn loaned the funds directly to the unrelated foreign customers who used them to buy the products from USM for cash?

8. EastLaw, Inc., a U.S. corporation, has developed an on-line legal research database. EastLaw, Inc. owns all of the stock of Foreign Base Company, S.A., a corporation formed under the laws of Bermuda, a low-tax country. Foreign Base Company, S.A. purchases access to the legal research database from EastLaw, Inc. and then sells access to the database to various unrelated third-party customers located in foreign countries outside of Bermuda. Is the income that Foreign Base Company, S.A. earns from these sales of access to the database foreign base company income?

9. Nile, Inc., a U.S. corporation, sells computers and electronic equipment over the Internet. Nile, Inc. owns all of the stock of Tax Avoidance, Ltd., a corporation organized under the laws of the Netherlands Antilles, another low-tax country. Tax Avoidance, Ltd. processes customer orders for Nile, Inc. and arranges for product delivery to customers of Nile, Inc. in return for a fee paid to it by Nile, Inc. Tax Avoidance, Ltd.’s employees perform all of their work for Nile, Inc. in the Netherlands Antilles but the customers of Nile, Inc. for whom the work is performed are located in foreign countries outside of the Netherlands Antilles. Is the fee paid to Tax Avoidance, Ltd. by Nile, Inc. foreign base company income?
Section 956

With the enactment of section 245A, a domestic corporation that is a US shareholder is entitled to claim a 100% foreign dividends received deduction with respect to actual dividends received from a controlled foreign corporation. After the enactment of section 245A, the question became whether and to what extent an investment in US property under section 956 should create an income inclusion to a domestic corporate US shareholder. In 2019, the Treasury Department issued final regulations that exclude domestic corporate US shareholders (as defined in section 951(b)) from the application of section 956 in order to maintain symmetry between the taxation of actual repatriations (that in effect are non-taxable by reason of the 100% foreign dividends received deduction) and the taxation of effective repatriations through section 956. To achieve symmetrical results between actual repatriations and deemed repatriations by reason of section 956, the final section 956 regulations provide that an amount that otherwise would have resulted in an inclusion by reason of section 956 (the “tentative section 956 amount”) with respect to a domestic corporate U.S. shareholder is reduced to the extent that the U.S. shareholder would be allowed a deduction under section 245A if the U.S. shareholder had received a distribution from the CFC in an amount equal to the tentative section 956 amount (the “hypothetical distribution”). Thus, section 956 is largely inapplicable to domestic corporate US shareholders after the enactment of these regulations.

However, individual US shareholders are not eligible to receive a 100% foreign dividends received deduction, so section 956 remains a potent anti-deferral provision with respect to those shareholders. Moreover, whereas the Treasury Department has worked to provide symmetry between actual distributions and synthetic distributions for domestic corporate US shareholders, the same cannot be said as to the tax treatment of actual versus synthetic distributions for individual US shareholders. In this regard, an actual dividend to an individual US shareholder from a controlled foreign corporation would be eligible for the preferential capital gains rates set for in section 1(h)(11) if the controlled foreign corporation were a qualified foreign corporation. However, in contrast, a synthetic distribution to an individual US shareholder by reason of section 956 creates an ordinary income inclusion to the US shareholder. Does this discontinuity in results make sense? Consider the reasoning in the below case:

SIH PARTNERS LLLP v. Commissioner
923 F.3d 296 3rd Cir. 2019)

I. INTRODUCTION

This matter comes on before this Court on the appeal of SIH Partners LLLP Explorer Partner Corp., Tax Matters Partner, challenging a United States Tax Court decision on summary judgment holding it liable for back income taxes. For the reasons stated below, exercising plenary review, see Duquesne Light Holdings, Inc. & Subsidiaries v. Comm'r of Internal Revenue, 861 F.3d 396, 403 [120 AFTR 2d 2017-5010] (3d Cir. 2017), we will affirm the decision and order of the Tax Court.

I. BACKGROUND***

Normally, a CFC’s income is not taxable to its domestic shareholder or shareholders unless and until the income is distributed to them, a process commonly known as repatriation. Thus, a
domestic shareholder in a CFC does not incur a taxable event by reason of its CFC earning income until the shareholder actually receives a monetary return from its foreign investment and holdings. In the face of this straightforward principle, easily stated though not always easily applied, taxpayers attempting to avoid domestic taxes though nevertheless seeking to benefit from foreign earnings of their CFC hit upon the idea of taking loans either from the CFC or from third-party financial institutions using the CFC's assets as collateral or having the CFC guarantee the loans. Even though those maneuvers allowed domestic shareholders to benefit from a CFC's earnings, it appears that prior to 1962 the IRS did not consider the taking of a collateralized or guaranteed loan from or with the participation of a CFC as a taxable event, even though the process allowed domestic shareholders effectively to obtain a monetary return on their foreign investment.

The foregoing tax avoidance method permitted a domestic shareholder to delay indefinitely any taxes on foreign income, while making use of the foreign income by continuously taking out loans using its CFC’s assets as collateral or by having the CFC guarantee the loans. Domestic corporations exploited this loophole by forming CFCs in foreign tax havens to which they transferred portable income, thereby avoiding or at least delaying taxes on the income at United States domestic tax rates, even though the taxpayers had the benefit of having received the income.

Not surprisingly Congress took steps to close the CFC loophole by enacting the Revenue Act of 1962 ("Act") "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." Dougherty v. Comm’r of Internal Revenue, 60 T.C. 917, 929 (1973) (citation omitted). The Act essentially requires the inclusion in the domestic shareholder's annual income of any increase in investment in United States properties made by a CFC it controls. The rationale for the Act is clear—any investment by a CFC in United States properties is tantamount to its repatriation. Id. United States property is defined as including, among other things, "an obligation of a United States person[.]" 26 U.S.C. § 956(c)(1)(C); see also id. § 951. The Act goes further as it provides that "a controlled foreign corporation shall, under regulations prescribed by the Secretary [of the Treasury], be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligations." Id. § 956(d).

Taking up the baton from Congress, in 1964 the IRS promulgated the two regulations at issue in this case. First, the agency determined when a CFC's pledge or guarantee would result in the CFC being deemed the holder of the loan:

[A]ny obligation of a United States person with respect to which a controlled foreign corporation ... is a pledgor or guarantor will be considered to be held by the controlled foreign corporation ....

26 C.F.R. § 1.956-2(c)(1). Second, the IRS determined how much of the "obligation" a CFC pledgor or guarantor would be deemed to hold:

[T]he amount of an obligation treated as held ... as a result of a pledge or guarantee described in § 1.956-2(c) is the unpaid principal amount of the obligation ....

Id. § 1.956-1(e)(2). As the Tax Court summarized, "a CFC whose assets serve (even though indirectly) as security for the performance of an obligation of a United States person will be considered a pledgor or guarantor of that obligation." SIH Partners, 2018 WL 487089, at *5.

Apparently the regulations were unchallenged for an extended period. But almost 50 years after their adoption, these statutes and regulations have come to bite Appellant, one of a cluster of companies affiliated with Susquehanna International Holdings ("SIH"). Through the SIH family, Appellant owns two CFCs. Another SIH affiliate, investment firm SIG, borrowed $1.5 billion from Merrill Lynch in 2007 in a loan guaranteed by over thirty SIH affiliates, including the two CFCs that
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Appellant owns. Even though the loan dwarfed the CFCs' assets that were roughly $240 million, Merrill Lynch insisted on having the CFCs guarantee the loan in order to "ring fence" the transaction—that is, for protection in case the deeper-pocketed domestic guarantors tried to dump their assets overseas with the CFCs.

In 2011, when the CFCs distributed earnings to Appellant, their domestic shareholder, the IRS stepped in. Applying the above regulations, the agency determined that Appellant should have reported its income from the CFCs at the time the CFCs guaranteed the loan to SIG. Per the regulations, the IRS treated each CFC as if it had made the entire loan directly, though the amount included in Appellant's income was reduced from the $1.5 billion principal of the loan to the CFCs' combined "applicable earnings." See 26 U.S.C. § 956(a)(2) (capping the taxable income to domestic shareholders at "the applicable earnings of such controlled foreign corporation"). This addition to income even in the reduced amount was no small thing, as it resulted in an additional tax of $378,312,576 to Appellant.

Having applied its regulations to increase Appellant's taxable income and accelerate the tax date from 2011 to 2007, the IRS took the final step of raising Appellant's tax rate. Although the 2011 distribution of CFC earnings to Appellant would have been taxed at the 15% rate for "qualified dividend income" under 26 U.S.C. § 1(h)(11)(B)(i), the IRS found that its accelerated income inclusion through §§ 956(c)(1)(C) and 956(d) was not a dividend and therefore was taxable at the then applicable 35% rate for ordinary income. In the Tax Court, Appellant challenged both the validity of the § 956(d) regulations and the use of the ordinary income tax rate. These proceedings followed and resulted in the Tax Court granting summary judgment to the IRS, so Appellant lost on both issues.

II. DISCUSSION

A. Validity of the Regulations

Before we begin our analysis, we note that Appellant does not challenge the Commissioner's calculations with regard to the amount of its taxable income. Instead, it argues that the implementing regulations are invalid because they are arbitrary and capricious and violate the Administrative Procedure Act ("APA"), 5 U.S.C. § 706(2)(A), and thus the addition to its income was unauthorized. Inasmuch as Appellant does not challenge the Commissioner's calculation of the amount included in its income, we need not explain how the Commissioner made his calculations.

While we appreciate and agree with the Tax Court's masterful analysis rejecting Appellant's argument challenging the validity of the regulations, we need not explicitly rely on that analysis because Appellant's argument fails for a reason on which the Tax Court did not rely, inasmuch as Appellant asks us to review the regulations taking into account hindsight derived from matters occurring after their adoption. The Tax Court did not address the hindsight issue, but Appellant almost invited us to do so, for in its brief it argues that the IRS practice shows that the regulations are unreasonable. Appellant's br. 32. The IRS's practice, of course, followed the adoption of the regulations. Though the Commissioner has not raised this hindsight point on this appeal as a ground to affirm, we nevertheless consider it because a "court of appeals may affirm Tax Court decisions on any grounds found in the record regardless of Tax Court's rationale[.]"] ACM P'ship v. Comm'r of Internal Revenue, 157 F.3d 231, 249 [82 AFTR 2d 98-6682] n.33 (3d Cir. 1998) (citation omitted). Thus, "[w]e may affirm a [decision of a lower] court for any reason supported by the record," Disability Rights N.J., Inc. v. Comm'r, N.J. Dep't of Human Servs., 796 F.3d 293, 300-01 (3d Cir. 2015), even though no party has advanced the reason to affirm. See Kline v. Zimmer Holdings, Inc., 662 F. App'x 121, 124 n.2 (3d Cir. 2016).

The rule supporting our approach with respect to hindsight evidence is clear, for we have stated that when reviewing an agency action under the APA, 5 U.S.C. § 706(2)(A), we must confine our review to "the full administrative
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record that was before the [agency] at the time" it took the action under review. C.K. v. N.J. Dep’t of Health and Human Servs., 92 F.3d 171, 182 (3d Cir. 1996) (quoting Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 420, 91 S.Ct. 814, 825 (1971)); see Tinicum Twp. v. U.S. Dep’t of Transp., 685 F.3d 288, 294 (3d Cir. 2012). Specifically, Appellant argues that the regulations are arbitrary and capricious, because they do not take into consideration the possibility that if the IRS considers individually multiple CFCs that guaranteed the entire loan, the CFC shareholder may incur income larger than the loan, indeed potentially an amount multiple times the loan. Appellant further argues that even though certain loans triggering the taxable event could not have been made without the security provided by a CFC’s guarantee, such is not always the case, so only those guarantees that are necessary for a shareholder to obtain a loan should be regarded as a repatriation and accordingly be treated as income to the domestic shareholder.

In support of the two above contentions, Appellant cites to the IRS’s internal guidance, stating that the inclusion of income under § 956(c)(1)(C) of the Act should be determined on the facts and circumstances of each case to ascertain if there has been a repatriation of earnings. Appellant's br. 33-34. But Appellant's argument runs into the insurmountable obstacle that every guidance and ruling it cites in its brief occurred decades after the promulgation of the regulations under the Act in 1964.

In the circumstances, though the authorities might demonstrate the IRS’s post-adoption recognition that the regulations do not always address economic reality, they are not evidence that the regulations were arbitrary or capricious at the time they were promulgated. We cannot and will not find half-century old regulations arbitrary and capricious, based on insights gained in the decades after their promulgation, when the challenger, here Appellant, has not made a showing that those insights were known or, perhaps, at least should have been known to the agency at the time of the regulations' promulgation. See San Luis & Delta-Mendota Water Auth. v. Locke, 776 F.3d 971, 993 (9th Cir. 2014) ("Reviewing courts may admit evidence ... only to help the court understand whether the agency complied with the APA’s requirement that the agency's decision be neither arbitrary nor capricious... But reviewing courts may not look to this evidence as a basis for questioning the agency's ... analyses or conclusions."); Fearin v. Fox Creek Valley Conservancy Dist., 793 F.2d 1291 (6th Cir. 1986) ("While such subsequent factors may have some relevance, we may not simply substitute our judgment, improved by the luxury of hindsight, for that of the [agency], and hence cannot consider them as controlling.").

When we raised the hindsight problem with Appellant at oral argument, Appellant argued that even at the time they were promulgated the regulations were arbitrary and capricious because the IRS failed to exercise its expertise to recognize the issues Appellant raises here. But the Supreme Court never has held that agency regulations must be the best or the most perfect solution possible to the problem at hand given the record before it. Rather, as that Court has explained:

The scope of review under the ‘arbitrary and capricious' standard is narrow. A court is not to ask whether a regulatory decision is the best one possible or even whether it is better than the alternatives. Rather, the court must uphold a rule if the agency has examined the relevant considerations and articulated a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.


We see nothing arbitrary and capricious in the regulations which make an obvious and straight-forward determination that the amount to be included in the domestic shareholder's income should equal the amount of the loan the
CFC guaranteed up to the amount of the CFC’s earnings. After all, no reasonable argument could be made otherwise with respect to the income to be included in the shareholder’s income if the CFC makes a direct loan to its domestic shareholders. Consequently, it makes logical sense to hold that loan guarantees should be treated the same as a direct loan, a position supported by a straight-forward reading of the Act. See 26 U.S.C. § 956(d).

Appellant argues that, by enacting § 956(d) separately, Congress intended the Commissioner to promulgate more substantive regulations in its treatment of § 956(c)(1)(C) income, but Appellant does not explain what substantive mandates § 956(d) specifically imposed, and it certainly does not explain how the enactment of §956(d) relates to the two issues it raises here that we describe above. There is no showing that Congress even recognized these issues. Absent evidence that the agency failed to follow a clear statutory mandate, we cannot find that the regulations were arbitrary and capricious. "If a statute is ambiguous, and if the implementing agency's construction is reasonable, [Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 104 S.Ct. 2778 (1984)] requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation." Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 980, 125 S.Ct. 2688, 2699 (2005) (citing Chevron, 467 U.S. at 843-44 & n.11, 104 S.Ct. at 2782 & n.11). "Where Congress has not merely failed to address a precise question, but has given an 'express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' then the agency's 'legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.'" Zheng v. Gonzales, 422 F.3d 98, 112 (3d Cir. 2005) (quoting Chevron, 467 U.S. at 843-44, 104 S.Ct. at 2782). Nothing in the record here shows that the agency's interpretation of the scope of the statutes was unreasonable, or that the regulations in question failed to implement an articulable statutory mandate. Though there were other things the agency could have addressed in the regulations, we only review what it did.

Moreover, as the Tax Court noted in its opinion, when the agency solicited public comments about the regulations when it was considering their adoption, it did not receive any comment about the possibility of multiple-counting of loan guarantors being an issue with the regulations. SIH Partners, 2018 WL 487089, at *7. Furthermore, the Commissioner noted at oral argument that he was unaware of a single instance where the inclusion of income under § 956(c)(1)(C) has resulted in the domestic shareholder receiving income greater than the loan amount. Appellant does not claim that it did in this case. It very well could be that the practice of loan guarantees by multiple CFCs was exceedingly rare or simply did not occur back in 1964 and thus escaped agency consideration when it adopted the regulations, or that the hypothetical multiple-counting problem was not serious enough to require further examination. Appellant does not provide evidence suggesting another explanation.

Additionally, in 2015, the IRS did consider amending the regulations to include a cap on the inclusion of all income under § 956(c)(1)(C) to that of the loan amount guaranteed, see 80 Fed. Reg. 53,058, 53,062 (2015) (noting that "there could be multiple section 951 inclusions with respect to the same obligation that exceed, in the aggregate, the unpaid principal amount of the obligation" and requesting comments "on whether the Treasury Department and the IRS should adopt" a rule limiting this result), but decided against it. See Crestek, Inc. v. Comm'r of Internal Revenue, 149 T.C. 112, 129 n.8 (2017) (explaining the IRS's decision not to issue final rules). Even 50 years after the adoption of the regulations at a time that the IRS had the benefit of hindsight with respect to the regulations' application in practice, it chose to maintain the status quo. Evidently, the Commissioner did not consider the multiple counting issue a serious enough problem to warrant amendment of the
regulations to deal with it.

In any event, we are satisfied that the regulations are not arbitrary or capricious merely because they may not adhere to the policies embodied in the statutes in every case. As the Supreme Court has recognized, "there are numerous federal statutes that could be said to embody countless policies. If agency action may be disturbed whenever a reviewing court is able to point to an arguably relevant statutory policy that was not explicitly considered, then a very large number of agency decisions might be open to judicial invalidation." *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 646, 110 S.Ct. 2668, 2676 (1990). To sum up this portion of our opinion, we see no compelling or even plausible reason to intervene under the APA to invalidate the regulations.

Appellant further argues that even if we uphold the regulations, we should remand the matter to the IRS and require it to employ a facts-and-circumstances determination with respect to their application in this case, as Appellant asserts that IRS internal guidances, in particular Revenue Ruling 89-73, required it to make such an analysis. *See* Appellant's br. 33. Appellant contends that because the CFC guarantees were not essential to its domestic parent entity's ability to obtain the loans, the guarantees should not have been deemed as investments in United States properties under § 956(c)(1)(C), and thus should not have been included in its income. It further argues that Merrill Lynch insisted on the CFC guarantees to ensure that the domestic entity could not simply transfer assets to the CFCs in the event of its insolvency or default. The Tax Court in considering this point held that:

Neither section 956(d) nor the regulations inquire into the relative importance that a creditor attaches to a guaranty. A guarantor's precise financial condition or the likelihood that it would be able to make good on its guaranty are irrelevant in determining under the regulations whether the guaranty gives rise to an investment in United States property. The regulations applicable in this case provide categorically that any obligation of a United States person with respect to which the CFC is a guarantor shall be considered United States property held by the CFC in the amount equal to the unpaid principal. They make no provision for reducing the section 956 inclusion by reference to the guarantor's financial strength or its relative creditworthiness.

*SIH Partners*, 2018 WL 487089, at *15 (citations omitted).

Surely the Tax Court was correct. Neither the Act nor the regulations nor any other statute states that the purpose of a CFC loan guarantee should be a factor in the determination of what constitutes § 956(c)(1)(C) income. Although Appellant argues that the IRS should have employed its own facts-and-circumstances guidance and determined that the guarantees were not in substance repatriations, internal guidance directions are not binding on an agency and do not have the force of law. *See* *Schweiker v. Hansen*, 450 U.S. 785, 789, 101 S.Ct. 1468, 1471 (1981). "A revenue ruling is simply the opinion of the Service's legal counsel which has not received the approval of the Secretary nor of Congress. A ruling is not a regulation and does not bind the IRS." *Temple Univ. v. United States*, 769 F.2d 126, 137 [56 AFTR 2d 85-5538] (3d Cir. 1985). "[A]lthough revenue rulings may be helpful, they do not have the force of law." *Geib v. N.Y. State Teamsters Conference Pension & Ret. Fund*, 758 F.2d 973, 976 (3d Cir. 1985). Moreover, Appellant's contention that the guarantees were not "necessary" is a matter of opinion rather than a recitation of historical fact.

We point out that, although the observation is not controlling, we cannot dismiss at least the possibility, if not the likelihood, that Merrill Lynch would not have made the loans without the CFC guarantees. There is no way to know for sure if it would have taken that position because Appellant *was* in control of the CFCs and the circumstances at the time of the loans cannot be recreated. Though we realize that Merrill Lynch could have made the loans on
the basis of the parent entity's creditworthiness, we see no reason to doubt that it made its decision based on its assessment of the parent entity's ability to repay the loans and the guarantees on which it insisted. After all, Merrill Lynch surely recognized that it could have sought to recover the loans from the CFCs, if necessary to do so if the parent entity did not repay them. In sum, we are satisfied that the guarantees were properly included in Appellant's income.

B. The Tax Rate

Appellant's final argument is that even if income was validly attributed to it by the regulations, the tax rate on the income should be the favorable rate applicable to dividends in the years in question, rather than the higher rate applicable to ordinary income, because the statutes deem the repatriation "as if it were a dividend." Dougherty, 60 T.C. at 926; see SIH Partners, 2018 WL 487089, at *18. The Tax Court rejected this argument, as it held "[t]he fact that [the Act] in operation treat[s] a CFC's investment in United States property 'as if it were a dividend' in no way establishes that the income inclusions required for shareholders thereunder actually are dividends for general purposes of the Code." Id. The Court, of course, was correct-analogizing one concept to another does not make them completely interchangeable.

We start our analysis of the tax rate issue by pointing out that the obligation of a United States person is just one type of property the Act defines as an investment in United States properties for income inclusion purposes. Other types of property include tangible property, stock in a domestic corporation, intellectual property rights, inventions, designs, and trade secrets. 26 U.S.C. § 956(c)(1). Accordingly, a CFC's domestic shareholders incur taxable income when the CFC makes an investment in United States properties-that is, if it simply purchased domestic land, stock, or intellectual property rights for whatever purpose regardless of whether it distributed any such purchases to any shareholder. Under Appellant's proposed construction, all such income would become "dividends," which we understood it conceded at oral argument to be the consequence of its proposed construction. To Appellant, they are "constructive dividends."

But as we have held, "unless a distribution which is sought to be taxed to a stockholder as a dividend is made to him or for his benefit it may not be regarded as either a dividend or the legal equivalent of a dividend." Holsey v. Comm'rs of Internal Revenue, 258 F.2d 865, 868 [2 AFTR 2d 5660] (3d Cir. 1958) (emphasis added). Indeed, the Internal Revenue Code defines dividends as "any distribution of property made by a corporation to its shareholders[.]" 26 U.S.C. § 316(a) (emphasis added). Appellant asks us to construe the Act in such a way as to find that all income inclusions under §956 to be "constructive dividends," regardless of whether any distribution has been made by the CFC, or whether any such investments are for the benefit of the domestic shareholders. We can find no case law holding that a taxpayer has received dividend income when neither of those two criteria has been satisfied. See Rodriguez v. Comm'rs of Internal Revenue, 722 F.3d 306, 309 [112 AFTR 2d 2013-5172] (5th Cir. 2013) (finding that § 956 "inclusions do not constitute actual dividends because actual dividends require a distribution by a corporation and receipt by the shareholder"). As such, Appellant's overbroad construction of § 956 would result in income being classified as a "constructive dividend" even when that income does not come within any plausible definition of a "dividend." We reject such implausible construction of § 956 income.

We recognize the crux of Appellant's real argument to be that loan guarantees under § 956(c)(1)(C) are special cases, as guarantees ordinarily are given for the benefit of shareholders, and thus loan proceeds are akin to distributions and should be taxed as dividends if they are taxed at all. However, § 956(c)(1)(C) mandates the inclusion of a loan guarantee as income when the CFC holds "an obligation of a United States person[.]" That person does not have to be a shareholder. In fact, a CFC may guarantee a loan to a
charitable organization for charitable purposes, and if it does so the CFC's domestic shareholders will receive taxable income. To hold in that scenario that the domestic shareholders' income should be regarded as a dividend would defy common sense.

Furthermore, Congress knows how to deem § 951(a) income as dividend income for specific purposes. See, e.g., 26 U.S.C. §§ 904(d)(3)(G) & 960(a)(1) (2017). Thus "Congress specifically designates when § 951 inclusions are to be treated as dividends," but "Congress has not so stated" for purposes of the tax rate for qualified dividend income under 26 U.S.C. § 1(h)(11)(B)(i). Rodriguez, 722 F.3d at 311. As the Tax Court noted, if Congress desired to tax §956(c)(1)(C) income as dividends, it could have done so in the fifty-plus years since the Act's original passage, and it did not. SIH Partners, 2018 WL 487089, at *18. "[I]t is clear that Congress did not intend to deem as dividends the [] inclusions at issue here. The statute is completely silent [on the point,] a fact which carries added weight when compared to the myriad provisions specifically stating that certain income is to be treated as if it were a dividend." Rodriguez, 722 F.3d at 312.

Significantly, Appellant's own actions undermined its argument: in 2010 and 2011, the CFCs made distributions of dividends to their shareholders, and by doing so triggered the IRS audit leading to the income inclusion and thus to this litigation. Appellant's br. 16. If Appellant wanted the CFCs' income to be treated as dividends, it was well aware of the best way to do so—paying out actual dividends to shareholders. The circumstance that its tax planning did not lead to a result favorable to it does not provide us with a reason to adopt a questionable construction of a well-established statute and the regulations under it. As another court has stated:

Appellants could have caused a dividend to issue. They could have also paid themselves a salary or invested ... earnings elsewhere. Each of these decisions would have carried different tax implications, thereby altering our analysis. Appellants cannot now avoid their tax obligation simply because they regret the specific decision they made.

Rodriguez, 722 F.3d at 310.

III. CONCLUSION

For the foregoing reasons, we will affirm the Tax Court's January 18, 2018 decision and order in its entirety.

NOTES & QUESTIONS:

1. The status of an indirectly owned foreign entity as a partnership versus a corporation can have a meaningful impact on whether the ultimate US shareholder has an investment in US property within the meaning of section 956 from the investments held by the indirect foreign entity. In this regard, for purposes of section 956, a partner in a partnership is treated as holding its attributable share of any property held by the partnership. For purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property. In general, a partner's attributable share of partnership property is determined in accordance with the partner's liquidation value percentage. The following two examples provides a helpful illustration of the problem:
Example 1: Individual A, a US person, wholly owns CFC, a controlled foreign corporation, which, in turn, owns a 40% interest in FPRS, a foreign partnership. The remaining interest in FPRS is owned by an unrelated foreign person. FPRS holds nondepreciable property with an adjusted basis of $100x (the “FPRS property”) that would be United States property if held by CFC directly. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, for CFC with respect to FPRS is 25%. There are no special allocations in the FPRS partnership agreement.

Result. For purposes of section 956, CFC is treated as holding its attributable share of the property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in such property. CFC's attributable share of property held by FPRS is determined in accordance with FS's liquidation value percentage, which is 25%. Thus, FS's attributable share of the FPRS property is 25%, and its attributable share of FPRS's basis in the FPRS property is $25x. Accordingly, for purposes of determining the amount of United States property held by CFC as of the close of quarter 1 of year 1, FS is treated as holding United States property with an adjusted basis of $25x.

Example 2: Individual A, a US person, wholly owns CFC, a controlled foreign corporation, which, in turn, owns a 40% interest in FC, a foreign corporation. The remaining interest in FC is owned by an unrelated foreign person. FC holds nondepreciable property with an adjusted basis of $100x (the “FC property”) that would be United States property if held by CFC directly.

Result: FC, as a foreign corporation, would not have been subject to the partnership look-through rule, and so the U.S. real estate that is owned by FC is not imputed to CFC. The “formed or funded” anti-avoidance rule of Reg. §1.956-1(b) would also not have applied on these facts because FC is not controlled by CFC.

2. An investment in US property must exist on a particular testing date, and so the question then arises as to whether and to what extent a taxpayer can artificially manipulate the amount of its US property investment over a testing period. In Rev. Rul. 89-73, 1989-1 C.B. 258, the IRS ruled that a year-end divestment of US property followed by its reacquisition after the year-end would be subject to attack on substance-over-form principles. Further, back-to-back loans through an unrelated party is subject to being looked through as a conduit for purposes of applying section 956. See Rev. Rul. 87-89, 1987-2 C.B. 195.

3. Certain short-term obligations of a US person are disregarded from the definition of a US property interest. See Notice 88-108, 1988-2 C.B. 445. However, during periods of economic downturn, the Treasury Department has been willing to extend allow even broader exclusions. See Notice 2008-91, 2008-2 C.B. 1001 (allows US receivables outstanding for 60 days to 180 days to be excluded from the definition of US property); Notice 2009-10, 2009-5 I.R.B. 419 (extends relief of Notice 2008-91 for three additional years); Notice 2010-12, 2010-4 I.R.B. 326 (applies same relief for calendar 2010 tax year).
**Problem Set on Section 956**

1. Delft, a Dutch corporation, all of the voting stock of which is owned by Eurotile, Inc., a U.S. corporation, is engaged in manufacturing and selling plastic kitchen utensils in the Netherlands. Consider the possible U.S. tax consequences if a portion of Delft’s surplus earnings is loaned to Eurotile, Inc. or is invested in stock of an unrelated corporation listed on the New York Stock Exchange. What are the U.S. tax consequences if Delft purchases from an unrelated party the exclusive right to use, manufacture and sell in the United States an invention protected by a U.S. patent for the life of the patent?

2. Review the facts of the alternative transactions in Problems 2 and 3 at ¶ 6195. What are the tax consequences of those transactions under Sections 951(a)(1)(B) and 956?

**Section 1248**

Section 1248 and its companion provision of section 964(e) serve as an important recast provision.

For domestic corporate US shareholders, the deemed allows the domestic corporate US shareholder the opportunity to claim a 100% foreign dividends received deduction subject to the restrictions applicable to extraordinary reductions set forth in Reg. §1.245A-5T. You should consult the Wells Insights & Concepts book for a further discussion of those issues.

Individual shareholders are entitled to claim that any recast dividend income is potentially eligible for preferential capital gains rates if the controlled foreign corporation were a qualified foreign corporation. In Sec. 4.01 of the below Notice 2004-70, the Treasury Department confirmed this result. But, note the balancing act that the Treasury Department employed in its analysis for why deemed repatriations under section 1248 are eligible for the preferential rate that applies for qualified dividends whereas subpart F inclusions are not so entitled.

**Notice 2004-70, 2004-2 CB 724**

This notice provides guidance regarding the extent to which distributions, inclusions and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income for purposes of section 1(h)(11) of the Internal Revenue Code (Code). This guidance is necessary to reflect the provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, 117 Stat. 752) (2003 Act) that provided for reduced rates of tax on certain dividends for taxable years beginning after December 31, 2002. The Treasury Department and the Internal Revenue Service intend to issue regulations under section 1(h)(11) of the Code that incorporate the guidance set forth in this notice.

