the Tax Court's decision, the Fifth Circuit rejected the taxpayer's argument stating:

> "Where section 351 applies to make the sale or exchange non-recognized and non-taxable, taxpayer cannot seriously argue that he is entitled to make the section 453 election as to when to be taxed on a nontaxable event . . . . For the taxpayer to treat the amounts received in payment of the security as installment payments on a gain realized at the time of the transfer contradicts the tax-free status of that original transfer. We hold that section 351 negates section 453 in that a section 351 transfer to a corporation controlled by the transferor in exchange for stock or securities in that corporation does not qualify for treatment under section 453.[6]

If doubt regarding the matter existed prior to the *Dennis* decision, its logic clearly dictates that a transfer to a controlled corporation of an asset such as a patent will qualify for adoption of installment method reporting only where there has been a bona fide sale of the asset to the corporation. Of course, pursuant to Section 1239, characterization of the resulting payments will be ordinary income where the control exceeds 80 percent when either a patent or copyright is involved.[7]

When the installment reporting method is available, however, it has a broad utility. For example in Revenue Ruling 234[8] the Internal Revenue Service issued clearance for its use by a nonprofessional author. In this ruling, the taxpayer-author entered into an agreement with a publisher for the sale of a manuscript for 120x dollars in each of four succeeding years, the latter represented by four non-interest bearing notes. The ruling permitted the reporting of the proceeds of the sale under Section 453(b).[9] A 10x dollar loan made to the

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capital gain status to the payments Dennis received on the notes was Section 1232. However, the statute was unavailable to the taxpayer because the note was neither in registered form or with coupons attached as the provision requires of notes issued prior to January 1, 1955. The taxpayer argued the note was not of the type contemplated by Section 1232 because it had no independent significance. Rather, it was solely an evidence to pay a prescribed installment purchase price for the patent rights. The payments received thus qualify for long-term capital gain treatment pursuant to the installment sales provisions of Section 453(d).

[6] Note 4 *supra* at 284–285.

[7] See generally discussion ¶ 1.5b *supra.*

[8] 1953-2 C.B. 29.

[9] The cost of the manuscript constituted the basis of the property for the purpose of computing the gain realized.

for a particular sale, the election may not be changed either by way of an amended return for the year of sale or in any subsequent year.[16]

¶ 3.1c Computation and Reporting of Gain

If a taxpayer elects the installment reporting method, gain on the sale or other disposition will be reportable over the period in which the installment payments are actually received. The amount of gain reportable in each year is "that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price." [17]

Example: A patent is sold for $100,000 to be paid in ten equal yearly installments. Its basis is $10,000. The gain reportable in the first year is:

$$\frac{\$\,90{,}000\ (\text{total gain})}{\$100{,}000\ (\text{total contract price})} \times \$10{,}000\ (\text{first year payment}) = \$9{,}000\ (\text{gain reportable in the first year})$$

¶ 3.2 THE OPEN TRANSACTION DOCTRINE

Although a licensor receiving contingent payments from the sale of intangible property is precluded from utilizing Section 453, he may still be able to spread the resulting gain from such a transaction over a number of tax accounting periods via the "open transaction" doctrine. The origin of the doctrine is the *Burnet v. Logan* case [18] where the Supreme Court found that if it is impossible to determine the fair market value of a contractual promise due to uncertainties or contingencies, a taxpayer is entitled to a return of capital before being subject to tax. However, the Internal Revenue Service takes a strict view with respect to application of the open transaction doctrine. The Regulations provide that only in rare and extraordinary circumstances does property have no fair market value.[19] Nevertheless, it

[16] Marks v. United States, 98 F.2d 564 (2d Cir. 1938), *cert. denied* 305 U.S. 652; Felton v. United States, 57-1 U.S.T.C. ¶ 9391 (M.D. Ga. 1957). Since 1969 an exception is available in the unlikely event the licensor is classed as a dealer. Under Section 453(c)(4) for taxable years ending on or after December 30, 1969, a dealer may revoke an installment election.

[17] I.R.C. § 453(a).

[18] 283 U.S. 404, (1931).

[19] Reg. § 1.1001-1(a); Reg. § 1.453-6(a)(2). See also Rev. Rul. 58-402, 1958-2 C.B. 15. The Service was concerned that the ordinary income tax on

involved are occasionally quite complicated and should not be undertaken without a careful review of the Regulations.

