DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

September 9, 1999

Number: **199950002**
Release Date: 12/17/1999
CC:INTL:Br1
WTA-N-114343-99
UILC: 894.04-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: W. Edward Williams
Senior Technical Reviewer CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to a request made by your office on June 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Corp A =

Corp B =

Corp C =

Corp D =

Corp E =

Year 1 =

Year 2 =

Year 3 =

Group 1 =

Date A =

Date B =

Treaty 1 =

Treaty 2 =

Article A =

Article B =

Article C =

Article D =

Article E =

ISSUES:

1. Whether the royalties received by Corp A from Corp C are exempt from withholding under sections 881 and 1442 of the Code pursuant to Article A(1) of Treaty 1.

2. Whether the royalties received by Corp B from Corp A are subject to withholding under sections 881 and 1442 of the Internal Revenue Code pursuant to Article A(5) of Treaty 1.

3. Whether the royalties received by Corp B from Corp D are exempt from withholding under sections 881 and 1442 of the Code pursuant to Article A(1) of Treaty 1.

CONCLUSIONS:

1. If Corp A qualifies for benefits under Treaty 1, the royalties paid to it by Corp C attributable to the use of, or right to use, an intangible in the United States are exempt from U.S. taxation. If Corp A is not entitled to treaty benefits, such royalties would be subject to U.S. income tax only if Corp C is a conduit or the principles of Rev. Rul. 80-362 apply.

2. Royalties paid to Corp B by Corp A attributable to use of, or right to use, an intangible in the United States are subject to U.S. income tax only if one of the circumstances in Article A(5) of Treaty 1 applies.

3. Royalties paid to Corp B by Corp D attributable to use of, or right to use, an intangible in the United States are subject to U.S. income tax, unless Corp B is entitled to the benefits of Article A of Treaty 1.

FACTS:

Pursuant to an agreement dated Date A, between Corp A, a Country 1 corporation, and Corp B, also a Country 1 corporation, Corp B granted to Corp A the exclusive rights to exploit throughout the world, during a term that included the years Year 1 through Year 2, certain master recordings embodying the recorded performances of Group 1. Corp A sublicensed to certain of its affiliates the right to distribute the Group 1 recordings in various territories throughout the world (including the United States).

Pursuant to licensing agreements between Corp A and Corp C, a Country 2 Corporation, and between Corp C and Corp E, a U.S. corporation, royalties were paid by Corp E to Corp C.[1] The royalties were then paid by Corp C to Corp A which in turn paid the royalties to Corp B.[2]

In addition, pursuant to a licensing agreement between Corp B and Corp D, a U.S. corporation, granting Corp D certain worldwide rights, Corp B received royalties for the use of Group 1-related intangibles in the United States.[3]

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[1] The existence of these licensing agreements has not been established. Further, it is not clear that your office is treating the group of which Corps A, C and E are members as separate from the group of which Corp B is a member, or alternatively, both groups as one taxpayer.

[2] In a statement dated Date B, Corp A denies, under penalties of perjury, ever receiving, or having the right to receive, any royalties with respect to the exploitation of the recordings in the United States. In a letter dated Date B, the taxpayer's representative states that Corp B received no royalties from Corp A during the years Year 1 through Year 2 attributable to exploitation of the recordings in the United States.

[3] We note that Corp B denies that any of the royalties received from Corp D were attributable to use of the intangibles in the United States.

LAW AND ANALYSIS

Whether Corp A Qualifies for Treaty Benefits

In general, sections 861(a)(4) and 862(a)(4) treat royalties as having a source in the place of use of the property for which the royalties are paid. Pursuant to this “place-of-use” test, section 861(a)(4) provides that royalties from property located in the United States or from any interest in such property will be treated as income from sources within the United States. Specifically, section 861(a)(4) treats as gross income from sources within the United States

> royalties from property located in the United States or from any interest in such property, including ... royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property.

U.S. source royalties paid to a foreign corporation not connected with a U.S. business are subject to a 30 percent tax.[4] See sections 881 and 1442. The 30 percent rate of tax may be lowered or eliminated pursuant to the terms of an income tax treaty.