2. Overview

The 2003 Act provides that qualified dividend income received by an individual shareholder is subject to
tax at reduced rates. This notice provides guidance regarding the extent to which distributions, inclusions, and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income for purposes of section 1(h)(11) of the Code. Section 3 of this notice describes the statutory rules for determining whether income is qualified dividend income and describes in general the anti-deferral regimes applicable to controlled foreign corporations (as defined in sections 957(a) and (b) and 953(c)(1)(B)) (CFCs), foreign personal holding companies (as defined in section 552(a)) (FPHCs), foreign investment companies (as defined in section 1246(b)) (FICs), and passive foreign investment companies (as defined in section 1297(a)) (PFICs). These rules are relevant principally because section 1(h)(11)(C)(iii) provides that dividends from a foreign corporation which for the taxable year of the corporation in which the dividend is paid, or the preceding taxable year, is an FPHC, a FIC, or a PFIC, are not qualified dividend income. Section 4 of this notice provides guidance with respect to distributions, inclusions, and other amounts from a CFC that is not also an FPHC, a FIC, or a PFIC. Section 5 of this notice provides guidance with respect to FPHCs, including FPHCs that are also CFCs. Section 6 of this notice provides guidance with respect to FICs, including FICs that are also CFCs. Section 7 of this notice provides guidance with respect to PFICs, including PFICs that are also CFCs.

This notice provides that distributions of non-previously taxed earnings and profits from a CFC to an individual are qualified dividend income, and therefore are eligible for the reduced rates of tax applicable to certain capital gains under section 1(h)(1) of the Code, provided that the CFC is otherwise a qualified foreign corporation. This notice also provides that section 951(a)(1) inclusions from a CFC *** are not qualified dividend income under section 1(h)(11)(B)(i)(II) and therefore are not eligible for the reduced rates of tax applicable to certain capital gains under section 1(h)(1). ***

3. Background

.01. The 2003 Act

.01. In general, section 1(h)(1) of the Code provides that an individual taxpayer's net capital gain for any taxable year is subject to a maximum tax rate of 15 percent (or 5 percent in the case of certain taxpayers). Section 1(h)(11) provides that, for purposes of section 1(h), the term "net capital gain" means net capital gain increased by qualified dividend income.

"Qualified dividend income" is defined as dividends received during the taxable year from domestic corporations and qualified foreign corporations. Section 1(h)(11)(B)(i) of the Code. The term "qualified foreign corporation" does not include any foreign corporation that, for the taxable year of the corporation in which the dividend is paid, or the preceding taxable year, is an FPHC, a FIC, or a PFIC. Section 1(h)(11)(C)(iii). Subject to this limitation, the term "qualified foreign corporation" means any foreign corporation that is incorporated in a possession of the United States or that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program. Section 1(h)(11)(C)(i). In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Section 1(h)(11)(C)(ii).

.02. Anti-deferral Regimes under the Code

.02. Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax when such income is distributed to a U.S. person that holds stock in such foreign corporation. Accordingly, a U.S. person that is a shareholder of a foreign corporation generally is not subject to U.S. tax on the income earned by the foreign corporation until that income is distributed to the shareholder as a
A brief summary of the rules applicable to foreign corporations subject to each of the anti-deferral regimes addressed in this notice is provided below.

(1) CFCs. In general, a CFC is any foreign corporation with respect to which U.S. shareholders own more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of such corporation. Under section 951(b) of the Code, a "United States shareholder" is a U.S. person (as defined in section 957(c)) that owns ten percent or more of the total combined voting power of all classes of stock entitled to vote. United States shareholders of CFCs are required to include in gross income currently their pro rata share of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed by the CFC to its shareholders in the year the income is earned. Section 951(a)(1)(A) of the Code. Subpart F income includes foreign base company income, including foreign personal holding company income (e.g., dividends, interest, annuities and other specified passive income), and certain insurance income. Sections 952, 953, and 954. United States shareholders of a CFC also are required to include currently in income their pro rata share of the CFC's earnings to the extent invested by the CFC in U.S. property. Section 951(a)(1)(B). The amounts so included in income under section 951(a)(1) are limited to the shareholder's pro rata share of the current earnings and profits of the CFC. Section 951(a)(2) and (c)(1)(A). Income of a CFC that has been included in the gross income of its United States shareholders as an inclusion under section 951(a)(1) of the Code is not included in gross income again when it actually is distributed to the United States shareholders. Section 959(a)(1). Any income of a CFC that is not included in the gross income of its United States shareholders under section 951(a)(1) is not subject to U.S. tax as income of the United States shareholders until actually distributed as a dividend. A United States shareholder of a CFC that sells its stock in the CFC generally is required to report any recognized gain from the sale of the stock as a dividend to the extent of the untaxed undistributed earnings and profits of the CFC and certain subsidiaries that are attributable to the United States shareholder. Section 1248(a) and (c)(2).

4. Controlled Foreign Corporations

This section provides guidance with respect to distributions, inclusions, and other amounts received by individual shareholders from a CFC that is not also a PFIC (and that was not a PFIC in the preceding taxable year). The treatment of distributions, inclusions, and other amounts received by individual shareholders of a CFC that is also a PFIC is addressed in sections 5, 6, and 7 of this notice, respectively.

Individual United States shareholders of CFCs may have amounts included in income under section 951(a)(1) of the Code, distributions of amounts previously taxed under section 951(a)(1), or distributions of amounts that have not been previously taxed under section 951(a)(1). The tax treatment of these amounts in the context of section 1(h)(11) is discussed below.

.01. Distributions of Amounts Not Previously Taxed

.01. Section 1(h)(11) of the Code does not exclude CFCs from the definition of "qualified foreign corporations." Thus, actual dividends from a CFC's non- previously taxed earnings and profits to an individual shareholder are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met. Similarly, amounts treated as dividends under section 1248(a) are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met. See section 1248(a) (stating gain recognized on the sale or exchange of stock...
in certain foreign corporations shall be included in the gross income of a shareholder as a dividend). In addition, amounts treated as dividends under section 1.367(b)-2(e)(2) of the regulations (i.e., section 1248 amounts and all earnings and profits amounts) are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met.

.02. Section 951(a)(1) Inclusions

.02. Neither section 951(a)(1) nor the corresponding regulations characterize a section 951(a)(1) inclusion as a dividend. In contrast, deemed inclusions under the FPHC and PFIC regimes are characterized as dividends throughout the statutory provisions governing these regimes. See, e.g., section 551(b) (stating that undistributed foreign personal holding company income is included in a foreign personal holding company shareholder's gross income as a dividend). Moreover, while section 1248 requires inclusions in gross income as a dividend, section 951 simply requires inclusions in gross income. Accordingly, for purposes of section 1(h)(11), section 951(a)(1) inclusions are not dividends and therefore cannot constitute qualified dividend income.

.03. Distributions of Previously Taxed Income

.03. Distributions of previously taxed income excluded from gross income under section 959(a) of the Code are not qualified dividend income because they are not subject to U.S. tax and are not dividends. See section 959(a) and (d).

Problem on Section 1248

Heavy Metal Manufacturing, Inc. (‘‘Heavy Metal’’), a U.S. corporation, owns 80 percent of the stock of Foreign Base Company, Inc., a controlled foreign corporation within the meaning of Section 957(a). The other 20 percent of Foreign Base Company, Inc.’s stock is owned by Mary, a U.S. citizen. Heavy Metal and Mary have owned all of the stock of Foreign Base Company, Inc. since its incorporation in 1987. Since that time, Foreign Base Company, Inc. has $1,200,000 of net earnings from foreign business and investment activities on which it has paid foreign income taxes of $120,000. Only $200,000 of that income and $20,000 of the foreign income taxes paid on the income are attributable to amounts that have been previously included in Heavy Metal’s and Mary’s gross incomes under Section 951 by reason of the income being Subpart F income. Foreign Base Company, Inc. has not made any dividend distributions to Heavy Metal or Mary. During the current year, Heavy Metal sells one fourth of its stock interest in Foreign Base Company, Inc. (i.e., a 20–percent stock interest in Foreign Base Company, Inc.), in which Heavy Metal has an adjusted basis of $50,000, for $300,000 (its fair market value at the time of sale). Mary sells all of her stock in Foreign Base Company, Inc., in which she has an adjusted basis of $50,000, for the same price, $300,000. What are the federal income tax consequences to Heavy Metal and Mary on account of these stock sales? (Do not attempt to compute the Section 1248(b) limitation on Mary’s tax liability. Assume that no foreign country imposes any income tax on these stock sales.)
Chapter 8

TANNENWALD, Judge:

Some of the facts have been stipulated and are so found. The stipulation of facts and the accompanying exhibits are incorporated herein by this reference. ***

Amoco Egypt has filed annual income tax returns with the [Egyptian Tax Department] ETD from 1964 through 1992. For the period 1964 through June 30, 1975, Amoco Egypt paid its income taxes directly to the ETD.

For the period July 1, 1975, through December 31, 1992, [the Egyptian General Petroleum Corporation] EGPC paid Amoco Egypt's Egyptian income taxes in Egyptian pounds to the ETD. The ETD issued official receipts reflecting the income tax payments made by EGPC in the name of and on behalf of Amoco Egypt. The ETD typically delivered the receipts to EGPC, which in turn delivered them to Amoco Egypt. EGPC's payments of Amoco Egypt's income taxes were posted by ETD in its Amoco Egypt tax file (No. 440/4). None of EGPC's tax payments on behalf of Amoco Egypt for Amoco Egypt's 1979 to 1982 tax years were posted to EGPC's tax file (No. 440/6).

Amoco Egypt's annual tax returns were audited by the Petroleum Section of the Department of Tax on Joint Stock Companies within the ETD.

Amoco Egypt dealt directly with the ETD in connection with the department audits of its Egyptian income tax returns and disputes arising out of those audits.

EGPC's Tax Treatment of Amoco Egypt's Taxes

EGPC is required by law to file annual income tax returns. EGPC was a calendar year taxpayer for years ending before January 1, 1980. Thereafter, EGPC became a June 30 fiscal year taxpayer, with its first fiscal year for the short period ending June 30, 1980.

EGPC's tax payments of its own tax liability are posted to EGPC's tax file (No. 440/6) by the ETD. EGPC's tax returns are audited by the Petroleum Section of the Department of Tax on Joint Stock Companies within the ETD.

On EGPC's Egyptian income tax returns for years prior to its taxable year ended June 30, 1993, EGPC credited royalty payments and income taxes paid on behalf of its foreign partners against its own income tax liabilities.

For the 1975 to 1980 tax years, ETD did not challenge the credit taken by EGPC against its tax liability for taxes paid on behalf of foreign partners, including Amoco Egypt. See infra pp. 42-46 for subsequent action by the ETD.

*** Notice of Deficiency ***

On June 18, 1992, respondent issued a statutory notice of deficiency to petitioner for the 1980, 1981, and 1982 tax years. In the notice of deficiency, respondent determined that Amoco Egypt's Egyptian income taxes had not been paid within the meaning of section 901 and the regulations thereunder. Respondent disallowed all of petitioner's foreign tax credits relating to Egyptian income taxes for the 1980, 1981, and 1982 tax years, as well as the Egyptian foreign tax credit carryforward from 1979. Respondent also decreased petitioner's gross income by amounts corresponding to the foreign tax credits claimed for the 1980, 1981, and 1982 tax years. Petitioner timely filed a petition with this Court on September 11, 1992, contesting the proposed deficiencies in tax and claiming an overpayment of tax plus interest in respect of other items.

OPINION
Section 901 allows a domestic corporation a credit against its Federal income tax in the amount of any taxes paid or accrued during the taxable years to any foreign country. See American Chicle Co. v. United States, 316 U.S. 450 [29 AFTR 193] (1942). The purpose of the credit is to reduce international double taxation. Id. at 452. Whether petitioner is entitled to foreign tax credits is to be determined by applying principles of domestic tax law. United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 [64 AFTR 2d 89-5841] (1989); Phillips Petroleum Co. v. Commissioner, 104 T.C. 256, 295 (1995). In applying this mandate, however, we look first to the law of the foreign state in order to determine the nature of the obligations and rights which form the basis of the claim of a foreign tax credit. Cf. Phillips Petroleum Co. v. Commissioner, supra; H. H. Robertson Co. v. Commissioner, 8 T.C. 1333 (1947), affd. 176 F.2d 704 [38 AFTR 391] (3d Cir. 1949). In so doing, we note that the parties are in agreement that the Egyptian tax involved herein constitutes an "income tax" within the meaning of section 901. See also Rev. Rul. 82-119, 1982-1 C.B. 105. ***

The initial dispute between the parties involves the question whether, under Egyptian law, EGPC was entitled to claim a credit against its income taxes for the payments made on account of Amoco Egypt's income taxes. ***

EGPC credited Amoco Egypt's income taxes paid by it against its income taxes. These issues relate to the assertion by respondent that such action on EGPC's part constituted a refund or subsidy which should deprive Amoco Egypt of its claimed foreign tax credit. ***

Initially, we note that our reasoning in respect of the existence of a refund disposes of any question of a direct subsidy within the meaning of section1.901-2(e)(3)(i), Income Tax Regs., and Amoco Egypt is entitled to the benefit of Example (3) of section 1.901-2(f)(2)(ii), Income Tax Regs. Petitioner further argues that EGPC derived no benefit from the credits because it was required annually to remit its surplus to the Egyptian Finance Ministry. Respondent argues that EGPC is a separate legal entity which should not be equated to the Egyptian Government and that Example (3) therefore has no bearing on the issue before us and that, as a result, EGPC is "another person" within the meaning of section1.901-2(e)(3)(ii), Income Tax Regs. Respondent further argues that the benefit EGPC derived from the credits for Amoco Egypt's income taxes is not negated by the requirement that EGPC transfer its surplus annually to the Egyptian Government. Consequently, respondent concludes that Amoco Egypt received an indirect subsidy with the result that the foreign tax credits claimed by petitioner for the Egyptian income taxes of Amoco Egypt should not be allowed.

*** [W]e note that EGPC in fact took the credit in the pre-June 1980 years and that collection based upon a disallowance of such action by the ETD would have been barred by the period
of limitations. Although, as we have pointed out, see supra p. 74, the running of the statute of limitations does not constitute approval of EGPC's action, it is the equivalent to authorization in substantive result. This circumstance raises the issue of an authorized credit constituting a subsidy.

We find it unnecessary to resolve the differences between the parties as to these two issues, i.e., payment or authorization, because of our conclusion in respect of the application of Example (3), particularly in light of the last sentence of the example specifically exempting from the subsidy rules a transaction which complies with its terms.

Respondent points to the reference to Example (3) in Continental Illinois Corp. v. Commissioner, T.C. Memo. 1991-66 [¶91,066 PH Memo TC], aff'd in part, revd. in part 998 F.2d 513 [72 AFTR 2d 93-5308] (7th Cir. 1993). In that case, we cursorily dismissed Example (3) as inapplicable. Since that case turned on the absence of a legal liability for the foreign withholding tax on the part of the withholding agent and the U.S. taxpayer as well, id. T.C. Memo. 1991-66 [¶91,066 PH Memo TC] at n. 46, the inapplicability of Example (3) was obvious. Certainly the case offers no support for respondent's position herein where there clearly was a legal liability on the part of Amoco Egypt and the assumption of that liability by EGPC.

Respondent's reliance on Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765 (1987), is misplaced. In Nissho, a U.S. taxpayer had engaged in a net loan transaction with a private borrower in Brazil, whereby the borrower agreed to pay interest at a certain rate net of any Brazilian withholding taxes. Simultaneous with remittance of the tax by the borrower, the borrower received a subsidy from the Brazilian Government based on the amount of the tax paid. The Court applied the indirect subsidy rule in the temporary regulations, section 4.901-2(f)(3)(ii), Temporary Income Tax Regs., 45 Fed. Reg. 75653-75654 (Nov. 17, 1980), which it held was reasonable, and denied foreign tax credits to the taxpayer for the amount of tax which was credited to the Brazilian borrower.

The holding in Nissho is based upon the finding that the borrower received the subsidy by virtue of the refund of the withheld tax. The borrower was a private party, and thus there was no question it obtained a benefit, so that it does not aid us in our determination herein. Continental Illinois Corp. v. Commissioner, 998 F.2d 513 [72 AFTR 2d 93-5308] (7th Cir. 1993), affg. in part and revg. in part T.C. Memo. 1991-66 [¶91,066 PH Memo TC], affg. T.C. Memo. 1989-636 [¶89,636 PH Memo TC], and affg. in part and revg. in part T.C. Memo. 1988-318 [¶88,318 PH Memo TC], and Norwest Corp. v. Commissioner, T.C. Memo. 1992-282 [1992 RIA TC Memo ¶92,282], affd. 69 F.3d 1404 [76 AFTR 2d 95-7409] (8th Cir. 1995), are inapplicable for the same reasons.


The background material, cited by respondent, provides:

Special treatment for government (or government-owned) entities also was rejected because it would create the potential for a credit to be claimed for a tax nominally paid by or on behalf of a U.S. person when the substance of the transaction with a government entity was to grant a tax holiday to the U.S. taxpayer. This is especially true in the case of a transaction with a government entity that pays taxes: where a tax holiday for the U.S. taxpayer is intended, the government entity could simply assume a tax liability that was nominally borne by the U.S. person and receive a tax credit against its own liability in the amount of the tax.

Example (4) of section 1.901-2(e)(3)(iv), Income Tax Regs. (1991), discusses a situation very similar to the one herein, providing that a credit to a State petroleum authority for a portion of the income taxes paid by it on behalf of a U.S. taxpayer is a subsidy, and that the U.S. taxpayer is not entitled to a foreign tax credit for the amount of the subsidy. FN17

FN17 Sec. 1.901-2(e)(3)(iv) Example (4), Income Tax Regs. (1991), provides:

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in section 1.901-2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Section 901(i), as well as the regulations thereunder, are applicable only to foreign taxes paid or accrued in taxable years beginning after December 31, 1986. Tax Reform Act of 1986, Pub. L. 99-514, sec. 1204(a), 100 Stat. 2085, 2532; sec. 1.901-2(e)(3)(v), Income Tax Regs. (1991). We need not decide whether petitioner would be entitled to foreign tax credit for foreign taxes paid or accrued after December 31, 1986. See T.D. 8372, 1991-2 C.B. at 340. We note, however, that the focus of the background material seems to confirm concern on respondent's part that prior law did not disallow foreign tax credits in certain situations where a government owned entity assumed a U.S. taxpayer's foreign tax liability. In this connection, it is at least arguable that just as the presence of a specific exception in the regulations in Qantas Airways Ltd. v. United States, supra, saved the day for respondent, its absence produces the opposite result herein. The reasoning of the Court of Appeals in State of Michigan v. United States, supra, which reflects an unwillingness to carve out an exception to a general statutory provision, in the absence of evidence of specific intent to that effect, lends support to this view. Compare Larson v. Commissioner, 66 T.C. 159, 185 (1976), where we applied regulations, establishing criteria for determining whether an organization was a partnership or a corporation, as they were written but recognized that respondent might have prevailed if the regulatory power had been exercised to its full extent. ***

Respondent's position is based on the premise that EGPC should not be equated with the Egyptian Government. Given our holding to the contrary, it follows that respondent's argument should be and is rejected. Indeed, having concluded that EGPC was part of the Egyptian Government, a finding of a subsidy would mean that one can subsidize oneself. In so stating, we do not imply that respondent is necessarily precluded from treating, by regulation, entities such as EGPC as separate from the foreign government and therefore "another person" for purposes of determining the existence of a subsidy.

Given our conclusion that there was no subsidy, we need not address the question whether, if Example (3) did not apply and EGPC were treated as "another person" under section 1.901-2(e)(3)(ii), Income Tax Regs., see supra p. 81, EGPC's obligation to transfer its surplus annually to the Finance Ministry (which also received Amoco Egypt's taxes paid by EGPC) in and of itself negated any benefit to EGPC and therefore precluded a finding of a subsidy. *** An appropriate order will be issued disposing of the foreign tax credit issue.
Rev. Rul. 78-234, 1978-1 CB 237

Advice has been requested whether the withholding tax imposed by the Republic of Tanzania under section 49(1) of the East African Income Tax Management Act, 1958 (Management Act), as modified by the East African Income Tax Management (Amendment) Act, 1971 (Amendment Act), is an income tax for which credit is allowable under section 901 of the Internal Revenue Code of 1954.

In its Income Tax (Allowances and Rates) Act, 1972 (Allowances and Rates Act), Tanzania adopted the provisions of the Management Act, as modified by the Amendment Act, and promulgated certain schedules of allowances and rates applicable to such provisions. As applicable to Tanzania, section 49(1) of the Management Act, imposes a withholding tax on dividends, interest, royalties, and management or professional fees paid to a nonresident person not having a permanent establishment in Tanzania. The general effect of the permanent establishment provision of section 49(1) with respect to dividends, interest, and royalties is that the tax imposed by section 49(1) would not be imposed on any income that would be considered, under United States principles, to be connected with the conduct of a business in Tanzania. Item 1 of the Third Schedule of the Allowances and Rates Act provides that the rate of nonresident withholding tax under section 49(1) shall be 12½ percent of the gross amount payable in respect of dividends, 12½ percent of the gross amount payable in respect of interest, 20 percent of the gross amount payable in respect of royalties, and 20 percent of the gross amount payable in respect of "management or professional fees." Section 2(d) of the Management Act, as modified by the Amendment Act, defines the term "management or professional fees" as any payment made to any person, other than a payment made to an employee of the person making the payment, in consideration for any services of a managerial, technical, professional or consultancy nature, whether payment is on a fixed sum or calculated on the basis of profits or otherwise.

Section 901(b) of the Code generally allows qualifying United States taxpayers to claim a foreign tax credit for the amount of any income, war profits, or excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.

Whether a foreign tax qualifies as an income tax within the meaning of section 901 of the Code depends on whether that tax is the substantial equivalent of an "income tax" as determined from an examination of the Federal income tax laws of the United States. Biddle v. Commissioner, 302 U.S. 573 [19 AFTR 1253] (1938), 1938-1 C.B. 309, and Commissioner v. American Metal Co., 221 F.2d 134, 137 [47 AFTR 395] (2d Cir. 1955). Thus, a foreign tax will not be considered to be an income tax in the United States sense unless its purpose is to reach net gain and it is so structured as to be almost certain of doing so. Bank of America National T. & S. Assn. v. United States, 459 F.2d 513 [29 AFTR 2d 72-1172] (Ct. Cl. 1972), cert. denied, 409 F.2d 949 (1972); Bank of America Nat'l T. & S. Assn. v. Commissioner, 61 T.C. 752 (1974); and Rev. Rul. 78-61, page 221.

In addition, the gain on which the foreign tax is levied must be realized in the United States sense. The United States Federal income tax, a tax of general application, does tax in certain limited situations the constructive or deemed receipt of income. However, as a whole, the Federal income tax is imposed on gain actually realized. Eisner v. Macomber, 252 U.S. 189 [3 AFTR 3020] (1920), 3 C.B. 25. A substantially equivalent degree of realization is required with respect to foreign taxes. Commissioner v. American Metal Co., 221 F.2d 134 [47 AFTR 395] (2d Cir. 1955), cert. denied, 350 U.S. 829 (1955), Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 [30 AFTR 990] (3d Cir. 1943), and Lanman & Kemp-Barclay & Co., of Colombia, v. Commissioner, 26 T.C. 582 (1956).

The tax imposed by section 49(1) of the Management Act is not an integrated, indivisible, or unified tax since dividends, interest, royalties, and management or professional fees each form a separate tax base on
which a tax is separately computed. See, for example, Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner, Rev. Rul. 64-260, 1964-2 C.B. 187, and Rev. Rul. 59-208, 1959-1 C.B. 192, as amplified by Rev. Rul. 63-268, 1963-2 C.B. 290. The determination whether the tax is imposed on realized net gain must therefore be made separately with respect to dividends, interest, royalties, and management or professional fees.

Applying this general test to the tax imposed by section 49(1) of the Management Act on gross management or professional fees leads to the conclusion that the tax is not the substantial equivalent of an income tax in the United States sense. The tax is levied on business income since performing personal services is classified as a trade or business. See section 864(b) of the Code. In general, a tax on business income will not reach net gain unless it allows for the deduction of the generally significant expenses related to the production of such income. Compare Keasbey & Mattison Co. v. Rothensies with Bank of America National T.&S. Assn. v. United States, 459 F.2d 513 [29 AFTR 2d 72-1172] (Ct. Cl. 1972). Section 49(1), of the Management Act levies a tax on the gross amount of management or professional fees derived from the conduct of a trade or business in Tanzania without allowing for the deduction of the expenses attributable to the production of that income. Because these expenses may be substantial, a tax imposed by a tax law that does not permit their deduction is not almost certain of falling on net gain. Furthermore, the tax may be imposed when the taxpayer has incurred a loss in its business of performing professional or management service.

Accordingly, the tax imposed by section 49(1) of the Management Act on the gross amount of management and professional fees is not the substantial equivalent of an income tax and, therefore, is not creditable under section 901 of the Code.

The separate taxes imposed by section 49(1) of the Management Act on the gross amount of dividends, interest, and royalties do not, in fact, allow for deductions. Certain foreign taxes on gross dividends, interest, and royalties have been held to qualify as income taxes in the United States sense. See, e.g., Rev. Rul. 73-106, 1973-1 C.B. 343. Additionally, similar taxes have long been imposed by the United States on dividends, interest, and royalties paid to nonresident aliens and foreign corporations (that are not effectively connected with the conduct of a trade or business in the United States) as a basic part of the United States income tax system. See sections 871(a)(1)(A) and 881(a)(1) of the Code. The thrust of these United States tax provisions is realistically directed against net gain. See Bank of America Nat'l Trust & Savings Assn. v. Commissioner, 61 T.C. 752 (1974). Accordingly, the taxes imposed by section 49(1) of the Management Act on the gross amount of dividends, interest, and royalties qualify as income taxes available for credit within the meaning of section 901 of the Code.
PPL v. Commissioner
569 U.S. 329 (2013)

Thomas, J., delivered the opinion for a unanimous Court.

In 1997, the United Kingdom (U. K.) imposed a one-time "windfall tax" on 32 U. K. companies privatized between 1984 and 1996. This case addresses whether that tax is creditable for U. S. tax purposes. Internal Revenue Code §901(b)(1) states that any "income, war profits, and excess profits taxes" paid overseas are creditable against U. S. income taxes. 26 U. S. C. §901(b)(1). Treasury Regulations interpret this section to mean that a foreign tax is creditable if its "predominant character" "is that of an income tax in the U. S. sense." Treas. Reg. §1.901-2(a)(1)(ii), 26 CFR §1.901-2(a)(1) (1992). Consistent with precedent and the Tax Court's analysis below, we apply the predominant character test using a commonsense approach that considers the substantive effect of the tax. Under this approach, we hold that the U. K. tax is creditable under §901 and reverse the judgment of the Court of Appeals for the Third Circuit.

I

During the 1980's and 1990's, the U. K.'s Conservative Party controlled Parliament and privatized a number of government-owned companies. These companies were sold to private parties through an initial sale of shares, known as a "flotation." As part of privatization, many companies were required to continue providing services at the same rates they had offered under government control for a fixed period, typically their first four years of private operation. As a result, the companies could only increase profits in the process.

The U. K.'s Labour Party, which had unsuccessfully opposed privatization, used the companies' profitability as a campaign issue against the Conservative Party. In part because of campaign promises to tax what it characterized as undue profits, the Labour Party defeated the Conservative Party at the polls in 1997. Prior to coming to power, Labour Party leaders hired accounting firm Arthur Andersen to structure a tax that would capture excess, or "windfall," profits earned during the initial years in which the companies were prohibited from increasing rates. Parliament eventually adopted the tax, which applied only to the regulated companies that were prohibited from raising their rates. See Finance (No. 2) Act, 1997, ch. 58, pt. 1, cls. 1 and 2(5) (Eng.) (U. K. Windfall Tax Act). It imposed a 23 percent tax on any "windfall" earned by such companies. Id., cl. 1(2). A separate schedule "set[s] out how to quantify the windfall from which a company was benefitting." Id., cl. 1(3). See id., sched. 1. In the proceedings below, the parties stipulated that the following formula summarizes the tax imposed by the Labour Party:

\[
\text{Tax} = 23\% \left(365 \times \frac{P}{D} \times 9 \right) - \text{FV}
\]

D equals the number of days a company was subject to rate regulation (also known as the "initial period"), P equals the total profits earned during the initial period, and FV equals the flotation value, or market capitalization value after sale. For 27 of the 32 companies subject to the tax, the number of days in the initial period was 1,461 days (or four years). Of the remaining five companies, one had no tax liability because it did not earn any windfall profits. Three had initial periods close to four years (1,463, 1,456, and 1,380 days). The last was privatized shortly before the Labour Party took power and had an initial period of only 316 days.

The number 9 in the formula was characterized as a price-to-earnings ratio and was selected because it represented the lowest average price-to-earnings ratio of the 32 companies subject to the tax during the relevant period. A price-to-earnings ratio "is defined as the stock price divided by annual earnings per share. It is typically calculated by
dividing the current stock price by the sum of the previous four quarters of earnings." 3 New Palgrave Dictionary of Money & Finance 176 (1992).

See id., sched. 1, §1, cl. 2(3); Brief for Respondent 7. The statute expressly set its value, and that value was the same for all companies. U. K. Windfall Tax Act, sched. 1, §1, cl. 2(3). The only variables that changed in the windfall tax formula for all the companies were profits \( P \) and flotation value \( FV \); the initial period \( D \) varied for only a few of the companies subject to the tax. The Labour government asserted that the term \( 365 \times (P/D) \times 9 \) represented what the flotation value should have been given the assumed price-to-earnings ratio of 9. Thus, it claimed (and the Commissioner here reiterates) that the tax was simply a 23 percent tax on the difference between what the companies' flotation values should have been and what they actually were.

II

Petitioner PPL Corporation (PPL) was an owner, through a number of subsidiaries, of 25 percent of South Western Electricity plc, 1 of 12 government-owned electric companies that were privatized in 1990 and that were subject to the tax. See 135 T. C. 304, 307, App. (2010) (diagram of PPL corporate structure in 1997). South Western Electricity's total U. K. windfall tax burden was £90,419,265. In its 1997 federal income-tax return, PPL claimed a credit under §901 for its share of the bill. The Commissioner of Internal Revenue (Commissioner) rejected the claim, but the Tax Court held that the U. K. windfall tax was creditable for U. S. tax purposes under §901. See id., at 342. The Third Circuit reversed. 665 F. 3d 60, 68 [108 AFTR 2d 2011-7571] (2011). We grant certiorari, 568 U. S. ___ (2012), to resolve a Circuit split concerning the windfall tax's creditability under §901. Compare 665 F. 3d, at 68, with Energy Corp. & Affiliated Subsidiaries v. Commissioner, 683 F. 3d 233, 239 [109 AFTR 2d 2012-2425] (CA5 2012).

Internal Revenue Code §901(b)(1) provides that "[i]n the case of ... a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States" shall be creditable. Under relevant Treasury Regulations, "[a] foreign levy is an income tax if and only if ... [t]he predominant character of that tax is that of an income tax in the U. S. sense." 26 CFR §1.901-2(a)(1). The parties agree that Treasury Regulation §1.901-2 applies to this case. That regulation codifies longstanding doctrine dating back to Biddle v. Commissioner, 302 U. S. 573, 578-579 [19 AFTR 1253] (1938), and provides the relevant legal standard.

The regulation establishes several principles relevant to our inquiry. First, the "predominant character" of a tax, or the normal manner in which a tax applies, is controlling. See id., at 579 ("We are here concerned only with the "standard" or normal tax"). Under this principle, a foreign tax that operates as an income, war profits, or excess profits tax in most instances is creditable, even if it may affect a handful of taxpayers differently. Creditability is an all or nothing proposition. As the Treasury Regulations confirm, "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax." 26 CFR §1.901-2(a)(1).