Income averaging is available at the taxpayer's election.[23] It applies only to that portion of an individual's taxable income[24] which exceeds the average base period income by more than one-fifth.[25] The base period consists of the four taxable years immediately preceding the taxable year in which the income to be averaged is earned.[26] Additionally, there is a de minimis rule which requires that the amount eligible for averaging exceed $3,000 before income averaging is available.[27]

Example: A taxpayer has taxable income of $50,000 in 1973. His average income for the base period 1969 through 1972 is $25,000. The amount not eligible for averaging is 120 percent × $25,000, or $30,000. The $20,000 remaining exceeds $3,000. Therefore, the entire $20,000 is subject to averaging. If the taxpayer's 1973 income was $33,000 or less it would be entirely ineligible for averaging.

¶ 3.3b Eligible Taxpayers

A taxpayer may qualify for income averaging only if he is a citizen or resident of the United States for the entire computation year and has not been a nonresident at any time during the base period.[28] Students and others who are not self-supporting during the base period, as well as trusts and estates, are not eligible for income averaging.[29]

Generally, income averaging is useful only where extraordinary amounts of ordinary income are bunched into a single year. Therefore, the amount of tax saving that income averaging can offer will depend upon each taxpayer's individual circumstances. In view of the unpredictable nature of royalty income, its use as a tax planning device for licensors is somewhat questionable. It does, however, serve as an excellent emergency device for those who have not made other tax planning arrangements or who are blessed with unexpected

[23] I.R.C. § 1304(a); Reg. § 1.1304-1(a).

[24] For a definition of the term "taxable income" see I.R.C. § 1302(a)(2).

[25] I.R.C. § 1301. For years before 1970 the figure was one-third. (See former Code § 1301.)

[26] I.R.C. § 1302(c)(2).

[27] Note 25 *supra*.

[28] I.R.C. § 1303(a)(b).

[29] I.R.C. § 1303(c)(d); Reg. § 1.1303-1(a).

sequently makes an intrafamily transfer of the contract by gift. If the royalty contract is assumed to be in the nature of income-producing property then its gift to another should effectively shift the taxability of the resulting payments to the donee. Conversely, if only an assignment of future income has occurred the donor remains taxable on the royalties. Although some contrary judicial authority exists[32] the better approach appears to be that an individual may make a valid assignment of a royalty contract for tax purposes.[33]

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family gift of deferred rental income); and Comm'r v. Court Holding Co., 324 U.S. 591 (1945).

[32] Wodehouse v. Comm'r, 178 F.2d 987 (4th Cir. 1950), *aff'g in part* 8 T.C. 637 (1947); Heim v. Fitzpatrick, 151 F. Supp. 574 (D.C. Conn. 1957). The latter case was reversed, see note 33 *infra*.

[33] Wodehouse v. Comm'r, 177 F.2d 881 (2d Cir. 1949), *rev'g in part* 8 T.C. 637 (1947); Comm'r v. Reece, 233 F.2d 30 (1st Cir. 1956); Heim v. Fitzpatrick, 292 F.2d 887 (2d Cir. 1959). In 1956-1 C.B. 6, the Commissioner issued a nonacquiescence in the *Reece* case. The nonacquiescence has since been withdrawn. It should be kept in mind that such a procedure will be effective only as to future royalties. Royalties earned before the date of the assignment, even though not yet payable, remain taxable to the donor. For an analysis of the area see, Hoffman, "Tax Planning for Authors," 46 Taxes 430 (1968).

CHAPTER 4

Licensing Payments to Nonresident Aliens and Foreign Corporations

¶ 4.2a Source Rules Background

In 1916 the concept of source of income first appeared in the Internal Revenue Code as the base for net income tax on nonresident aliens and foreign corporations.[4] Elaborations were added by the Revenue Act of 1921[5] in response to an opinion of the Attorney General construing the provisions as exempting from federal income taxation profits which were made by foreign corporations manufacturing or purchasing goods in the United States, but selling them abroad.[6] Codifying the Attorney General's opinion, the 1921 Act declared that income from the purchase and sale of personal property was derived entirely from the country of sale. However, it specified that income from property produced in the United States but sold abroad, or produced abroad but sold in the United States, should be allocated to sources partly within and partly without the United States. Provisions were also included allocating income from interest, dividends, personal services, transportation, rentals, royalties, and the sale of real property.[7]

The 1921 provisions have been retained without substantial amendment for more than fifty years. When policy reasons have demanded refinement, Congress has responded by distinguishing among types of foreign or domestic income rather than altering the definitions themselves. For example, most recently, when Congress concluded that the distinction between domestic and foreign source income was too artificial it inserted the "effectively connected" concept into the source rules in the Foreign Investors Tax Act of 1966. Without altering the basic definitional lines, the 1966 amendments tax nonresident aliens and foreign corporations on certain categories of foreign source income which is "effectively connected" with the conduct of a United States trade or business.[8]

