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subject: Depositary Receipts Programs

This memorandum responds to your request for generic legal advice. This advice may not be used or cited as precedent.

ISSUE

In the case of payments by a U.S. depositary institution to a foreign corporation for expenses the corporation incurs to institute a sponsored American Depositary Receipts program having holders located both inside and outside the United States, or payments by such depositary institution to the corporation pursuant to a revenue-sharing arrangement, what is the character and source of income of the corporation in respect of the payments?

CONCLUSION

Both types of payments represent consideration for the U.S. depositary institution's exclusive right to establish, control, and exploit the trading of the foreign corporation's American Depositary Receipts in the United States. Such right constitutes a property right made available by the foreign corporation for use for a limited period of time solely in the United States, regardless of whether the holders are located inside or outside the United States, and thus both types of payments to the foreign corporation are treated as income solely from sources

within the United States and, absent treaty relief, are subject to withholding of U.S. tax.

FACTS

Description of Depositary Receipts Programs

Corporate issuers of stock may use Depositary Receipts ("DR") programs to make their stock more accessible to investors in foreign markets. DR programs that make stock of foreign issuers ("issuers") available in U.S. markets are known as "American Depositary Receipt" ("ADR") programs.

An ADR is a negotiable certificate that evidences ownership of American Depositary Shares ("ADS") which, in turn, represent an interest in a specified number (or fraction) of an issuer's shares. While an ADR represents the evidence of an interest in ADS, the terms ADR and ADS are often used interchangeably by market participants.

ADRs are created by a U.S. depositary institution (usually a U.S. bank or trust company) ("DI") when the foreign issuer, or an investor who already holds the underlying foreign securities, deposits the foreign securities with the DI or its custodian in the foreign issuer's home country.[1] The DI then issues ADRs representing those shares to the investor (or "holder").[2] The holder will be able to re-sell the ADRs on a U.S. stock exchange or the over-the-counter (OTC) market.[3] ADR holders may also surrender ADRs in exchange for receiving the shares of the issuer.[4]

ADRs provide an efficient way for U.S. investors to invest in foreign companies without the complications implicit in cross-border trading.[5] ADRs are priced in U.S. dollars and the DI makes dividend equivalent payments in U.S. dollars to investors based on dividends paid in foreign currency by the issuer to the DI. ADRs trade, clear, and settle like any other U.S. security. Although the ADR mechanism is geared towards U.S. investors, investors in ADRs may be located inside the United States or outside the United States.

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[1] See SEC Office of Investor Education and Advocacy, *Investor Bulletin: American Depositary Receipts* (Aug. 2012).
[2] Id.
[3] Id. The OTC market is a decentralized market, without a central physical location, where market participants trade with one another through various communication modes such as telephone, email, and proprietary electronic trading systems. The Financial Industry Regulatory Authority (FINRA) regulates broker-dealers that operate in the OTC market. See https://www.sec.gov/divisions/marketreg/mrotc.shtml.
[4] SEC Office of Investor Education and Advocacy, *Investor Bulletin: American Depositary Receipts* (Aug. 2012).
[5] See H. Schimkat, The SEC's Proposed Regulations of Foreign Securities Issues in the United States, 60 FORDHAM L. REV. 203 (May 1992).

ADR programs may be established as either "unsponsored" or "sponsored," both of which are subject, in varying degrees, to Securities and Exchange Commission ("SEC") oversight. An unsponsored ADR program is set up without the cooperation of the issuer and may be initiated by a broker-dealer wishing to establish a U.S. trading market.[6] A sponsored ADR program is established jointly by an issuer and a DI, and represents the vehicle by which the issuer sponsors the ADRs' entry into the U.S. capital markets. The issuer establishes a sponsored ADR program by appointing a DI as the exclusive depositary and agent for the issuance and other activities in respect of ADRs for the issuer's stock in the United States. The issuer of the deposited securities enters into a deposit agreement with the DI[7] and signs the SEC Form F-6 registration statement.[8] This memorandum pertains to "sponsored" ADR programs.