Second, the way a foreign government characterizes its tax is not dispositive with respect to the U. S. creditability analysis. See §1.901-2(a)(1)(ii) (foreign tax creditable if predominantly "an income tax in the U. S. sense"). In Biddle, the Court considered the creditability of certain U. K. taxes on stock dividends under the substantively identical predecessor to §901. The Court recognized that "there is nothing in [the statute's] language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation." 302 U. S., at 578-579. See also United States v. Goodyear Tire & Rubber Co., 493 U. S. 132, 145 [64 AFTR 2d 89-5841] (1989) (noting in interpreting 26 U. S. C. §902 that Biddle is particularly applicable "where a contrary interpretation would leave' tax interpretation "to the varying tax policies of foreign tax authorities"); Heiner v. Mellon, 304 U. S. 271,
279 [20 AFTR 1263], and n. 7 (1938) (state-law definitions generally not controlling in federal tax context). Instead of the foreign government's characterization of the tax, the crucial inquiry is the tax's economic effect. See Biddle, supra, at 579 (inquiry is "whether [a tax] is the substantial equivalent of payment of the tax as those terms are used in our own statute"). In other words, foreign tax creditability depends on whether the tax, if enacted in the U. S., would be an income, war profits, or excess profits tax.

Giving further form to these principles, Treasury Regulation §1.901-2(a)(3)(i) explains that a foreign tax's predominant character is that of a U. S. income tax "[i]f ... the foreign tax is likely to reach net gain in the normal circumstances in which it applies." The regulation then sets forth three tests for assessing whether a foreign tax reaches net gain. A tax does so if, "judged on the basis of its predominant character, [it] satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section." §1.901-2(b)(1). The tests indicate that net gain (also referred to as net income) consists of realized gross receipts reduced by significant costs and expenses attributable to such gross receipts. A foreign tax that reaches net income, or profits, is creditable.

III
A
[1] It is undisputed that net income is a component of the U. K.'s "windfall tax" formula. See Brief for Respondent 23 ("The windfall tax takes into account a company's profits during its four-year initial period"). Indeed, annual profit is a variable in the tax formula. U. K. Windfall Tax Act, sched. 1, §1, cls. 2(2) and 5. It is also undisputed that there is no meaningful difference for our purposes in the accounting principles by which the U. K. and the U. S. calculate profits. See Brief for Petitioners 47. The disagreement instead centers on how to characterize the tax formula the Labour Party adopted.

The Third Circuit, following the Commissioner's lead, believed it could look no further than the tax formula that the Parliament enacted and the way in which the Labour government characterized it. Under that view, the windfall tax must be considered a tax on the difference between a company's flotation value (the total amount investors paid for the company when the government sold it) and an imputed "profit-making value," defined as a company's "average annual profit during its "initial period" ... times 9, the assumed price-to-earnings ratio." 665 F. 3d, at 65. So characterized, the tax captures a portion of the difference between the price at which each company was sold and the price at which the Labour government believed each company should have been sold given the actual profits earned during the initial period. Relying on this characterization, the Third Circuit believed the windfall tax failed at least the Treasury Regulation's realization and gross receipts tests because it reached some artificial form of valuation instead of profits. See id., at 67, and n. 3.

In contrast, PPL's position is that the substance of the windfall tax is that of an income tax in the U. S. sense. While recognizing that the tax ostensibly is based on the difference between two values, it argues that every "variable" in the windfall tax formula except for profits and flotation value is fixed (at least with regard to 27 of the 32 companies). PPL emphasizes that the only way the Labour government was able to calculate the imputed "profit-making value" at which it claimed companies should have been privatized was by looking after the fact at the actual profits earned by each company. In PPL's view, it matters not how the U. K. chose to arrange the formula or what it claimed to be taxing, because a tax based on profits above some threshold is an excess profits tax, regardless of how it is mathematically arranged or what labels foreign law places on it. PPL, thus, contends that the windfall taxes it paid meet the Treasury Regulation's tests and are creditable under §901.

We agree with PPL and conclude that the predominant character of the windfall tax is that of an excess profits tax, a category of income tax in the U. S. sense. It is important to note that the Labour government's conception of "profit-making value" as a backward-looking analysis
of historic profits is not a recognized valuation method; instead, it is a fictitious value calculated using an imputed price-to-earnings ratio. At trial, one of PPL's expert witnesses explained that "9 is not an accurate P/E multiple, and it is not applied to current or expected future earnings." 135 T. C., at 326, n. 17 (quoting testimony). Instead, the windfall tax is a tax on realized net income disguised as a tax on the difference between two values, one of which is completely fictitious. See App. 251, Report ¶1.7 ("[T]he value in profit making terms described in the wording of the act ... is not a real value: it is rather a construct based on realised profits that would not have been known at the date of privatisation").

The substance of the windfall tax confirms the accuracy of this observation. As already noted, the parties stipulated that the windfall tax could be calculated as follows:

\[
\text{Tax} = 23\% \left( 365 \times \frac{P}{D} \times 9 \right) - \text{FV}
\]

This formula can be rearranged algebraically to the following formula, which is mathematically and substantively identical:\footnote{The rearrangement requires only basic algebraic manipulation. First, because order of operations does not matter for multiplication and division, the formula is rearranged to the following: Tax = 23\% \left[ (365 \times 9 \times \frac{P}{D} - \text{FV}) \right] \right. Next, everything outside the brackets is multiplied by \left[ \frac{365 \times 9}{D} \right], and everything inside the brackets is multiplied by the inverse, \left[ \frac{D}{(365 \times 9)} \right]. The effect is the same as multiplication by the number one (since \left( \frac{365 \times 9}{D} \right) \times \left( \frac{D}{(365 \times 9)} \right) = 1). That multiplication yields the formula in the text.}

\[
\text{Tax} = \left[ \frac{356 \times 9 \times 23\%}{D} \right] \times \{ P - \left[ \frac{\text{FV} \times \frac{D}{365 \times 9}}{D} \right] \}
\]

Simplifying the formula by multiplying and dividing numbers reduces the formula to:

\[
\text{Tax} = 51.71\% \times \left[ P - \left( \frac{\text{FV}}{9} \right) \right] \times 4.0027
\]

As noted, FV represents the value at which each company was privatized. FV is then divided by 9, the arbitrary "price-to-earnings ratio" applied to every company. The economic effect is to convert flotation value into the profits a company should have earned given the assumed price-to-earnings ratio. See 135 T. C., at 327 ("In effect, the way the tax works is to say that the amount of profits you're allowed in any year before you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and there is a tax" (quoting testimony from the treasurer of South Western Electricity plc)). The annual profits are then multiplied by 4.0027, giving the total "acceptable" profits (as opposed to windfall profit) that each company's flotation value entitled it to earn during the initial period given the artificial price-to-earnings ratio of 9. This fictitious amount is finally subtracted from actual profits, yielding the excess profits, which were taxed at an effective rate of 51.71 percent.

The rearranged tax formula demonstrates that the windfall tax is economically equivalent to the difference between the profits each company actually earned and the amount the Labour government believed it should have earned given its flotation value. For the 27 companies that had 1,461-day initial periods, the U. K. tax formula's substantive effect was to impose a 51.71 percent tax on all profits earned above a threshold. That is a classic excess profits tax. See, e.g., Act of Mar. 3, 1917, ch. 159, Tit. II, §201, 39 Stat. 1000 (8 percent tax imposed on excess profits exceeding the sum of $5,000 plus 8 percent of invested capital).

Of course, other algebraic reformulations of the windfall tax equation are possible. See 665 F. 3d, at 66; Brief for Anne Alstott et al. as Amici Curiae 21-23 (Alstott Brief). The point of the reformulation is not that it yields a particular percentage (51.75 percent for most of the
companies). Rather, the algebraic reformulations illustrate the economic substance of the tax and its interrelationship with net income. The Commissioner argues that any algebraic rearrangement is improper, asserting that U. S. courts must take the foreign tax rate as written and accept whatever tax base the foreign tax purports to adopt. Brief for Respondent 28. As a result, the Commissioner claims that the analysis begins and ends with the Labour government's choice to characterize its tax base as the difference between "profit-making value" and flotation value. Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that "tax law deals in economic realities, not legal abstractions." Commissioner v. Southwest Exploration Co., 350 U. S. 308, 315 [48 AFTR 683] (1956). Given the artificiality of the U. K.'s method of calculating purported "value," we follow substance over form and recognize that the windfall tax is nothing more than a tax on actual profits above a threshold.

B

We find the Commissioner's other arguments unpersuasive as well. First, the Commissioner attempts to buttress the argument that the windfall tax is a tax on value by noting that some U. S. gift and estate taxes use actual, past profits to estimate value. Brief for Respondent 17-18 (citing 26 CFR §20.2031-3 (2012) and 26 U. S. C. §2032A). This argument misses the point. In the case of valuation for gift and estate taxes, past income may be used to estimate future income streams. But, it is future revenue-earning potential, reduced to market value, that is subject to taxation. The windfall profit tax, by contrast, undisputedly taxed past, realized net income alone.

The Commissioner contends that the U. K. was not trying to establish valuation as of the 1997 date on which the windfall tax was enacted but instead was attempting to derive a proper flotation valuation as of each company's flotation date. Brief for Respondent 21. The Commissioner asserts that there was no need to estimate future income (as in the case of the gift or estate recipient) because actual revenue numbers for the privatized companies were available. Ibid. That argument also misses the mark. It is true, of course, that the companies might have been privatized at higher flotation values had the government recognized how efficient-and thus how profitable-the companies would become. But, the windfall tax requires an underlying concept of value (based on actual ex post earnings) that would be alien to any valuer. Taxing actual, realized net income in hindsight is not the same as considering past income for purposes of estimating future earning potential.

The Commissioner's reliance on Example 3 to the Treasury Regulation's gross receipts test is also misplaced. Id., at 37-38; 26 CFR §1.901-2(b)(3)(ii), Ex. 3. That example posits a petroleum tax in which "gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts." Ibid. Under the example, a tax based on inflated gross receipts is not creditable.

The Third Circuit believed that the same type of algebraic rearrangement used above could also be used to rearrange a tax imposed on Example 3. It hypothesized:

"Say that the tax rate on the hypothetical extraction tax is 20%. It is true that a 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts, the latter of which would satisfy the gross receipts requirement. PPL proposes that we make the same move here, increasing the tax rate from 23% to 51.75% so that there is no multiple of receipts in the tax base. But if the regulation allowed us to do that, the example would be a nullity. Any tax on a multiple of receipts or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate." 665 F. 3d, at 67.

There are three basic problems with this approach. As the Fifth Circuit correctly recognized, there is a difference between imputed and actual receipts. "Example 3 hypothesizes a tax on the extraction of petroleum where the income value of the petroleum is deemed to be ... deliberately greater than actual gross receipts." Entergy Corp., 683 F. 3d, at 238. In contrast, the windfall tax depends on actual figures. Ibid. ("There was no need to calculate imputed gross receipts; gross receipts were actually known"). Example 3 simply addresses a different foreign taxation issue.

The argument also incorrectly equates imputed gross receipts under Example 3 with net income. See 665 F. 3d, at 67 ("[a]ny tax on a multiple of receipts or profits"). As noted, a tax is creditable only if it applies to realized gross receipts reduced by significant costs and expenses attributable to such gross receipts. 26 CFR §1.901-2(b)(4)(i). A tax based solely on gross receipts (like the Third Circuit's analysis) would be noncreditable because it would fail the Treasury Regulation's net income requirement.

Finally, even if expenses were subtracted from imputed gross receipts before a tax was imposed, the effect of inflating only gross receipts would be to inflate revenue while holding expenses (the other component of net income) constant. A tax imposed on inflated income minus actual expenses is not the same as a tax on net income. FN5

FN5 Mathematically, the Third Circuit's hypothetical was incomplete. It should have been: 20% [105% (Gross Receipts) − Expenses] = Tax. But 105% of gross receipts minus expenses is not net income. Thus, the 20% tax is not a tax on net income and is not creditable.

For these reasons, a tax based on imputed gross receipts is not creditable. But, as the Fifth Circuit explained in rejecting the Third Circuit's analysis, Example 3 is "facially irrelevant" to the analysis of the U. K. windfall tax, which is based on true net income. Entergy Corp., supra, at 238.

*** The economic substance of the U. K. windfall tax is that of a U. S. income tax. The tax is based on net income, and the fact that the Labour government chose to characterize it as a tax on the difference between two values is not dispositive under Treasury Regulation §1.901-2. Therefore, the tax is creditable under §901.

The judgment of the Third Circuit is reversed.

It is so ordered.

Section 903 In Lieu of Tax

Section 903 has two key conceptual issues: is a levy completely in lieu of an income tax and secondarily is the tax that the levy is in lieu of itself a generally applicable income tax. But, a predecessor question is when is a levy a separate levy that is separate from the generally applicable income tax and when is it not. Foreign countries can embed a variety of taxes into a general income tax regime. Reg. §1.901-1(d)(1) provides that whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes.

The regulations go on to state that a levy imposed by one taxing authority (e.g., the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (e.g., a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered to be imposed as a separate levy. For example,
regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others.

Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of §1.903-1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, e.g., wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also §1.901-2A(a).

This separate levy rule, in combination with the complete substitution requirements of section 903, create difficult interpretive issues. A taxpayer makes a single payment to the foreign tax office, but is that lump-sum payment composed of a payment related to multiple separate levies that are contained with the foreign country’s income tax laws. If a payment is a separate levy, then it must qualify in its own right as an income tax under section 901 or be in complete substitution of the generally applicable income tax. The below case provides a good example of the interaction of the multiple levy rule now contained in Reg. §1.901-1(d) and the completely in lieu of requirement of section 903.

Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner 
26 TC 582 (1956)

FINDINGS OF FACT ***

In its United States income tax return for 1947, petitioner claimed a foreign tax credit of $13,760.38 on account of taxes accrued for that year to the Republic of Colombia. In a claim for a refund filed on May 2, 1949, the petitioner sought an additional credit of $264.19 or a total foreign tax credit of $14,024.57. The respondent determined a deficiency in the petitioner's income tax for 1947 in the amount of $3,313.90. The statement accompanying the notice of deficiency reads, in part, as follows:

It is held that that portion of the foreign tax credit claimed by you which represents the Colombian Patrimony tax does not qualify as a foreign tax credit under the applicable provisions of the Internal Revenue Code. ***

OPINION.

Kern, Judge:

The sole issue for decision is whether the Colombian patrimony tax of $3,257.67 (and the 35 per cent surcharge thereon of $1,120.22), accrued by the petitioner in 1947, is an income tax or a tax in lieu of a tax on income within the meaning of section 131 of the Internal Revenue Code of 1939 so as to qualify these amounts as foreign tax credits.

The petitioner bases its principal argument for
the allowance of the credit on the contention that under the laws of the Republic of Colombia, the tax paid to that country was "a single tax, not divisible into separate parts," that it was "predominantly an income tax," and hence the entire amount paid qualifies for the credit under section 131 (a). It points to the following indicia as support for its position on the classification of the tax: Article 64 of the Colombian tax law imposing the patrimony tax states that the income, patrimony, and excess profits taxes "shall be considered one and indivisible"; the judicial and administrative interpretations of the statute have construed the three levies as an indivisible whole, as only modalities or variations of the income tax; all information for the computation of the three-part tax and the surcharges thereon is submitted in a single report; the three levies are combined into one total which is reduced by the amount of an exemption before the surcharges are computed; and references in the Colombian law are to a single tax resulting from the combination of the three levies and the surcharges and not to separate taxes.

It is clear that under the law of the Republic of Colombia the patrimony tax is deemed to be a supplement to and indivisible from the income tax. It appears from the opinions of the Supreme Court of Justice that this characterization results not from mere administrative convenience in handling three taxes through one return, but from a fiscal policy based on the theory that the income tax, in order to be an equitable revenue system, requires a tax on capital to more fairly distribute the burdens among the nation's taxpayers and to prevent the state from being penalized if a property owner, through negligence or for some other reason, fails to realize the inherent productive potential of his property.

However, it is well settled that the determination of whether or not a foreign levy qualifies as an income tax within the meaning of section 131 (a) is to be made not upon the characterization of the foreign law, but under the criteria established by the internal revenue laws of the United States. Biddle v. Commissioner, 302 U. S. 573; Keasbey & Mattison Co. v. Rothensies, supra. In other words, "the determinative question is whether the foreign tax is the substantial equivalent of an income tax as the term is understood in the United States." Commissioner v. American Metal Co., (C. A. 2, 1955) 221 F.2d 134.

The doctrine that only those increases in value of property which are actually realized by the owner constitute taxable income is basic to the income tax system of the United States. See Commissioner v. Glenshaw Glass Co., 348 U. S. 426; United States v. Kirby Lumber Co., 284 U. S. 1; and Keasbey & Mattison Co. v. Rothensies, supra, in which the court said: "The defined concept of income has been uniformly restricted to a gain realized or a profit derived from capital, labor, or both." The Colombian income tax separately considered provides for the taxation of net income and its substantial equivalence to our own income tax has been recognized by the respondent in the instant case. The patrimony tax separately considered is really a tax on property and results in a levy upon the net value of the taxpayer's assets which will include any unrealized appreciation of such value. It is computed separately from the income tax from information respecting the taxpayer's assets and liabilities and does not give effect to items of income and expense. The petitioner's own expert witness testified that it is possible for a taxpayer to be liable for a patrimony tax in a year when the taxpayer has no revenue and is not liable for the income tax, and such testimony is in accord with the language of Article 64. The computation of the patrimony tax and the computation of the surcharge thereon are not so integrated with the income tax itself as to create any problem of allocating the total tax paid to Colombia. We are not bound by the classification of the patrimony tax under Colombian law as part of the income tax. L. Helena Wilson, supra. After careful consideration of the Colombian tax law, it is our conclusion that there is no substantial equivalent to the patrimony tax under our income tax system, and that this part of the Colombian tax is not an income tax within the meaning of section 131 (a).
The petitioner cites *Helvering v. Campbell*, (C. A. 4, 1944) 139 F. 2d 865, and Rev. Rul. 56-1 C. B. 320, for the proposition that for the purpose of section 131 the classification of a single tax will be governed by its predominant character and argues that the tax in issue herein was predominantly an income tax. The authorities cited by the petitioner do not involve the allowance of a credit for a separately computed tax not based on income and are clearly distinguishable. Furthermore, the petitioner's classification of the Colombian tax as a single tax predominantly income in character depends on the characterization of the Colombian law which we have held above is not controlling.

The petitioner's final argument is that the patrimony tax is at least a tax in lieu of a tax on income within the meaning of section 131 (h). The legislative purpose in enacting this subsection in 1942 is expressed in the report of the Senate Committee on Finance, S. Rept. No. 1631, 77th Cong., 2d Sess., pp. 131-132, as follows:

> Your committee believes further amendments should be made in section 131. Under that section as it now stands, a credit is allowed against United States tax for income, war profits or excess profits taxes paid or accrued to any foreign country or to any possession of the United States. In the interpretation of the term income tax, the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. Thus if a foreign country in imposing income taxation authorized, for reasons growing out of the administrative difficulties of determining net income or taxable basis within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but measured, for example, by gross income, gross sales or a number of units produced within the country, such tax has not heretofore been recognized as a basis for a credit. Your committee has deemed it desirable to extend the scope of this section. Accordingly, subsection (f) of section 160 provides that the term "income, war profits and excess profits taxes" shall, for the purposes of sections 131 and 23 (c) (1), include a tax paid by a domestic taxpayer in lieu of the tax upon income, war profits and excess profits taxes which would otherwise be imposed upon such taxpayer by any foreign country or by any possession of the United States. The limitation upon the amount of the credit will, of course, continue to apply, so that it will be allowed only if and to the extent the taxpayer has net income from sources within the foreign country or from sources without the United States, as the case may be.

Regulations 111, section 29.131-2, applicable to 1947, provide, in part, as follows:

For the purposes of section 131 and section 23 (c) (1) the term "income, war-profits, and excess-profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if (a) such country or possession has in force a general income tax law, (b) the taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and (c) such general income tax is not imposed upon the taxpayer thus subject to such substituted tax. For example, the A Corporation does business in the X country, which imposes an income tax upon substantially a net income base. The ascertainment of net income, though not the determination of gross income, from sources in X country is found administratively difficult. The X
country, by decree, provides that corporations circumstanced as was the A Corporation would, in lieu of the income tax at the rate of 20 percent otherwise payable, be subject to tax at the rate of 10 percent upon the amount of gross income from X country. In accordance with such decree, the A Corporation paid X country the sum of $25,000 in 1943 with respect to its tax liability to the X country for the year 1942. Such amount, subject to the applicable limitations, is available as a credit to the A Corporation as foreign income, war-profits, or excess-profits taxes against the United States tax liability for the year 1942.

***

The Committee Report and the regulations indicate that the substituted tax must be related to income or to the taxpayer's productive output. There is nothing in either to indicate that a property tax that has no relation to the taxpayer's income or production was to be deemed such a substitute. The petitioner was subject to and paid the Colombian income tax in 1947, and has been granted a credit under section 131 (a) for the amount of such tax. The patrimony tax, which we have construed to be a property tax, was imposed not as a substitute for but as a supplement to the Colombian income tax and no deduction is allowable for the amount of such tax against the Colombian income tax. Therefore, the patrimony tax does not qualify as a tax in lieu of a tax on income within the meaning of section 131 (h). See Compania Embotelladora Coca-Cola v. United States, (Ct. Cl. 1956) 139 F. Supp. 953.

Decision will be entered under Rule 50.

Problems on Basic Eligibility Rules of §901 and §903

1. Galaxy Inc. (“Galaxy”), a U.S. corporation, is engaged in the business of rendering engineering and project management services in Country A. Galaxy also licenses certain Country A patents to clients for use in connection with projects in which Galaxy is involved. Country A has no generally applicable income tax. It does, however, impose a withholding tax of 20 percent on gross royalties and a withholding tax of 25 percent on gross fees for services rendered in Country A when such royalties and fees are paid by residents of Country A to foreign persons. The gross royalties and gross service fees are independent tax bases on which each withholding tax is separately computed. No deductions are permitted. Galaxy receives royalties and engineering and project management fees from clients in Country A from which the 20 and 25 percent taxes are withheld, respectively. Are the withholding taxes creditable by Galaxy?

2. Would the results in Problem 1 be different if Country A has a generally applicable income tax that is not imposed on royalties and fees paid by Country A residents to foreign persons, which are subject to the withholding taxes described?

3. The government of Country B imposes an income tax of 30 percent on the net income realized from sources within Country B by foreign persons engaged in business there. Domestic persons (including Country B corporations) are not subject to the income tax. Cosmos Corporation, a U.S. corporation, is engaged in Country B in the business of mining and exporting copper ore through a wholly owned subsidiary organized under the laws of Country B. As a Country B corporation, the subsidiary is exempt from the income tax, but it pays an export tax of $1,000 per ton of the copper ore exported. No portion of this levy is paid in exchange for a specific economic benefit from the government of Country B. No deductions are permitted in calculating this tax, and $1,000 per ton is a rate that is fixed without reference to the market value of the exported copper. Is the export tax creditable?
4. Would the results in Problem 3 be different if Cosmos Corporation were engaged in the business described through a branch in Country B (rather than through a Country B subsidiary) and the branch were subject to the export tax rather than to the income tax?

5. Orbit Corporation ("Orbit"), a U.S. corporation, has established in Country C a branch office that coordinates the export sales throughout Africa of Orbit products manufactured by Orbit in the United States. Since the office is not actually engaged in the sales transactions, which are handled by Orbit’s export division in New York, no revenue appears on the books of the Country C branch; only the expenses of the office are reflected on its books. Country C has a generally applicable income tax. Recognizing, however, the difficulty of determining the proper amount of the net export income attributable to the Country C branch office, the Country C tax authorities issue a ruling to the effect that the branch will be taxed on the assumption that the gross income of the office will equal 120 percent of the expenses of the office. This assumed income less the actual expenses of the office will be subject to the generally applicable Country C income tax of 35 percent. Will the resulting Country C tax be creditable?

6. Sun Incorporated, a U.S. corporation, owns 5,000 acres of undeveloped land in Country D, but is not engaged in business in Country D and has no income (under U.S. concepts) from Country D sources. Country D has a generally applicable tax imposed on net income at a rate of 30 percent. Under Country D tax law, an owner of real estate is deemed to realize the imputed rental value of any real estate to the extent that the imputed rental value exceeds the actual rental income (if any) received. Costs and expenses attributable to the imputed rent are allowed as a deduction in computing the base of the Country D tax. Accordingly, the 30–percent Country D tax is imposed on an imputed rental value from Sun Incorporated’s land equal to $50,000 per year, less the costs and expenses attributed to the imputed rent. Is this tax creditable?

7. Would the results in Problem 6 be different if the United States had severed diplomatic relations with Country D?

8. Katherine, a U.S. citizen and resident, is employed for eight months in Country E by a Country E corporation and earns $90,000 during that period. She also owns shares of stock in several Country E corporations, which trade on the Country E stock exchange and have increased in total value by $50,000 during the current year. Under the tax laws of Country E, a taxpayer’s net income from all business and investment activities is subject to a tax rate of 25 percent. Net income from the sale of property, including stock, is subject to this tax when the property is sold or exchanged. The definition of net income for purposes of this tax is similar to the definition of taxable income in Section 63 of the Code, except that no personal deductions or exemptions are allowable. In determining the amount of a taxpayer’s income from the trade or business of being an employee, gross wages are includible in income and no deductions for the expenses attributable to the wage income are allowable. In addition, the aggregate net appreciation in the fair market value of all shares of stock in Country E corporations held by a taxpayer at the end of the tax year is subject to a tax of ten percent. The adjusted basis of the stock for purposes of the 25–percent tax on net income is adjusted upward in an amount equal to the net appreciation in the value of the stock that was subject to this ten-percent stock appreciation tax. During the current year, Katherine pays the 25–percent tax on her compensation income and the ten-percent tax on the appreciation in her stock in the Country E corporations. Are these Country E taxes creditable?

9. Lunar Inc. ("Lunar"), a U.S. corporation, is engaged in manufacturing widgets in Country F through a branch located there. Under its contract with the government of Country F, Lunar must pay tax to Country F equal to the greater of (i) $100 per item produced or (ii) the maximum
amount creditable by Lunar against its U.S. tax liability for that year with respect to income from its operations in Country F. Lunar is exempted from Country F’s otherwise generally imposed income tax. Lunar produces 500 widgets during the tax year and the maximum amount creditable by Lunar against its U.S. tax liability for the year is $75,000. If Lunar had been subject to Country F’s generally imposed income tax, it would have paid a tax to Country F of $40,000. How much, if any, of the $75,000 tax paid by Lunar to Country F will be creditable?

10. How would your answer in Problem 9 differ if Lunar had produced 1,000 widgets (and, thus, had to pay Country F a tax of $100,000 ($100 multiplied by the 1,000 widgets produced) because that amount exceeded the $75,000 maximum amount creditable by Lunar against its U.S. tax liability for the year)?

11. How would your answer in Problem 9 differ if Lunar would have paid $80,000 in tax to Country F if it had been subject to the generally imposed income tax?

12. Foreclosure Bank Corporation (‘‘Foreclosure’’), a U.S. banking corporation, lends money to Foreign Development, Inc., a development bank in Country G, a foreign country. Foreign Development, Inc. relends the borrowed funds to various Country G corporations. Country G imposes a 30– percent withholding tax of $300,000 on the $1,000,000 of interest paid by Foreign Development, Inc. to Foreclosure, which Foreign Development, Inc. withholds from the interest payments to Foreclosure. (This withholding tax applies to Foreclosure’s interest income instead of the generally imposed Country G net income tax.) Country G credits 60 percent of the tax to an account of Foreign Development, Inc. on the date the tax is withheld and requires Foreign Development, Inc. to transfer the credited amount to the various Country G corporations that had borrowed funds from Foreign Development, Inc. Is the $300,000 withholding tax on the interest income creditable by Foreclosure?

13. How would your answer in Problem 12 differ if the Country G corporations that had borrowed the funds from Foreign Development, Inc. were wholly owned by the Country G government?

14. In year 1, XYZ Manufacturing Corporation (‘‘XYZ’’), a U.S. corporation, receives $1,000,000 of interest income from a borrower who is resident in Country H, a foreign country. Country H has an income tax law that imposes a tax of 30 percent ($300,000) on the gross amount of such interest income and requires Country H debtors to collect the tax through withholding. However, a tax treaty between Country H and the United States provides that Country H may not tax interest received by a U.S. resident at a rate in excess of five percent. A U.S. resident may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (25 percent of the gross amount of interest income) after the end of the tax year. XYZ does not file a timely claim for refund of the $250,000 excess withheld amount. To what extent is the Country H tax paid by XYZ creditable?

15. How would your answer in Problem 14 differ if it is not clear whether XYZ is eligible for the treaty reduction because under the loan agreement the amount of XYZ’s interest income is, in part, contingent on the Country H borrower’s net profits for the year and the Country H treaty provision on interest income does not apply to certain types of contingent interest? XYZ has been advised by counsel that efforts to invoke the competent authority process have been fruitless and that securing the benefits of the treaty provision would probably involve costly litigation to establish XYZ’s entitlement to such benefits. Accordingly, XYZ decides not to pursue the refund claim.
Exxon Corp. v. Commissioner
113 TC 338 (1999)

SWIFT, Judge

The issue for decision is whether petroleum revenue tax (PRT) petitioners paid to the United Kingdom for 1983 through 1988 constitutes, for U.S. income tax purposes, a creditable income or excess profits tax under section 901 or a creditable tax in lieu thereof under section 903.

OPINION

With limitations not here pertinent, taxpayers may claim credits under section 901 against their Federal income taxes for, among other things, the amount of income and excess profits taxes paid to foreign countries. See sec. 901(b)(1). As an exemption from tax, the credit provisions of section 901 are to be strictly construed. See Inland Steel Co. v. United States, 230 Ct. Cl. 314 [49 AFTR 2d 82-1241], 677 F.2d 72, 79 (1982); Bank of Am. Natl. Trust & Sav. Association v. United States, 61 T.C. 752, 762 (1974), aff'd. without published opinion 538 F.2d 334 (9th Cir. 1976).

Under regulations applicable to the years in issue, foreign levies are to be regarded as income or excess profits taxes if they satisfy two tests: (1) The foreign levies constitute taxes, and (2) the predominant character of the taxes is that of an income tax in the U.S. sense. See sec. 1.901-2(a)(1), Income Tax Regs.

Generally, governmental levies imposed by and paid to foreign countries are to be treated as taxes if they constitute compulsory payments pursuant to the authority of the foreign countries to levy taxes. The regulations, however, also provide that foreign levies will not be regarded as taxes to the extent that payors of the levies receive specific economic benefits, directly or indirectly, from the foreign countries in exchange for payment of the levies. See sec. 1.901-2(a)(2), Income Tax Regs. The regulations also provide that economic benefits that foreign Governments do not make available on substantially the same terms to substantially all persons subject to the generally imposed income tax (such as a concession to extract Government-owned petroleum) will be regarded as specific economic benefits. See sec. 1.901-2(a)(2)(ii)(B), Income Tax Regs.