¶ 4.2b Licensing Transactions as Sales of Personal Property

Section 861(a)(6) provides that income from the "purchase of personal property without the United States . . . and its sale within the United States" shall be treated as income from sources within the United States.[9] On the other hand, the criteria for allocating

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[4] Revenue Act of 1916, ch. 463, § 1(a), 39 Stat. 756.
[5] Revenue Act of 1921, ch. 136, § 217, 42 Stat. 243.
[6] Op. Att'y. Gen. 336 (1920).
[7] See S. Rep. No. 275, 67th Cong., 1st Sess. 16 (1921).
[8] I.R.C. § 864(c).
[9] Nothing is said in Section 861(a)(6) about income from property both purchased and sold within or without the United States. This occurrence was

A related issue concerns the allocation of property and services where a transfer of foreign know-how occurs within the United States. While the source rules specify the place of sale as being determinative where income from the sale of personal property is involved, compensation for labor or personal services is regarded as income from the country in which such labor or personal services are performed.[15]

Revenue Ruling 55-17,[16] although subsequently modified for other reasons, has some instructive implications with respect to this issue. The ruling involved a nonresident corporation which received payments under an agreement licensing a domestic corporation to use the technical know-how of the foreign corporation. The Treasury Department ruled that the essence of the agreement was the availability of the know-how to the domestic corporation, resulting in United States-source royalty income, all of which was subject to withholding. The personal services rendered by the foreign corporation (which produced foreign source income) were held to have only a nominal value apart from the know-how license.

On several occasions, the Tax Court has, likewise, at least inferentially, given support to the view that the service component of know-how will not be determinative for source purposes if its value is insignificant in relation to the total value of the transfer.[17] These holdings suggest that apparently for lack of any other guidelines the courts and the Treasury are turning to the domestic capital gains structure standards to interpret the source of income rules.[18] The nonresident alien or foreign corporation selling know-how in the United States should structure sales agreements accordingly.[19]

The relatively few authorities dealing with the service component of patents and copyrights are also not particularly illuminating. For

thority, that section through its present regulations deals only with additional specified items of income. For a detailed discussion, see Roberts & Warren, U.S. Income Taxation of Foreign Corporations and Nonresident Aliens VI-95 (1968).

15 I.R.C. § 861(a)(3).

16 1955-1 C.B. 388.

17 United States Mineral Products Co., 52 T.C. 177 (1969); PPG Industries, Inc., 1970 P-H T.C. Mem. 70-1391.

18 See discussion ¶ 1.2a[3] *supra*.

19 Where the service component of a proposed know-how transfer is substantial, the consideration should be specifically allocated between proprietary know-how and services. On the other hand, if the services to be furnished are insubstantial in relation to the know-how to be transferred, the place of the sale (and resulting source of income) will be dependent upon each individual taxpayer's circumstances.

to an author's attempt to characterize his efforts as personal services.[23]

Nevertheless, it is currently possible for an individual or corporate inventor or author to produce intellectual property in return for which payment is made as "compensation for personal services" within the source rules. The entire work is then attributable to the country where the work was created. On the other hand if the producer retains title and sells or licenses his efforts, under the source of income rules the resulting income may be attributable to entirely different countries.

¶ 4.2c The Place of Sale

The Internal Revenue Code furnishes no criteria for determining whether a sale of property occurs within or without the United States. Treasury and judicial pronouncements have focused primarily on the place of sale of tangible goods marketed in international trade by manufacturers and merchandisers. In an early development the Treasury ruled that the income from such transactions was derived from foreign sources if the sales occurred and title to the property passed abroad.[24] Subsequent rulings reinforced the title-passage concept.[25] However, in 1930 the Treasury, as a consequence of misinterpreting a Supreme Court decision,[26] shifted its position from the title-passage concept by ruling that the decisive factor in determining the place of sale for source of income purposes was the essential character of the transaction, i.e., the contract of sale.[27] After successive judicial rejections of the contract-of-sale rule[28] the Treasury

royalties, to pay royalties on all books sold, and to publish at least two books per year. The Board, citing *Ingram v. Bowers,* held that the alien's income was from a license rather than personal services. See also Rev. Rul. 71-182, 1971-1 C.B. 214; Rev. Rul. 71-183, 1971-1 C.B. 215; Rev. Rul. 55-636, 1955-2 C.B. 17.

[23] See Mark Tobey, 60 T.C. 227 (1973) (concerning the question of the Section 911 earned income exemption).

[24] O.D. 1100, 5 C.B. 118 (1921).

[25] I.T. 1569, II-1 C.B. 126 (1923); I.T. 2068, III-2 C.B. 164 (1924); G.C.M. 2467, VII-2 C.B. 188 (1928).