Article A of Treaty 1 provides that royalties arising in one of the States and beneficially owned by a resident of the other States shall be taxable only in that other State. However, Article B of Treaty 1 limits indirect use of Treaty 1 by persons who are not entitled to its benefits by reason of residence in the United States, Country 1, or in some cases, countries other than the United States and Country 1. If Corp A qualifies for treaty benefits, the royalties paid to it by Corp C are exempt from U.S. taxation.[5]

Article B sets forth various requirements for entitlement to benefits under Treaty 1. Set forth below is a discussion of the requirements Corp A must satisfy in order to qualify for treaty benefits. As the discussion indicates, determining whether Corp A qualifies for treaty benefits would require substantial additional factual development.

Article B of Treaty 1 provides that a resident of Country 1 is entitled to the benefits of Treaty 1 if it is engaged in the active conduct of a trade or business in

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[4]There is no indication that any of the foreign corporations involved in this case are engaged in a U.S. trade or business. Therefore, the issue of whether any of the U.S. source royalties are “effectively connected” with a U.S. trade or business and, therefore, not subject to withholding, does not arise.

[5]Assuming that the royalties derived from Corp E are beneficially owned by Corp C, they would be exempt from U.S. taxation pursuant to Article E of Treaty 2.

its country of residence and either (1) the income from the other country is “derived in connection with” that trade or business and is “substantial” in relation to the activity producing the income, or (2) the income is “incidental” to that trade or business.

The term “active trade or business” is not specifically defined in Article B(2). However, Treasury’s technical explanation of Treaty 1 provides that the regulations issued under code section 367(a) will be used to define the term. Section 367(a) in general terms provides that transfers of assets to foreign corporations will be taxable. An exception exists for transfers of assets that constitute an active trade or business. In the context of royalties, the section 367(a) regulations provide that the principles under section 1.954-2(d)(1) (without regard to whether the rents or royalties are received from an unrelated person) will apply. Section 1.367(a)-2T(b)(3).

Section 1.954(d)(1) provides that royalties will be considered to be derived from the active conduct of a trade or business in two circumstances. In the first, the property must be property that the licensor has developed, created, or produced, or has acquired and added substantial value to. This applies only if the licensor is regularly engaged in the development, creation, production of, or in the acquisition of and addition of substantial value to, intangible property. Section 1.954-2(d)(1)(i). The performance of marketing functions will not be considered to add substantial value to property. Section 1.954-2(d)(2)(i).

In the second set of circumstances in which royalties will be considered to be derived from the active conduct of a trade or business, the property being licensed must be property that is licensed as a result of the performance of marketing functions by the licensor. Section 1.954-2(d)(1)(ii). The licensor, active through its own staff of employees located in a foreign country, must maintain and operate an organization in that country that is regularly engaged in the business of marketing and servicing the licensed property. The organization must be substantial in relation to the amount or royalties derived from the licensing of such property.

Whether an organization in a foreign country is substantial in relation to the amount of royalties it receives is determined based on all of the facts and circumstances. Section 1.954-2(d)(2)(ii). However, an organization will be considered substantial in relation to the amount of royalties if active licensing expenses equal or exceed 25 percent of the adjusted licensing profit. Adjusted licensing profit means the gross income of the licensor from royalties reduced by the amounts set forth in section 1.954-2(d)(2)(iv).

The term active licensing expenses means the deduction incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation. Section 1.954-2(d)(2)(iii). Certain deductions are not allowed.

As previously noted, even if Corp A is engaged in an active trade or business in Country 1, the royalties received by it must be either (1) “derived in connection with” that trade or business and “substantial” in relation to the activity producing the royalties, or (2) the royalties must be “incidental” to that trade or business. Article B (2)(a) of Treaty 1.

The royalties received by Corp A are derived in connection with a trade or business if the income-producing activity in the United States is a line of business which forms a part of or is complementary to the trade or business of Corp A in Country 1. Article B(2)(b) of Treaty 1. The technical explanation to Treaty 1 provides that royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable.

Article B(2)(c) of Treaty 1 provides that whether the trade or business of Corp A is substantial will generally be determined by reference to its proportionate share of the trade or business in the United States, the nature of the activities performed and the relative contributions made to the conduct of the trade or business in both the United States and Country 1. The trade or business of Corp A will be deemed to be substantial if, for the preceding taxable year, Year 3, the average of the ratios for the following three factors exceeds 10 percent and each of the ratios exceeds 7.5 percent, provided that for any separate factor that does not meet the 7.5 percent test in the first preceding taxable year the average of the ratios for that factor in the three preceding taxable years may be substituted:

i) the ratios of the value of assets used or held for use in the active conduct of the trade or business by the income recipient in Country 1 to all, or, as the case may be, the proportionate share of the value of such assets so used or held for use by the trade or business producing the income in the United States;

ii) the ratio of gross income derived from the active conduct of the trade or business by the income recipient in Country 1 to all, or as the case may be, the proportionate share of the gross income so derived by the trade or business producing the income in the United States; and

iii) the ratio of the payroll expense of the trade or business for services performed within Country 1 to all, or, as the case may be, the proportionate share of the payroll expense of the trade or business for services performed in the United States.

