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TAX COURT ENDS THE 'CASCADING ROYALTY' PROBLEM

BY SUSAN JACOBINI HARRINGTON, ALAN I. APPEL, HARRISON J. COHEN, AND THOMAS P. NORTH

The Service's assault on back-to-back royalties was dealt a serious blow by a recent Tax Court decision which suggests that royalties paid by one foreign person to another cannot ever be U.S.-source income even if the rights are licensed for use in the U.S. The court expressed concern with cascading royalties, in which multiple taxation might be imposed on the same royalty as it makes its way up a chain of sublicensees, and held that there was no indication that Congress intended that result.

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In *SDI Netherlands B.V.*, 107 TC No. 10, the Tax Court recently rejected the Service's long-standing position that U.S.-source royalties received by foreign persons not engaged in a trade or business in the U.S. are subject to a second withholding tax when paid to another foreign person. Despite years of effort by the IRS to counter the use of back-to-back "royalty"-type arrangements to avoid the 30% withholding tax imposed by Sections 871(a) and 881(a) on such foreign persons, the court held that a foreign corporation not engaged in a U.S. trade or business is not liable for withholding taxes on royalties it derived partly from sources within the U.S. that it substantially onpaid to another foreign corporation. In reaching its holding, the Tax Court specifically rejected *Rev. Rul.* 80-362, 1980-2 CB 208, which reflects the Service's position that royalties from the use of a patent in the U.S. remain U.S.-source income under Section 861(a)(4) and subject to withholding under Section 1441, regardless of the residence or identity of the payor.

Facts

SDI Ltd., a corporation organized under the laws of Bermuda, was the parent of the SDI Group of companies. The taxpayer—SDI Netherlands B.V.—was a Dutch corporation that was a wholly owned second-tier subsidiary of SDI Ltd. and a member of the SDI Group. The SDI Group also included SDI Bermuda Ltd., a corporation organized under the laws of Bermuda that also was a wholly owned subsidiary of SDI Ltd. (i.e., a sister corporation to SDI Netherlands). SDI USA, Inc., a corporation organized under the laws of California, was a wholly owned subsidiary of the taxpayer.

SDI Bermuda granted the taxpayer worldwide rights to certain commercial software systems for IBM mainframe computers. This agreement (the "Bermuda license agreement") gave the taxpayer a nonexclusive license to use (or 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 Bermuda license agreement contained no express reference to the U.S.

During the years in issue (1987-90), the taxpayer was a party to an exclusive agreement with SDI USA that provided for the licensing and use of the software in the U.S. ("the U.S. license agreement"), under which SDI USA was responsible for direct marketing and sales. The U.S. licensing agreement, required SDI USA to pay the taxpayer an annual royalty of 50% of its annual gross revenues from leasing and sublicensing of the software. The only deductions permitted by the U.S. license agreement were for rebates, discounts, and sales or value-added taxes.

SDI USA made the royalty payments to the taxpayer that were called for under the agreement. No tax was withheld under Section 1441 by SDI USA on these payments since royalties paid by SDI USA to the taxpayer were exempt by virtue of Section 894 and Article IX of the 1948 version of the U.S.-Netherlands Income Tax Con-

vention, as amended. During these four years, the taxpayer received close to $20 million in sublicense royalties, of which nearly $11 million were received under the sublicense with SDI USA. In turn, the taxpayer paid nearly $19 million in royalties to SDI Bermuda. The formula for computing the royalties owed by the taxpayer was based on a fraction of its receipts under the sublicenses, and therefore the royalties it owed to SDI Bermuda were not identical to what it received from SDI USA.

Decision of the Tax Court

The issue facing the court was whether the royalties paid by SDI Netherlands to SDI Bermuda were income received from sources within the U.S. by SDI Bermuda. Had the Tax Court decided for the Service, the taxpayer would have been required to withhold 30% U.S. tax on the U.S.-source portion of the royalties under Sections 1441 and 1442, corresponding to a 30% U.S. tax liability of SDI Bermuda under Section 881. Because the taxpayer was protected by the 1948 U.S.-Netherlands treaty from U.S. tax on its own royalty income under the sublicense to SDI USA, such a 30% withholding tax on the taxpayer's royalty expense would have been the only U.S. tax owed by the taxpayer and SDI Bermuda. In light of the court's apparent negative answer to the source question, however, no U.S. tax was owed by SDI Netherlands or SDI Bermuda.