[26] Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue, 279 U.S. 306 (1929). In this case the Court held that the sale was made when the sales transaction was confirmed in the Philippines (thus, the income was taxable there as well), notwithstanding the fact that the goods were physically within the United States. Actually, the case restates and adheres to the title passage rule inasmuch as the final acts which made the sale effective took place in the Philippines.

[27] G.C.M. 8594, IX-2 C.B. 354, 358 (1930).

[28] See, e.g., Comm'r v. East Coast Oil Co., 85 F.2d 322 (5th Cir. 1936), *aff'g* 31 B.T.A. 558 (1934), *cert. denied,* 299 U.S. 608 (1936); Ronrico Corp., 44 B.T.A. 1130 (1941).

England when the publisher's offers were accepted although the negotiations for the contracts took place in the United States.[34] The case was eventually reversed on other grounds, yet on appeal neither the court of appeals nor the Internal Revenue Service questioned the propriety of the place of contract test.[35] Thus, a nonresident alien, even if subject to United States taxing jurisdiction on capital gains because of his presence or business in the United States, may in most instances avoid all United States tax on the lump-sum sale of intangible intellectual property rights if the place of contract occurs outside the United States.[36]

¶ 4.2d Royalty Payments—Place of Use

If a licensing transaction does not qualify as a sale, the source of the resulting royalty income is governed by a very generally worded statute which (1) fails to distinguish between tangible and intangible property; (2) considers neither the place of production nor where the licensing contract was negotiated or executed; and (3) uses the same criteria whether the taxpayer purchased or produced the licensed property. Section 861(a)(4) merely treats the following as income from United States sources:

> "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 the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, tradebrands, franchises, and other like property."

Accordingly, where a nonsale licensing of intangible property occurs, the source of the resulting income depends not on the place of contract

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[34] *Id.* at 709, n. 1.

[35] 98 F.2d 753 (2d Cir. 1938). In Rohmer v. Comm'r, 153 F.2d 61, 63 (2d Cir. 1946), the court said about its *Sabatini* decision:

> "The tax on aliens at that time included a tax on the proceeds of a sale of personal property, but not if the property was produced without and sold without the United States; . . . we assumed that, because the contract was made in England, if the transaction was a 'sale,' it was not taxable . . . ."

[36] In Kaspare Cohn, Inc. v. Comm'r, 35 B.T.A. 646 (1937), the Tax Court advanced the substance-of-the-sale rule as an alternative to place of contract for one type of intangible property (stock). Subsequently, the Internal Revenue Service cited the case in adopting the substance-of-the-sale test where tax avoidance motives are present. G.C.M. 25131, 1947-2 C.B. 85. Hence, a nonresident alien subject to United States taxation on potential United States-source capital gains might wish to avoid any possible complications by both conducting negotiations and signing the contract outside of the United States.

assigned all of his rights to the invention and resulting patents to a United States corporation in return for a percentage of the sales of the chemical essential to the process. The United States corporation entered into some domestic sales of the chemical for ultimate use in foreign countries where licensees were allowed to utilize the process on a royalty-free basis. The taxpayer contended that the ultimate destination of the chemical should determine the source of the royalty payments. The Tax Court rejected the argument stating:

> "Where one domestic corporation sells and delivers to another domestic corporation a product manufactured in the United States, pursuant to a contract entered into in the United States, for which payment is received in the United States, it can scarcely be argued that the shipment of the product thereafter for use in a foreign country makes the money paid for it income arising from a source outside the United States."[40]

Alternatively, the court pointed out that whatever royalties might have been received for use of the taxpayer's foreign patents were renounced when purchasers were allowed, presumably as part of the inducement to buy at the sales price charged for the chemical, to use the process patents for nothing. Therefore, even though the amount of the royalty was based upon total sales by the United States corporation, the taxpayer received only what was due him from a domestic exclusive licensee and nothing from the use of any foreign patents.

Where patents and know-how are concerned, economic reality of the place-of-use approach coupled with recent Internal Revenue Service indications of continued adherence to it suggests the place of use of technological intangible property will generally be considered to be where the property right itself is both protected (either by registration or in the case of know-how by the laws of the country concerned) and exploited. The location will ordinarily, but not always, coincide with the place where the physical product resulting from the intellectual property is produced and sold.

An important additional definitional question concerns the allocation of licensing payments where licenses are granted to the same licensee for both domestic and foreign rights. Early cases held that where the parties themselves placed no price on domestic and foreign rights, no segregation would be permitted and thus all income should be attributed to the United States.[41] Subsequently, the rule was

[40] *Id.* at 1147.