Exxon acknowledges that the licenses it received from the United Kingdom to exploit North Sea petroleum resources constitute the receipt of specific economic benefits and therefore that Exxon is to be treated under the regulations as a "dual capacity" taxpayer and as subject to the regulations with regard thereto under sections 1.901-2(a)(2) and 1.901-2A, Income Tax Regs. Thereunder, dual capacity taxpayers (who pay levies and who also receive specific economic benefits from the Government) have the burden to establish the extent, if any, to which foreign levies they pay constitute taxes - as opposed to payments for the specific economic benefits received - either by relying on the regulations' safe harbor method or on the facts and circumstances method. See sec. 1.901-2A(c)(1) and (2), Income Tax Regs. Exxon herein relies on the facts and circumstances method, and Exxon is required to establish, under all of the relevant facts and circumstances associated with its payment of PRT, what portion, if any, of PRT paid by it to the United Kingdom constitutes taxes, as distinguished from payments in exchange for the license rights it received. See sec. 1.901-2A(b), (c), Income Tax Regs.

*** The parties have stipulated that PRT meets the realization and gross receipts requirements of section 1.901-2(b)(2), (3), Income Tax Regs., that PRT constitutes a compulsory payment imposed by the United Kingdom within the meaning of section 1.901-2(a)(2)(i), Income Tax Regs., and that PRT does not
constitute a soak-up tax within the meaning of section 1.901-2(c), Income Tax Regs. The only issues before us are whether PRT paid by Exxon is to be treated as a tax (as opposed to payment for specific economic benefits) and whether the predominant character of PRT may be regarded as an income tax in the U.S. sense and thereby as satisfying the net income test. 8

PRT and Compensation for Specific Economic Benefits

The evidence in these cases establishes that PRT paid by Exxon does not constitute compensation in exchange for license rights or other specific economic benefits received by Exxon. Upon enactment of PRT and upon or in exchange for payment of PRT, Exxon was granted no additional rights, under its licenses or otherwise, with respect to North Sea petroleum resources. Exxon's rights to explore for, develop, and exploit petroleum resources in the North Sea during the years in issue arose from and were dependent upon licenses Exxon obtained from the United Kingdom in prior years (before PRT was enacted) and on Exxon's payment to the United Kingdom of license fees and royalties due under those licenses.

The United Kingdom's purpose in enacting PRT in 1975 was to take advantage of rising oil prices and to ensure that the United Kingdom realize an appropriate share of excess profits to be realized by Exxon and by other oil and gas companies from exploitation of petroleum resources in the North Sea during the years in issue arose from and were dependent upon licenses Exxon obtained from the United Kingdom in prior years (before PRT was enacted) and on Exxon's payment to the United Kingdom of license fees and royalties due under those licenses.

License fees owed and paid by Exxon under terms of the discretionary licenses (consisting of the up-front fees, annual fees, and 12-1/2-percent royalties) represented substantial and reasonable compensation to the United Kingdom for the licenses. As indicated, through 1992 the oil and gas companies have paid to the U.K. Government more than GBP 16 billion in royalties alone in connection with the North Sea licenses.

Under its sovereign taxing power, the United Kingdom intended to and did impose PRT as a tax, not as payment for specific economic benefits. Respondent stipulates that PRT was not negotiated but was imposed unilaterally, as a compulsory payment, and that PRT was enacted and is administered as a tax under U.K. law - all characteristics of taxes, not of payments for specific economic benefits. The parties herein rely heavily on expert witnesses - from the petroleum industry, from the United Kingdom, from legal, tax, accounting, and economic professions - as to the character of PRT as a tax or as payment for specific economic benefits.

The basis of the opinions rendered by respondent's economic experts seems to be that, in hindsight, oil companies "got a good deal" when they entered into North Sea license agreements, that the licenses turned out to be more valuable than anyone anticipated at the time the licenses were issued, and therefore that the oil companies "probably felt there was an implicit contract" to pay some type of additional charges, and that these additional charges (whatever they may be called, however they are administered, and regardless of their features) should be regarded as what respondent's expert witnesses refer to as "economic rent" (i.e., as deferred payments in exchange for the licenses granted in earlier years to the oil companies) and not as taxes.

Respondent's experts overemphasize the fact that North Sea licenses issued by the United Kingdom to the oil and gas companies in the late 1960's and in the 1970's were issued largely without an auction system. As we have found, throughout the world most countries traditionally have not relied on auction systems to issue licenses for the right to exploit petroleum resources.

In considering North Sea licenses Exxon received and under which it operated in the North Sea, respondent's experts fail to recognize and to give proper weight to the significant uncertainties, risks, and investment commitments associated with oil and gas exploration and production in the North Sea that, at the time the licenses were issued to Exxon, were associated with the licenses - risks
that insufficient oil and gas deposits in the North Sea would be found, that petroleum resources that might be discovered would not be commercially recoverable, and that the large investments required to explore for oil and gas and to operate in the North Sea would be lost.

Respondent's experts speculate that in light of increased oil prices in the late 1970's and early 1980's, the United Kingdom could have set the license fees higher and obtained higher revenues under the North Sea licenses. That, however, is not the proper inquiry. We are not particularly concerned with speculation, about whether in retrospect the United Kingdom extracted all the revenues it could have from oil companies under the licenses. Rather, as Exxon's witnesses emphasize, the proper focus is whether PRT was imposed and paid "in exchange for" North Sea license rights. This is the focus of the regulations under section 901 and that focus is to be maintained here. See sec. 1.901-2(a)(2), Income Tax Regs; see also Phillips Petroleum Co. v. Commissioner, 104 T.C. 256, 297 (1995).

In Phillips Petroleum Co., we held that Norway's Special Tax on oil and gas activity in the Norwegian sector of the North Sea constituted, for U.S. Federal income tax purposes, a creditable tax under section 901. Norway's Special Tax is similar in a number of significant respects to PRT.

Under temporary Treasury regulations applicable to the years involved in Phillips Petroleum Co., Norway's Special Tax was to be treated as a tax as long as "no significant part of the charge [represents] compensation for the specific economic benefit received". See sec. 4.901-2(b)(2)(iii), Temporary Income Tax Regs., 45 Fed. Reg. 75649 (Nov. 17, 1980), as applicable to 1979 to 1982. Applying that test, we held in Phillips Petroleum Co. v. Commissioner, supra at 289-297, that Norway's Special Tax constituted a tax and not payment for specific economic benefits.

The Norway Special Tax was enacted in 1975 and was imposed on oil and gas companies operating under discretionary licenses granted by Norway requiring payment of initial fees, annual fees, and 10 percent royalties. We concluded that by payment of the Special Tax the oil and gas companies were not granted additional rights under their licenses, that the fees and royalties paid under the licenses represented substantial compensation for such licenses, that the Special Tax constituted a tax and not an additional royalty, and that the purpose of the Special Tax was to impose taxes on excess and unexpected profits, not to impose additional charges on oil companies for rights to extract oil, and therefore that the Special Tax constituted a tax, not a levy in exchange for specific economic benefits. In Phillips Petroleum Co. v. Commissioner, supra at 295, we explained:

The word "tax" in [the U.S.] *** is generally understood to mean an involuntary charge imposed by legislative authority for public purposes. It is exclusively of statutory origin. Tax burdens and contractual liabilities are very different things. A tax is compulsory, an exaction of sovereignty rather than something derived by agreement. A tax is a revenue-raising levy imposed by a governmental unit. It is a required contribution to the governmental revenue without option to pay. A royalty refers to a share of the product or profit reserved by an owner for permitting another to use a property. [Citations omitted.]

In Phillips Petroleum Co., we then concluded that the Norwegian Special Tax was enacted to take advantage of a new profit situation created by surging oil prices, and to receive a larger share of what Norway saw as extraordinarily high and unforeseen profits generated from Norwegian resources, and at the same time to allow petroleum companies to earn a reasonable profit. [Id. at 292.]

Phillips Petroleum Co. v. Commissioner, supra, supports our finding and conclusion herein that PRT is not to be regarded as payment in exchange for specific economic benefits Exxon received under its North Sea licenses.
All of the PRT the character of which is in dispute in these cases was paid by Exxon with respect to oil production from fields licensed to Exxon before 1975 and before PRT was enacted. As one of respondent's experts acknowledges, Exxon did not receive any special benefits under its licenses, or otherwise, for paying PRT, and Exxon in later years, as a result of paying PRT, did not receive any special advantages in obtaining additional North Sea licenses.

The credible and persuasive evidence strongly supports and we conclude that all PRT paid by Exxon for the years in question constitutes taxes, not payments for specific economic benefits.

**PRT and the Net Income Test**

The purpose, administration, and structure of PRT indicate that PRT constitutes an income or excess profits tax in the U.S. sense. The provisions of PRT include in the tax base, with limited exceptions, income earned from North Sea-related activity and permit allowances, reliefs, and exemptions that effectively compensate for nondeductibility of certain oil company expenses, particularly interest. Although a deduction is not allowed for interest expense related to North Sea operations, uplift, oil, safeguard, and tariff receipts allowances provide sufficient relief to offset for nonallowance of a deduction for interest expense. See sec. 1.901-2(b)(4)(i), Income Tax Regs. For 1975 through 1988, representative industry data indicate that oil companies received uplift allowances alone of GBP 12.4 billion as compared to North Sea-related interest expense not allowed of GBP 8.6 billion.

Evidence at trial covering approximately 88 percent of total oil production in the North Sea and 98 percent of total PRT paid by oil companies during 1975 through 1988 shows that special allowances and reliefs under PRT significantly exceed the amount of disallowed interest expense for Exxon and other oil companies. These special allowances and reliefs reduce the base of PRT to a subset of net income representing excess profits and establish that, in its predominant character, PRT constitutes and is to be treated as an income tax.

Although PRT does not allow a deduction for interest expense - certainly a significant expense - under the special provisions allowed (particularly uplift), the oil companies are provided under PRT allowances that effectively compensate for the nondeductibility of interest expense.

As explained by the Government official who on April 10, 1975, first presented for formal legislative consideration the proposed Ring Fence Tax and PRT to the U.K. House of Lords, "In fact, of course, this tax [PRT] represents an excess profits tax."

*** We conclude that PRT constitutes a tax, that the predominant character of PRT constitutes an excess profits or income tax in the U.S. sense, and that PRT paid by Exxon to the United Kingdom for the years in issue is creditable under section 901 against Exxon's U.S. Federal income tax liability. In light of our resolution of the above issues, we need not address Exxon's alternative argument that PRT qualifies under section 903 as a creditable tax in lieu of an income tax.

To reflect the foregoing,

*Decisions will be entered under Rule 155.*
Chapter 9

When a corporation transfers an intangible to a foreign corporation for stock, the transaction would generally represent a nonrecognition transaction under Section 351. However, the whipsaw is obvious, isn’t it? A US developer of an intangible was likely entitled to an immediate deduction for the U.S. research and development costs under Section 174, and the U.S. developer may also have been entitled to a U.S. tax credit for incremental research activities under section 41. Having claimed significant deductions for the development of the intangible, the ownership of the intangible (once proven) is then transferred to a foreign corporation that has no U.S. taxable presence to then exploit that intangible.

Property.
But, in order for this technique to have been effective, the taxpayer must have ownership of something that constitutes “property” (in contrast to “services”) and the ownership of that “property” must then be “transferred.” In this regard, Reg. §1.482-9(m) provides that “a transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as … a transfer of tangible or intangible property.” The regulations then provide the following Example 4

Example (4).
(i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both companies perform research and development activities relating to integrated circuits. In addition, Company Y manufactures integrated circuits. In years 1 through 3, Company X engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report. In years 1 through 3, Company X generates overall net operating losses as a result of the expenditures associated with this research and development effort. At the beginning of year 4, Company X enters into a technical assistance agreement with Company Y. As part of this agreement, the researchers from Company X responsible for this project meet with the researchers from Company Y and provide them with a copy of the written report. Three months later, the researchers from Company Y apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researchers from Company X.
(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (such as, know-how). Because the element relating to the intangible property is material to the arm’s length evaluation, the arm’s length result for that element must be corroborated or determined by an analysis under §1.482-4.

See Reg. §1.482-9(m)(5) Example (4).

The below revenue ruling is the leading ruling on what constitutes “know how” that rises to the level of an intangible asset that can be transferred.
Rev. Rul. 64-56, 1964-1 CB 133

The Internal Revenue Service has received inquiries whether technical "know-how" constitutes property which can be transferred, without recognition of gain or loss, in exchange for stock or securities under section 351 of the Internal Revenue Code of 1954.

The issue has been drawn to the attention of the Service, particularly in cases in which a manufacturer agrees to assist a newly organized foreign corporation to enter upon a business abroad of making and selling the same kind of product as it makes. The transferor typically grants to the transferee rights to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. The transferor also often agrees to furnish technical assistance in the construction and operation of the plant and to provide on a continuing basis technical information as to new developments in the field.

Some of this consideration is commonly called "know-how." In exchange, the transferee typically issues to the transferor all or part of its stock.

Section 351 of the Code provides, in part, as follows:

(a) General Rule.-No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property. (Emphasis added.)

Since the term "know-how" does not appear in section 351 of the Code, its meaning is immaterial in applying this section, and the Service will look behind the term in each case to determine to what extent, if any, the items so called constitute "property *** transferred to a corporation *** in exchange for stock."

The term "property" for purposes of section 351 of the Code will be held to include anything qualifying as "secret processes and formulas" within the meaning of sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for (see G.C.M. 21507, C.B. 1939-2, 189; Wall Products Inc. v. Commissioner, 11 T.C. 51, at 57 (1948), acquiescence, C.B. 1949-1, 4; Ralph L. Evans v. Commissioner, 8 B.T.A. 543 (1927), and without regard to whether it is patentable in the patent law sense (see Marvin R. Thompson v. Johnson, United States District Court for the Southern District of New York, entered July 26, 1950, 50-2, U.S. Tax Cases, paragraph 9428, 42 American Federal Tax Reports 1284). Other information which is secret will be given consideration as "property" on a case-by-case basis.

The fact that information is recorded on paper or some other physical material is not itself an indication that the information is property. See, for example, Harold L. Regenstein, et ux. v. Commissioner, 35 T.C. 183 (1960), where the fact that a program for providing group life insurance to Federal Government employees was transmitted in the form of a written plan did not preclude a finding that the payment for the plan was a payment for personal services.

It is assumed for the purpose of this Revenue Ruling that the country in which the transferee is to operate affords to the transferor substantial legal protection against the unauthorized disclosure and use of the process, formula, or other secret information involved.

Once it is established that "property" has been transferred, the transfer will be tax-free under section 351 even though services were used to produce the property. Such is generally the case where the transferor developed the property primarily for use in its own manufacturing business. However, where the information transferred has been developed specially for the transferee, the stock received in exchange for it may be treated as payment for services rendered. See Regenstein, supra, where the taxpayer developed a plan for selling insurance which he ultimately sold to certain insurance companies. The court held that
the consideration received was payment for services.

Where the transferor agrees to perform services in connection with a transfer of property, tax-free treatment will be accorded if the services are merely ancillary and subsidiary to the property transfer. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective "starting-up" of the property transferred, or by performing under a guarantee relating to such effective starting-up. Compare Raymond M. Hessert v. Commissioner, Tax Court Memorandum Opinion, entered October 31, 1947, and Arthur C. Ruge, et ux. v. Commissioner, 26 T.C. 138, at 143 (1956), acquiescence, C.B. 1958-2, 7. Where both property and services are furnished as consideration, and the services are not merely ancillary and subsidiary to the property transfer, a reasonable allocation is to be made.

Training the transferee's employees in skills of any grade through expertness, for example, in a recognized profession, craft, or trade is to be distinguished as essentially educational and, like any other teaching services, is taxable when compensated in stock or otherwise, without being affected by section 351 of the Code. However, where the transferee's employees concerned already have the particular skills in question, it will ordinarily follow as a matter of fact that other consideration alone and not training in those skills is being furnished for the transferor's stock.

Continuing technical assistance after the starting-up phase will not be regarded as performance under a guarantee, and the consideration therefor will ordinarily be treated as compensation for professional services, taxable without regard to section 351 of the Code. Compare Paulsen Spence, et ux. v. United States, 156 Fed. Supp. 556, at 560 (1957), where the Hessert and Ruge cases were distinguished and compare Kimble Glass Company v. Commissioner, 9 T.C. 183 at 189 (1947), acquiescence, C.B. 1947-2, 3.

Assistance in the construction of a plant building to house machinery transferred, or to house machinery to be used in applying a patented or other process or formula which qualifies as property transferred, will ordinarily be considered to be in the nature of an architect's or construction engineer's services rendered to the transferee and not merely rendered on behalf of the transferor in producing, or promoting the sale or exchange of, the things transferred. Similarly, advice as to the lay-out of plant machinery and equipment may be so unrelated to the particular property transferred as to constitute no more than a rendering of advisory services to the transferee.

The transfer of all substantial rights in property of the kind hereinbefore specified will be treated as a transfer of property for purposes of section 351 of the Code. The transfer will also qualify under section 351 of the Code if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding that rights are retained as to some other country's territory. See Lanova Corporation v. Commissioner, 17 T.C. 1178 (1952), acquiescence, C.B. 1952-1, 3.

The property right in a formula may consist of the method of making a composition and the composition itself, namely the proportions of its ingredients, or it may consist of only the method of making the composition. Where the property right in the secret formula consists of both the composition and the method of making it, the unqualified transfer in perpetuity of the exclusive right to use the formula, including the right to use and sell the products made from and representing the formula, within all the territory of the country will be treated as the transfer of all substantial rights in the property in that country.

The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country, or the unqualified transfer in perpetuity of the exclusive right to make, use and sell an unpatented but secret product within all the territory of a country, will be treated as the transfer of all substantial rights in the property in that country.
Revenue Ruling 55-17, C.B. 1955-1, 388, is modified to remove the implication that payments for the rights described there as "know-how" will be treated as royalty income without regard to the factors applied here to determine whether such rights constitute property.

NOTES & QUESTIONS

1. The transfer of an intangible asset need not be in perpetuity if the transfer represents the entire expected economic life of the asset. Thus, in Rev. Rul. 71-564, 1971-2 C.B. 179, the IRS held that the transfer of the exclusive right to a trade secret for the period in which it was not publicly known represented a transfer of an intangible asset.

2. Prior to 1984, taxpayers were required to obtain an advance ruling if they wanted to qualify a transfer of an intangible to a foreign corporation for nonrecognition treatment under section 351. That process is no longer required, but this revenue procedure remains helpful in terms of identifying the types of issues that are relevant to determine whether know how represents “services” or is in fact an intangible asset for U.S. tax purposes.


1. PURPOSE.

The purpose of this Revenue Procedure is to set forth the conditions or circumstances under which, for purposes of advance rulings under section 367 of the Internal Revenue Code of 1954, the Internal Revenue Service will issue a ruling that an agreement which purports to furnish technical "know-how" in exchange for stock is a transfer of property within the meaning of section 351 of the Code.

2. BACKGROUND.

.01. In order for a secret process, formula, or other secret information (often referred to as technical "know-how," and hereinafter referred to simply as "information") to qualify as property that can be transferred, without recognition of gain or loss, in exchange for stock or securities under section 351 of the Code, Revenue Ruling 64-56 , C.B. 1964-1 (Part I), 133, provides in part that (1) the consideration from the transferor (the "information") must actually qualify as property within the meaning of sections 861(a)(4) and 862(a)(4) of the Code rather than personal services in the form of technical assistance and (2) the country in which the transferee is to operate must afford to the transferor substantial legal protection against the unauthorized disclosure and use of the "information."

.02. These requirements encompass issues of both fact and law. Resolution of these issues requires factual information and determinations, making it difficult to issue an unqualified ruling before the transaction has been consummated. Nevertheless, in spite of such difficulties, it is in the interest of sound tax administration to continue to answer inquiries of taxpayers on these issues. Therefore, the Service upon request will continue to issue rulings on these transactions provided the taxpayer can in good faith make certain factual representations in his application regarding the issue based upon information that would be readily available to the Service upon request.

3. STATEMENTS TO BE INCLUDED IN RULING REQUESTS.

.01. Ordinarily, for purposes of advance rulings under section 367 of the Code where the request involves the transfer of "information" in exchange for stock under section 351, the Service will accept appropriate representations referred to in section 2.02 above. If appropriate, statements as follows should be included in the request for ruling:

- "It is represented that the "information" being transferred in exchange for stock under section 351 is "property" within the meaning of Revenue Ruling 64-56, C.B. 1964-1 (Part
I), 133, and as such is afforded substantial legal protection against unauthorized disclosure and use under the laws of the country from which it is being transferred. It is further represented that any services to be performed in connection with the transfer of the property are merely ancillary and subsidiary to the property transfer within the meaning of Revenue, ruling 64-56 or the transferor will be compensated by a fee negotiated at arm's length (in consideration other than stock or securities of the transferee unless such stock or securities are identified) for any other services to be performed on behalf of the transferee.’

.02. In making such representations the taxpayer should in his request for ruling describe the "information" involved and state that:

- (a) the "information" is secret in that it is known only by the owner and those confidential employees who require the "information" for use in the conduct of the activities to which it is related and adequate safeguards have been taken to guard the secret against unauthorized disclosure, and

- (b) the "information" represents a discovery and, while not necessarily patentable, the "information" is original, unique, and novel.

.03. The statements and representations described in .01 and .02 above must be based upon the following criteria and facts and the request for a ruling should affirmatively state the presence or absence of such criteria or facts by reference to this subsection of this Revenue Procedure:

- (a) The "information" is not revealed by a patent, is not the subject of a patent application, nor is it disclosed by the product on which it is used or to which it is related.

- (b) The "information" does not represent mere knowledge, or efficiency resulting from experience, or mere skill in manipulation or total accumulated experience and skill of the transferor.

- (c) The "information" involved is not merely the rights to tangible evidence of information such as blueprints, drawings or other physical material on which it is recorded.

- (d) The "information" has not been developed especially for the transferee.

- (e) The "information" is not in the form of assistance in the construction of a plant building or advice as to the layout of machinery and equipment.

- (f) The "information" is not training of the transferee's employees that is essentially educational in nature.

- (g) Technical information of a related or similar nature such as new developments in the field will not be furnished on a continuing basis without adequate compensation therefor in the manner prescribed for services in the statement in subsection .01 above. ****

3. To obtain that advance ruling, the IRS wanted taxpayers to represent, per Sec. 3.02, that the information was protected from disclosure in the foreign jurisdiction and that adequate safeguards were in place to protect against such disclosure. In jurisdictions that do not have strong protections for intangible property, this representation may well have been difficult to satisfy.

Transfer. Even when the taxpayer is able to demonstrate that it has an intangible asset that is capable to be transferred, the next question that must be addressed is whether this intangible was in fact transferred. To represent a transfer, the transferor must transfer “all substantial rights,” as articulated in Rev. Rul. 64-56 above. What does that mean? A leading case on this question
follows.

DU PONT DE NEMOURS & CO. v. U.S.
471 F.2d 1211 (Ct. Cl. 1973)

Before COWEN, Chief Judge, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, Judges.

Judge: DAVIS, Judge, delivered the opinion of the court:

We are narrowly concerned with only one issue on these limited cross-motions for partial summary judgment in plaintiff E. I. Du Pont de Nemours and Company's (Du Pont) complex tax refund suits for 1959 and 1960. That question involves only one of the firm's inter-corporate transactions, presented by a setoff defense raised by the Government against the refund claims. There is agreement upon the facts of this transaction, and only a legal problem—the application of section 351 of the Internal Revenue Code, 26 U.S.C. §351 (1970)—remains to be decided.

In 1959, Du Pont was engaged in the domestic sale and exportation (to France, among other places) of urea herbicides. Although, doing the manufacturing in this country, the company owned French patents for the product. French law provided that French-patented items must be manufactured in France within three years of the issuance of the patent. If this were not done, the owner had to grant, upon request, a license to a French producer. In order to forestall that result, with its potential loss of income, Du Pont organized (in October 1959) a wholly-owned French subsidiary, Du Pont de Nemours (France) S.A., to manufacture the herbicide in France. By agreement in December 1959 plaintiff granted to the subsidiary a royalty-free, non-exclusive license to make, use and sell urea herbicides under the French patents. Du Pont thereby gave up its right to assert patent infringement against the subsidiary's products for the duration of the license, which was for the remaining life of the patents. The subsidiary had the right to sublicense manufacturing for its own needs, but any other sublicensing could only be done with the parent's consent. In exchange for this grant, and in lieu of royalties, Du Pont received stock in the subsidiary valued at $411,500. After the award of the license, the subsidiary proceeded to arrange for manufacture of the herbicides for its own account by an unrelated French firm.

Before undertaking this arrangement, taxpayer requested rulings from the Commissioner of Internal Revenue as to whether the proposed transaction would comply with the requirements of sections 351 and 367 of the Code. Section 351(a), as enacted in the 1954 Code and in effect in 1959, provided that:

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.
Section 367 declared that, if the transaction involved transfer of property to a foreign corporation in exchange for its stock, nonrecognition would only be granted if it were established to the Commissioner's satisfaction that the exchange were not part of a plan for the avoidance of federal income tax. The Internal Revenue Service ruled in November 1959 that the demands of section 367 were met, but not those of section 351. It was said that "[s]ince all substantial rights of the patents will not be transferred *** to the new French company, such patents will not be considered property within the meaning of section 351 ***." Despite this holding, Du Pont proceeded with the incorporation of the subsidiary, and the grant of the non-exclusive license, but the worth of the affiliate's stock was not included as income in taxpayer's 1959 return. Since the shares received by Du Pont were valued at $411,500, and it claimed no basis in the patents, the size of the present claim by defendant for setoff is $411,500.

[1] There is no question, of course, that plaintiff meets the condition of section 351 that it must be in control of the subsidiary after the transaction. The controversy implicates the other prime elements of the provision: "property", "transfer", "exchange." The Government has vacillated somewhat in tying the articulation of its position to one or another of those statutory terms. The 1959 ruling given to taxpayer deemed the patent rights transferred to the subsidiary not to be "property". Conceding that this "did not adequately express the basis for the Government's action," the defendant now stresses the reasoning of Rev. Rul. 69-156, 1969-1 Cum. Bull. 101:

The grant of patent rights to a corporation will constitute a transfer of property within the meaning of section 351 of the Code only if the grant of these rights in a transaction which would ordinarily be taxable, would constitute a sale or exchange of property rather than a license for purposes of determining gain or loss. In order for such a grant of patent rights to *** constitute a sale or exchange, the grant must consist of all substantial rights to the patent.

The present emphasis is thus on the "exchange" requirement, with that factor being equated with the concept of "sale or exchange" under the capital gains provisions of the Code. If a transaction does not qualify as a "sale or exchange" for those purposes, it cannot (according to the defendant) be a "transfer" of "property" "in exchange" under section 351. On that view, the Government would be entitled to its offset since it is settled that the proceeds of a grant of a simple non-exclusive patent license are not eligible for capital gains treatment. To attain that status there must normally be a transfer of an interest in all substantial rights to the patent, or of exclusive rights in a defined area. See, e.g., E. I Du Pont de Nemours & Co. v. United States, 153 Ct. Cl. 274, 287-88, 288 F.2d 904, 911-12 [7 AFTR 2d 1107] (1961).

I.

The first and principal problem, then, is whether section 351 embodies the same notions as the capital gains provisions (26 U.S.C. §§1201 et seq. (1970)). In searching out the answer, we look to the language of the sections being compared, their individual purposes, their history and context, as well as their treatment by the courts.

Congress, it is plain, did not use identical
wording. First, section 351 speaks of "property", not of "capital assets", and the Government concedes that section 351 can apply to property which is not a capital asset. Nonrecognition under the provision has been granted, for instance, to transfers of physical inventory (see Connolly Tool & Eng'r Co., [¶64,202 P-H Memo TC] 23 CCH Tax Ct. Mem. 1222, 1224 (1964)), of accounts receivable (see P. A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 [26 AFTR 197] (C.A. 7, 1940), and of money (Halliburton v. Commissioner, 78 F.2d 265 [16 AFTR 368] (C.A. 9, 1935), accepted in G.C.M. 24415, 1944 Cum. Bull. 219). Second, the capital gains part of the Code uses "sale or exchange" of an asset (see 26 U.S.C. §1222 1970)), while section 351 is phrased in terms of property "transferred *** in exchange." This latter difference is obviously not controlling, but the fact that the drafters made the distinction in language cautions against a wholesale and automatic adoption for section 351 of the concepts of the capital gains provisions. The bare words of the statutes do not compel, or even favor, their parallel application, as might have been the case if they were worded identically. With some indulgence to defendant, we can count the language as basically neutral in itself.

However, we do view the contrasting purposes of the two parts of the Code as undermining, affirmatively and seriously, the Government's position. In order to qualify for the tax relief of lower rates under the capital gains provisions, there must be complete divestiture of the taxpayer's interest in property of a particular nature, capital assets. In such cases, there is no doubt about the actual flow of gain to the taxpayer from an outside source. Section 351, on the other hand, is not concerned with situations involving true severance of control and true flow of gain, but, rather, with instances which Congress considered as revealing illusory or artificial relinquishment of control and illusory or artificial gain. The transferor in section 351 cases is required to remain in control, albeit indirectly, after the transfer. There is, in short, a transfer in form only, a technical transfer not one of substance. The section is designed to give present tax relief for internal rearrangements of the taxpayer's own assets, accompanied by no sacrifice of control and no real generation of income for the owner and to defer taxation until a true outside disposition is made.

Congressional interest in avoiding taxation of these "form" exchanges in reflected in the legislative records of the 1921 Act, in which the predecessor of section 351 first appeared. Dr. T. S. Adams, Treasury tax advisor and reputed father of the statute, gave detailed testimony on the bill to the Senate Finance Committee. Generally, the object of proposed section 202(d) was to alter the presumption of taxability in property-for-property exchanges to one of nontaxability. In the course of commenting on section 202(d)(3) of the bill (the progenitor of current section 351), Dr. Adams stated that:

If one man incorporates his property or if a group of men incorporate their property, that mere formality, in one sense, of placing the property in corporate ownership subjects them to a tax ***. *** I cannot believe that there is enough difference in the ownership of the property and the stock under such circumstances to justify us in recognizing taxable gain ***.

The Senate Finance Committee mirrored this attitude in its report. The section was to provide "new rules for those exchanges or
'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit." Gain or loss would be determined at the time of subsequent "sale".

This concentration on continuance-of-taxpayer-control as the core of 351 is prominently reflected in the opinions involving the section. For example, in American Compress & Warehouse Co. v. Bender, 70 F.2d 655 [13 AFTR 1052] (C. A. 5), cert. denied, 293 U.S. 607 (1934), the court found that:

> *** the statute evidences a recognition that the transaction *** effects a change in form, but not in substance, of the beneficial interests of the transferors in the transferred property. The transaction *** lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it [;] *** no third person then having acquired any beneficial interest in property which was a subject of the transfer.

It is this cardinal element of continuing control by the taxpayer i.e. that a third party does not at the time acquire substantial interest in the property transferred, or control over it which supports the nonrecognition of gain under section 351.