The direct path to the result. As stated by the court, the Service viewed the case as a simple matter of tracing a portion of the foreign-to-foreign royalty back to the U.S.-to-foreign royalty (which was easy to do in light of the relationship between the SDI Netherlands's royalty liabilities and its royalty receipts), and treating that portion of the foreign-to-foreign royalty as U.S.-source. The court referred to this as the Service's "'flow-through' position," and approached this case using the analysis employed in *Aiken Industries, Inc.*, 56 TC 925 (1971). This was highly detrimental to the Service's case because of the clear factual distinctions between *Aiken Industries* (perhaps as good a conduit case from the Service's perspective as ever has been) and *SDI Netherlands*. The court reasoned as follows:

"Although Aiken Industries ... and Northern Indiana Public Service Co. v. Commissioner, [105 TC 341 (1995)], 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...." (Emphasis added.)

IRS viewed the case as a simple matter of tracing a portion of the foreign-to-foreign royalty back to the U.S.-to-foreign royalty.

The court continued: "The facts of the matter are that the two license agreements had separate and distinct terms and that [the taxpayer] had an independent role as the licensee from SDI Bermuda and the licensor of the other entitles, 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 [the taxpayer] for its efforts. Like the finance subsidiary in Northern Indiana, [the taxpayer] 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 [the taxpayer] to SDI Bermuda were derived from the royalties received by [the taxpayer] from SDI USA, they were separate payments." (Footnote omitted.)

The court's side observations. It is easy to agree with the court's view that this was not a "conduit" case in which the "conduit entity" could rightly be ignored; this was not *Aiken Industries.* There is no evidence that the Service disagreed, either. But, in light of that, what the court really seems to have held is that royalties for the license of rights in a geographic area that includes the U.S. cannot to any extent be U.S.-source income if the payer is a foreign person. This is striking (to put it mildly) because Section 861(a)(4) sources royalty income by the place of use of the intangible, not the residence of the payer.

The evidence that the Tax Court drew such a far-reaching conclusion lies in its analysis of *Rev. Rul.* 80-362. That Ruling involved a foreign-to-foreign license of a U.S. patent, followed by a sublicense to a U.S. corporation. The Ruling states that because the royalties under the first license "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)."

The court could have distinguished the Ruling from the *SDI Netherlands* case factually, on the ground that the Ruling involved a foreign-to-foreign license of a right that had value only in the U.S. It might have held that a royalty generated by use throughout the world cannot be U.S.-source income even if a foreign-to-foreign royalty generated by use only in the U.S. clearly falls within the ambit of Section 861(a)(4). (Although if that were generally the case, *query* how one would apply, for example, a treaty provision like the U.S.-Canada treaty article on royalties, which provides for different tax rates on royalties for different rights that are typically bundled in a single license for a single royalty.) The court, however, drew no such distinction but simply ignored *Rev. Rul.* 80-362 because "[i]t fails to reflect any reasoning or supporting legal authority."

The true meaning of the court's decision also is evident in its discussion of "cascading," i.e., the multiple withholding of taxes on the same royalty

payment as it is transferred up the chain of licensors. It observed that, if one put aside the possibility of treaty relief, sourcing based on place of use, combined with the presence of foreign licensors and sublicensors, can cause U.S. gross-basis taxes to pile up, as royalties for the use of a single bundle of U.S. rights are paid up a chain of sublicensees to the ultimate licensor. This the court found impossible to accept: "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 [the IRS]."

Potential Fall-Out

One might have thought, before reading the *SDI Netherlands* case, that it was clear that cascading *was* part of the law. Now, however, the Tax Court has given taxpayers a basis for claiming that it is not, "in the absence of any legislative expression on the subject." If the law on the sourcing of royalties does not permit cascading liabilities, perhaps one can argue that the same is true of the law for sourcing *other* items of income, the source of which is not a function of the residence of the payer or payee—for example, insurance premiums, services income, or rentals. On the reasoning of *SDI Netherlands,* for example, TAM 9621001 would be incorrect, and there would be no U.S. excise tax under Section 4371 on premiums paid by a foreign insurance company to reinsure a U.S. risk (or a group of risks including a U.S. risk) with a foreign reinsurer. Indeed, one might take the Tax Court's rationale further and argue in other situations involving a potential double U.S. tax on the same income (e.g., Subpart F inclusions of income of a foreign corporation that are also subject to U.S. tax on the same income) that no double tax could have been intended by Congress.