The deposit agreement sets forth the rights and responsibilities of the issuer, the DI, and the ADR holders. The DI serves three main functions.[9] First, the DI assists brokers by issuing and canceling ADRs that trade in the U.S. capital markets.[10] Second, the DI serves as the issuer's transfer agent in the United States—maintaining ADR holder records, disbursing dividend payments to ADR holders, and sending out proxy notices to ADR holders.[11] Third, the DI acts as an administrator for the issuer by promoting ADRs in the U.S. capital markets.[12]

Market participants have generally categorized ADR programs into three "levels," depending on the extent to which the issuer has accessed the U.S. capital markets.[13] Levels I and II relate to shares already outstanding, while Level III relates to a new offering of shares. Each level involves SEC registration requirements of varying complexity.

Level I ADR programs establish a trading presence in the U.S. but may not be used to raise capital.[14] Level I ADRs trade over the counter in the United States, and the issuer is required to file SEC Form F-6, the simplified Securities Act of 1933 registration statement, with the SEC. In addition, an issuer is required to publish on its website

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[6] Id.
[7] Each ADR holder also becomes a party to such agreement through its acceptance of the ADR. ADR holders are deemed to have agreed to all terms in the deposit agreement by their acceptance and holding of ADRs.
[8] SEC Form F-6 is used for the registration under the Securities Act of 1933 of ADS evidenced by ADRs issued by a DI against the deposit of the securities of an issuer. See SEC, Form F-6, General Instructions, p. 2.
[9] See J. Velli, American Depositary Receipts: An Overview, 17 FORDHAM INT'L L. J. S38 (1994).
[10] Id.
[11] Id.
[12] Id.
[13] SEC Office of Investor Education and Advocacy, Investor Bulletin: American Depositary Receipts (Aug. 2012).
[14] Id.

English-language versions of market disclosure documents that the issuer has provided in its home country.

Level II ADR programs establish a securities market presence in the United States on a national securities exchange (e.g., New York Stock Exchange, NASDAQ) but may not be used to raise capital.[15] Again, the issuer uses SEC Form F-6 to register the ADRs.[16] The issuer is also required to file annual reports on Form 20-F with the SEC.[17]

Level III ADR programs may be used not only to establish a securities market presence in the United States, but also to raise capital for the issuer.[18] In addition to the Form F-6 used to register the ADRs, the issuer must file a registration statement on Form F-1, Form F-3, or Form F-4 with the SEC for an ADR public offering, which requires detailed disclosure about both the issuer and the securities being offered to the public.[19] The issuer is also required to file annual reports on Form 20-F with the SEC.[20]

Holders of sponsored ADRs generally have all the rights of other shareholders of the underlying foreign shares, including the right to receive reports, vote their shares, and receive dividends. If a holder relinquishes an ADR, the ADR is deemed "cancelled." The cancelled ADR is returned to the DI, which then either returns the stock to the issuer or sells it to another holder.

A DI earns fees from holders for issuing and cancelling ADRs, converting and distributing dividends to holders, and providing annual depositary services. A DI may also earn fees from holders for other corporate actions that require unique servicing, including, but not limited to, enhanced dividends, exchange offers, odd-lot buy-ups, ratio changes, rights issues or warrants, spin-offs and de-mergers, and stock splits.

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[15] Id.
[16] Id.
[17] SEC Form 20-F is necessary in order to register the underlying class of securities the ADR represents.
[18] SEC Office of Investor Education and Advocacy, Investor Bulletin: American Depositary Receipts (Aug. 2012).
[19] Id.
[20] Id.