[41] Estate of Marton, 47 B.T.A. 184 (1942); Rohmer v. Comm'r, 153 F.2d 61 (2d Cir. 1946); Molnar v. Comm'r, 156 F.2d 924 (2d Cir. 1946).

erty.[48] By incorporating Section 871(e)(2) into the Foreign Investors Tax Act of 1966 Congress attempted to end the confusion via enactment of a place-of-use source rule for determining whether the sale or exchange of intangibles in return for contingent payments is from United States sources. The section's special rule, set out below, is applicable to gains from the sale, for a contingent price, of property described in and taxed pursuant to Sections 871(a)(1)(D) and 881(a)(4), which include patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in such property:

> "(2) Source rule—In determining whether gains described in subsection (a)(1)(D) and section 881(a)(4) are received from sources within the United States, such gains shall be treated as rentals or royalties for the use of, or privilege of using, property or an interest in property."

Where Section 871(e)(2) is applicable to sale of intangible property in return for contingent payments, its place-of-use source rule eliminates any confusion by attributing all income to United States sources if the intangible property is used in the United States, regardless of where the sale may have occurred.[49] Nevertheless, the statute is limited in scope, and in some instances a residue of uncertainty with respect to its application and interpretation results. For example, by expressly limiting its application to gains from sales described in Sections 871(a)(1)(D) and 881(a)(4) the special place-of-use source rule is inapplicable to gains not encompassed by those provisions, most notably where payments are not contingent. There ensues an obvious problem, typified in the installment sales provision,[50] as to whether certain payment provisions are contingent, for example, where provision is made for maximum or minimum royalties.[51]

Moreover, it should be noted that the special place-of-use source rule is relevant only in determining whether gains are received from sources within the United States. Apparently, the statute has no effect where its application would result in characterization as foreign source income. For instance, it would be inapplicable to a sale of a foreign copyright or patent within the United States for use outside the United States. Rather, the place of contract rule would apply to characterize the resulting income as derived from United States sources.

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[48] See, e.g., Sabatini v. Comm'r, 32 B.T.A. 705 (1935).
[49] See discussion ¶ 4.2b *supra.*
[50] See discussion ¶ 3.1a *supra.*
[51] See discussion ¶ 4.3a *infra.*

(3) Nonresident aliens, not engaged in trade or business in the United States at any time during the taxable year, who had a gross income from fixed or periodical income and capital gain exceeding $15,400[57] was taxed at the regular rates applicable to citizens on such income.[58]

The foregoing statutory scheme produced arbitrary tax consequences because the treatment of investment income, including royalties and capital gains, varied depending upon whether a nonresident alien had an unrelated trade or business in the United States. In addition, the size of a nonresident alien's United States source income generated arbitrary distinctions.[59] In the Foreign Investors Tax Act of 1966,[60] Congress endeavored to rectify these distinctions by retaining the rule taxing nonresident aliens' United States trade or business income at regular rates, while changing the rule regarding investment income by taxing it at regular rates only if such income is effectively connected with a United States trade or business.

¶ 4.3b Fixed or Determinable Periodical Income

Pursuant to Section 871, nonresident aliens are presently taxed at a flat rate of 30 percent on receipt of gross fixed or determinable annual or periodical income from United States sources. However, as a consequence of the 1966 changes the flat rate applies only to the extent the income is not effectively connected with the conduct of a United States trade or business.[61] Nevertheless, the tax is applicable regardless of whether or not the nonresident alien taxpayer is engaged in a United States trade or business during the taxable year. The

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[57] For the taxable year 1964 the amount was $19,000. For the taxable years 1965–1966 the amount was $21,200. Pub. L. 88-272, § 113(b)(1, 3) (Feb. 26, 1964) (for taxable years beginning after Dec. 31, 1963).

[58] I.R.C. § 871(b).

[59] The Senate Finance Committee Report stated:

> "[I]t has been found in practice that only a small amount of tax has been collected as a result of imposing the graduated rates. It is also thought that by applying the uniform flat rate with respect to income not effectively connected with a trade or business in the United States would tend to encourage investment here by foreigners."

S. Rep. No. 1707, 89th Cong., 2d Sess. 4446, 4468 (1966).

[60] Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (1966), approved Nov. 13, 1966, generally applicable to taxable years beginning after Dec. 31, 1966.