In contrast, an important test for the capital gains provisions is whether there has been a full and complete divestiture by the taxpayer of his interests in the assets, and a corresponding acquisition of the property by a new owner. That is the precise reason why assignments of patents are held to fall under the protection of those sections, while an ordinary non-exclusive license is ruled not to be covered. The assignment represents full divestiture while a mere license bespeaks continued control of the heart of the patent by the owner. See Commissioner v. Hopkinson, 126 F.2d 406, 409-10 [28 AFTR 1349] (C. A. 2, 1942); E. I. Du Pont de Nemours & Co. v. United States, supra, 153 Ct. Cl. at 287-89, 288 F.2d at 911-12.

This direct opposition in the aims of the two sets of provisions the capital gains sections stressing the completeness of disposition by the taxpayer while section 351 is grounded in the taxpayer's continuance in control supplies a compelling reason for putting aside, in applying the latter, capital gains formulations. Where the goals of two pieces of legislation are contradictory, it is appropriate, if the words permit, to treat them independently and to let the application of each be governed by its own separate purpose.

In two decisions the Tax Court has explicitly taken that stance. In Alexander E. Duncan, 9 T.C. 468 (1947), the taxpayers received stock in exchange for judgment claims stemming from promissory notes issued by the transferee. The Government relied upon the earlier capital gain-and-loss case of Hale v. Helvering, 85 F.2d 819 [18 AFTR 520] (C.A.D.C., 1936), aff'd 32 B.T.A. 356 (1935), in which the transferee gave cash instead of stock in settlement of a debt. The court in Hale had concluded that there was no "sale or exchange" since there was no acquisition of property by the
transferee. "[P]roperty in the notes as capital assets was extinguished, not sold." 85 F.2d at 821. The taxpayer therefore had no capital loss. The Duncan court refrained from applying this principle to its own 351 situation where stock was received by the transferor. While the surrender of obligations did not increase the assets of the obligor-transferee, it did free them of certain liabilities. At the same time, the transferors "did not receive payment of their debts, but exchanged those debts for a continuing interest in the new corporation [;]" "the intent of section 112(b)(5) [of the 1939 Code, now section 351(a) of the 1954 Code] is to defer the recognition of gain or loss until the continuing interest of the former creditors is finally terminated as, for example, by the disposition of their stock." 9 T.C. at 471. It was this continuation-of-interest that led to the Duncan court's refusal to apply the capital assets "sale or exchange" test. The relationship had been altered from its original creditor/debtor form but it had not ended. See Miller & Paine, 42 B.T.A. 586, 593 (1940). The defendant would distinguish Duncan on the ground that the unique nature of indebtedness-its incapability of being "transferred" back to the obligor-justified extension of the section 351 "exchange" requirement beyond narrow capital-gain-and-loss "sale or exchange" boundaries. However, the basis for the difference in result between Hale and Duncan was the element of the transferor's continuing interest, a component unaffected by the uniqueness of indebtedness.

More recently, H. B. Zachry Co., 49 T.C. 73 (1967), in deciding whether a carved-out oil payment (which did not represent substantially all the transferor's interest in the lease out of which it was payable) was "property" under section 351, also rejected the Government's invocation of capital gains notions. The court pointed out that, unlike "the problem of capital gain versus ordinary income", section 351 is "concerned solely with the historic exemption of transfers to a controlled corporation where the taxpayer's interest in the property continues although the form of ownership is changed." 49 T.C. at 80.

This emphasis on the taxpayer's continuous interest and continuous control, as the essence of section 351, is convincing to us, and persuades strongly against defendant's point that the requirement of full disposition as a precondition to a "sale or exchange" for capital gains purposes should be imported into 351. In view of the congressional aim in the latter provision to disregard dispositions which are merely formal and do not have economic or commercial reality, it is proper to accept, as a "transfer *** in exchange", those dispositions which are less than substantially complete. If the transactions that most look like complete dispositions, but in reality are not dispositions at all, are free of tax because they are not deemed true dispositions, then transactions that have less appearance of complete dispositions should also be free, so long as control is maintained over what is transferred through the receipt of the transferee's stock. It would be odd to hold that a transfer had to look most like a complete disposition in order to avoid being treated for tax purposes as a complete disposition.

If Du Pont had made a full assignment of the patents to its subsidiary, the Government would agree that section 351 was entirely satisfied-and yet the taxpayer would have made no more of a true disposition to an outsider than in the present situation; in reality there would be no greater severance of control. In terms of the ends of section 351, there is no more reason for that transaction to be covered
than the one we have here. In other words, in this respect the capital gains concept of a "sale and exchange" is simply irrelevant to section 351, which has a quite different purpose and an independent postulate. To insist, nevertheless, on applying that alien notion is to bring about disparate results not rationally connected to the fundamental principle behind section 351—the paradigmatic example of "mechanical jurisprudence."

Defendant's best counter-argument is that the predecessors of section 351 and the capital-gain-and-loss provisions had their joint birth in the Revenue Act of 1921 where they were placed in very close proximity, and that this juxtaposition continued for many years. Until 1954, the recognition provision for "sales or exchanges" and the exceptions to the recognition provision (including the forerunners of section 351) were positioned next to each other. See, e.g., 26 U.S.C. §§112(a), (b) (1952). The Government draws the conclusion that, at least where a nonrecognition section uses the word "exchange", Congress intended the very same meaning to be given to that term as in the "sale or exchange" recognition provisions; those nonrecognition sections should simply be read, defendant says, as subordinate exceptions to the general provision providing for recognition of gain from a "sale or exchange".

There is obviously some force to this textual contention, but an "inference drawn from the juxtaposition and cross referencing" of related sections will be overborne by other more powerful factors. Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 250 [25 AFTR 1236] (1941). We think that is true here. The elements of cognate origin and statutory juxtaposition are outbalanced by the great variance between the purposes of 351 and of the capital gains sections, and by the clear irrelevance of the concepts from the latter, which defendant invokes, to the goals and theory of the former. And, as we have already said, the bare terminology of 351 is not so identical to that of the capital gains sections that a court might feel driven by the parallelism of language to treat them as twins, despite the clear difference in purpose.

II

Having rejected defendant's chief point that "transfer *** in exchange" under section 351 is tied to and has the same scope as "sale or exchange" under the capital gains sections, we still have to determine whether 351, as an autonomous provision, covers plaintiff's transaction. That inquiry we now undertake in the light of the discussion in Part I, supra.

Once the capital gains concepts are seen as irrelevant, it is not difficult to find that the non-exclusive license handed over to the subsidiary was "property". Both patents themselves and the exclusive licensing of patents have long been considered "property" under 351. It is not a far step to include a non-exclusive license of substantial value—commonly thought of in the commercial world as a positive business asset. Unless there is some special reason intrinsic to the particular provision (as there is with respect to capital assets), the general word "property" has a broad reach in tax law. See Parmelee Transp. Co. v. United States, 173 Ct. Cl. 139, 146, 351 F.2d 619, 623 [16 AFTR 2d 5744] (1965); cf. Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134-35 [5 AFTR 2d 1770] (1960). For section 351, in particular, courts have advocated a generous definition of "property" (see H. B. Zachry Co., supra, 49 T.C. at 80 & n. 6 (1967); Halliburton v. Commissioner, supra, 78 F.2d at 268-69 (C.A. 9, 1935)),
and it has been suggested in one capital gains case that nonexclusive licenses can be viewed as property though not as capital assets. See Fawick v. Commissioner, 436 F.2d 655, 663 [27 AFTR 2d 71-381] (C.A. 6, 1971). H. B. Zachry Co., supra, held a carved-out oil payment—quite comparable to a non-exclusive license—to be 351 "property."

We see no adequate reason for refusing to follow these leads. Defendant now concedes that the license was "property" in the hands of the transferee, but does not agree that Du Pont gave up any "property." But, as taxpayer says, although the rights granted were "not all the rights under the patents, they were perpetual, irrevocable, and quite substantial in value." Taxpayer surrendered its right to assert infringement against the subsidiary even though it retained the right to prevent others from operating under the patent. The subsidiary could proceed without fear of an infringement suit. One chunk of rights was permanently severed from the main property—the patent. In common understanding, this segment can easily be considered "property" transferred, although it was not a full cross section of the patent. Nothing in the legislative purpose of section 351 counsels a narrower reading. Congress, as we have said, wished to free taxpayers from immediate tax where they remained in control of valuable items, even though the taxpayer made some intra-business rearrangements, and to postpone the tax until complete disposition to an outsider. That objective fits this case exactly; Du Pont remains in control, and there has not as yet been a disposition to an outsider. Under the theory of the section, there is no reason for tax at this time.

Similarly with the other statutory elements of "transfer" and "exchange." Freed of the capital gains gloss, those terms plainly apply to this transaction. Du Pont handed over something of value and received stock in return; in normal understanding there was a mutual exchange. The Senate Finance Committee’s report on the 1921 predecessor of section 351, quoted supra, equated "exchanges" with the popular term "trades", and there is no hint that the word has any special, non-ordinary meaning. See Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33, 36 [33 AFTR 610] (C.A. 6, 1945) (construing "exchange" in a very closely related non-recognition provision as having "its ordinary meaning"). In Alexander E. Duncan, supra, 9 T.C. 468 (1947), the Tax Court found a "transfer *** in exchange" in the much less normal circumstance of extinguishment of a debt. And, again, the aim of section 351 is advanced and fulfilled by applying it to taxpayer’s transaction.

To all of this the defendant’s answer—aside from its primary contention rejected in Part I, supra—is that, if non-exclusive licenses are covered by 351, it will be extremely difficult to determine what portion of the transferor’s basis for his patent should be carried over to a non-exclusive license, when the licensor retains the right to issue an indeterminate number of additional licenses. Generally, by section 362(a), the transferee’s basis for the transferred property would be the "same as it would be in the hands of the transferor", increased by the amount of gain recognized by the transferor through the transfer. See P. A. Birren & Son, Inc. v. Commissioner, supra.

In this particular case there is no problem of basis allocation since Du Pont claims no basis in the French patents. But we need not rest on that happenstance. Other cases have presented similar problems of proper allocation between retained and transferred value, and the courts have been able to reach satisfactory solutions. True, evaluation of non-exclusive licenses is
complicated by the indefiniteness of the number of licenses that may be issued. But that does not mean that it is impossible to make any appraisal. One may be able, for instance, to weigh the probability, in the specific circumstances, of more licenses being issued. Certainly in the present case, even if Du Pont had a basis for the patents, there was little prospect of its issuing licenses to other companies to produce in competition with its own subsidiary. The license granted to the subsidiary was a primary asset of the new corporation and Du Pont had a proprietary interest in the success of the venture. In similar circumstances, it has been found that difficulty of evaluation should not thwart application of the statute:

Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. *** These considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose ***

Finally, the Government suggests, quite generally, that applying section 351 to this type of transaction can open up the gate to improper tax avoidance by allowing the conversion of ordinary income into capital gain. The Revenue Service has, however, officially determined under section 367 that is not so in this case, and that provision of the Code is adequate protection where the transfer is to a foreign corporation. If the transaction is wholly domestic, there are other principles, such as those relating to the assignment of income, step transactions, and the Commissioner's power to allocate income, which have been (and no doubt will continue to be) utilized by the Service and the courts if an attempt is made to employ section 351 for an improper end outside of the congressional purpose to postpone imposition of the tax until disposition to an outsider.

In this instance, we see no such possibility of tax avoidance. Du Pont's subsidiary has a zero basis in the license, under section 362(a), and its gain from use of the patent would be ordinary income, just as it would have been if Du Pont had not formed the subsidiary but had exploited the patent itself. There is no adequate reason here to refuse to apply section 351 according to its terms. Nor have we been shown any real need to adopt a wholesale prophylactic rule, rigidly excluding all transactions of this type from section 351, in order to forestall possible tax avoidance in other circumstances not before us and not even known to exist.

For these reasons, we hold that section 351 applies to taxpayer's transaction, and defendant is not entitled to the offset it claims. Plaintiff's motion for partial summary judgment is granted, the defendant's cross-motion is denied, and the defendant's claimed offset with respect to this transaction is disallowed.

**Superroyalty Provision of Section 367(d)**

The above background is helpful to understand the contours of Section 367(d). If an intangible were transferred in a taxable transaction, then section 482 would apply including the “commensurate with income” standards of that provision. However, section 482 did not apply to
a nonrecognition transfer of property in exchange for stock that was governed by section 351. So, the outbound tax-free transfer of an intangible under section 351 was seen as an end-run around the impact of section 482. So, Congress responded by enacting section 367(d).

The policy goals of section 367(d) are not difficult to understand. Section 367(d) seeks to prevent residual profits related to U.S. developed intangible assets from migrating out of the U.S. tax jurisdiction via the outbound tax-free contribution or transfer of intangibles to a related foreign corporation. Seen in its historical context, section 367(d) is best understood as an effort to expand the applicability of the assignment of income doctrine past its historic scope, providing in effect that no transfer of intangible property (whether the fruit, the tree, or the tree with its fruit) will serve to deflect the income from that intangible property away from the U.S. developer.

Thus, rightly viewed, section 367(d) is a denial of the possibility of transferring the income generated by U.S. developed intangibles away from the U.S. developer to a related foreign corporation by means of outbound transfers of income-producing intangibles, as was allowed in cases such as *E.I. Dupont de Nemours & Co. v. United States*, *Eli Lily & Co. v. Commissioner*, *G.D. Searle & Co. v. Commissioner*, and *Bausch & Lomb, Inc. v. Commissioner*. Section 367(d) assigns the income derived from the transferred intangible back to the U.S. developer even when ownership of the underlying “tree” (i.e., the income-producing intangible asset) has been transferred to a related foreign corporation. Thus, section 367(d) fits like a glove with section 482. If the owner-developer of an intangible seeks to license the intangible, then section 482 applies in that context. If the owner-developer attempts to transfer its intangible to a related foreign person, then section 367(d) recasts that transaction as if the U.S. developer still owned the intangible and is required to include a superroyalty in income that complies with the arm’s length standard. Thus, section 367(d) is a backstop that prevents the owner-developer from being able to assign away its intangible asset to a related foreign corporation and achieve a different outcome than what would occur from the ongoing ownership and licensing of that intangible by the U.S. person.

In 1986, concurrent with the addition of the “commensurate with income” standard to section 482, Congress incorporated this same standard into section 367(d), providing that the amount of the ongoing annual section 367(d) superroyalty payment must be commensurate with the income generated by the transferred intangible. Said differently, this commensurate with income standard was intended to make clear that where taxpayers transfer an enumerated intangible with high-profit potential, the ongoing superroyalty cannot be benchmarked with generic industry data. Instead, it must be valued based upon the actual ongoing profit experience of the transferred intangible. This commensurate with income standard accomplishes its objective by deeming the foreign transferee corporation as paying a royalty to the U.S. transferor that is determined in amount by the actual income generated from the exploitation of the transferred intangible. Thus, the addition of the commensurate with income standard to section 367(d)(2) in 1986 was an important step towards harmonizing section 367(d)’s superroyalty amount with Congress’s underlying goal of codifying the assignment of income doctrine because it made clear that income arising from the contributed intangible would be assigned back to the original U.S. transferor by reason of the fact that the superroyalty must always remain commensurate in amount with the amount of the income actually generated by the transferred intangible. Thus, whereas the government had failed to convince the courts to expand their judicially created
assignment of income doctrine to assign the income attributable to transferred income-generating intangible property back to the U.S. developer-transferor, Congress by 1986 had statutorily codified this doctrine thus preventing the deflection of intangible returns away from the U.S. developer via the transfer of income-generating intangibles to a foreign corporation.

In 1997, Congress modified section 367(d) again to provide that the superroyalty would be considered foreign source income to the extent that section 482 would have so sourced an actual ongoing royalty if one had been paid between the parties thus allowing the tax results afforded under section 367(d) to approximate more closely the results attained under section 482.

Section 367(d) provides the IRS with authority to require all transfer pricing arrangements, including cost sharing agreements, to comply with the commensurate with income requirements regardless of which entity owns the intangible. However, instead of exercising that authority to harmonize the residual profit allocations afforded under the cost sharing regulations to the residual profit allocations afforded under Reg. § 1.482–6, the IRS has instead limited its policing of cost sharing agreements to contesting (1) the buy-in payment amount for pre-existing intangibles and (2) whether the MNE had included all of the intangible development costs as part of the cost shares. Furthermore, the existing cost sharing regulations grandfathered even more lenient cost sharing agreements entered before the issuance of the current regulations. Thus, existing Reg. § 1.482–7 provides significant opportunities for a multinational enterprise to sidestep the intended reach of section 367(d) to assign the development rights to a related foreign risk-taker entrepreneur affiliate with respect to intangible property that is created by other affiliates without the need to provide any further significant contribution towards their creation other than internal funding. Consequently, just as we saw in chapter 4 in the discussion of the transfer pricing rules involving the licensing of an intangible, the IRS provides an exception to section 367(d) with respect to intangibles developed under a qualified cost sharing agreement. If an intangible is created and does not have the benefit of a cost sharing agreement, then the licensing arrangements of the U.S. developer must comply with the commensurate with income standard (by reason of section 482), and any effort to transfer that intangible to a related foreign person would in effect be recharacterized such that the U.S. developer is required to receive an ongoing royalty “as if” it had licensed that intangible to the foreign related party and that deemed superroyalty must be in an amount that complies with the commensurate with income standard. The stakes could not be higher with respect to whether an intangible is developed under a qualified cost sharing agreement or not.

Cost Sharing

After studying the “commensurate with income” provision as set forth in Reg. § 1.482–4(f)(2) and after considering the import of the IRS’s power to use hindsight to its advantage in a situation where an intangible is licensed among related parties and then considering the impact of section 367(d) that prevents the use of a section 351 transfer to avoid the import of section 482, one might have the impression that the deck is heavily stacked in favor of the government when it comes to the transfer of intangible property among related parties. However, that assessment would be premature, particularly in the case of a multinational enterprise that engages in ongoing development of its next generation of intangibles. In the context of a multinational enterprise that has ongoing development of intangibles, the IRS has allowed taxpayers the ability to assign the development rights of those intangibles to an internal funding party that bears the cost of the development under a qualified cost sharing agreement.
The ability to utilize a qualified cost sharing arrangement that complies with Reg. § 1.482–7(b) to assign ownership of a developed intangible to an offshore risk-taking affiliate provides a way to shift the residual profits associated with that newly developed intangible property to an offshore affiliate and away from the U.S. affiliate that actually developed the intangible asset. Essentially, qualified cost sharing arrangements allow two or more controlled parties to share the costs and risks of a research and development project for an agreed upon scope in exchange for a specified interest in the results of that project. As the participants jointly own the developed technology, there is typically no royalty obligation for the use of the developed intangible by any participant. Consideration for use of intangibles developed in a qualified cost sharing arrangement is paid in advance during the course of development as opposed to after the development (typically as royalties) where the intangibles are developed by another person. In effect, a qualified cost sharing agreement involves multiple developers.

The IRS has struggled with its cost sharing regulations in defense of the U.S. tax base since the mid-1960s. In pre-1986 cases, courts typically sided with taxpayers. While the 1986 Act did not specifically address cost sharing agreements, the legislative history indicates that the commensurate with income provisions of section 482 were not intended to prevent appropriate use of such arrangements. The regulatory experience of the succeeding decades has been that the cost sharing regulations have become more and more complicated.

Where a cost sharing arrangement is put into place among parties that both contribute non-routine intangibles and where their cost shares (i.e., their expected future benefits) are equivalent to their relative contribution of the non-routine functions creating the developed intangible, then the results achieved under the cost sharing regulations should mirror the results provided by a transfer pricing method conducted within the framework of Regulation section 1.482–6. Thus, in such a fact pattern, the cost sharing arrangement formalizes an arrangement that comports with the profit-split approaches. On the other hand, when a cost sharing arrangement allows a multinational enterprise to choose a risk-taking entrepreneurial affiliate to fund the intangible development for an amount in excess of its functional contribution towards the creation of that developed intangible, then the cost sharing regulations allow the ownership of the intangible and its residual profits to be stripped away from the functions that created those residual profits and to be given to the offshore “risk-taker.”

It is helpful, perhaps, to consider some real life examples in order to understand the import of what has just been discussed. In Congressional hearings relating to the base erosion and profit shifting phenomenon, cost sharing arrangements have played a prominent role. If public statements are to be believed, in the case of Apple, Inc. its tax haven affiliate funded $5 billion of Apple’s research and development expenditures and in return became the owner of Apple’s developed intangibles in the European markets and was allocated $79 billion of income (or $74 billion in residual profits net of the $5 billion of research expenditures). From a normative perspective, Apple’s tax haven subsidiary should not be entitled to share in the residual profits unless it met the functional standard. As a general rule, a risk-taking is not a “function” that creates residual profits. Instead, the residual profits should be allocated to the affiliate whose functions actually contributed to the creation of the valuable intangible. If all functions that contributed to the creation of the developed intangible were located in Silicon Valley in the United States, then all of Apple’s residual profits should be allocated to the United States. If, however, a significant nonroutine European marketing intangible existed in the Apple fact pattern, and that European marketing intangible contributed towards the generation of the
combined residual profits, then the residual profits should be split based on the relative contribution of the offshore marketing intangible’s contribution versus the contribution of the other intangibles that contributed to Apple’s combined residual profits. However, in any case, the residual profits would only be allocated to those entities whose activities contributed to the development of the intangible that generated the residual profits. Thus, under a residual profits split methodology, residual profits would not be shared with Apple’s Irish risk-taking affiliate absent a substantive functional contribution (which was not readily apparent from the publicly-disclosed documents). Instead, that Irish risk-taking affiliate would be provided a routine profit for its routine risk capital function. Yet, in contrast to a result that would be afforded under the commensurate with income standard, the development of intangible property under a qualified cost sharing agreement is not subject to the commensurate with income standard.

**Branch Loss Recapture**

A U.S. domestic corporation is subject to taxation on its worldwide income under section 61(a), and this is particularly beneficial to the U.S. domestic corporation if that domestic corporation has a foreign branch that has losses. The ability to include foreign branch losses as deductible trade or business expenses can thus reduce the overall U.S. taxable income of the domestic corporation. Now, suppose that after several years of incurring losses in its foreign branch, the foreign branch operations are just about to turn the corner. The domestic corporation can see that the foreign branch is on the verge of “kicking the ball out of the stadium” in terms of future profitability. It is at that moment that the domestic corporation decides to incorporate the foreign branch. By doing so, the domestic corporation hopes to claim that any future earnings from the foreign corporation would be eligible for a 100 percent dividends received deduction under section 245A when actually distributed. The asymmetry is obvious. The domestic corporation claimed the foreign branch losses as part of an ongoing trade or business that was engaged in for profit, but at the moment the business does become profitable it is transferred to a foreign corporation and out of the domestic corporation. The original assumption about the potential future profitability is thus shown to be inconsistent with what has actually transpired. Envision Charlie Brown running as hard as he can to kick the football being held by Lucy only to find that she pulls the ball away moments before he kicks the football, leaving Charlie Brown flat on his back and having missed the football.

Congress was tired of the “Lucy tax planning strategy” indicated above. Originally contained in section 367 and in 2017 moved (and somewhat revamped to only apply to domestic corporations), section 91 exists to address the apparent asymmetry. At its core, section 91 provides that upon the incorporation of a foreign branch, the prior branch losses must be recaptured. Thus, if the domestic corporation incurred $5 million of branch losses in prior years, then the incorporation of the foreign branch would require recapture of the $5 million.

The amount of the branch loss recapture can be reduced to the extent branch income was recognized in a year after the branch loss was deducted, and if the branch assets have built-in gain that is taxable by reason of section 367(a) at the time of the branch’s incorporation, then the amount of the branch loss recapture is reduced to the extent of the gain recognized by reason section 367(a) at the time of the branch incorporation.

**Problems**

1. Comet Corporation (“‘Comet’”), a U.S. corporation, is in the regular business of buying U.S. and foreign pharmaceutical patents from small laboratories. Comet has a staff of employees
in the United States who include scientists, technicians and administrative, financial and marketing personnel. Comet’s employees are responsible for designing production equipment, testing the patented processes, shepherding the drugs through clinical trials and the procedures required for Food and Drug Administration approvals and eventually commercializing them, by licensing the inventions to unrelated large drug companies in the United States and abroad in return for royalties equal to a specified percentage of the net sales by the licensees. What is the source of royalties received by Comet? In what foreign tax credit limitation basket do they fall?

2. Cyber Corporation (“Cyber”), a U.S. corporation, intends to grant an exclusive license under Mexican patents to an independent licensee in Mexico. Assume that the license would otherwise qualify as a sale. Consider whether, if the agreement provides for retention by Cyber of the right to terminate the license and recapture the rights to the Mexican patents under the following alternative circumstances, the transfer would fail to qualify as a sale for U.S. tax purposes:
   a. After the license has been in effect for ten years;
   b. Mexico imposes exchange controls that prevent the licensee from paying royalties in U.S. dollars as required under the license;
   c. Upon the bankruptcy of the licensee;
   d. The licensee fails to reach specified and reasonably attainable levels of production and sales within three years of the inception of the license;
   e. The licensee fails to use best efforts to develop the market within Mexico;
   f. The licensee fails to maintain the quality standards specified in an annex to the license;
   g. The licensee fails to supply the reasonable needs of customers in Mexico or
   h. The licensor retains a right to veto any sublicensing by the licensee.

3. Would your analysis change if Cyber did not have the right to terminate the agreement and recapture the licensed patent rights, but, instead, upon the happening of any of the above-specified events, the exclusive license would become nonexclusive? If the license became nonexclusive, Cyber would be enabled to sell the patented products into Mexico or grant a nonexclusive license to another licensee in Mexico.

4. Seaborne Inc. (“Seaborne”), a U.S. corporation, is engaged in the manufacture of power boats for sale inside and outside the United States. Seaborne is considering a program that will tap more effectively into the European market for power boats. Seaborne has a considerable number of important patents registered in the United States, Canada and the European Union (“EU”) countries, all of which relate to power boat manufacturing inventions. All of these inventions were developed by Seaborne’s own research and development facility in the United States. Seaborne has not yet used, licensed or otherwise earned income on its EU country patents, and no depreciation or amortization deductions have been allowable or taken by Seaborne on these patents. The patents have a value of $20 million and a U.S. tax basis of $1 million. Seaborne has decided to establish its own wholly owned manufacturing corporation (soci´et´e anonyme) organized under French law,
(‘‘Seaborne France’’), in Toulon, France. Seaborne France would manufacture power boats in France and sell them to unrelated distributors in the EU. It will be at least three years before Seaborne France will be ready to begin manufacturing operations. Seaborne is considering the following alternatives:

a. Assume that Seaborne would grant Seaborne France a nonexclusive license to use, manufacture and sell the patented inventions and boats incorporating them under the EU patents owned by Seaborne. The license would run throughout the EU for the life of the patents. Under the first alternative, Seaborne would require Seaborne France to pay royalties in U.S. dollars of 5 percent of the annual net sales by Seaborne France of the licensed boats it manufactures and sells. Under the second alternative, the nonexclusive license would be exchanged not for royalties but for shares of the stock of Seaborne France worth $20 million. What are the tax consequences of these alternatives and which would produce the more desirable U.S. and French tax consequences for Seaborne?

b. Seaborne is also considering not granting a license to Seaborne France directly but granting a license similar to the license described in the first alternative of the preceding paragraph a. to a wholly owned licensing subsidiary of Seaborne, called Seaborne Licensing (‘‘SL’’), to be organized as a corporation (Aktiengesellschaft) under the laws of Switzerland. The only difference in the license granted by Seaborne would be that the royalty to be paid by SL to Seaborne would be 30 percent of the gross royalty income realized by SL under licenses it granted to others. At the outset, SL would grant licenses similar to the license described in the first alternative of the preceding paragraph a. to Seaborne France and to unrelated EU companies that would manufacture outside Switzerland components needed by Seaborne France and unrelated companies that manufacture power boats. The unrelated licensees of SL would be selected by Seaborne, and Seaborne would be responsible for any license negotiations. SL’s employees would include an administrator charged with monitoring the manufacturing operations by the licensees under the licenses granted by SL and an accountant charged with auditing the royalties SL receives. For the first three years, SL’s only income would be the royalties from these unrelated EU manufacturers. Would the royalty income that would be received by SL under this proposal from licenses it granted to the unrelated EU manufacturing companies be foreign personal holding company income under the controlled foreign corporation rules of Subpart F?

c. In what foreign tax credit limitation basket would the royalty income that would be received by Seaborne from SL under the proposal described in the preceding paragraph b. be placed?

5. Pharma Corporation (‘‘Pharma’’) is a U.S. corporation engaged in the development, manufacture and sale of pharmaceuticals in the United States and foreign countries. As a result of its research and development efforts in the United States, Pharma discovered drug A, a safe and effective drug for use in the treatment of disease T, a serious infectious disease. Drug A is a significant improvement over other available treatments for disease T, and Pharma has obtained patents covering drug A in the United States and in various foreign countries. Pharma has not completed the necessary clinical trials for drug A, and has not yet obtained necessary government authorization to market drug A in the United States or any foreign country. In addition to its own research and development activities, Pharma actively seeks to expand its product line by obtaining licenses from unrelated parties covering promising pharmaceutical agents in the treatment of human diseases. As part of these efforts, Pharma obtained a license to make, use and sell in the United States drug B, a safe and effective drug for use in the treatment of disease V,
another serious infectious disease. This license was obtained from Worlddrug, S.A., an unrelated foreign pharmaceutical company that developed drug B and that holds patents on drug B in the United States and in various foreign countries. Drug B represents a significant improvement over other treatments currently available for disease V, and, under the “use restrictions” contained in the license agreement between Pharma and Worlddrug, S.A., Pharma may use or sell drug B only for use in the treatment of disease V. Clinical trials on drug B have not been completed, and sale of the drug has not yet been approved by the United States or foreign governments. Pharma estimates that, within the first two years of its introduction in the United States, drug B will achieve annual sales of at least $300 million, with potentially higher sales thereafter. Pharma further estimates that drug B will achieve an average annual profit from sales in the United States of at least $100 million over the life of the drug. Based on this estimate of the profit potential for drug B, and in the face of competing license offers to Worlddrug, S.A. from other independent U.S. pharmaceutical companies unrelated to Pharma or Worlddrug, S.A., Pharma agreed to pay Worlddrug, S.A. a royalty of 12 percent of sales.

During this same period, Pharma granted its wholly owned foreign subsidiary, Pharma International (“International”), a license in perpetuity to make, use and sell drug A in foreign countries but only for use in the treatment of disease T. Pharma estimates that within the first two years of its introduction into the foreign market, drug A will achieve annual sales of at least $300 million, with potentially higher sales thereafter, and should achieve an average annual profit of at least $100 million from sales in the foreign market over the life of the drug. The license agreement provides for a royalty rate of 12 percent of sales, based on the rate paid by Pharma to Worlddrug, S.A. for the license related to drug B.

At the same time, Pharma also granted International a license in perpetuity to make, use and sell drug C in foreign countries, but only for use in the treatment of disease W. Pharma is the discoverer and patent holder of drug C. Drug C is comparable to drugs A and B in that all three drugs are protected by patents, treat serious health problems, represent significant improvements over other treatments available for the relevant diseases, are expected to achieve sales of at least $300 million in the first two years, with potentially higher sales thereafter, and are expected to achieve average annual profits from sales in their respective geographic markets of at least $100 million over their economic lives. However, at the time drug C was licensed to International, all clinical trials had been completed, and Pharma had obtained all necessary governmental authorizations to market drug C for treatment of disease W. To reflect the fact that drug C was licensed at a later stage of development than were drugs A and B, and to compensate Pharma for the increased costs incurred to obtain government authorizations, the royalty rate on drug C was set at 14 percent of sales. Consider whether the royalties payable by International to Pharma can be justified as arm’s length under the Section 482 regulations.