Payment Arrangements

Reimbursement Arrangements

The issuer incurs expenses to institute an ADR program. As an inducement to grant an exclusive arrangement for a sponsored ADR program, it is common for the DI to offer to pay a portion of the expenses the issuer will incur in setting up the program. The terms of this arrangement are set forth in a contract between the DI and the issuer. The contract also describes the ADR program, the role of the DI, and the fees that the DI will charge holders.

The expenses of the issuer typically paid by the DI under these arrangements include legal fees, accounting fees, SEC registration costs, marketing expenses, expenses for participating in investor conventions, costs for acquiring and maintaining electronic communication systems, exchange and listing fees, filing fees, underwriting fees, mailing and printing costs in connection with sending out financial reports, annual reports, proxy mailings, and other administrative costs.

Under a typical deposit agreement, the issuer must seek payments from the DI within a specified time. Payments are usually made after the issuer presents acceptable documentation substantiating payments by the issuer of ADR program-related fees or expenses. If the issuer does not incur or does not timely submit its proof of expenditures, the issuer typically will not receive any payments from the DI. The DI may make payments on behalf of the issuer to third party vendors (usually to exchanges, law firms, investment banks, and investor relations firms), or it may make payments directly to the issuer.

Under a typical deposit agreement, the expenses of the issuer that the DI agrees to pay are subject to a cap, either a fixed dollar amount or an amount calculated by reference to the size of the ADR program. The expenses typically are of a kind that the issuer would not have incurred but for the ADR program.

Revenue-sharing Arrangements

Instead of a reimbursement arrangement, some sponsored ADR program deposit agreements provide for revenue-sharing arrangements. In such cases, a DI may pay the issuer a percentage of fees collected from holders. These arrangements may be structured in a number of different ways and are generally negotiated separately with each issuer. For instance, in some cases, the revenue-sharing payment may be paid in combination with a reimbursement amount based on program-related expenses. In other cases, the revenue-sharing payment may be the sole payment from the DI to the issuer for the right to be the exclusive depositary. Similar to the reimbursement model,

the revenue-sharing payment is typically subject to a cap, either a fixed dollar amount or an amount calculated by reference to the size of the ADR program.

LAW AND ANALYSIS

Payments by the DI to the issuer, or to third parties on behalf of the issuer, of the issuer's expenses or otherwise pursuant to a reimbursement arrangement,[21] and payments pursuant to a revenue-sharing arrangement, are gross income of the issuer within the meaning of section[22] 61, and consequently, subject to section 882(b), are gross income of the issuer for purposes of sections 881 and 882.

Section 881 imposes a 30 percent tax on the gross amount of U.S. source fixed or determinable, annual or periodical income ("FDAP income") derived by a foreign corporation that is not effectively connected with the conduct of a U.S. trade or business. FDAP income generally includes all amounts included in gross income under section 61 other than gains from the sale of property. See Treas. Reg. § 1.1441-2(b).

Sections 1441 and 1442 require any person making a payment of U.S. source FDAP income to a nonresident alien or a foreign corporation to withhold from the payment a tax equal to 30 percent, unless such withholding rate is reduced pursuant to a provision of the Code or an income tax treaty or the income is effectively connected with the conduct of a U.S. trade or business. These withholding requirements rely in part on the character and source of payments made to the nonresident alien or foreign corporation.

Character

In sponsored ADR programs, the issuer appoints an exclusive DI to handle its stock in the United States.[23] In exchange for this right,[24] the DI generally agrees to pay the issuer either a capped amount representing a portion of the issuer's ADR program expenses or a portion of the fees collected from investors. The ADR program payments to the issuer are consideration for the DI's exclusive right for a limited period of time to manage the trading of the issuer's ADRs in the U.S. capital markets. That right confers to the DI control over the issuance and cancelation of ADRs, which are registered with the SEC, trade in U.S. equity markets, and benefit from the protections and oversight