[61] I.R.C. § 871(a)(1), as amended by § 103(a)(1) of the Foreign Investors Tax Act of 1966.

gibles in exchange for contingent payments qualified as sales of personal property or fixed or determinable periodical income.[66]

As previously noted,[67] the new statutory structure does not attempt to answer the specific issue of whether certain types of payment provisions are contingent, for example, where provision is made for maximum or minimum royalties. Of course, the concept of partial versus full characterization of total annual payments as contingent under Section 871(e)(1) recognizes that payments attributable to sales or exchanges of intangible property may be fragmented between their contingent and noncontingent portions. Further, both Revenue Ruling 57-317,[68] which considered the problem under prior law, and the examples in the proposed regulations concerning Section 871(e),[69] assume that a minimum payment which is not dependent in any way upon the volume of sales or production, (i.e., is payable in all events) qualifies as a noncontingent payment.[70]

Yet, a minimum amount—contingent payment contract provision is not a panacea for avoidance of the fixed or determinable annual or periodical characterization on the minimum payment portion of intangible sales contract payments. The mercurial nature of contingent licensing payments coupled with the partial versus full characterization of such income as contingency payments under the Section 871(e)(1) 50 percent rule may produce a shifting source and characterization of the minimum annual payment from year to year, resulting in a highly unpredictable after tax yield.[71] Further, unless the non-

66 Sabatini v. Comm'r, 32 B.T.A. 705 (1935).

67 See discussion ¶ 4.2c *supra*.

68 1957-2 C.B. 909, modified for other reasons by Rev. Rul. 69-156, 1969-1 C.B. 101. In Revenue Ruling 57-317 a nonresident foreign corporation granted an exclusive license to make, use, and sell certain products in the United States and Canada in consideration for an initial payment and future annual payments measured by exploitation, but with a minimum payment each year. It was held that the transfer was a sale and therefore did not result in "fixed or determinable annual or periodical income." In support of its position the Internal Revenue Service asserted: "it can hardly be said that an economic interest in the successful exploitation of a patent has been retained where there is a total consideration to be paid not dependent in any way upon the volume of sales or production." The reasoning for the Service's conclusion in its ruling strongly suggests that a minimum amount payable in all events qualifies as a noncontingent payment.

69 Prop. Reg. § 1.871-11(f), Example 1 and 2.

70 By contrast, where a maximum amount is not payable in all events, the resulting payments would be contingent.

71 In fact, an unprecedented success in exploitation of the intangible property could trigger a tax disaster for the licensor where minimum contingency licensing provision calls for too small a minimum payment in light of changed circumstances.

between a 30 percent tax on gross licensing receipts and a nonassertion of any United States taxing jurisdiction. As the discussion in the following subsection indicates, however, the tendency of both the courts and the Internal Revenue Service in this area has been to follow correlative domestic developments concerning capital gains which, although generally favorable to taxpayers, have at times provided little predictability.

The flat 30 percent withholding rate on fixed or determinable periodical licensing receipts frequently approximates an effective tax rate of more than twice that rate if the same income were taxed on a net basis at graduated rates. Nonresident alien licensors, not fortunate enough to be exempted from United States withholding tax as residents of a country which has a bilateral tax treaty with the United States, may attempt to avert the fixed or determinable periodical income classification by structuring their transactions as sales for a fixed price, payable either in a lump sum or in installments. Alternatively, the nonresident alien author or inventor may hire out to a foreign firm to write or invent for it, thus receiving foreign source personal service compensation in return.[73] If his property is already created, he can assign it to a foreign firm, or use it himself, and export the products produced from his patent, know-how, or copyright to the United States. In many such instances, no United States tax will be due.[74] Finally, the nonresident alien author or inventor may establish his own United States trade or business to exploit his idea or creation resulting in assessment on a net income rather than gross receipts basis for United States taxation purposes.

¶ 4.3c Sales of Personal Property

[1] Statutory Structure. Under Section 871, United States-source payments to a nonresident alien licensor from the transfer of intan-

[73] If the alien's services are rendered abroad none of this compensation will be from United States sources. I.R.C. § 862(a)(3).

[74] As discussed in ¶ 4.2c, if title to tangible goods imported to the United States passes outside the United States the income from the sale of the goods is foreign-source income. Thus, the alien's profit on United States patents and copyrights can be derived from United States markets free of United States income tax. When the owner of a patent or copyright exploits it by publishing and selling books for building and selling patented machines, part of his income from sale of the books or machines is theoretically derived from his copyright or patent. If the patent or copyright is valuable at all, it contributes to the profitability of the sales of the product. Moreover, when the owner sells a book or a machine, he is granting an infinitesimal portion of his rights under the copyright or patent – the right to a limited use of the product. He retains, however, the more substantial rights to permit others to use or reproduce the work. Hence, he has not in any practical sense "sold" or granted a "license"

treatment.[80] The question now is whether the capital gains are effectively connected with the conduct of such a trade or business. Additionally, the prior law distinction of whether the capital gains were realized during the presence or absence of the nonresident alien in the United States has been abolished.[81] Finally, under the new law the presence of the nonresident alien in the United States is given new importance, and the effective time element in that connection is changed from ninety to 183 days.[82] Nevertheless, the prior structure remains important for sales or exchanges of intangible property occurring before 1967.[83]

