The Source of Royalty Income

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This proposal suggests that the government enforce the language of section 861(a)(4).

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. This is the latest in a series of Shelf Project international tax proposals by the author.

The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Royalties

Sections 861(a)(4) and 862(a)(4) determine the source of royalties from the use of intangible property by reference to where the property is located and used. Thus, payment of royalties for use of a U.S. patent or copyright is income from sources within the United States, because the legal rights protect against unauthorized use only in this country. As a corollary, payment of royalties for use of a non-U.S. patent or copyright constitutes foreign-source income. The royalty source rules also apply to gain from the sale of an intangible to the extent that proceeds are contingent on its productivity. The rationale is that the seller's retained interest in the property makes the proceeds economically equivalent to royalties.[1]

In practice, taxpayers and tax administrators have often assumed that the source of royalty income is determined by the residence of the payer. On that assumption, royalties paid by a Netherlands corporation for use of a U.S. copyright would constitute foreign-source income to a person not entitled to a U.S. tax treaty and that person would not incur (nor the Netherlands corporation have to withhold) U.S. tax.

Rev. Rul. 80-362[2] attempted to prevent this avoidance of U.S. tax by using the situation of A, an individual in a tax haven country who licenses rights to a U.S. patent to X, an unrelated Netherlands corporation. X in turn relicenses the patent to Y, an unrelated U.S. corporation. The ruling goes out of its way to establish that these are bona fide business dealings at arm's length between unrelated entities.

The ruling concludes that the payments from the U.S. corporation Y to the Netherlands Corporation X are U.S.-source income, but are exempt from tax under the income tax convention between the United States and the Netherlands. The payment from Netherlands corporation X to tax haven individual A, however, was also considered U.S.-source income under section 861(a)(4) because it is paid for the use of property located in the United States (a U.S. patent). Because A was not entitled to the benefit of a tax treaty, the individual was subject to U.S. tax of 30 percent under section 871(a)(1)(A), and section 1441(a) required Netherlands Corporation X to withhold that amount.[3]

The case of *SDI Netherlands*[4] presented a similar situation, but with related parties. B, a Bermuda corporation not entitled to the benefit of a tax treaty, owned X, a Netherlands corporation. X in turn owned both Y, a U.S. corporation, and European corporations. Corporation B licensed worldwide intangible rights to X, which in turn relicensed the U.S. rights to corporation Y and the non-U.S. rights to X's European subsidiaries. The opinion stated that Rev. Rul. 80-362 had ''no significant support,'' although the ruling is based on the literal language of section 861(a)(4). The decision also found that X was not a conduit for royalty payments between X and B, and —

[1]Section 865(d)(1)(B). *See General Explanation of the Tax Reform Act of 1986*, p. 919.

[2]1980-2 C.B. 208.

[3]The withholding requirement might be enforced by going against X's assets in the United States, including its rights to royalty payments from Y.

[4]*SDI Netherlands v. Commissioner*, 107 T.C. 161, *Doc 96-27031, 96 TNT 194-5* (1996). The government dropped its appeal from *SDI Netherlands* shortly after the decision in *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506, *Doc 97-16951, 97 TNT 111-17* (7th Cir. 1997), a record low in tax jurisprudence. The late Sidney Roberts told the author that he had written his *Harvard Law Review* colleague Judge Tannenwald to lament the latter's reasoning in *SDI*, which accepted the *Northern Indiana* decision.

despite X's payment to B being determined with reference to about 93 percent of X's revenue from relicensing — the decision refused to trace any of X's royalty payments to B as attributable to the U.S. royalties which X received.[5]

The anticonduit financing regulations issued under section 7701(l), which were not in effect for the years at issue in *SDI*, assume the validity of Rev. Rul. 80-362 and do not envision the *SDI* result.[6] The regulations may be inferred to prescribe conduit treatment if their premise that section 861(a)(4) makes the royalty paid by the Netherlands corporation U.S.-source income is "without support." But based on *SDI*, taxpayers may well enter into related-party transactions without concern for penalties (which were asserted in *SDI* on the basis of the code and ruling but became moot when no tax was considered owed).