6. Astra Corporation (“Astra”) is a U.S. corporation with two wholly owned foreign subsidiaries, FS1 and FS2. All three corporations enter into a qualifying CSA. The participants project that shares of anticipated benefits will be as follows: Astra 45 percent, FS1 35 percent and FS2 20 percent. Actual benefits for years 1 and 2 prove to be as follows: Astra 50 percent, FS1 20 percent and FS2 30 percent. Can the IRS adjust the cost shares under these circumstances?
Chapter 11

A fixed place of business of a partnership is attributed to each of the partners of the partnership. This was a direct holding of Balanovksi, discussed in Chapter 5, in the domestic law context as required by Section 875(1). However, the interpretation of U.S. treaties applies a similar (analogous) line of reasoning, as indicating in the below ruling.


Issue

Whether a nonresident partner in a service partnership that has a fixed base in the United States is subject to U.S. tax on income attributable to that fixed base under Article 14, Independent Personal Services, of the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed on August 29, 1989, as amended by the Protocol signed on the same date (the "Treaty").

Facts

P is a service partnership that is organized under the laws of Germany. P has offices in Germany and the United States. Its U.S. office is a fixed base under Article 14 of the Treaty. P is comprised of two partners: A, a nonresident alien individual who is a resident of Germany under Article 4 of the Treaty, and B, a U.S. resident. A performs services solely at P's office in Germany and B performs services solely at P's office in the United States. A and B agree to divide the profits of the partnership equally.

Law And Analysis

Under section 701 of the Internal Revenue Code (the "Code"), a partnership is not subject to income tax; rather, the persons carrying on the business of the partnership as partners are liable for income tax in their separate or individual capacities. Code section 702 requires a partner to determine its income tax by separately taking into account its distributive share of the partnership's income. Under section 702(b), the character of an item of income, gain, loss, deduction, or credit is determined as if such item were realized directly from the source from which it was realized by the partnership, or incurred in the same manner as incurred by the partnership. Under Code section 704, a partner's distributive share generally is determined by the partnership agreement unless an allocation under the agreement does not have substantial economic effect.

Under section 875(1) of the Code, a nonresident alien individual who is a partner in a partnership that is engaged in a U.S. trade or business is himself considered to be so engaged. Section 871(b)(1) of the Code provides that a nonresident alien individual is taxable under Code sections 1 or 55 on his taxable income that is effectively connected with the conduct of a U.S. trade or business.

Section 894(a)(1) states that the provisions of the Code shall be applied to any taxpayer with due regard to any U.S. treaty obligation that applies to such taxpayer. In Donroy, Ltd. v. United States, 301 F.2d 200 [9 AFTR 2d 1129] (9th Cir. 1962), the court held that the U.S. permanent establishment of a partnership was attributable to a foreign person that was a limited partner under the 1942 U.S.-Canada income tax treaty. In Unger v. Commissioner, 936 F.2d 1316,1319 [68 AFTR 2d 91-5204](D.C. Cir. 1991), the court followed the holding in Donroy, noting that it stood for the proposition that the office
or permanent establishment of a partnership is, as a matter of law, the office of each of the partners—whether general or limited. See also Johnston v. Commissioner, 24 T.C. 920 (1955) (holding that a partnership's permanent establishment is deemed to be a permanent establishment of its partners); Rev. Rul. 90-80, 1990-2 C.B. 170 (same [Ed. Note: same per Situation 1 which was deleted in the excerpt indicated above]).

Article 14 of the Treaty provides:

1. Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.

2. The term "personal services in an independent capacity" includes but is not limited to independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, economists, architects, dentists, and accountants.

Applying Article 14 in the partnership context requires a determination of whether an individual partner in a service partnership who derives income attributable to the fixed base of the service partnership in the other Contracting State is taxable on that income even though the partner does not perform any services in the other Contracting State. Consistent with section 875 and the case law discussed above, the fixed base of a partnership is attributed to its partners for purposes of applying Article 14 of the Treaty. Accordingly, A is treated as having a fixed base regularly available to him in the United States. A is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to the fixed base in the United States without regard to whether A performs services in the United States.

Holding

A is treated as having a fixed base regularly available to him in the United States and is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to P's fixed base in the United States, without regard to whether A performs services in the United States. This holding also is applicable in interpreting other U.S. income tax treaties that contain provisions that are the same or similar to Article 14 of the Treaty.

**Fixed Place of Business.** Another area of controversy involves whether the business presence is sufficiently “fixed.”

**Insert: Adams (UK) Limited v. U.S.**

**Dependent Agent Permanent Establishment**

An agent that has an habitually exercises the authority to conclude contracts that are binding on the enterprise represents a permanent establishment of that enterprise under Article 5(5) unless the agent’s activities are limited to those activities specified in Article 5(4) which in turn would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business. Note also that the agent creates a permanent establishment risk if the contracts relate to the essential business operations of the enterprise, rather than ancillary activities, and the agent has the authority to “bind the enterprise.” The Treasury Department’s explanation makes clear
that a contract can bind an enterprise even if the contract does not need to be formally designated in the name of the enterprise. An agent has authority to bind the enterprise if it has and exercises “sufficient authority to bind the enterprises participation in the business activity in the State concerned.” Even if an agent does have such an authority and regularly exercises such authority, Article 5(6) provides that a permanent establishment is not created if the agent is one of independent status. Whether an agent is a “dependent agent” or an agent of “independent status” is a factual determination. The below revenue ruling sets forth the permanent establishment analysis in the context of a dependent agent. The following case of Tasei Fire & Marine Ins. Co., Ltd. v. Commissioner is the leading case on the distinction between an independent and dependent agent under US tax treaties.

**Rev. Rul. 90-80, 1990-2 CB 170**

**ISSUE**

Are the foreign persons in the two situations described below subject to United States tax on gain from barter transactions in the United States?

**FACTS ****

**Situation 2**

D, a citizen and resident of FC (described in Situation 1), wished to invest $20,000 in the United States. On January 1, 1989, D entered into a written agreement (the Agreement) with C, a citizen and resident of the United States. The Agreement gives C the authority to negotiate and conclude barter transactions in D’s name. C will act only on behalf of D in these transactions, will be under D’s management and control, and will have no other employment during 1989.

Acting under the Agreement, C maintained an office and performed bartering activities identical to those of A in Situation 1. After paying C for his services, D made a profit of $70,000 on the 1989 barter transactions.

**LAW AND ANALYSIS**

Under section 1001 of the Code, gain or loss will be recognized on each separate barter exchange. The amount of gain or loss will be the difference between the adjusted basis of the property exchanged and the fair market value of the property received. ****

**Situation 2**

C has and habitually exercises in the United States the authority to conclude barter contracts and transactions in D’s name. C is not an independent agent because C has no other employment during 1989 and is under D’s management and control. Therefore, under Article 5 of the Convention, D has a permanent establishment in the United States in 1989 by virtue of the activities C undertakes for D and the office maintained by C for the purpose of conducting D’s barter transactions.

Since D is treated as having a permanent establishment in the United States, under Article 7(1) of the <Page 172>Convention, the 1989 business profits of D that are attributable to its United States permanent establishment are taxable in the United States. The $70,000 profit that D derived from the barter transactions is attributable to D’s United States permanent establishment, and thus, those profits are subject to tax under section 871(b) of the Code. Under section 871(b), D’s taxable income will be taxable as provided in section 1 or 55.

D must file a 1989 United States tax return.

**HOLDING ****
Situation 2
For 1989, D is subject to tax under section 871(b) of the Code on its $70,000 profit from the barter transactions.

_Taisei Fire & Marine Ins. Co., Ltd. v. Commissioner_
104 TC 535, Code Sec(s) 864.

NOTES & QUESTIONS:
1. The Tax Court’s analysis was based in part on non-US law precedent and the interpretive guidance of the Organization for Economic Cooperation and Development (the “OECD”), which in turn is a non-governmental organization (NGO). Thus, Taisei Fire & Marine Ins. Co., Ltd. v. Commissioner is important for the proposition that when the United States utilizes terms in its treaties that have a commonly understood international meaning, then the interpretation of those terms must consider this broader interpretive understanding unless the U.S. government expressly indicated otherwise.
Problems on U.S. Permanent Establishment

1. Revisit the Traditions Problems discussed in Chapter 5 and reproduced again here. Would your responses be modified if the U.S. Model Treaty were in effect between the United States and Traditions’ country of incorporation and operation?

African Art Traditions, Ltd. (‘‘Traditions’’) is a long-established, family-owned company organized and operated in a West African country to purchase art objects produced by artists and craftsmen in West Africa and sell them to tourists visiting the country. Traditions has never sold such objects in the United States. However, the scion of the family has recently returned to the home office of Traditions after completing study in the United States that included courses in sales and marketing. He has convinced his family that West African art could generate big volume sales at substantial profit in many of the more chic stores in the United States. Members of the family have invited U.S. department store buyers to the home office to discuss the potential market for West African art in the United States. As a result of these discussions, the family has determined to start exporting art to the United States, aiming at substantial sales to a limited number of stores (20 or 25). They are considering a number of possibilities:

a. Have no representation in the United States. Sell only to U.S. department store buyers who visit the home office or other countries in the region where Traditions has agents. In addition, sell to U.S. buyers who order by phone, fax, mail or on the Internet.

b. Have a Traditions officer visit the United States annually for three or four months to travel throughout the country promoting and selling the art to department stores and accepting orders, which would be forwarded for approval to the Traditions home office. Traditions would have no warehouse, office or other fixed place of business in the United States. Art would be shipped from the home office directly to the customer.

c. Have a permanent sales office, but no warehouse, in the United States staffed with Traditions personnel. Art objects would be shipped from the home office directly to the customer.

d. Have Traditions set up no sales office in the United States, but retain under contract an independent sales agent that has a U.S. office and employees who will organize marketing efforts and conduct sales campaigns in the United States.

e. Authorize an independent sales agent, in addition to the activities described in d., to solicit, negotiate and accept orders for art in the name and on behalf of Traditions.

f. Have Traditions establish a shop on Fifth Avenue in New York that would maintain a modest inventory. The shop would sell directly to customers, fill orders by mail, fax or on the Internet received from customers in certain Central and South American countries and accept orders from customers in Asian countries that would be forwarded to and filled by shipments directly from the home office to the customers. All sales would be under commercial terms prescribed by the home office. However, employees in New York would have the power to decide whether or not to accept and fill all orders.

2. Consider the following variations on the Traditions situation if the U.S. Model Treaty were in effect between the United States and Traditions’ country of incorporation and operation:
a. Suppose that Traditions sells art it purchases from local artists and craftsmen in the United States through traveling sales employees in the United States who operate from hotel rooms across the country and solicit orders on Traditions’ standard conditions of sale. All sales orders are accepted at Traditions’ home office. Traditions maintains no sales office in the United States. Would Traditions be subject to U.S. income tax?

b. How would your response to a. be affected if Traditions has a warehouse and showroom in Chicago at which art is displayed and from which deliveries are made to customers?

c. How would your response to b. be affected if the art consisted of carvings that, while held in the U.S. warehouse, were painted, labeled and packaged for sale by an independent third party?

d. How would your response to a. be affected if Traditions also maintains a separate office in New York which conducts U.S. market research and directs U.S. advertising?

e. Suppose that the employees described in a. operate out of the Traditions warehouse described in b. and that the employees have the power, which is regularly exercised, to solicit, negotiate and conclude sales contracts with U.S. department stores. Would Traditions be subject to U.S. income tax?

3. How would the case of Handfield v. Commissioner, discussed in Chapter 5, be decided under the U.S. Model Treaty?

4. Medtech Inc. (‘‘Medtech’’) is a Delaware corporation with its headquarters in New York and operations in many countries. Sam Spode is a medical sleuth specializing in tracking down the origin of strange diseases. He is a citizen and resident of Costa Rica, a country with which the United States has concluded a tax treaty congruent with the provisions of the U.S. Model Treaty. Medtech would like to hire Sam either as an independent consultant or as a regular employee. In either event Sam would continue to maintain his Costa Rican residence and would spend no more than 100 days working in the United States in any year. Would it make any difference to Sam’s U.S. tax position whether he was an independent consultant or a regular employee of Medtech?

5. Sally Suarez is an associate in a law firm in Panama, of which she is a citizen and resident. She comes to New York to work on the acquisition of a Panamanian corporation by a U.S. corporation, which is a client of her firm. She spends 30 consecutive days in New York working on the deal and living in a fancy hotel. She receives compensation from the law firm of $10,000 for the time spent working in New York. The firm, which has no office in the United States, collects fees of $30,000 from the U.S. corporation as a result of the work of Suarez in New York. Assuming that the U.S. Model Treaty is in force between Panama and the United States, are either Suarez or the firm subject to U.S. income tax on the amounts they receive? Would the U.S. tax consequences be altered if the law firm had an office in New York and Suarez did most of her work on the deal in that office?

6. Global History, Ltd. (‘‘Global History’’) is a corporation organized under the laws of India where its headquarters and principal operations are located. Global History has acquired the right to publish electronically 100,000 volumes of history books in many different languages. Its
operations in the United States are effected through a web site maintained in this country by an independent service provider. All advertising in the United States is on the web site. When customers in the United States wish to acquire an electronic version of a history book, an order is placed through the web site and payment is tendered electronically by a credit card acceptable to Global History. When the order and payment are confirmed at headquarters in India, the book is “shipped” electronically to the customer in the United States. During recent years, Global History has sold an average of 100,000 volumes producing gross revenues of $2,500,000. Is Global History conducting a U.S. trade or business? If the U.S. Model Treaty were in force between the United States and India, would Global Business have a permanent establishment in the United States?

Section 894(a) provides that U.S. tax laws are to be applied “with due regard to any treaty obligation of the United States which applies to such taxpayer.” Moreover, Article 24(1) of the U.S. model treaty generally provides that a person entitled to U.S. treaty relief shall not be subjected to any requirement that is more burdensome than to which nationals are be subjected. Thus, taxpayers are allowed to choose whether to apply the benefits of a tax treaty or the domestic tax law apart from the treaty. However, the IRS position is that a taxpayer must apply the treaty or domestic law on a consistent basis with respect to its U.S. business activities, as indicated in the below ruling.

**Rev. Rul. 84-17, 1984-1 CB 308**

**ISSUE**

Whether a taxpayer can elect the provisions of the United States-Polish People’s Republic Income Tax Convention (the Convention), 1977-1 C.B. 416, with respect to the taxability of business gain that is in part attributable to a permanent establishment and in part not attributable thereto, while in the same taxable year elect the provisions of the Internal Revenue Code with respect to a nonattributable business loss under the circumstances described below.

**FACTS**

In Rev. Rul. 81-78, 1981-1 C.B. 604, a Polish corporation (the taxpayer) markets two entirely different products in the United States through separate and unrelated business activities. One business activity, the manufacturing and marketing of product a both in the United States and abroad, constitutes a permanent establishment in the United States within the meaning of Article 6 of the Convention. The profits attributable to the activity of the permanent establishment are taxable by the United States under Article 8(1) of the Convention. The profits attributable to the second business activity, the manufacturing of the product b in Poland and the sale of the product through an independent contractor in the United States and abroad, are not taxable under the Convention by the United States since the activity does not constitute a permanent establishment in the United States.

Assume that the facts of Rev. Rul. 81-78 apply in the subsequent taxable year. In addition to the manufacture and sale of products a and b, the taxpayer manufactures products c in its home office in Poland and sells the product through another independent contractor in the United States. The manufacture and sale of product c are wholly independent of the taxpayer’s operations through the permanent establishment in the United States and from the sale of product b in the United States through an independent contractor. In the taxable year in question, the taxpayer has gain from the
manufacture and sale of product \( a \) through the permanent establishment, gain on the sale of product \( b \),
and a loss from the sale of product \( c \) in the United States. The gain or loss from the sale of products \( b \)
and \( c \) in the United States is not attributable to a permanent establishment in the United States, but, like
the income from the sale of product \( a \), is effectively connected with the conduct of a trade or business
in the United States within the meaning of sections 882(a) and 864(c)(3) of the Internal Revenue Code.

The taxpayer claimed the provisions of the Convention with respect to the gain-producing activities,
involving products \( a \) and \( b \), so that the gain from the permanent establishment was subject to United
States income taxation and the gain from the sale of product \( b \) was exempt from United States income
taxation. The taxpayer claimed the provisions of the Code with respect to the loss producing activity so
that the loss from the sale of product \( c \) was used to off-set the product \( a \) gain from the permanent
establishment in determining the taxpayer’s United States income tax liability.

LAW AND ANALYSIS

Section 882(a) of the Code provides that a foreign corporation engaged in a trade or business within the
United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable
income that is effectively connected with the conduct of a trade or business within the United States.

Section 864©(3) of the Code provides that all income, gain, or loss from sources within the United
States (other than income, gain, or loss to which section 864©(2) applies) shall be treated as effectively
connected with the conduct of a trade or business within the United States.

Section 894(a) of the Code provides that income, to the extent required by any treaty obligation of the
United States, shall be exempt from taxation under subtitle A.

Article 5(2)(a) of the Convention prevents the United States from construing the Convention to restrict
in any manner any deduction allowed by the laws of the United States in the determination of the tax
that the United States imposes.

The Technical Explanation of the Convention, 1977-1 C.B. 427, states that the rule of Article 5(2)(a)
reflects the principle that a convention should not increase the tax burden on residents of the
Contracting States.

Article 8(1) of the Convention provides that the profits of an enterprise of a Contracting State, in this
case Poland, will be taxable only by Poland unless the enterprise carries on business in the other
Contracting State, in this case the United States, through a permanent establishment situated therein; if
the enterprise carries on business as aforesaid, only the profits of the enterprise that are attributable to
the permanent establishment may be taxed by the United States.

The provisions of the Convention dealing with business profits indicate an intent to subject Polish
businesses to United States income taxation only on profits attributable to a permanent establishment in
the United States. All nonattributable profits are to be taxed only by Poland. This intent is further
evidenced by a statement in the report of the Senate Foreign Relations Committee describing the
general objectives of the Convention. The Committee stated that ordinarily business income is not
taxable in the source country, in this case the United States, unless the taxpayer has a fixed place of
business there; if there is only a temporary or minimal presence in the source country, the conventions
typically provide for taxation exclusively by the residence country, in this case Poland. S. Ex. Rep. No.

The intent under the Convention-that the United States will only tax business profits of a Polish
enterprise that are attributable to a trade or business conducted by such enterprise in the United States-
would be thwarted if losses not attributable to a permanent establishment in the United States are offset
against gain attributable to a permanent establishment in the United States. Further, such an offset
would require the inconsistent treatment (during a taxable year) of nonattributable gain and loss-such
gain being exempt under the Convention and such loss being deductible under the Code. Accordingly, the product c nonattributable loss cannot be used to offset the product a gain attributable to the United States permanent establishment because the provisions of the Convention have been claimed with respect to the product a and product b gain.

However, Article 5(2)(a) allows the taxpayer the option to use the provisions of the Code to determine the tax liability with respect to the sales activities for products a, b, and c if this results in a lower tax liability than that obtained using the provisions of the Convention with respect to all of those sales activities. If the Code provisions are used, the effectively connected product c loss can be used to offset the effectively connected gain from products a and b in determining the taxpayer’s United States income tax liability.

HOLDING

The taxpayer must use the provisions of the Convention with respect to the taxability of the product c nonattributable loss for the taxable year in question because those provisions are used with respect to the taxability of the gain from products a and b.

If, for the taxable year, the taxpayer desires to use the provisions of the Code with respect to the taxability of the product c loss, the provisions of the Code must also be used with respect to the taxability of the gain from products a and b.

NOTES & QUESTIONS:

1. Consistency in Terms of Determining Taxable Status. The consistency requirement articulated in Rev. Rul. 84-17 is parroted in the U.S. Technical Explanation in paragraph 2 of the explanation of Article 1(2), which provides as follows:
   “a taxpayer’s U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax.”

   The Technical Explanation then continues on by providing an example that draws from the facts that are stipulated in Rev. Rul 84-17 and then cites Rev. Rul. 84-17 for this proposition. Thus, although Rev. Rul. 84-17 only addressed the Polish-US tax treaty that existed in 1984, it has had far-reaching applicability in terms of interpreting US Treaties generally.

2. No Consistency Requirement For Income That is Neither Effectively Connected nor Business Profits. What level of “consistency” is required? Although consistency is required in terms of applying the permanent establishment concept or the domestic law U.S. trade or business standard, consistency is not required universally. In this regard, after citing and applying the rationale in Rev. Rul. 84-17 to determine a U.S. trade or business or permanent establishment on a consistent basis, that same paragraph 2 of the Technical Explanation to Article 1(2) then continues on and states as follows:

   If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

   Thus, a taxpayer may utilize the domestic law for determining a U.S. trade or business and for its effectively connected income in lieu of reliance on the U.S. tax treaty’s permanent establishment provisions. But, even after having done so, the taxpayer is then free to choose again whether to apply the U.S. tax treaty provisions or to rely on domestic U.S. tax law with respect to income that is not otherwise effectively connected to the conduct of any of its U.S.
trade or businesses.

3. Consistency in Terms of Determining Taxable Profits. However, a taxpayer cannot take inconsistent positions in terms of applying the Code’s effectively connected income criteria for some activities and then assert the U.S. Model Treaty’s business profits provisions for other activities. Said differently, the taxpayer must do either of the following: (i) if it has elected to apply the Code’s U.S. trade or business standard, then the taxpayer must consistently thereafter apply the effectively connected income standard to all of its activities; or (ii) if the taxpayer elected to apply the permanent establishment provisions of Article 5 of the U.S. Model Treaty, then the taxpayer must consistently apply the business profits provisions of Article 7 to all of its business activities. In paragraph 3 to Article 7(2) of the Treasury Technical Explanation to the U.S. Model Treaty, the Treasury Department attempts to thread this needle in the following statement:

For example, a taxpayer that has a significant amount of foreign source royalty income attributable to a U.S. branch may find that it will pay less tax in the United States by applying section 864 of the Code, rather than the rules of Article 7, if the foreign source royalties are not derived in the active conduct of a trade or business and thus would not be effectively connected income. But, as described in the Technical Explanation to Article 1(2), if it does so, it may not then use Article 7 principles to exempt other income that would be effectively connected to the U.S. trade or business. Conversely, if it uses Article 7 principles to exempt other effectively connected income that is not attributable to its U.S. permanent establishment, then it must include the foreign source royalties in its net taxable income even though such royalties would not constitute effectively connected income.

Business Profits. Once a taxpayer has a permanent establishment, then Article 7 provides that it is subject to U.S. taxation with respect to the business profits that are attributable to that permanent establishment. Although the determination of “attributable business profits” serves a similar function to the determination of a taxpayer’s “effectively connected income” under the Code, the treaty-based inquiry involving “attributable business profits” can diverge from how the Code would have determining the amount of effectively connected income and the expenses that are allowable. Consistent with Rev. Rul. 84-17, the below decision indicates that the taxpayer is entitled to rely on either the Code’s determination of taxable income under the effectively connected income standard or can instead rely on the U.S. tax treaties “attributable business profits standard. Where those standards diverge, the taxpayer is entitled to rely on the more favorable of the two approaches.

NATIONAL WESTMINSTER BANK PLC v. U.S.,
44 Fed. Cl. 120 (1999)

TURNER, Judge:

Tax refund suit; interest deduction; application of U.S.-U.K. treaty to avoid double taxation; issue whether Treas. Reg. section 1.882-5 is inconsistent with business profits provisions of tax treaty.

This is a tax refund case pertaining to plaintiff's tax years 1981 through 1987. The matter stands on cross-motions for partial summary judgment (plaintiff's motion filed July 3, 1996 and defendant's cross-
motion filed April 30, 1997).


We conclude that the regulation is inconsistent with Article 7 of the Treaty. Consequently, we further conclude that plaintiff's motion for partial summary judgment should be granted and that defendant's cross-motion for partial summary judgment must be denied.

I

The essential facts are simple and undisputed.

Plaintiff (NatWest) is a United Kingdom corporation engaged in a wide range of banking, financial and related activities throughout the world, including the United States. NatWest's offices and business outlets in this country, through which its United States operations are conducted, are collectively called the U.S. Branch.

Banking operations of the U.S. Branch are supported by the worldwide capital of NatWest. If the U.S. Branch were a subsidiary corporation rather than an integral part of NatWest, it would, as both a legal and practical matter, be required to maintain capital reserves which are unnecessary as a result of its branch relationship with NatWest.

Typically, the U.S. Branch obtains the funds to conduct its banking operations by borrowing from NatWest's headquarters office or from other branches of NatWest (e.g., the Hong Kong branch), as well as from other banks and lending institutions having no relationship with NatWest. In turn, funds so acquired by the U.S. Branch are lent to its customers, thereby generating interest income. There may be occasions when the U.S. Branch lends funds to other branches of NatWest.

Concerning any such borrowing and lending transactions which are intra-corporate, the lending headquarters or branch would "charge" interest on its loans to the U.S. Branch, and the U.S. Branch would "charge" interest on its loans to other units of NatWest, just as if each branch were unrelated to NatWest. The books of account of the U.S. Branch (and of other units within NatWest) would reflect both interest income received from other branches and interest expense paid pursuant to such interbranch transactions just as if they resulted from transactions with unrelated commercial banks.

Plaintiff's U.S. tax returns for the years at issue, 1981-87, reflected such interbranch transactions in the calculation of income and expense, and resulting taxable profit, attributable to the U.S. Branch as if it were a separate business entity.

Upon audit, the Internal Revenue Service disallowed a portion of the interest expense reflected on the books of the U.S. Branch and insisted that the allowable interest deduction for calculation of profit attributable to the U.S. Branch be determined in accordance with the formula set out in Treas. Reg. section 1.882-5 (1980). This disallowance resulted in higher taxes which plaintiff paid and now seeks to recover.

II

A

Plaintiff asserts that application of Treas. Reg. section 1.882-5 to plaintiff's U.S. Branch operations violates the Treaty. Defendant argues that the regulation is consistent with the Treaty. The parties agree that, in the circumstances of this case, if Treas. Reg. section 1.882-5 is inconsistent with the Treaty, the Treaty will control. Tr. (5/1/98) at 24, 39.

The descriptive full title of the Treaty is "Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion
With Respect to Taxes on Income and Capital Gains." Each of the signatory countries is referred to in the Treaty as a "Contracting State."

As suggested by its title, the purpose of the Treaty is to avoid, with respect to residents (including resident corporations) of each Contracting State, taxation of particular items of income by both Contracting States. The general rule adopted to achieve this purpose is that the income of a resident of one Contracting State, even though connected to obligations or activities in the other, is taxed only by the Contracting State of residence. The several exceptions to this general rule (one of which concerns business profits) are specifically addressed in the Treaty.

With respect to business operations, the general principle espoused in the Treaty is that business profits also shall be taxed only by the country of residence, unless the enterprise carries on business in the other state through a "permanent establishment" located in the other state. A "permanent establishment," as defined in the Treaty, Article 5(1) & (2), is "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and includes a branch and an office.

The parties agree that the U.S. Branch of plaintiff is such a "permanent establishment" and that business profits of plaintiff attributable to the U.S. Branch are subject to United States income taxation. Further, the parties agree that Treas. Reg. 1.882-5 was duly adopted pursuant to lawful authority.

B

The parties' core disagreement concerns whether the regulation is inconsistent with the Treaty and thus inapplicable to the U.S. Branch. Thus, the provisions of the Treaty dealing with the business profits of a permanent establishment become critical to resolution of this case. Those provisions are found in Article 7 (Business Profits) which states, in pertinent part:

(1) The business profits of an enterprise of a Contracting State [e.g., United Kingdom] shall be taxable only in that State unless the enterprise carried on business in the other Contracting State [United States] through a permanent establishment situated therein. If the enterprise [e.g., plaintiff] carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State [United States] but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3), where an enterprise of a Contracting State [e.g., United Kingdom] carries on business in the other Contracting State [United States] through a permanent establishment situated therein [e.g., U.S. Branch], there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of a permanent establishment [e.g., U.S. Branch], there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole... whether incurred in the State in which the permanent establishment is situated or elsewhere.

C

While the parties agree that Article 7 of the
Treaty insures that the U.S. Branch must be treated for tax purposes as if it were a separate enterprise, they disagree over whether, in calculating profits attributable to the U.S. Branch, intra-corporate "loan" transactions between U.S. Branch and other non-U.S. units of plaintiff may be treated as transactions between separate entities. (Of course, this litigation directly concerns only the interest deduction for calculating taxable income of the U.S. Branch, not interest income from such transactions.)

In practical terms, the precise, narrow issue for resolution at this juncture in the proceedings is whether, in the determination of the interest expense deduction for the U.S. Branch, the interest expense reflected in its books of account - with appropriate adjustments, if necessary, to reflect imputation of adequate capital and arm's-length, market interest rates in intra-corporate "borrowing" transactions - may be used in calculating plaintiff's U.S. tax liability, or whether, with respect to interest expense, the defendant may require use of a formulary approach, such as that in Treas. Reg. section 1.882-5, which disregards intra-corporate "lending" transactions reflected in the books of account.

III


We first explore sources bearing on a proper interpretation of the critical Treaty terms, beginning with the text of Article 7.

Article 7(1) starts with the presumption that with respect to a U.K. corporation such as plaintiff, no business profits whatever may be taxed by the United States unless the corporation carries on business in this country through a permanent establishment. Article 7(1) then provides that if there is a permanent establishment such as the U.S. Branch, only profits attributable to that permanent establishment may be taxed by the United States.

Article 7(2), building on the foundation that only profits attributable to the permanent establishment may be taxed, provides that there shall be attributed to a permanent establishment such as the U.S. Branch the profits "which it might be expected to make if it were a distinct and separate enterprise engaged in" the same business activity "and dealing wholly independently with the enterprise of which it is a permanent establishment." (Emphasis added.) Fundamentally, profits are derived by deducting expenses from gross income.

This Treaty paragraph is made subject to Article 7(3) which provides for an additional deduction to determine taxable profits of the permanent establishment, to wit, "a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole..." wherever incurred. Thus, in addition to deductions for expenses shown on its own books reflecting its separate operations, a permanent establishment may deduct a reasonable portion of home-office expense.

The face of Article 7, then, would appear to provide in the context of this case that, to determine taxable income of the U.S. Branch, the U.S. Branch is to be regarded as an independent, separate entity dealing arm's length with other units of NatWest as if they were wholly unrelated, except that the U.S. Branch may deduct, in addition to its "own" expenses, a reasonable allocation of home office expense. Words such as "distinct" and "separate" and the phrase "dealing wholly independently" (emphasis added) would appear to permit no other interpretation.

Contemporaneous commentaries and reports generally support this interpretation.

IV

A 1977 report of the United States Department of the Treasury concerning the then-proposed Treaty said with respect to paragraph 2 of Article 7 that the United States (as one of the "Contracting States") "will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity..." Treasury
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Department Technical Explanation of the United States and United Kingdom Income Tax Treaty, March 9, 1977 at 16. This was the Treasury's contemporaneous understanding while the Treaty draft was under consideration but before adoption.