The improvements brought to the substantive taxing provisions in the nonresident alien capital gains area failed, however, to dispense with the difficult problem of the proper characterization of lump-sum or installment payments (emanating from certain types of intangible licensing transations) as fixed or determinable periodic income or capital gain income from the sale of personal property. In simple cases at either end of the spectrum, the distinction between the two types of income creates no serious problem. For instance, a nonexclusive license for less than the entire life of a patent in consideration for a contingent payment measured by the sales or production by the licensee of the resulting product is royalty income. By contrast, an assignment of all rights in a patent in return for a lump-sum price clearly constitutes a sale, usually generating income taxable as capital gain. Yet, the area between these two extremes remains one of uncertainty and confusion, especially for foreign taxpayers. In large measure, the confusion is attributable to a dependence by judicial and administrative bodies upon ill-suited domestic capital gains concepts utilized to fill conceptual gaps in the nonresident alien taxation scheme.

As the discussion in Chapters 1 and 2 indicates, domestic income from investments is separated from income which contains sufficient personal service elements to make it undeserving of capital gains treatment at two levels; (1) in defining "capital assets," and (2) in defining "sale or exchange." Since the limits of the term "capital assets" are not well specified, the courts and administrators often

[80] I.R.C. § 871(a)(2) prior to its amendment by the Foreign Investors Tax Act of 1966.

[81] I.R.C. § 871(a)(2)(A), (B), prior to their amendment by the Foreign Investors Tax Act of 1966.

[82] *Id.*

[83] The Foreign Investors Tax Act of 1966 which is the origin of the present statutory structure is effective for taxable years beginning after December 31, 1966. Pub. L. No. 89-809, § 103(n)(1), 80 Stat. 1539 (1966).

Early cases involving "other property" only involved sales of particular rights or privileges in such property. The Second Circuit in *Rohmer v. Comm'r* [86] held that a copyright was indivisible and could not be partially assigned. Therefore, a grant of limited rights was determined to be a mere license rather than a sale. However, in *Wodehouse v. Comm'r*,[87] the Fourth Circuit considered a similar factual context and found instead that payments for a grant of limited rights in a copyright are exempt as "proceeds of the sales of personal property." The court stated that "we cannot suppose that Congress intended to exempt the proceeds of a single sale of all rights in a literary production to one person, but to tax the proceeds of separate sales of parts of the whole." [88]

On appeal, the Supreme Court attempted to resolve the conflicting views.[89] The Court held such payments were taxable as fixed or determinable periodic income, but in so doing, it contributed more confusion to the matter. Apparently, the Court was unwilling to construe the nonresident alien taxing statutes in such a way as to permit aliens to go untaxed on United States-source income which

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industrial or commercial know-how is not a capital asset, although it may still qualify as property. See discussion ¶ 1.2a[3] *supra*. Finally, the stock in trade exception to capital gain treatment of intangibles also indirectly applies to sales of such property by nonresident aliens through the effectively connected concept.

[86] 153 F.2d 61 (2d Cir. 1946), *cert. denied*, 328 U.S. 862 (1946). In *Rohmer*, an author who was a citizen and resident of England assigned the American and Canadian serial rights in his novel to an American magazine publisher, retaining movie, stage, and book rights. The publisher paid Rohmer's American agent a lump sum of $10,000 for the rights. The Commissioner assessed the flat rate tax under the predecessor of Section 871(a)(1) (I.R.C. (1939) § 211) on the entire $10,000. Rohmer sued for a refund, contending the proceeds were not fixed or determinable annual or periodical income because the transaction was a "sale of personal property" and because the consideration, having been paid in a lump sum, was not "annual or periodical." The court rejected both arguments stating that:

> "Where a copyright owner transfers . . . substantially less than the entire 'bundle of rights' conferred by the copyright, then payment therefor, whether in one sum or in several payments, constitutes royalties within the meaning of section 211(a)(1)(A). [Now section 871(a)(1)]. For such a transfer is the grant of a license. Payment for the grant of such a license . . . is no less a royalty paid for such use when disbursed in a single amount. . . . It is like interest paid for several years in one sum or rent paid in advance for the use of a building for a period of years. . . ."

Id. at 63.

[87] 166 F.2d 986 (4th Cir. 1948).