[21] See AM 2010-006.
[22] Unless otherwise stated herein, all references to "section" or "§" are references to the Internal Revenue Code of 1986, as amended ("the Code").
[23] J. Evans, Banks Vie to Sponsor Foreign Stock, 155 AMERICAN BANKER 16 (June 20, 1990) (stating that U.S. banks will pay a foreign company for the exclusive right to handle its stock in the United States).
[24] Id. (maintaining that aggressive competition among U.S. depositary banks has resulted in payment to issuers for the exclusive right to handle issuer's stock in the United States).

afforded by U.S. regulation.[25]

In effect, under a sponsored ADR program, the issuer provides the DI with the right to conduct business activities related to the ADR program in the United States for remuneration for an agreed duration, which may be extended by agreement. The arrangement may be analogized to a franchise to the extent it creates geographically-defined rights in which the DI may establish a sponsored ADR program with respect to the issuer. Under section 861(a)(4) (described more fully below under "Source"), a franchise, goodwill, trade brands, and "other like property" are examples of similar property rights that may give rise to royalties.[26]

A further analogy is illustrated by the decision in Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938). In that case, the taxpayer was a British author who was not present in the United States before or during the years at issue. The taxpayer entered into contracts with a U.S. publisher under which he granted the right to publish certain books he had written, some of which were subject to copyright and some of which were not.[27] As to the latter category of works, the taxpayer agreed to exclusively authorize the publisher to publish the books in the United States so long as the publisher left in print

[25] In 2017, the District Court for the Northern District of California held that the U.S. securities laws apply to OTC transactions in the case of sponsored Level I ADR programs. See In re: Volkswagen "Clean Diesel" Marketing, Sales Practices, and Products Liability Litigation, 2017 WL 66281 (N.D. Cal. Jan. 4, 2017). In Morrison v. Nat'l Australia Bank Ltd., the U.S. Supreme Court held that the U.S. securities laws do not apply extraterritorially, but rather apply only to (1) "transactions in securities listed on domestic exchanges" (Prong 1), or (2) "domestic transactions in other securities" (Prong 2). 561 U.S. 247 (2010). In Volkswagen, Judge Breyer concluded that the first prong of Morrison was not satisfied (the OTC market is not a "domestic exchange") but the second prong of Morrison (domestic transaction in other securities) was satisfied, and was not persuaded that the level of ADRs (Level I versus Level II or Level III) made any difference to the analysis. The defendants argued that the second prong was not satisfied because the securities were "predominately foreign." Judge Breyer disagreed noting that Volkswagen's ADRs had numerous connections to the United States: they traded in the United States pursuant to a deposit agreement that was subject to U.S. law; Volkswagen filed Form F-6 Registration Statements with the SEC to make the ADRs available in the United States; ADRs were offered to U.S. investors on an OTC market located in the United States; and the foreign issuer met the SEC requirement to provide on its website an English-language version of its market disclosure documents. These factors "establish a sufficient connection between Volkswagen's ADRs and the United States." Accordingly, Judge Breyer concluded that Morrison's second prong was met and thus U.S. securities laws may apply to sponsored Level I ADR programs. Similarly, the Ninth Circuit Court of Appeals found that U.S. securities laws may also apply to unsponsored ADR programs. See Stoyas v. Toshiba Corp., 896 F.3d 933 (9th Cir. 2018).

[26] Provided the parties do not intend to operate a joint venture and share profits, the ADR program should not constitute a constructive partnership, even if revenues are shared.

[27] Regarding the latter category of books for which no copyrights were obtainable, the Second Circuit "take[s] this to mean that the works . . . were already in the public domain." Sabatini, 98 F.2d at 754-55. The Court observed that rights to publish such works "may not have been of great value" but concluded that "the parties did value it and the author received the payments as agreed" and "[w]e are not now concerned with the quality of the consideration he gave but only with the taxability of that which he received." Id. at 755.

its editions of the books. The taxpayer was paid a percentage of the publisher's retail trade list price for each volume sold.