The royalties derived from the United States are incidental to the trade or business of Corp A if the income is not derived in connection with a trade or business of either company and the production of the income facilitates the conduct of the trade or business of the companies in Country 1 (for example the investment of the working capital of such trade or business). Article B(2)(d) of Treaty 1.

In addition, Corp A may not be eligible for the benefits of Treaty 1 if it is a conduit company as defined in Article B. Article B(1)(c)(iii)(C) of Treaty 1 provides that in the case of a company that is a resident of Country 1, treaty benefits shall apply only if the company is not a conduit company as defined in subparagraph 8(m). Subparagraph 8(m) provides that the term “conduit company” means a company that makes payments of interest, royalties and any other payments included in the definition of deductible payments (as defined in subparagraph (5)(c)) in an amount equal to or greater than 90 percent of its aggregate receipts of such items during the same taxable year. Subparagraph (5)(c) provides that the term “deductible payments” includes payments for interest or royalties.

As previously noted, substantial factual development would be required to determine whether Corp A satisfies the above described requirements and, therefore, is entitled to the benefits of Article A(1) of Treaty 1.

<u>If Corp A Does Not Qualify For Treaty Benefits</u>

If Corp A does not qualify for benefits under Treaty 1, then the royalties paid to it by Corp C are subject to U.S. taxation under either of two arguments. First, the Service may rely on the anti-conduit regulations set forth in section 1.881-3 (Conduit financing arrangements) of the Income Tax Regulations for any U.S. source royalties received by Corp A from Corp C after September 10, 1995,[6] the effective date of the regulations. In general, Section 1.881-3 provides the Service with the authority to disregard the participation of one or more intermediate entities when these entities are acting as conduit entities in a financing arrangement. A financing arrangement is a series of two or more “financing transactions” (including a license[7]) involving a “financing entity” (the licensor; here Corp A), and a “financed entity” (the licensee; here Corp E), when the arrangement is effected through one or more “intermediate entities” (Corp C). Section 1.881-3(a)(2)(i). When the intermediate entity and either the financing entity or the financed entity are related,[8] the Service may determine that the intermediate entity is a conduit entity and disregard the entity. Accordingly, if the Service can establish either that Corp C and Corp E are related or that Corp C and Corp A are related, then Corp C may be disregarded and the royalties received by Corp A would be treated as having been received directly from Corp E, thereby subjecting them to U.S. taxation. Section 1.881-3(a).

Alternatively, the Service may rely on Revenue Ruling 80-362, 1980-2 C.B. 208. In Revenue Ruling 80-362, the Commissioner dealt with cascading royalties

[6]For taxable years prior to the effective date of the regulations, the Service may rely on prior case law involving conduit situations.

[7]Section 1.881-3(a)(2)(ii)(A)(3).

[8]The term “related” is defined in section 1.881-3(a)(2)(ii)(B)(2)(v).

for the use of intangible property in the United States. In the Revenue Ruling, a nonresident alien individual residing in a foreign country with which the United States had no income tax treaty licensed U.S. rights on a patent to an unrelated Dutch corporation. The Dutch corporation relicensed the patent to a U.S. corporation. Royalties paid to the Dutch corporation by the U.S. corporation were exempt under the prior Country 1 treaty. However, Rev. Rul. 80-362 holds that the royalties paid by the Dutch corporation to the alien individual in the non-treaty country are subject to the 30 percent U.S. tax imposed by section 871(a)(1)(A), which the Dutch corporation was required to withhold. Rev. Rul. 80-362 embodies the place-of-use test of section 861(a)(4) and 862(a)(4), i.e., since the royalties paid by the Dutch company to the taxpayer were for the privilege of using a patent in the United States, the royalties were U.S. source income under section 861(a)(4) and, as such, subject to withholding.