With respect to paragraph 3 of Article 7, the Treasury report said: "[E]xpenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, ... will be allowed as deductions in determining the business profits of the permanent establishment." Id.

The Report of the Senate Committee on Foreign Relations, dated April 25, 1978, concerning its consideration and favorable recommendation of the Treaty, in explanation of Article 7 stated:

The profits of a permanent establishment are to be determined on an arm's-length basis. Thus, there is to be attributed to it the...commercial profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment.

Def. Br. (4/30/97), Ex. 18 at 18 (emphasis added).

V

The United States and the United Kingdom (together with Canada, Turkey and most western European countries) have been members of the Organization for Economic Co-Operation and Development (OECD) since 1961. Pl. Mem. (7/3/96), Ex. D at 2.

International double taxation was recognized by the OECD as an obstacle to the development of economic relations between member countries. In an effort to enhance economic development, the OECD, in 1963, published a Draft Double Taxation Convention on Income and Capital (OECD Document).

The OECD Document, prepared by the OECD's Fiscal Committee and approved by its Council, was proposed for adoption by member countries. OECD Document at 167-68. The U.S.-U.K. Treaty on double taxation is based on the OECD Document.

The drafters of the OECD Document, as stated therein, set out to establish a series of Articles which could be easily interpreted and applied in spite of the differences in national taxation laws and economic interests. The Articles...provide a means of settling on a uniform basis the most common problems of double taxation. In certain cases, supplementary provisions or solutions for special questions have been specified or outlined in the Commentaries on the Articles.

OECD Document, paragraph 6 at 10.

Although the entire OECD Document is designated a draft "Convention," the convention (treaty) proposed for adoption by member countries constitutes only a part of the document. The full document includes introductory and explanatory material concerning its history, terms, interpretation and implementation, OECD Document at 7-32, an Annex I consisting of the actual proposed (model) tax treaty (also called the "Draft Convention"), Id. at 36-58, and an Annex II consisting of "Commentaries on The Articles of the Draft Convention," Id. at 60-164. (The document also includes the decisions of the OECD Council pertaining to implementation of the OECD Document, Id. at 167-68.)

The initial explanatory material of the OECD Document and the Commentaries in Annex II thereof are important and helpful in determining the probable mutual understanding of countries which used the Document as the basis for a tax treaty. This was intended by the drafters of the OECD Document. Thus, explanatory material in the OECD Document is appropriate for use in divining probable intent of countries adopting treaties based thereon.
The OECD Document, specifically addressing the Commentaries and their intended use, states:

For each of the Articles in the Convention there is a detailed Commentary which is designed to illustrate or interpret the provisions...Although the present Commentaries are not designed to be annexed in any manner to the Conventions to be signed by Member countries, which alone constitute legally binding international instruments, they can nevertheless be of great assistance in the application of the conventions and, in particular, in the settlement of eventual disputes.

OECD Document, paragraph 34 at 18 (emphasis added).

The Commentaries on the Articles of the Draft Convention, OECD Document, Annex II, are presumed to have been in the minds of the negotiators when they drafted the Treaty; consequently, they are persuasive in resolving disputed interpretations.

VI

The text of the OECD Document, in the course of providing an overview of the Draft Convention, says concerning Article 7:

Article 7...formulates the basic principle which must govern the calculation of the profits of the permanent establishment, namely that the permanent establishment must be treated as an enterprise distinct and separate from the head office of the enterprise. It settles the question of the expenses which must be allowed as deductions in computing the profits of the permanent establishment...

OECD Document, paragraph 14 at 12 (emphasis added). 

Time and again throughout the Commentary on Article 7, OECD Document at 79-89, one finds affirmation of the concept that where the books of account of a permanent establishment are, with adjustments, adequate to determine the profits (gross revenues less expenses) of the permanent establishment as a separate entity, then those books should be used (and presumably not some substituted formula).

The Commentary pertaining to Article 7(2) provides:

This paragraph [i.e., Article 7(2)] contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view...that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, this would be the same profit that one would expect to be reached by the ordinary processes of good business accountancy. In the great majority of cases, therefore, trading accounts of the permanent establishment - which are commonly available if only because a well-run business organization is normally concerned to know what is the profitability of its various branches - will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment...[W]here there are such accounts, they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits...[i]t is always necessary to start with the real facts of the situation as they appear from the
OECD Document at 82-83, Commentary on Article 7, paragraphs 11 & 12 (emphasis added).

Paragraph 21 of the Commentary on Article 7, applicable to paragraph 7(3) of the model treaty, provides as follows:

21. It is usually found that there are, or there can be constructed, adequate accounts for each part...of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is...to be preferred in general wherever it is reasonably practicable to adopt it.

OECD Document at 86, Commentary on Article 7, paragraph 21.

Paragraph 22 of the Commentary on Article 7 actually pertains to paragraph 7(4) of the model treaty which does not appear in the Treaty at issue. However, language of this Commentary paragraph is helpful to an understanding of the general tenor of Article 7 concerning intra-corporate dealings and further illustrates the intent of provisions for "separate enterprise" treatment:

22. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2 of the Article [7], since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits...

OECD Document at 86, Commentary on Article 7, paragraph 22.

VII
One would suppose that the clear wording of paragraph 2 of Article 7 - especially in combination with paragraphs 10, 11 and 12 of the Commentary on Article 7 emphasizing use of a permanent establishment's books of account even with respect to intra-corporate transactions - would apply to all transactions between a permanent establishment and its parent enterprise giving rise to items of income and expense. However, as emphasized by defendant, paragraphs 14 and 15 of the Commentary on Article 7, OECD Document at 83-84, provide that despite the literal wording of paragraph 2, there are several exceptions to a strict interpretation of the "wholly independent/separate enterprise" concept.

Paragraphs 14 and 15 of the Article 7 Commentary provide:

14. Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next five paragraphs discuss three specific cases of this kind and give solutions for them...

15. The first of these cases relates to interest, royalties and other similar payments made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a Case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. (Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits.) It is, however, recognized that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g., a Bank) to each other on advances, etc., (as distinct from capital allotted to them), in view of the fact that making and receiving advances in narrowly related to the ordinary business of such enterprises...

OECD Document at 83-84 (emphasis added).

Although these Commentary paragraphs provide that certain intra-corporate interest charges "should not be allowed as deductions in computing the permanent establishment's taxable profits," we conclude for several reasons that such provision was not intended to apply to banks and other financial institutions whose ordinary business is the borrowing and relending of money.

First, the language of paragraph 14 begins: "Apart from what may be regarded as ordinary expenses, there are some classes of [intra-corporate] payment...which give rise to special problems..." The intra-corporate interest payments involved in this case are, for a banking enterprise such as plaintiff, the most ordinary of expenses. The very business of banking is the borrowing and relending of funds. Consequently, it is presumed that what follows the opening clause concerning intra-corporate lending transactions is not intended to be applicable to banking enterprises but rather to manufacturing and other non-financial operations.

This interpretation is reinforced by wording in paragraph 15 of the Commentary pertaining, inter alia, to "payments made by a permanent establishment to its head office in return for money loaned...by the latter to the permanent establishment." After then stating that such payments should not be allowed as deductions "in computing the permanent establishment's taxable profits," the Commentary paragraph provides:

It is, however, recognized that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g., a bank) to each
other on advances, etc., (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises.

OECD Document at 83-84, Commentary on Article 7, paragraph 15 (emphasis added).

Although the "special considerations apply" language of the quoted sentence is somewhat cryptic and leaves room for defendant to argue, as it does, that the exception to the general thrust of paragraph 15 does not unequivocally say that intra-corporate interest payments by a permanent establishment of a banking enterprise must be allowed, it is concluded that the principal provision of paragraph 15 pertaining to intra-corporate loan transactions was intended for application to non-financial enterprises and not to banks. Given the nature of the ordinary business of banks, this interpretation is consistent both with the language of Article 7 Commentary paragraphs 14 and 15, viewed as a whole, and with other Treaty provisions and Commentaries, whereas a contrary interpretation would be highly inconsistent.

VIII

The foregoing examination of Article 7 of the Treaty, pre-ratification reports of the Treasury Department and the Senate, and Commentaries intended to assist in interpretation leads to the conclusion that the Treaty contemplates that a foreign banking corporation in the position of plaintiff will be subjected to U.S. taxation only on the profits of its U.S. branch and that such profits should be based on the books of account of such branch maintained as if the branch were a distinct and separate enterprise dealing wholly independently with the remainder of the foreign corporation, provided that the financial records of the branch, especially those reflecting intra-corporate lending transactions, are subject to adjustment as may be necessary for imputation of adequate capital to the branch and to insure use of market rates in computing interest expense. In addition to normal deductible expenses reflected on the books of the branch, as adjusted, there shall be allowed in the determination of the profits of the U.S. Branch a reasonable allocation of general and administrative expenses incurred for the purposes of the foreign enterprise as a whole.

We next consider whether Treas. Reg. section 1.882-5 is consistent with this interpretation of the Treaty.

IX

Section 882(c)(1) of the Internal Revenue Code states:

[T]he proper apportionment and allocation of the deductions...[allowable in the determination of tax on the income of foreign corporations engaged in business within the United States] shall be determined as provided by regulations prescribed by the Secretary.

Treas. Reg. section 1.882-5 is the regulation prescribed by the Secretary for determining a foreign corporation's interest expense deduction. The regulation, by its terms, applies to all foreign corporations with income from business operations in the United States but applies to no purely domestic corporations.

The regulation makes no distinction between businesses of countries with which the U.S. has entered a treaty, like the one at issue, to avoid double taxation, and enterprises of those countries with which no such treaty exists. (Further, the regulation applies to all foreign corporations engaged in U.S. business regardless of the nature of the business; for present purposes we need only be aware that it unquestionably applies to banking corporations.)

The regulation was amended in 1996, although the general scheme remained the same as that described below. In this opinion we quote from and cite to the original 1981 version in effect during the 1981-87 tax years in issue.

A

Treas. Reg. section 1.882-5 applies a complex formula to all foreign corporations with U.S. branches and, in very general terms, operates as
follows: Before application of the formula, the regulation requires that all interbranch lending/borrowing transactions be disregarded: "Assets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation are disregarded." Treas. Reg. section 1.882-5(a)(5). The formula then uses a three-step process to determine the interest deduction allowable to off-set income from U.S. operations.

The first step requires the calculation of the amount of the assets of the U.S. branch of a foreign corporation (but excludes from the total any funds resulting from interbranch borrowing).

The second step requires a calculation of liabilities of the U.S. operation (but, again, excluding from the total any "obligations" arising from interbranch borrowing). This calculation begins with establishment of a ratio which must be either a fixed percentage (95 percent for banks and similar financial enterprises or 50 percent for other businesses) or the ratio of the foreign corporation's actual worldwide liabilities to its actual worldwide assets (i.e., the foreign corporation's capital ratio). The resulting fraction or fixed percentage is then multiplied by the assets calculated in step one; the resulting amount is presumed to be the liabilities of the foreign corporation's U.S. operation.

The third step of the formula is the determination of the actual allowable interest expense deduction with respect to the U.S. operation. The foreign taxpayer is given a choice of two methods to determine its actual allowable interest expense deduction, both of which begin by comparing the "presumed" liabilities computed in step two with actual liabilities of the U.S. branch to third parties (thus disregarding interbranch borrowing). This comparison determines whether the foreign corporation will be permitted to deduct in excess of that shown on the books of the U.S. branch as paid to third parties. If the "presumed" liabilities exceed the liabilities to third parties, as is usually the case, see Transcript (5/1/98) at 54, the taxpayer is allowed to deduct (in addition to that paid to third parties) interest on the portion of the liabilities computed in step two which exceeds the actual liabilities to third parties, but the rates to determine such additional interest will be average rates incurred on various liabilities of the foreign corporation having no direct relation to the U.S. branch.

Keeping in mind that Treas. Reg. section 1.882-5 purports to control the interest expense deduction for the U.S. operations of all foreign corporations, whether or not U.S. operations are the subject of a tax treaty like the one in issue, it is intended to accomplish (1) imputation or allocation of capital to the U.S. branch, (2) application of arm's length interest rates for intra-corporate borrowing and (3) prevention of improper, intentional shifting of income away from the U.S. branch merely to avoid United States income taxation.

Defendant argues that the regulation, with respect to interest expense, treats all U.S. branches of foreign enterprises as separate entities and merely uses the regulation's formulary approach as an effective yet simple means to allocate capital, adjust charges for intra-corporate "borrowing" and insure correction of any improper manipulation among branches of the foreign enterprise to shift income for tax avoidance.

We find that rather than treating the U.S. branch of foreign enterprises as separate entities, the regulation plainly treats each U.S. branch as a unit of a worldwide enterprise and, thus, is inconsistent with the "separate entity" provision of Article 7(2) of the Treaty.

B

Stated broadly, Treas. Reg. section 1-882-5 is inconsistent with Article 7 of the Treaty for two reasons. First, the regulation, in the computation of the interest expense deduction, disregards all interbranch transactions, even for banking operations (although a portion of a U.S. branch's interbranch borrowing will typically be restored in step three of the deduction calculation). Second, the regulation computes liabilities (in step two), and from that
figure the ultimate interest deduction (in step three), on the basis of worldwide assets and worldwide liabilities of the entire foreign enterprise, rather than determining the interest deduction on the basis of the separate, independent operations of the U.S. branch.

The regulation simply disregards, as an initial matter and before application of the interest expense formula, all "[a]ssets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation." Treas. Reg. section 1.882-5(a)(5). This plainly violates the separate entity/wholly independent provision of Article 7, paragraph 2 of the Treaty, especially as interpreted in light of paragraphs 10, 11 and 12 of the Commentary on Article 7, OECD Document at 82-83. This initial requirement of the regulation affects every step of its formula.

The first step of the formula requires calculation of the assets of the U.S. branch, but without the assets appearing on the books of the branch which result from interbranch transactions. This is contrary to the separate entity/wholly independent provision of Article 7.

The second step requires a calculation of liabilities, but not the liabilities actually shown on the books of the branch; instead, step two requires application to the assets figure a fixed percentage (an assumed capital ratio) or the actual capital ratio of the entire foreign enterprise (determined, of course, on the basis of the worldwide operations of the foreign enterprise). This also is contrary to the separate entity/wholly independent provision of Article 7.

The third step, involving the determination of the actual interest deduction amount, begins by comparing the "presumed" liabilities computed in step two with actual liabilities of the U.S. branch to third parties (thus disregarding interbranch borrowing shown on the books of the branch). If the "presumed" liabilities exceed the liabilities to third parties, the taxpayer may deduct, in addition to interest paid to third parties, a deemed interest on the portion of the "presumed" liabilities which exceeds the actual liabilities to third parties, but the rates to determine such additional interest are average worldwide rates incurred in various other worldwide transactions of the foreign corporation unrelated to the U.S. branch. Use of the "presumed" liability figure is, as explained above, inconsistent with Article 7. Further, requiring the use of worldwide average rates of the foreign enterprise and not permitting use of borrowings and rates shown on the branch’s books of account, both adjusted as may be necessary, are plainly inconsistent with the separate entity/wholly independent provision of Article 7.

In sum, insofar as the U.S. branch of a banking corporation is concerned, Treas. Reg. section 1.882-5 is fundamentally incompatible with paragraphs 2 and 3 of Article 7 of the Treaty.

X

The defendant had occasion in 1989 to consider the same issue presented by the parties' cross-motions and held, in Revenue Ruling 89-115, that "Articles 7(2) and 7(3) of the [Treaty]... cannot be interpreted to allow [a foreign banking corporation such as NatWest]...to allocate and apportion interest in a manner other than that mandated by [Treas. Reg.] section 1.882-5." Rev. Rul. 89-115, 1989-2 C.B. 130 (Pl. Mem (7/3/96), Ex. K). (The revenue ruling was concerned only with application of the Treaty to the U.S. permanent establishment of a banking corporation, as are we in our consideration of the regulation and the revenue ruling.)

Of course, based on the foregoing discussion, we disagree with the conclusion in Revenue Ruling 89-115. We believe that it misinterprets both paragraphs 2 and 3 of Article 7 of the Treaty. However, in our view, its fundamental flaw is in its preliminary position that the Treaty does not provide (for banking corporations) "a specific rule for the allocation of interest expense to the profits of a permanent establishment." On the contrary, Article 7, paragraphs 2 and 3, especially when interpreted in light of the Commentary pertaining thereto, clearly contemplate that interest expense with respect to the permanent establishment of a bank shall be allocated as any other significant
deductible expense, particularly for a bank whose very business is the borrowing and lending of money. We believe it is clear that this allocation should be as shown on the books of account of the permanent establishment, with necessary adjustments, as if the permanent establishment were "a distinct and separate enterprise...dealing wholly independently with" the foreign enterprise.

XI

Based on the foregoing, plaintiff is entitled to a ruling that Treas. Reg. section 1.882-5 is inconsistent with the "separate entity" treatment provided by Article 7 of the Treaty. Accordingly, plaintiff's motion filed on July 3, 1996 for partial summary judgment is Granted, and defendant's cross-motion filed April 30, 1997 for partial summary judgment is Denied.

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Rev. Proc. 2007-23, 2007-1 CB 675

1. Purpose

This revenue procedure provides administrable tax rules under domestic and international provisions of the Internal Revenue Code for certain patent cross licensing arrangements. This revenue procedure is issued in response to comments and requests for guidance in connection with Notice 2006-34, 2006-14 I.R.B. 705. In general, and as described below, this revenue procedure provides rules permitting taxpayers to change to, or continue to use, the Net Consideration Method described in section 5 of this revenue procedure for a qualified patent cross licensing arrangement (QPCLA) described in section 4 of this revenue procedure. This revenue procedure does not provide rules concerning the treatment of cross licensing arrangements that are not QPCLAs.

2. Definitions

.01. Application. The definitions contained in this section 2 apply only for purposes of this revenue procedure.

.02. Cross Licensing Arrangement. A "cross licensing arrangement" is a contractual arrangement between two or more parties that own intellectual property under which each party grants to the other a license of specified intellectual property that is properly characterized as a license under applicable U.S. tax law principles. ***

3. Background

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.03. Applicable Law. Section 61(a) of the Internal Revenue Code provides the general rule that, except as otherwise provided by law, gross income includes all income from whatever source derived.

Section 162 permits a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 263A provides that in the case of any property to which § 263A applies, the direct costs of such property and such property's proper share of those indirect costs (including taxes), part or all of which are allocable to such property shall, in the case of property which is inventory in the hands of the taxpayer, be
included in inventory costs and, in the case of any other property, shall be capitalized. With certain exceptions, § 263A applies to real or tangible personal property produced by the taxpayer and real or personal property described in § 1221(a)(1) which is acquired by the taxpayer for resale. In relevant part, §§ 871(a) and 881(a) impose a 30-percent tax on U.S. source fixed or determinable annual or periodical gains, profits, and income (FDAP) received by nonresident aliens and foreign corporations to the extent such FDAP is not effectively connected with the conduct of a trade or business within the United States. Royalties, whether paid in one lump sum or periodically, constitute FDAP. Commissioner v. Wodehouse, 337 U.S. 369, 392 [37 AFTR 1363] (1949); see also §§ 1.871-7(b)(1) and 1.1441-2(b).

Section 1441(a) provides the general rule that all payors having the control, receipt, custody, disposal or payment of items described in § 1441(b) must deduct and withhold a tax equal to 30 percent on payments of certain items of income to nonresident aliens to the extent that such items constitute gross income from sources within the United States. Section 1441(b) provides that these items of income include interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments or other fixed or determinable annual or periodical gains, profits, and income. Section 1442(a) provides that, in the case of foreign corporations subject to taxation under subtitle A of the Code, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in § 1441 a tax equal to 30 percent thereof.

Section 861(a)(4) provides that rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property, shall be treated as income from sources within the United States. Section 862(a)(4) provides that 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 for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property, shall be treated as income from sources without the United States.

Section 863(a) provides that items of gross income, expenses, losses, and deductions, other than those specified in §§ 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary.

Section 863(b) provides that, in the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The section further provides that the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary. Sections 871(b) and 882 provide that when a nonresident alien individual or a foreign corporation is engaged in a trade or business within the United States, the individual or corporation is taxable at U.S. graduated tax rates on taxable income which is effectively connected with the conduct of a trade or business within the United States (ECI). Section 864(c) provides specific rules for determining the income, gain, or loss treated as ECI.

Section 1031(a)(1) provides generally that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. For § 1031 to apply, a taxpayer must have realized gain or loss from a disposition of property, as described in § 1001. While a sale or other disposition of a patent generally gives rise to a gain or loss
under § 1001, the mere grant of a patent license does not because it is not a sale or other disposition of property within the meaning of § 1001(a). Similarly, gain or loss under § 1001 does not arise in the case of mutual grants of licenses. Thus, § 1031 has no application to a QPCLA addressed in this revenue procedure.

In general, the foregoing rules regarding inclusion, deduction, sourcing, and withholding operate independently as to each item of gross income and expense.

.04. Administrability Issues. The Treasury Department (Treasury) and the Internal Revenue Service (IRS) recognize that QPCLAs entered into by uncontrolled parties to pursue their businesses free from potential patent infringement claims raise many difficult issues for both taxpayers and the IRS. In light of the large number of patent applications and grants, and the difficulty and cost of resolving patent infringement disputes, it is often very difficult to ascertain the validity and scope of patent rights without incurring significant expense, which may include the cost of litigation. Thus, this unique interaction of patent and tax law creates administrative challenges for the taxation of QPCLAs.

For instance, while valuation of intellectual property is always difficult, valuation of patent rights is exceedingly difficult where the parties enter into the cross licensing arrangement to avoid or settle patent infringement disputes. Uncertainty in the patent law increases the difficulties of reaching a valuation when the parties enter into a cross licensing arrangement to avoid the costs and risks of determining their ultimate patent rights by litigation.

Similarly, the sourcing of gross income from QPCLAs entered into to avoid or settle patent infringement disputes may present administrative problems. In those arrangements, the difficulty in tracing the location and use of intangibles to a particular jurisdiction in the absence of objective benchmarks (for example, if a QPCLA did not provide for per-unit cash royalties based on sales of products) may make it difficult to allocate income to a particular source.

For these reasons, Treasury and the IRS have determined that, in the interest of sound tax administration, taxpayers are not required to take into account amounts other than the "net consideration" as defined in section 5.02 of this revenue procedure for QPCLAs described in section 4 of this revenue procedure.

4. Qualified Patent Cross Licensing Arrangement (QPCLA)

A QPCLA is a nonexclusive, nontransferable patent cross licensing arrangement among uncontrolled parties, the subject matter of which is limited to the parties' present or future patent rights, as specified in the arrangement. If the parties to an arrangement also engage in more than de minimis licensing or other transfer of other intangible property (including copyrights, trademarks, and know how) pursuant to the arrangement, the arrangement is not a QPCLA. The determination of whether the licensing or other transfer of other intangible property is de minimis is determined under all the facts and circumstances.

5. Net Consideration Method

.01. Scope. The Net Consideration Method provided in this section 5 may be used for a QPCLA by any taxpayer without regard to whether the taxpayer has made a payment of income subject to withholding with respect to the QPCLA.

.02. Net Consideration. For purposes of this section, "net consideration" is defined as the amount of consideration other than license rights and de minimis other intangible property received in the taxable year by a party pursuant to the arrangement, reduced by the amount of consideration other than license rights and de minimis other intangible property paid in the taxable year by the party pursuant to the
.03. **Financial Statement Conformity.** A taxpayer may not use the Net Consideration Method discussed in this section for a QPCLA unless the taxpayer takes into account only the "net consideration", as defined in subsection 5.02 of this revenue procedure, for such arrangement on its audited financial statements (if any), or similar statement in the case of a foreign corporation, for all years ending after February 14, 2007, that the net consideration method is used for tax purposes.

.04. **Use of Net Consideration Method.** A taxpayer choosing to use the Net Consideration Method must apply the Net Consideration Method as provided in sections 5.05 and 5.06 of this revenue procedure. The use of the Net Consideration Method will be presumed to clearly reflect a taxpayer's income.

.05. **Withholding.** Under the Net Consideration Method, only the net consideration transferred between the parties to a QPCLA during a taxable year will be taken into account for withholding purposes. The Net Consideration Method applies whether the QPCLA is entered into in advance of, during, or after a patent dispute.

.06. **Capitalization.** Under the Net Consideration Method, only the net consideration transferred between the parties to a QPCLA during a taxable year will be taken into account for capitalization purposes under § 263(a) or § 263A of the Code.

.07. **Example.** X, a domestic corporation, and Y, a foreign corporation, each hold patents potentially implicated by the manufacture and sale of product P. In addition, each actively engages in the manufacture and sale of product P on a global basis. Y does not have income effectively connected with a U.S. trade or business. In 2007, X and Y enter into a QPCLA with respect to their respective patents. In accordance with the terms of the QPCLA, $20 million is paid by X to Y. The only consideration for the QPCLA taken into account on X's financial statements is the $20 million payment made by X to Y. X may use the Net Consideration Method to determine its withholding obligations and the amount subject to capitalization for federal income tax purposes.

Under the Net Consideration Method, only the $20 million payment made by X under the QPCLA is treated as income to Y for withholding purposes. Therefore, withholding under § 1442 will apply only with respect to the portion of the $20 million payment by X attributable to U.S. sources under § 861(a)(4). Further, only the $20 million payment by X is subject to capitalization under § 263(a) or § 263A.

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**Earning Stripping and Treaty Shopping.** The elimination of withholding taxes on tax deductible payments (such as interest, rents, and royalties) under the U.S. model treaty may well represent a bilateral concession to promote free trade among the two nations, but in the context of a multinational enterprise the availability of these reductions in source-based taxation creates the opportunity to engage in earning stripping and base erosion strategies that result in the creation of homeless income. The reader should study the essential fact pattern set forth in *Aiken* as (which in simplified form is set forth in the accompanying diagram) contains the essential elements of international tax-haven operations: the deflection of income (by deductions from income that would otherwise be heavily taxed) to an environment where it is less heavily taxed, all the while remaining under the same beneficial ownership. The
problem highlighted by this structure is that the use of an intermediate company located in a
treaty jurisdiction allows a non-treaty resident to benefit from a US tax treaty by interposing an
intermediate entity. Thus, the bilateral tax treaty has, in effect, become a tax treaty to the world.
The IRS, with some success, attacked such a structure in Aiken, and that decision is reproduced
below. But, the judicial constraint on such techniques were highly fact specific. Broader based
protections were needed to protect against these techniques. We will return to the policy
implications posed by the tax planning posited in Aiken in detail.

**AIKEN INDUSTRIES, INC.**
**56 TC 925 (1971)**

Quealy, Judge:

The issues presented for decision with respect to that year are:

(1) Whether interest paid by a United States corporation to a Honduran corporation organized to collect such interest on behalf of a Bahamian corporation was exempt from United States income tax under an income tax convention between the United States and Honduras, or whether petitioner, as successor by merger to the United States corporation making the interest payments, is liable for withholding taxes on such payments.

(2) Whether the petitioner, as successor by merger to a subsidiary corporation, is liable for the addition to tax established by section 6651(a)(1) for failure to file a required return.

**FINDINGS OF FACT**

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Aiken Industries, Inc. (hereinafter referred to as petitioner), successor by merger to Mechanical Products, Inc. (hereinafter referred to as MPI), is a Delaware corporation which had its principal place of business at all times pertinent hereto in New York, N.Y.

MPI was incorporated March 25, 1963, under the laws of Delaware and was a United States corporation during the calendar years 1964 and 1965. During these years, all of the outstanding stock of MPI was owned by petitioner, and 99.997 percent of the outstanding stock of the petitioner was owned by the Ecuadorian Corp., Ltd. (hereinafter referred to as ECL), a Bahamian corporation. ECL also owned all of the outstanding stock of Compania de Cervezas Nacionales (hereinafter referred to as CCN), an Ecuadorian corporation.

Industrias Hondureñas S.A. de C.V. (hereinafter referred to as Industrias) was incorporated under the laws of the Republic of Honduras on March 30, 1964. From that date through December 31, 1965, all stock of Industrias was beneficially owned by CCN.

On April 1, 1963, MPI borrowed the sum of $2,250,000 from ECL. In return for this loan, MPI issued to ECL a 4-percent sinking fund promissory note (hereinafter sometimes referred to as the note) due in 1983.

On March 31, 1964, ECL assigned the 4-percent sinking fund promissory note of MPI to Industrias. The consideration received by ECL for this assignment of MPI's note was nine promissory notes of Industrias. Each note was payable on demand, each note was in the principal amount of $250,000, and each bore interest in the amount of 4 percent per annum. The directors of Industrias authorized the issuance of Industrias' notes in exchange for the
note of MPI at a board of directors meeting held on March 31, 1964. ECL's board of directors ratified the transfer of MPI's note in exchange for Industrias' notes at a meeting held on April 29, 1964.

On March 31, 1964, the treasurer of ECL notified MPI by letter that:

Please be informed that we have assigned and sold on this date all of our right, title and interest in and to the promissory note issued by you to the undersigned on April 1, 1963 in the principal amount of Two Million Two Hundred and Fifty Thousand Dollars ($2,250,000.00), to Industrias Hondurenas, S. A. de C. V., Room 207, Banco Atlantida, Tegucigalpa, Republic of Honduras. During the years 1964 and 1965, Industrias did not maintain an office in the United States, and it did not carry on any business within the United States. In addition, no United States citizen served as an officer, director, or employee of Industrias.

Industrias has filed tax returns for the years 1964 and 1965 with the Direccion General de la Tributacion Directa of Honduras and paid all taxes shown due thereon. The return for 1965 has been accepted by the Direccion General de la Tributacion Directa.

During the years 1964 and 1965, the only income received by Industrias was interest income in the amounts of 232,500 lempiras and 350,000 lempiras, respectively (a lempira was worth $0.50 at this time). All of this interest income was paid to Industrias by United States corporations, and in each of the years 1964 and 1965, MPI paid Industrias the sum of $90,000 (180,000 lempiras) per annum as interest on the 4-percent sinking fund note held by Industrias.

The tax returns for Industrias for the years 1964 and 1965 disclose deductions for interest paid or accrued in the amounts of 225,000 lempiras and 340,000 lempiras, respectively. Industrias paid all of this interest to ECL on account of notes of Industrias then owned by ECL.

During 1964 and 1965, the assets of Industrias consisted basically of cash, interest receivable, and investments in notes, bonds, or debentures. All of these investments were in bonds, notes, or debentures of the corporations owned wholly and/or beneficially by ECL.

The liabilities of Industrias for the years 1964 and 1965 consisted for the most part of interest and notes payable to ECL. In addition, the tax returns of Industrias show Honduran tax liabilities for the years 1964 and 1965 of 187.94 and 339.29 lempiras, respectively, and small expenditures for the maintenance of a corporate office in Honduras.