For the copyrightable works, the court held that the payments were treated as royalties for the use of U.S. copyrights. The taxpayer received royalties for granting the exclusive rights to publish with express permission. For the works where no copyrights were obtainable, the court found that the payments fell within the "other like property" category of section 119(a)(4) (the predecessor of section 861(a)(4)) as the payments were received in consideration of the taxpayer granting the publisher the exclusive right to publish in the United States. The court viewed the payments as made to the taxpayer for forgoing his right to authorize others for a time to publish the works in the United States, even though the amount of the payments may have exceeded the strict legal value of the rights. The court found that the rights in both types of contracts "were an interest in property in the United States, in the one instance the statutory copyrights obtainable and in the other the exclusive right to publish with his permission." Id. at 755.

ADR program payments (whether as a reimbursement of expenses or a share of revenues)[28] are an inducement for the issuer to enter into a sponsored ADR program with the DI, namely, one conveying exclusive rights to manage the trading of the issuer's ADRs, as well as ancillary aspects of the program (e.g., currency conversion and dividend remittances), in the United States. Absent this agreement, the issuer could convey these rights to a different DI. Here, as in Sabatini, the issuer is forgoing its right to authorize another to manage trading of its ADRs and, as such, the ADR program payments, if not otherwise royalties, fall within the "other like property" category of section 861(a)(4). Based on the foregoing, we think it is proper to regard the payments to the issuer as having the character of payments for the use of property rights within the United States.

Source

Section 861(a)(4) provides that rentals or 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, copyright, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property are treated as income from sources within the United States. Section 862(a)(4) provides a parallel rule, defining foreign source income as including similar items of gross income

[28] The origin of the funds used by the DI to pay the issuer does not affect the character of the income of the issuer (or the income's source, as noted below). Unless the parties are considered partners in a partnership for U.S. tax purposes, revenue that is shared nevertheless is considered earned by the DI, and its assignment to the issuer is a separate transaction, under normal U.S. federal income tax assignment of income principles.

paid for the privilege of using such property without the United States. This provision was first enacted as section 217(a)(4) of the Revenue Act of 1921. The legislative history, however, does not explain how the location of use will be determined.

The ADR program payments by the DI to the issuer are consideration for an exclusive right to control the issuance, trading, and other activities in respect of the issuer's ADRs in the United States, which constitutes an interest in property rights protected by contract and defined geographically by reference to the United States.

In the case of legal rights protected by statute, the jurisdiction in which the rights are legally protected and exploited is considered the place of use. For example, in Sabatini, the United States was the place of use for sourcing royalties from the sale of books subject to U.S. copyright protection. Similarly, in Rohmer v. Comm'r, 14 T.C. 1467 (1950), the Tax Court concluded that the source of a royalty is the place where the copyrighted material is consumed and protected by copyright. The same approach governs the sourcing of payments for industrial technology and for trademarks. See Rev. Rul. 80-362, 1980-2 C.B. 208 (royalties in respect of the U.S. rights under a patent sourced to the United States); Rev. Rul. 68-443, 1968-2 C.B. 304 (trademark royalties sourced where product sold to end user).

Here, the intangible property is not protected under a U.S. statutory regime. Nevertheless, by analogy, section 861(a)(4) should apply in a similar manner. As noted in AM 2013-003, the exclusive nature of the arrangement in this case is analogous to the arrangement in Sabatini with respect to non-copyrightable works, in which the author received U.S. source payments in respect of exclusive contractual rights to publish in the United States. A prominent commentator observes that "[i]ntellectual property is a monopoly right" and it "yield[s] income to the holder of the property where competition is restrained." L. Lokken, The Sources of Income from International Uses and Dispositions of Intellectual Property, 36 TAX L. REV. 233, 277 (1981). That is, the income should be assigned to the place of restraint that is "most important to the income earning process." Id. at 278.[29]