Moreover, the reasoning of *SDI* remains available to unrelated parties. For example, if a Cayman corporation owning the copyright rights to an extremely popular set of recordings by a musical group either licenses or sells them (for a contingent price) to a Netherlands or even Bermuda corporation, the United States may not collect revenue on payments for use of its copyrights because the U.S. portion of worldwide rights cannot be determined.

This is not a theoretical issue. Recent newspaper articles indicate that blockbuster groups like the Rolling Stones and U2 have been using Netherlands corporations to avoid home country tax on their royalties.[7] Because their songs are in English, a large percentage of their copyrights royalties likely constitutes U.S.-source income under section 861(a)(4). Owing to either *SDI* or unintended application of the Netherlands-U.S. treaty, the United States is not collecting the tax due it as source country, and little or no residence tax is being paid by the Netherlands corporation or the rock groups.

Any income from royalties or contingent sales proceeds paid to a Netherlands corporation might be considered exempt from U.S. tax under the income tax convention between the United States and the Netherlands. The exemption afforded by treaty is denied if the Netherlands company acts as a conduit by paying the most of the income received to a third party not directly entitled to a treaty exemption from U.S. tax. The idea of denying the exemption is that if those payments are deducted from Netherlands income, no substantial tax will be imposed by any country.

But the Netherlands may allow a deduction for *imputed* payment by the Netherlands corporation to the Rolling Stones or U2. In that case, the Netherlands tax could be minimal enough to attract those groups to use it as a base[8] while literally not violating the treaty language denying exemption.

Recommendations

It is recommended that payments by a foreign corporation for U.S. intangibles be sourced in accordance with the language of section 861(a)(4) and that those payments be allocated between U.S. and non-U.S. rights as if the two were granted by unrelated parties. It should also be clarified that foreign corporations are required to withhold U.S. tax on those payments, with enforcement against the present and future of U.S. assets of an entire affiliated group.

At the same time, however, payment of tax on U.S.-source royalties should be prevented from cascading. Thus, if a Netherlands corporation pays U.S. royalties to a Bermuda corporation that in turn pays royalties for the same property to a Cayman Islands corporation, there should be only one tax imposed by section 871(a) or section 881(a).[9]

For treaties, it should be spelled out that a limitation on benefits clause includes not only amounts paid out, but also amounts deductible under the laws of the foreign country as if paid out. No inference should be drawn as to the current interpretation of treaties.

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[5]Even if X had not received any royalties but had used the licensed U.S. intangible to manufacture and sell the product, an unrelated person who had licensed only the U.S. rights would certainly have determined how much of X's income was attributable to that license. Public corporations like GE and IBM do this both internally and in their financial statements.

[6]Example 10 of reg. section 1.881-3(e) in effect restates Rev. Rul. 80-362. Paragraph 8 of Article 12 of the Canada-U.S. tax treaty reflects a similar interpretation. They assume that the English language — this most beautiful instrument — means what it says.

[7]Lynnley Browning, "The Netherlands, the New Tax Shelter Hot Spot," *The New York Times*, Feb. 4, 2007; Fergal O'Brien; "U2 defends move to avoid Irish tax raise," *Int'l Herald Tribune*, Oct. 17, 2006. The O'Brien article, which discusses Bono's call for Ireland to give more aid to Africa, mentions that U2 — by transferring their copyrights from an Irish to a Netherlands corporation — is avoiding Irish tax on $110 million of annual royalties. An Irish equivalent of section 367(d) would have stopped that.

[8]The O'Brien article states that the Dutch tax on royalties received by the Netherlands corporation is about 5 percent, although the Dutch statutory corporate tax rate is at least five times that.

[9]This was a concern of the *SDI* decision.