Assuming that the relevant facts can be established, Rev. Rul. 80-362 applies to the instant case and supports imposition of the tax provided for in section 881 on the royalties paid by Corp C to Corp A.

We note that the right to tax a cascading royalty was successfully challenged by a Netherlands corporation in SDI Netherlands v. Commissioner, 107 T.C. 161 (1996), wherein the Tax Court refused to apply Rev. Rul. 80-362.[9] Therefore, the Commissioner would face litigation hazards in the Tax Court should an income tax deficiency be determined on the basis of Rev. Rul. 80-362.

Taxation of Royalties Paid to Corp B by Corp A

We note that even if Corp A qualifies for benefits under Treaty 1, Article A(5) provides for U.S. taxation of royalties paid by a resident of Country 1 to another person, under certain specified circumstances.[10] Article A(5) provides for U.S. taxation of royalties paid by a resident of Country 1 in the following circumstances:

a) the royalties are paid to a resident of the United States;

b) the royalties are attributable to a permanent establishment or a fixed base situated in the United States;

c) the contract under which the royalties are paid was concluded in connection with a permanent establishment or a fixed base which Country 1 payer has in the United States and the royalties are

[9]No Action On Decision has been issued with respect to the case.

[10]It should be noted that Article A(5) supports the place-of-use test embodied in section 861(a)(4). Article A limits those instances where U.S. tax may be imposed on royalties paid by a Netherlands resident.

borne by such permanent establishment or fixed base and are not paid to a Country 1 resident; or

d) the royalties are paid in respect of intangible property used in the United States and not paid to a resident of Country 1, but only where the payer has also received a royalty paid by a resident of the United States, or borne by a permanent establishment or fixed base situated in the United States, in respect of the use of the property in the United States and provided that the use of the intangible property in question is not a component part of nor directly related to the active conduct of a trade or business in which the payer is engaged within the meaning of paragraph 2 of Article B.

The taxpayer asserts none of the exceptions set forth above apply to the payment of royalties to Corp B by Corp A as follows. Since Corp B is not a U.S. resident, exception a) does not apply. Since Corp B did not have a permanent establishment or fixed base in the U.S. to which the amounts in question were attributable, exception b) does not apply. Since the payee, Corp B is a Country 1 resident, neither exception c) nor exception d) applies.[11]

Regarding exception a) there presently is no information indicating that Corp B is a resident of the United States.[12] Regarding exceptions b), c) and d), there presently is no information indicating that either Corp A or Corp B had a permanent establishment or fixed base in the United States[13] or that Corp B is not a resident of Country 1 for purposes of Treaty 1.[14] Accordingly, assuming that the taxpayer's factual assertions are correct, U.S. income tax may not be imposed on the royalties paid to Corp B by Corp A pursuant to Article A(5) of the Treaty.

Royalties Received By Corp B From Corp D

As previously noted, Corp B received royalties from Corp D pursuant to a licensing agreement granting Corp D certain worldwide rights to Group 1-related intangibles. The taxpayer has denied that any of the royalties received pursuant to

[11] See page 3 of letter from taxpayer's representative dated Date B.

[12] In general, Article C of Treaty 1 provides, with respect to corporations, that the term "resident of one of the contracting States" means any person who, under the laws of that State is liable to tax therein by reason of his place of management, and who otherwise qualifies for treaty benefits under Article B of Treaty 1.

[13] Whether Corp A has a permanent establishment or fixed base in the United States would be determined under Article D of Treaty 1.

[14] We note in this regard that Corp B must be a resident entitled to all of the benefits of Treaty 1, and therefore must qualify under Article B of Treaty 1.

the agreement were for the use of the intangibles in the United States, emphasizing that the agreement granted certain worldwide rights to Corp D for the use of intangibles in the United States.[15] As explained above, section 861(a)(4) treats as U.S. source income any royalties received for use of an intangible in the United States, as well as any royalties "for the privilege of using intangibles in the United States."

[redacted] If you have any further questions, please call (202) 622-3880.

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[15]See page 6 of letter from taxpayer's representative dated Date B.

[16]We note that Country 1's Competent Authority certified that Corp B was qualified to receive benefits under Treaty 1. However, Country 1's determination is not binding on the United States. See Notice 94-85, 1994 C.B. 511. Accordingly, the discussion of whether Corp A is entitled to benefits under Treaty 1 is relevant for determining whether Corp B is entitled to benefits under Treaty 1.