During the years 1964 and 1965, there was in force a "Convention Between the United States of America and the Republic of Honduras for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income" (hereinafter referred to as the convention). Article IX of the convention provides:

Interest on bonds, securities, notes or on any other form of indebtedness from sources within one of the contracting States received by a resident, corporation or other entity of the other contracting State not having a permanent establishment within the former State at any time during the taxable year in which such interest is received, shall be exempt from tax by such former State. ***

OPINION

In this case, MPI, a United States corporation, was a wholly owned subsidiary of the petitioner (also a United States corporation) which in turn was a 99.997-percent subsidiary of ECL, a Bahamian corporation. ECL also owned all outstanding stock of CCN, an Ecuadorian corporation.

In April 1963, MPI borrowed $2,250,000 from ECL and issued its 4-percent sinking fund promissory note in recognition of the debt. In March 1964, Industrias was incorporated under the laws of Honduras with all of its stock being held by CCN. ECL then transferred the note of MPI to Industrias in exchange for nine of the latter's notes. Each of the nine notes was payable
on demand, each note was for the same principal amount of $250,000, and each carried the same 4-percent annual interest rate.

Generally, section 1441(a) requires "all persons, in whatever capacity acting," to withhold taxes on payment of any items of income specified in section 1441(b) to "any nonresident alien individual" or to "any foreign partnership." Section 1441(b) designates interest as one of the items of income subject to section 1441(a).

Section 142(a) requires a tax of 30 percent to be "withheld at the source in the same manner and on the same items of income" as established in section 1441 if there is a payment of any of the designated income items to a foreign corporation "subject to taxation."

Under this statutory framework, MPI ordinarily would have been required to withhold tax on the interest which is paid to Industrias. However, during 1964 and 1965, there was in force a "United States-Honduras Income Tax Convention" (the convention was terminated on December 31, 1966) to provide for "the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on incomes." Article IX of the convention provided that interest paid by a United States corporation to a Honduran corporation not having a permanent establishment in the United States was to be exempt from United States tax.

On the basis of the convention, MPI claimed exemption from the withholding provision applicable to United States source income paid to foreign corporations, and having ostensibly conformed to the literal requirements of the withholding regulations prescribed under the convention, MPI did not withhold tax. The question for decision is whether the convention was applicable to the facts and circumstances of this case so as to exempt MPI from the requirements of withholding income tax on interest payments which it made to a foreign corporation, or whether petitioner, as successor by merger to MPI, is now liable for such taxes.

The respondent argues that the organization of Industrias and its existence as a corporate entity should be disregarded for tax purposes. He concludes that ECL should be deemed the true owner and recipient of the interest in question with the consequence that petitioner is now liable for the failure of MPI to withhold income tax.

Petitioner claims that an exemption from withholding flows from the exemption from taxation for interest found in article IX of the convention which provides in pertinent part:

- Interest
  from sources within one of the contracting States received by a
  *** corporation or other entity of the other contracting State not having a permanent establishment within the former State
  *** shall be exempt from tax by such former State.

In support of its claim for exemption from taxation under article IX, petitioner argues that Industrias conformed to the definition of a corporation established by article II, section (1)(g), in that it was "a corporation or other entity formed or organized in Honduras or under the laws of Honduras" and that it was therefore a corporation for purposes of article IX. On this basis, the petitioner concludes that Industrias cannot be disregarded as a corporate entity and that the interest paid to Industrias by MPI was exempt from United States taxation under article IX thus relieving MPI of its duty to withhold income tax on such interest.

The United States Constitution provides in article VI, clause 2, that:

- all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Thus, all treaties made under the authority of the United States are to be the supreme law of the land and superior to domestic tax laws. *Cook v. United States*, 288 U.S. 102 (1933). This concept has been expressly recognized in section 894(a) which, during the years in question,
SEC. 894. INCOME AFFECTED BY TREATY.
(a) Income Exempt Under Treaty.-Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

Consequently, neither the courts nor the taxing authorities may establish definitions for terms contained in a treaty contrary to those definitions expressly set forth in that treaty. Where the formal requirements of a definition established by a treaty are met, the benefits flowing from a treaty as the result of conforming to such formal definitional requirements cannot be denied by an inquiry behind those formal requirements. Maximov v. United States, 373 U.S. 49 (1963); Bacardi Corp. v. Domenech, 311 U.S. 150 (1940).

Article II, the definitional article of the convention, provides in section (1)(g):
(g) The term "Honduran enterprise" means an industrial or commercial or agricultural enterprise or undertaking carried on by a resident of Honduras*** or a fiduciary of Honduras or by a Honduran corporation or other entity; the term "Honduran corporation or other entity" means a corporation or other entity formed or organized in Honduras or under the laws of Honduras.

Article II, section (1)(f), is structured in the same manner with "United States" standing in place of "Honduras" or "Honduran" as the case may be.

The term "corporation" is nowhere defined in the convention in its own right, and in article II, sections (1)(f) and (1)(g), the definition of a corporation of a contracting State appears in the definition of an "enterprise" of such contracting State. However, in the absence of any indication to the contrary, it is clear that in defining the term "corporation" for one purpose, the contracting States intended that definition to apply in other contexts as well. Consequently, we are convinced that the term "corporation," as utilized in article IX, refers to a corporation or other entity formed or organized in one of the contracting States or under the laws of one of the contracting States.

Thus, Industrias, being a corporation organized under the laws of Honduras and conforming to the specific definition of "Honduran corporation" established by article II, section (1)(g), of the convention, was a "corporation or other entity" of one of the contracting States within the meaning of article IX. Therefore, the convention prevents us from ignoring the corporate entity as such. Maximov v. United States, supra; Bacardi Corp. v. Domenech, supra.

However, while we agree with the petitioner that Industrias was a "corporation" for purposes of article IX, and that it therefore cannot be disregarded, we do not agree with the petitioner's conclusion that this factor alone was sufficient to qualify the interest in question for the exemption from taxation granted by article IX. Rather, we must determine whether the transaction in question conforms to the other requirements established by article IX.

In seeking to give substance to the terms of article IX which establish those requirements, we are free under article II, section (2), of the convention, to assign to those terms "not otherwise defined" by the convention the meanings which would normally attach to such terms under our laws "unless the context otherwise requires." In so doing, we recognize that the fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention. See Gregory v. Helvering, 293 U.S. 465, 469 (1935). And we are aware of the necessity for liberal construction in determining the applicability of the convention. Jordan v. Tashiro, 278 U.S. 123, 127 (1928).

However, "To say that we should give a broad and efficacious scope to a treaty does not mean that we must sweep within the Convention what are legally and traditionally recognized to be ***
taxpayers not clearly within its protections."
Maximov v. United States, supra at 56. In deciding whether a given taxpayer in a specific instance is protected by the terms of a treaty, we must "give the specific words of a treaty a meaning consistent with the genuine shared expectations of the contracting parties," and in so doing, it is necessary to examine not only the language, but the entire context of agreement. Maximov v. United States, 299 F. 2d 565, 568 (C.A. 2, 1963), affd. 373 U.S. 49 (1963).

Applying these principles, we find that the interest payments in question were not "received by" a corporation of a contracting State (herein a Honduran corporation) within the meaning of article IX of the convention. As utilized in the context of article IX, we interpret the terms "received by" to mean interest received by a corporation of either of the contracting States as its own and not with the obligation to transmit it to another. The words "received by" refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds.

The convention requires more than a mere exchange of paper between related corporations to come within the protection of the exemption from taxation granted by article IX of the convention, and on the record as a whole, the petitioner has failed to demonstrate that a substantive indebtedness existed between a United States corporation and a Honduran corporation.

In this case, ECL transferred the $2,250,000 4-percent sinking fund promissory note of MPI to Industrias in exchange for nine notes of Industrias with each of those notes payable on demand, each with the same principal amount of $250,000, and each with the same 4-percent interest rate. In essence, Industrias acquired the $2,250,000 4-percent sinking fund promissory note of MPI by giving nine notes totaling $2,250,000 at 4-percent interest. Industrias obtained exactly what it gave up in a dollar-for-dollar exchange. Thus, it was committed to pay out exactly what it collected, and it made no profit on the acquisition of MPI's note in exchange for its own.

In these circumstances, where the transfer of MPI's note from ECL to Industrias in exchange for the notes of Industrias left Industrias with the same inflow and outflow of funds and where MPI, ECL, and Industrias were all members of the same corporate family, we cannot find that this transaction had any valid economic or business purpose. Its only purpose was to obtain the benefits of the exemption established by the treaty for interest paid by a United States corporation to a Honduran corporation. While such a tax-avoidance motive is not inherently fatal to a transaction, see Gregory v. Helvering, supra, such a motive standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes. See Knetsch v. United States, 364 U.S. 361 (1960); Higgins v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, supra.

In effect, Industrias, while a valid Honduran corporation, was a collection agent with respect to the interest it received from MPI. Industrias was merely a conduit for the passage of interest payments from MPI to ECL, and it cannot be said to have received the interest as its own. Industrias had no actual beneficial interest in the interest payments it received, and in substance, MPI was paying the interest to ECL which "received" the interest within the meaning of article IX. Consequently, the interest in question must be viewed as having been "received by" an entity (ECL) which was not a "corporation or other entity" of one of the contracting States involved herein, and we therefore hold that the interest in question was not exempt from taxation by the United States under article IX of the convention.

Having determined that the interest received by Industrias from MPI was not exempt from taxation by the United States under article IX of the convention because it was not "received by" a corporation of one of the contracting States (herein a Honduran corporation) within the meaning of that article, we must now face the question as to whether MPI (a United States corporation) was under any obligation to
withhold taxes in the absence of an initial determination that the interest did not qualify for the benefits of the convention and where it had ostensibly complied with all regulations providing for its exemption from withholding on the interest payments it made to a foreign corporation.

Under normal circumstances, we would answer this question in the negative. However, in this case, the Commissioner was misled by the insufficiency of MPI's statement setting forth the facts upon which the Commissioner would ordinarily make an appropriate determination. In seeking to comply with the withholding regulations so as to obtain the protection of the convention, Industrias sent a letter to MPI notifying MPI that it (Industrias) was the owner of the April 1, 1963, promissory note, that the interest payable was exempt from United States tax under article IX of the convention, that it was not a resident or citizen of the United States, and that it did not have a permanent establishment in the United States. The letter did not specify that Industrias had acquired the note from ECL, the corporation to which the note had originally been given.

In compliance with the withholding regulations, MPI filed a copy of the letter from Industrias with the Internal Revenue Service and enclosed a letter which stated in part:

The subject matter of the letter concerns a promissory note issued by Mechanical Products, Inc. on April 1, 1963 in the amount of $2,250,000.00, in favor of Industrias Hondurenas, S.A. de C.V. [Emphasis supplied.]

This letter from MPI to the Internal Revenue Service did not describe or discuss the relationship of ECL to the note or the transfer of the note from ECL to Industrias.

In these circumstances, where the Commissioner was not fully apprised of all the facts and circumstances surrounding the issuance of the April 1, 1963, note and its subsequent history and where MPI, Industrias, and ECL were all related corporations, the respondent cannot be faulted for his inaction. Consequently, MPI's right to rely on the respondent's inaction as a basis for its failure to withhold cannot be sustained. Therefore, we hold that MPI and petitioner, as the successor to MPI by virtue of merger, were and are liable for the withholding taxes on the interest paid under the note issued by MPI to a foreign entity.

Notwithstanding our holding with respect to the liability of the petitioner for withholding taxes, we do not find petitioner, as successor by merger to MPI, liable for the addition to tax for failure to file a return provided for in section 6651(a)(1). The failure to file a return on the advice of counsel cannot be said to have been due to willful neglect. Daisy M. Twinam, 22 T.C. 83 (1954), acq. 1954-2 C.B. 6; C. R. Lindback Foundation, 4 T.C. 652, 667 (1945). See also Haywood Lumber & Min. Co. v. Commissioner, 178 F. 2d 769 (C.A. 2, 1950).

Decision will be entered under Rule 50.

NOTES & QUESTIONS

1. Citing Aiken, the IRS stated that a back-to-back loan arrangement where the intermediary entity (a Netherlands Antilles corporation) that had retained a 1% margin (charged 11% on its loan and paid 10% on its borrowing) was a conduit and unable to rely on the U.S.-Netherlands tax treaty to claim a reduced withholding rate on the US entity’s cross-border payment of interest. The question of the reach of Rev. Rul. 84-152 and the holding of Aiken surfaced in the courts in Northern Indiana Public Service Co. v. Commissioner, 115 F.3d 506 (7th Cir. 1997), affirming 105 T.C. 341 (1995). That case involved a prototypical sandwich of back-to-back loans channeled through a Netherlands Antilles finance company. The IRS flung its entire arsenal at the taxpayer, but lost in both the Tax Court and the court of appeals. The mixed results demonstrated to most observers that a more prescriptive approach to attack
this phenomenon was needed if the US government did not want to simply allow unrestricted earning stripping opportunities.

2. Thus, even before the judicial decision in *Northern Indiana Public Service Co. v. Commissioner*, the Treasury Department attempted to deal with treaty shopping problem with another mechanism. Again, remember, the Treasury Department was in the process of adding limitation on benefits provisions in its treaties, but that was a slow process and did not holistically address the problem. As a result, Congress, in the 1993 Act, brought the Treasury another (unilateral) weapon in its campaign against sandwiches and other international tax havens: section 7701(1). Understated in form, section 7701(1) is potent in reach. Under the somewhat cryptic heading “Regulations Relating to Conduit Arrangements,” section 7701(1) reads, “The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.” Someone who did not have in mind the history of sandwiches and other tax-favored structures using finance intermediaries would be hard pressed to divine what section 7701(1) is about. In fact, this single sentence changes the balance of power between taxpayers and the Treasury in the matter of conduits, earnings-stripping, and back-to-back debt. The regulations under section 7701(1) are known as the “Conduit Regulations.” These regulations are a decidedly fierce read. What you should glean from them at a minimum is that they treat most chains of debt and many combinations of debt and leases or licenses as multiparty financing transactions. If there is a significant possibility of tax avoidance, the IRS can disregard the participation of any intermediate entity as a “conduit.”

3. But, at the same time that the Treasury Department issued its conduit regulations under Section 7701(l), it then set forth an effort to redress this technique under the terms of its treaties. What then followed was a multi-faceted effort to combat this inbound tax planning. In the treaty context, the U.S. attempted to add a limitations on benefits provision in its treaties, and the current iteration of that provision is found in Article 22 of the U.S. Model Treaty. The U.S. Model Treaty has contained a form of a limitations of benefits provision since 1977. The basic purpose of this provision remains clear even within the lavish profusion of words: it attempts to limit the benefit of a treaty to corporations that have some real economic connection with the treaty jurisdiction beyond the formality of a corporate charter. But, its contours are best understood by looking at specific hypotheticals, so please work the Problems on LOB Provisions of Treaties that follow.

**Problems on LOB Provisions of Treaties**

1. Olson and Johnson are wealthy investors who were born and raised in Sweden. Each owns half of International Lenders, Ltd. (“ILL”), a corporation organized and headquartered in Stockholm. ILL makes equity investments and loans all over the world. Several years ago, ILL loaned $100 million to the American Fish Company (“AmFish”), a U.S. corporation that operates solely in the United States. AmFish pays interest annually of $10 million on debt that does not qualify as a portfolio investment. The principal of the loan is to be paid at the end of ten years. Assume that the U.S. Model Treaty applies between Sweden and the United States. Are interest payments by AmFish to ILL subject to the U.S. withholding tax?

2. Does your answer in Problem 1 change if Olson retires and moves to Brazil, a country with which the United States has no tax treaty?
3. How, if at all, does your answer in Problem 1 change if Olson and Johnson sell all of their stock to Superrich Corp., a corporation organized and operated in Brazil?

4. How, if at all, does your answer in Problem 1 change if Olson and Johnson decide to list and sell all of their ILL shares on the stock exchange in Sweden?

5. How would your answer to Problem 4 change if they list and sell 75 percent of the shares, most of which are acquired by residents of a country having no tax treaty with the United States?

6. How would your answer to Problem 1 change if 75 percent of the shares are sold by Olson and Johnson directly to residents of countries that have no tax treaty with the United States?

7. Amcar, a U.S. corporation, has negotiated to borrow $20 million from a bank in Norway. The interest rate demanded by the bank is “eight percent, net of U.S. taxes.” Assume there is no tax treaty between the United States and Norway. Amcar owns a subsidiary, Partsub, established and operated in Sweden that manufactures several small parts imported into the United States for use in Amcar’s manufacturing operation. The Norwegian bank agrees to loan the $20 million to Partsub at a net interest of eight percent. Partsub in turn loans $20 million to Amcar at nine percent per annum. Assume that the U.S. Model Treaty applies between Sweden and the United States. Do U.S. withholding taxes apply to any interest payments?

8. Would your answer in Problem 7 change if Amcar guaranteed the loan to Partsub?

9. Would your answer in Problem 7 change if Partsub were established just before the loan agreements were signed and had not yet undertaken any other activity?

PROBLEMS on Tax Treaties §11.5

The casebook requires you to revisit earlier problems in earlier chapters. Those are repeated here in relevant part.

1. Assume in Chapter 1, review question 3, that A is not an Argentinean citizen but rather a citizen and resident of a country that concluded a treaty with the U.S. following the U.S. Model. How may your answer change?

A is a U.S. citizen, whose parents left the U.S. when she was 1-year old to move to a country that concluded a treaty with the U.S. following the U.S. Model. She has not been to the U.S. since. She is now 35 and a successful lawyer in her home country. She asks you whether she will be taxed as a U.S. resident on capital gains she expects to make on stock of a U.S. corporation that she wishes to purchase through an online broker. She has no other income with any connection to the U.S. or U.S. residents. She spent the months January-June (exactly) of 2017–2019 in the U.S., enjoying the sun in Miami’s south beach and doing nothing else. She continued to practice law in her home country the rest of the year.

2. Assume in Chapter 2, review question 1, that A is not a Brazilian citizen but rather a citizen and resident of a country that concluded a treaty with the U.S. following the U.S. Model. How may your answer change?

A is a lawyer (and citizen/resident of a treaty jurisdiction), who visited the U.S. for the first time in 2019, staying 50 days, primarily for business reasons, in New York City. In
2019, A earned the following items of income:

a. $100,000 salary paid (by his law firm) in Brazil to his Citibank account.
b. $1,000 honorarium paid by a group of Latin American law students, for whom he was invited to lecture while in New York.
c. $5,000 dividends paid on IBM stock he bought 5 years ago, through an online broker.
d. $1,000 paid on a CD (certificate of deposit) paid by Citibank (a U.S. corporation) to his account in Brazil (in the Brazilian branch of Citibank).
e. $1,000 gain on the sale of a zero-coupon bond of a U.S. corporation that he bought in 2009 and sold on Dec. 31, 2019, while in Brazil, to a Brazilian citizen and resident.
f. $10,000 gain on a painting of the Grand Canyon that he found in the attic of his house, and sold to a U.S. business partner of his. He shipped the painting to the U.S. at his expense, including the insurance, by FedEx.
g. $1,000,000 guaranteed payment on his money market account held in a Swiss bank and paid by the New York Branch of that bank while he was in New York.
h. B, his Brazilian friend, paid him (A) $20,000 with respect to a loan of $10,000 that A made to B last year and never thought about since.
i. $10,000 profit on hand-made dolls that A produces at home and normally ships to the U.S. at the expense of his U.S. (one) customer, but this year brought into the U.S. by A in a suitcase and delivered by hand to the customer in New York. This is a hobby and A is under no obligation to produce these dolls—the customer will purchase whatever produced whenever produced at the agreed price and quality specifications. Alternatively, A purchases the dolls from a neighbor who regularly sells the dolls in his shop in Brazil.
j. $1,000 for the exclusive worldwide distribution rights of a book he wrote in English for American lawyers with Brazilian customers. How much U.S. source income does A have in 2019?

3. Assume in Chapter 4, review question 3, that C is not a Nicaraguan citizen but rather a citizen and resident of a country that concluded a treaty with the U.S. following the U.S. Model. How may your answer change?

C is a Nicaraguan citizen and resident who was present (for the first time in her life) for 30 days in the U.S. in 2019. She developed certain software that she licenses in 2019 exclusively to P, a Delaware corporation, in exchange for a payment of $1,000 paid to her Swiss bank account. P uses the software in its products that are sold in the U.S.

a. What are C’s U.S. tax consequences of the above?
b. What if the license is for 10 years and $1,000 paid annually in these years?
c. What if in (b) the payment of $1,000 was due only if sales of the P product exceeded $100,000?
d. Assume in Chapter 5, review question 1, that FC is not organized under the laws of Argentina but rather under the laws of a country that concluded a treaty with the U.S. following the U.S. Model. How may your answer change?
FC is a large multinational corporation organized under the laws of Argentina. It manufactures and sells various products related to the cellular telecommunication industry throughout the world. In 2019 and 2019 it had offices in New York City, Chicago and Atlanta, with 100 employees primarily engaged in (as yet unsuccessful in 2018) attempts to interest American carriers with its products. Also in 2018, A, the son of FC's founder, who just completed his MBA, traded in stock using FC's NYC office on behalf of FC and his own parents, using the family's private accounts and any free cash deposited with FC's banks in the U.S. He has been successful and generated $1m of gains for FC alone during 2018. He received $200,000 for this service to FC. He was not involved in FC’s U.S. business otherwise. In 2019, A was asked by other friends and family to handle their stock portfolios in the U.S. He therefore rented a nicer loft in NYC, where he located his home office and handled the investments of these friends and family. He continued to invest for FC and generated another $1m of gains for FC during 2019. Again, he received $200,000 for this service to FC and was not involved in FC’s U.S. business otherwise. Also in 2019, FC got its first contract in the U.S. when B, the CEO of D, a Delaware corporation met FC’s CEO in Argentina and agreed on the supply of products that generated $10m to FC. The products were transferred (including title) to D’s agent in Buenos Aires and were shipped on D’s expense to the U.S. Neither B nor D were ever contacted or met any of FC’s employees in the U.S. and none of these employees were involved in any way in the negotiation or conclusion of this contract. B did see their advertisement in the U.S. and D was helped by an Atlanta employee by phone in the process of delivery of the products from the ships to D’s factory (this was technical assistance that took the employee approximately 2 hours and could be found on FC’s website for free). What, if any, are FC’s U.S. tax consequences of the above transactions?

a. Assume, alternatively, that FC manufactures, in addition to the cellular equipment, large (and expensive) telecommunication equipment. It regularly sells between 500–1000 units of these products to the U.S each year, always to the same few clients and passing title in Argentina. FC’s U.S. employees were never involved in this line of business, except that one of them sits on FC’s board (she travels to Argentina for board meetings). FC’s personnel visit their U.S. clients occasionally and sometimes pay visits to FC’s offices to make unrelated phone calls, faxes and secure consultations with headquarters (in which the U.S. office’s personnel never participate). Does FC have an office in the U.S. with respect to this line of business?

b. Assume, alternatively that J, FC’s President and controlling shareholder decided to purchase a NYC apartment in order to be closer to A, his son. He stays two months each year in that apartment and works in a home office established in that apartment. If an important meeting is required, he flies to Argentina for that purpose. He makes executive decisions, but does not participate in the daily management of FC, but he does insist on having a final word (veto) regarding all large equipment sales contracts, which he views as sensitive and critical to the success of FC. Assume that he has the right to review each sale for 24 during which he can veto the sale. Does FC have an office in the U.S. with respect to its large equipment business because of J’s actions above?
5. Assume in Chapter 8, review question 1, that countries T, B and Y concluded a treaty with the U.S. following the U.S. Model. How may your answer change?

USCO, a Delaware corporation, manufactures widgets in the U.S. (assume a flat 21% domestic corporate tax). USCO has distribution operations and offices in two additional countries—T, a country with a flat 40% tax, and B, a country with a flat 10% tax. USCO also wholly owns a country Y (33.33% flat tax) subsidiary—S.

a. In year 1, USCO had $500 of U.S. source income, $300 of income in T and $200 in B (assume that both are foreign source income). S had $1,500 of income in country Y, and distributed $1,000 to USCO. The distribution was subject to a 5% withholding tax in Y. What is USCO’s U.S. tax liability for the year?

b. Does your answer change if all of USCO’s income is derived from the sale of purchased inventory widgets and the terms of the sales contract are always that title passes to the final customer from USCO only after on-site installation and testing (on the customer’s premises)?

c. Assume now, in (a), that country B increases its taxes to 20%. How would USCO’s tax position change?

d. Could USCO “remedy” its excess credit position by investing in a tax haven—an investment that would generate (zero taxed) foreign source interest income of $100?

Final Review Problems:

The Problems that follow are intended to bring together many of the considerations raised by the materials in this and the prior two chapters. In each instance analyze the result under the usual sources of U.S. income tax law; then, consider whether your answer would be modified if the U.S. Model Treaty were in force with respect to the transaction.

1. Dickens, a citizen and resident of the United Kingdom, occasionally purchases and sells securities on the New York and American Stock Exchanges. He effects his transactions through a stockbroker in New York City, who is instructed by telephone from London. During the tax year, Dickens made 20 purchases and 15 sales. He received dividends during the year of $30,000. He realized gains of $200,000 and losses of $100,000 from transactions involving the shares. Dickens wishes to know the extent of any U.S. income tax liability. Advise him.

2. In Problem 1 would Dickens’ U.S. taxes be reduced if he had realized losses of $230,000?

3. The broker in Problem 1 has recently suggested that Dickens give him discretionary authority to buy and sell “to exploit fast-breaking market conditions.” Would such an arrangement affect your earlier responses?

4. Carlson, a citizen and resident of Denmark, is a commodities dealer operating in Copenhagen. During the tax year, Carlson, by e-mail from her home office, purchased several carloads of wheat. She took title to the wheat in Minneapolis. The wheat was sold to the government of India, FOB New York City, where the wheat was placed aboard a Liberian flag vessel. Carlson has never been to the United States. While she has occasionally purchased U.S. commodities in
the past, this is her sole transaction in the United States during the current year. Does she have any potential U.S. income tax liability?

5. Rosario, a corporation organized in Argentina, sells consumer products to retailers in the main cities of that country. Rosario has no office in the United States. Rosario sales representatives in Argentina send orders to a purchasing agent in New York. The purchasing agent purchases the products from U.S. manufacturers in Rosario’s name. The products are shipped to Miami and delivered to vessels bound for Argentina. Orders are accepted in Argentina. Title to the goods is transferred to customers at the port of destination. However, the customers have agreed contractually to insure against all losses attributable to shipwreck, fire and accident while the goods are in transit. The Argentine customers make payment to an account maintained by Rosario in Switzerland. Does Rosario have any liability for U.S. taxes? Would your answer differ if the purchasing agent is properly characterized as an “independent agent”?

6. Empire, Ltd. (“Empire”), is a German corporation engaged in the sale of machinery parts to various customers throughout Europe. For many years Empire purchased the parts from Colonial Ohio Corp. (“Colonial”), an Ohio corporation, in Youngstown, Ohio. Although Empire has no U.S. office, it took title to the parts in Youngstown, transported the parts to Europe and made delivery to its European customers. The two companies are each wholly owned by a Swiss holding company. Does Empire have any U.S. income tax liability? Should the relationship between Empire and Colonial affect the analysis?

7. The method of operation in Problem 6 has recently changed. Empire now arranges sales between Colonial and the European customers. The parts are delivered FOB Youngstown where title passes to the customers, who then pay all shipping costs. Empire receives a 20–percent commission from Colonial whenever customer payments are received. Does Empire have any U.S. income tax liability? Should the prior arrangement between the corporations affect the analysis?

8. Mimi Manon is a well-known soprano from France. While visiting Los Angeles for one week several years ago, Manon made a highly acclaimed recording which broke sales records around the world. Manon has returned to her home in France, where she receives monthly checks equal to ten percent of the gross revenues produced by worldwide record sales in accordance with a written contract between Manon and the U.S. recording company. The contract describes such payments as “royalties.” Does Manon have any U.S. income tax liability? Does the recording company have any obligation to withhold?

9. Horatio, a citizen and resident of Ireland, is an equal partner with Imogene, a U.S. citizen, in a consulting firm operating out of a Miami office and serving clients located in Florida. Under the terms of the partnership agreement, Horatio and Imogene are to share equally in profits and losses. During the course of the year, Horatio devotes 100 days to the venture, but works primarily at home in Dublin and communicates with his partner and his clients by telephone, fax and Internet. In fact Horatio is actually in the United States only ten days during the year. During the year the partnership earns net income of $200,000, all of which derives from the provision of consulting services by the partnership to clients in the United States. All of the partnership income is reinvested in the business and none is distributed to the partners. Horatio has no other economic involvement in the United States. To what extent, if at all, will Horatio be subject to U.S. income taxes for the year?
10. Leonardo and Verdi, citizens and residents of Italy, purchased some undeveloped farm land in Iowa for $1 million. They have leased the land to a tenant farmer who completely manages the agricultural use of the land, pays all real estate taxes (which amount to $80,000 annually) and pays an annual rental of $100,000. How should Leonardo and Verdi minimize their U.S. income tax liabilities in respect of the leasehold arrangements?

11. After a number of years Leonardo and Verdi have decided to sell the land and are delighted to have received an offer of $10 million for the property. Will they be taxed on the gain realized from the sale? Could they have avoided U.S. tax on the gain if they had not elected to minimize U.S. taxes in Problem 12?

12. Romano, a citizen and resident of Colombia, invested $6 million in Knickerbocker, a wholly owned U.S. corporation. Knickerbocker acquired an apartment building in New York for $2 million, purchased $2 million of stock in small holdings of publicly traded U.S. companies and invested $2 million in a fancy art gallery operated in rented space on Fifth Avenue that produced no U.S. real property income. Although the art gallery has been subject to an annual lease with no right of renewal, it has been operated at the same location since its establishment. After only five years, Knickerbocker was worth $100 million and Romano has decided to sell the company. Determine how much, if any, of Romano’s gain will be subject to U.S. income taxes in the circumstances described below. Assume that the property values indicated in each case represent the maximum values during the five years since Knickerbocker was organized.
   a. The apartment building is worth $60 million; the stock is worth $20 million; the gallery assets are worth $20 million.
   b. The apartment building is worth $40 million; the stock is worth $40 million; the gallery assets are worth $20 million.
   c. The apartment building is worth $40 million; the stock is worth $20 million; the gallery assets are worth $40 million.
   d. The apartment building is worth $100 million, but is subject to a mortgage of $80 million which secures loans to Knickerbocker used to finance art inventory purchases and executive bonuses; the stock is worth $40 million; the gallery assets are worth $40 million.

13. If Knickerbocker were a corporation organized in the Cayman Islands, in which of the circumstances described in Problem 14 would Romano be subject to U.S. income tax on the sale of stock in the corporation?

14. Blue Water Resorts Inc. (‘‘Blue Water’’), a U.S. corporation whose shares are not publicly traded, operates resort hotels in many countries of the Caribbean, but does not operate in the United States. By the end of Year 1, Blue Water owned real property in various other countries with an adjusted basis of $10,000,000 and a value of $30,000,000. In Year 2, Blue Water acquired American Paradise Co. (‘‘Paradise’’), a Bahamas corporation that operated resort properties in Florida. In fact all of the assets of Paradise consisted of real property in the United States. The value of the Paradise real property, which was also the purchase price paid by Blue Water for the stock, was $40,000,000, but the adjusted basis of the real property to Paradise was only $5,000,000. In early Year 3, Casino, a nonresident alien of the United States, realized a profit of $1,000,000 from the sale of shares in Blue Water. Is the gain realized by Casino subject to U.S. income tax?