In addition, assuming that a Dutch BV qualifies (under the limitation of benefits provision of Article 26) for benefits under the 1992 U.S.-Netherlands treaty, Article 13(5)(d) of the treaty purports to allow U.S. withholding tax on royalty payments made by a Dutch BV for the use of intellectual property in the U.S., provided the BV also has received royalty payments from a U.S. person for use of the same intellectual property rights in the U.S. Would the application of Article 13(5)(d) have resulted in a different conclusion by the Tax Court? The court's rationale was that the royalty payments by SDI Netherlands were not U.S.-source income. If this rationale were also followed under the 1992 treaty, the result may not be different since the 1992 treaty should not result in a greater tax obligation than would arise under U.S. domestic law. Absent a finding that a royalty payment by a BV is U.S.-source income, one may not even have to consider the U.S.-Netherlands treaty rules. Nevertheless, the Tax Court indicated in a footnote to the opinion that "changes in the U.S.-Netherlands treaty, applicable to years subsequent to the years before us, may provide a different framework for disposing of this issue." This is rather mild language for a U.S. court to employ to suggest that the *result* may be different under the new treaty. If anything, the court's footnote may be read to suggest that although the *framework* might be different, the result would likely be the same. Given the concern of the court that the Service's application of the flow-through sourcing rule could result in a "cascading royalty" problem, it appears doubtful that the result would be any different under the 1992 treaty.

Another issue is whether the application of the final conduit financing Regulations would compel a different result. In Section 7701(l), Congress directed the Service to implement Regulations on the problem of beneficial ownership in the context of back-to-back financing structures and the availability of treaty benefits. Does this Code section constitute a "legislative intention" to permit cascading? In a tantalizing hint, the Tax Court quotes with seeming approval an article critical of the cascading royalty potential under the final conduit financing Regulations.[1]

What the court really held is that royalties for the license of rights cannot to any extent be U.S.-source income if the payer is a foreign person.

In Section 7701(l), Congress did not expressly indicate the means by which Service was to implement this legislative mandate. The statutory language provides that "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among 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." This language suggests that the IRS was given a mandate to implement Regulations that would allow it to *disregard* an intermediate entity in a financing arrangement (i.e., apply conduit principles). The language does not suggest that the Service was given the mandate to require withholding on royalties paid by non-U.S. persons or to otherwise alter U.S. domestic sourcing rules (i.e., apply flow-through sourcing rules). In this regard, it may be significant that the Conference Report on Section 7701(l) quotes with seeming approval several IRS Rulings dealing with conduit arrangements but does not refer to Rev. Rul. 80-362.[2]

Further, rather than rely on conduit principles to recharacterize a royalty payment made by a U.S. person to an "intermediate entity," the Service chose to implement the flow-through sourcing rationale to royalties. Example 10 of the conduit financing Regulations (Reg. 1.881-3(e)) is a clear statement of the Service's approach to back-to-back royalty structures. The

NOTES

1 Glicklich, "Final Regulations on Conduit Financing Arrangements Empower the IRS," 84 JTAX 5 (January 1996).

2 See H. Rep't No. 103-213, 103d Cong., 1st Sess. 186, fns. 3-5 (Statement of the Managers, 8/4/93), citing Rev. Ruls. 84-152, 1984-2 CB 381, and 87-89, 1987-2 CB 195, and TAM 9133004.

3 See Rev. Rul. 95-56, 1995-2 CB 322, obsoleting Rev. Ruls. 84-152 and 87-89 (Situations 1 and 2), *supra* note 2, along with Rev. Ruls. 84-153, 1984-2 CB 383, and 85-163, 1985-2 CB 349.

example involves an intermediate entity in a treaty country (FS) that receives a royalty payment from a U.S. person (DS) for the use of intellectual property in the U.S. The intermediate entity pays a similar royalty to a non-treaty-country resident (FP) for the use of that same property. The IRS reasons that FS is not a conduit entity because the rate of withholding tax required on the payment by FS to FP is the same as would have applied on a direct payment by DS to FP; therefore, there is no reduction of U.S. withholding tax. The example provides—apparently on the basis of *Rev. Rul.* 80-362 and not the conduit financing Regulations per se—that FS is required to withhold 30% tax on its payment to FP. Furthermore, the Service did not revoke *Rev. Rul.* 80-362—unlike other back-to-back Rulings—after publication of the final conduit financing Regulations.[2] It therefore appears that the Service believes that reliance on *Rev. Rul.* 80-362 was sufficient basis to attack structures such as those described in Example 10.

Taxpayers now have a basis for claiming that cascading is not part of the law, 'in the absence of any legislative expression on the subject.'

Given the fact that Congress in section 7701(l) did not explicitly or implicitly authorize the IRS to employ flow-through sourcing rules to royalties but only to recharacterize financing transactions so as to ignore intermediate entities, it appears that the Service either has exceeded its authority in respect to the approach taken to royalties or has chosen the wrong approach (flow-through sourcing rather than conduit treatment). It further appears that the court's rationale in *SDI Netherlands* could be applied to payments and structures in place after the effective dates of the new U.S.-Netherlands treaty and the conduit financing Regulations.