The income at issue derives from the issuer's contract with the DI, which grants to the DI the exclusive right to issue ADRs in the U.S. capital markets—the situs of the contract performance as well as SEC regulation and oversight. In addition, this exclusive contract right restrains other U.S. depositary banks from trading the ADRs in the U.S. capital markets. The sponsored DI profits from such exclusive arrangement by

[29] This approach to sourcing is similar to that taken with respect to restraints from performing services, as in the case of noncompete agreements. See, e.g., Korfund Co., Inc. v. Comm'r, 1 T.C. 1180 (1943); Stemkowski v. Comm'r, 76 T.C. 252 (1981).

establishing a trading market for the ADRs in the United States. The value of the intangible ADR program rights derives from their exploitation in the United States.[30]

Benefits afforded by holding securities registered with the SEC may be enjoyed by holders located outside the United States as well as by holders inside the United States. And the amount paid by the DI to the issuer in exchange for this exclusive right is similarly not contingent on the location of the holder. The location of the holders, who pay the DI to participate in the ADR program, is merely incidental to rather than relevant to the sourcing of the issuer's own income from its contract with the DI.

In sum, the United States—the location of the capital markets the DI is accessing to profit from holders trading in ADRs and to which the U.S. securities laws apply—is the place of use in this case and hence is the source of the ADR program payments.

Accordingly, the ADR program payments, whether in the form of expense reimbursement or revenue sharing and whether, if in the form of expense reimbursement, the expense is paid to the issuer or directly to third parties[31] on the issuer's behalf, constitute FDAP income from sources within the United States. These payments are subject to 30% withholding under section 1442, unless the rate of tax is reduced under a U.S. income tax treaty,[32] or unless the withholding agent receives valid documentation with respect to the payments establishing that the income is effectively

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[30] More specifically, the DI enters into a deposit agreement to create a new U.S. instrument to trade in the U.S. capital markets (by issuing and canceling ADRs). Form F-6 Registration Statement is filed with the SEC to make the ADRs available for trading in the United States. All three sponsored ADR levels must comply with applicable SEC reporting requirements. At a minimum, Level I ADRs require an issuer of ADRs to provide on its website English-language versions of market disclosure documents provided in its home country. The ADRs are priced in U.S. dollars and pay dividends in U.S. dollars. ADRs trade, clear, and settle like any other U.S. security. The DI maintains shareholder records for ADRs and promotes the listing in the U.S. capital markets. All of these U.S.-centric functions indicate that the place of use for this exclusive contract right is the United States, the location of the capital markets that the DI is accessing in order to establish trading for the ADRs and to which the SEC affords protection. The United States is where the material relevant activities of the DI are conducted, its material relevant costs are incurred (and deducted for tax purposes), and value is provided to the issuer and the holders.

[31] Because ADR program payments that are made directly to third parties constitute gross income to the issuer, the DI is required to withhold in respect of these payments under section 1442, subject to treaty relief. See Treas. Reg. § 1.1441-2(e) ("A payment is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. . . . Thus, a payment of income is considered made to a beneficial owner if it is paid in complete or partial satisfaction of the beneficial owner's debt to a creditor.").

[32] In AM 2013-003, the IRS concluded that ADR program payments, despite being payments for transactions in property rights, are not "royalties" under the narrow definition used in the U.S. and OECD Model Treaties. Based on that analysis, payments governed by a provision corresponding to either such Model Treaty would be treated as "Other income" and subject to possible treaty relief accordingly, assuming that the Issuer is a resident and otherwise satisfies the requirements of any applicable "Limitation on Benefits" article.

connected with the conduct of a trade or business within the United States. See Treas. Reg. § 1.1441-4(a) and -1(b)(2)(vii).

Pursuant to section 6110(k)(3), this document may not be used or cited as precedent.

Please call Subin Seth at (202) 317-5003 or Robert Z. Kelley at (202) 317-5447 if you have any further questions.