Alternatively, even though the IRS apparently drafted the conduit Regulations under the assumption that *Rev. Rul.* 80-362 represented a correct interpretation of U.S. sourcing rules, if the Ruling must be abandoned the Service may argue that it can apply the strict conduit approach to back-to-back royalties. Example 10 is predicated on the assumption that no U.S. withholding tax is due on the payment from DS to FS because the payment from FS to FP is subject to U.S. withholding tax. If this assumption is incorrect, the Service could argue that the payment from DS to FP (via FS) is subject to U.S. withholding tax under the conduit theory rather than the sourcing theory. Whether the IRS could do this without revising the conduit Regulations seems questionable, however. As a general matter, there should be some point at which the Service is required to live with the rule it has explicitly set forth in Regulations.

Planning Opportunity

As a result of *SDI Netherlands,* source of income issues may become less important with respect to royalties. In addition, acquisitions by foreign acquirors may be easier to accomplish. It now may be possible, for example, to form an entity in a jurisdiction that has a treaty with the U.S. under which withholding would not be required. This entity would be used to hold intangible assets, and could become a central repository for the royalties. This would eliminate a secondary U.S. withholding tax when royalties were onpaid to another foreign entity that would not be covered by a U.S. treaty.

In an asset acquisition, separating the intangibles from the manufacturing assets while eliminating concerns about secondary withholding taxes can permit a foreign acquiror to effectively strip out earnings from a domestic acquired entity. It is necessary, however, that the royalty rates meet the requirements of Section 482. Furthermore, any limitation of benefits provision of the treaty with the country in which the entity is formed will have to be complied with.

Conclusion

It is one thing to say that a royalty paid for a bundle of rights, not all of which are subject to the same U.S. tax treatment, cannot be broken down into pieces subject to differing U.S. gross-basis tax consequences, or cannot be broken down under the facts of a particular case. Such a rationale could have served as the basis for the *SDI Netherlands* opinion but apparently did not. Instead, the Tax Court seems to have arrived at the more sweeping position that foreign-to-foreign payments for the use of U.S. intangible property cannot be U.S.-source income under any circumstances. It would not be surprising if, as in *Brown Group Inc.*, 77 F.3d 217, 77 AFTR2d 96-510 (CA-8, 1995), the IRS fights vigorously to have this case withdrawn, reheard, appealed, or whatever else it takes to expunge it from the books. It also would not be surprising if, as in *Brown Group,* the coming battle takes a few interesting turns. Future developments on this issue seem guaranteed. ■

NEW DEVELOPMENTS

Final Rules Govern Mixed-Source Income From Sales of Natural Resources and Other Inventory

Final Regulations under Section 863 (TD 8687, 11/27/96) provide rules for sourcing income from the sale of natural resources and farm products (including oil, timber, and crops) and other inventory property (1) produced in and sold outside, or (2) produced outside and sold in, the U.S. The rules are effective for tax years beginning after 12/30/96 and, at the taxpayer's option, may be applied to other tax years that began after 7/11/95. For the most part, the final Regulations conform to the 1995 Proposed Regulations, which were analyzed by John P. Kennedy, CPA, and Stephen C. Fox, CPA (a partner and a senior manager, respectively, in the Tri-State International Tax Group of Deloitte & Touche LLP, located in Parsippany, New Jersey), in "Careful Planning May Avoid Reduction in Foreign-Source Income Under Section 863(b) Prop. Regs.," 84 JTAX 232 (April 1996). Messrs. Kennedy and Fox observe that the final Regulations:

- Clarify certain aspects of the proposed rules.

- Make a cosmetic concession to the holding in *Phillips Petroleum Co.,* 70 F.3d 1282, 76 AFTR2d 95-7978 (CA-10, 1995), *aff'g without pub. opn.* 97 TC 30 (1991) and 101 TC 78 (1993).
- Provide important new rules regarding partnership determinations.
- Allow foreign sourcing for high seas title passage sales (except in certain situations).
- Provide two potentially significant anti-abuse rules.

The authors analyze the impact of these changes from the Proposed Regulations, as follows.

The 1995 proposal. Under the Proposed Regulations, taxpayers could choose one of three methods for determining the source of income from sales of inventory other than natural resources:

- The 50/50 method.
- The independent factory price (IFP) method.
- The books and records method, which required IRS approval.

Under the 50/50 method, half of the income was deemed from production activity and was sourced based on the portions of the production assets in foreign and U.S. locations (Prop. Reg. 1.863-3(c)). For this purpose, partners were treated as owning their share of partnership production assets (Prop. Reg. 1.863-3(c)(1)(i)(B)). The other half of the income was sourced to the place of sale, under title passage rules.

Under the IFP method, all income up to the fairly established IFP was sourced to the place of production. The remainder of the income was sourced to the place of sale. Prop. Reg. 1.863-3(b)(2) provided rules to determine when an IFP was fairly established.[1]

For natural resources (including farm products), the Proposed Regulations provided a 100% allocation rule for sourcing income from production and sale. That is, where the taxpayer did not engage in substantial additional production beyond production of the natural resource, the income would have been sourced entirely to the location of the natural resource (i.e., the mine, well, mineral deposit, or farm).

In *Phillips,* the Tenth Circuit had agreed with the Tax Court's finding that the then-existing rule was invalid to the extent it conflicted with the court's interpretation of Section 863(b)(2), which provides that gains, profits, and income for the sale of inventory produced in and sold outside the U.S. (or vice versa) must be treated as derived from sources partly within and partly outside the U.S. In Kennedy and Fox, *supra,* it was observed that IRS might have a difficult time applying its Proposed Regulation in view of the holding in *Phillips.*

The final Regulations. The most significant changes in the final Regulations may be in the natural resource area. The Service acted in an apparent attempt to deflect a potential attack against the Regulations in the Tax Court, which (as noted above) had invalidated the existing single-source rule to the extent that it was inconsistent with the statute's requirement for a mixed-source result. The final Regulations accede to the ruling in *Phillips,* but in a way that will minimize foreign-source income for U.S. exporters. Had these Regulations been in effect during the years at issue in that case, the IRS might have achieved most, if not all, of the results it unsuccessfully sought in litigating *Phillips.*

Under the final Regulations, income from natural resources is determined separately with respect to (1) gross receipts up to the export terminal value and (2) gross receipts in excess of that value. Receipts up to the FMV at the export terminal (or the value of the products before any additional production activity) are sourced to the place of production. Excess receipts are sourced to the country of sale. If, however, the taxpayer engages in additional production activity subsequent to shipment from the export terminal and outside the country of sale, the excess receipts are sourced under the inventory rules. Only the additional production activity assets are taken into account in determinations under the 50/50 method. Where the taxpayer engages in additional production activity prior to export, the value of the product immediately before that activity is effectively substituted for the export terminal value.

The definitions in Reg. 1.863-1(b) of "export terminal value," "additional production activity," and other terms are unchanged from the Proposed Regulations. Thus, the IRS has not retreated from its exclusion of liquefaction of natural gas from production activities. With regard to additional production activities in connection with mining, new Examples 1 and 5 in Reg. 1.863-1(b)(7) clarify that milling is part of the mining activity but smelting is an additional production activity.

New elections. The final Regulations add two new elections. Taxpayers now may separately elect the 50/50 or IFP method with regard to sales in and outside the U.S. (Reg. 1.863-3(a)(2)). This allows taxpayers in consolidated groups that have both inbound and outbound businesses to avoid distortions that otherwise might occur if a single election were required. In addition, for sales of inventory other than natural resources taxpayers may apply the 50/50 method to taxable rather than gross income. In certain instances, this alternative may affect the allocation and apportionment of expenses. It is unclear, however, whether this is an annual election or is linked to the election of the 50/50 method.

Reg. 1.863-3(e)(2) retains the pro-

NOTES

[1] In Intel Corp., 100 TC 616 (1993), *aff'd* 67 F.3d 1445, 76 AFTR2d 95-6825 (CA-9, 1995), the taxpayer had argued that the use of an IFP was elective. IRS asserted that if an IFP existed, its use was mandatory. The court held that it was mandatory only if all conditions specified under the old rules, including the existence of a sales or distribution branch outside the U.S., were satisfied. The Proposed Regulations made the IFP elective even where the requisite circumstances existed.

[2] Taxpayers should consider the implications of Bausch & Lomb Inc., TCM 1996-57, regarding what is manufacturing and what might be additional production activity under the Regulations.

[3] This regulatory change forces (or allows) taxpayers to do what the IRS always had the ability to do under Section 482. Aggressive positions taken by some taxpayers on intercompany pricing, which had artificially altered the sourcing of income, thus no longer have any impact. For more on Reg. 1.1502-13, see generally Casinelli, Hennessey, and Yates, "Final Intercompany Transaction Regs. Focus on Broad Concepts Rather Than Mechanics," 83 JTAX 325 (December 1995).