[88] *Id.* at 989, 990.

[89] Comm'r v. Wodehouse, 337 U.S. 369 (1949).

nonsecret know-how, who are not engaged in the active conduct of a United States trade or business, may transfer either all or fragmented parts of such property interests [94] within the United States under a *fixed*-sum sale contract without the proceeds being subjected to United States taxing jurisdiction as capital gains, or fixed or determinable periodic income, regardless of the length of the alien's physical presence in the United States.[95]

[3] Capital Gain Requirements. Even though the right of a nonresident alien in intangible property qualifies as a capital asset, Section 871(a)(2) capital gain characterization and consequent tax treatment (including possible exemption from United States taxing jurisdiction) on the disposition of such an asset is not a certainty. As previously indicated, the taxpayer must additionally transfer the asset in a transaction which qualifies as a "sale or exchange." Like their domestic counterparts, nonresident alien transferors of intangible capital assets must contend with two significant restrictions on sales or exchanges; (1) retained economic interests, and (2) fragmented asset transfers. Additionally, it is important to again emphasize the special Section 871(e) rule which recharacterizes what in many instances would be capital gains proceeds as fixed or determinable periodic income where a sale or exchange of an intangible capital asset by a nonresident alien is made in return for contingent payments based upon the use of the asset in the United States.[96]

Transfers of fragmented interests. For a long period the Internal Revenue Service maintained a so-called doctrine of indivisibility in the capital gains area with respect to fragmentations of intangible assets.[97] In the foreign arena the apex of its success is represented

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[94] From the ruling, it is not entirely clear what fragmentations the Service will consider "sales of personal property" rather than licenses for the use of such property. Nevertheless, the statement in the ruling that "property rights in copyrights and patents are similar in substance," as well as recent shifts by the Service regarding domestic fragmentations of intangible property for capital gains purposes, indicate that at least, geographical and field-of-use fragmentations will be recognized as sales of personal property. See discussion ¶¶ 1.3b-[2], 2.3b[3] *supra.*

[95] Nevertheless, such income will not entirely escape United States taxing jurisdiction. Section 864(c)(3) provides that all United States-source income, other than fixed or determinable periodical income and capital gains shall be treated as effectively connected with the conduct of a United States trade or business, (hence, taxable on a net basis at domestic rates).

[96] See discussion ¶¶ 4.2e, 4.3b *supra.*

[97] The indivisibility doctrine was initially announced in I.T. 2735, X11-2 C.B. 131 (1933), after some earlier rulings indicating transfers of partial rights

alien taxation structures.[105] If so, the recent decisions in the domestic fragmentation area favoring taxpayers suggests that a lump-sum sale by a nonresident alien in the United States of a capital asset interest in a patent, trademark, purchased copyright, or know-how, fragmented on a geographic or field-of-use basis will qualify for capital gain characterization and taxation pursuant to Section 871(a)(2).[106] On the other hand, the tax consequences are less certain where such a sale of a fragmented interest is coupled with retention of a participating economic interest.[107]

Retained economic interest. In at least one case, *Bloch v. United States,*[108] the Commissioner's early position on retained economic interests was also contested by foreign taxpayers. In *Bloch,* nonresident aliens granted an exclusive license under United States patents to make, use, and sell certain products in the United States. The grantors received $40,000 at the time of the grant and were also to receive periodic payments based upon future exploitation, but not less than a specified minimum. Treatment of these future periodic payments was the only issue before the court. Following the *Wodehouse* approach[109] the Second Circuit in *Bloch* refused to apply domestic capital gain criteria in interpreting nonresident alien taxing provisions. Instead, the circuit court preferred to cite the Supreme Court decision in *Wodehouse*[110] holding that the periodic payments were royalties taxable as fixed or determinable periodic income.[111]

In subsequent rulings the Internal Revenue Service has declined to follow the approach of the Second Circuit with regard to the

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105 Added indirect evidence of the Service's position on this issue is found in the modification of Rev. Rul. 57-317 (dealing with retained economic interests by a nonresident alien) by Rev. Rul. 69-156, 1969-1 C.B. 101.

106 See discussion ¶ 1.3b[2] *supra.*

107 See, e.g., Cory v. Comm'r, 230 F.2d 941 (2d Cir. 1956), *aff'g* 23 T.C. 775 (1955). Even though a transfer of a bundle of rights for a fixed sum or of all rights for an indeterminable sum might be a sale of property for capital gains purposes, where the transfer is both (1) a transfer of part of the cluster of rights, and (2) for an amount wholly indeterminable at the time of the transfer, no such sale occurs. 230 F.2d at 944.

108 200 F.2d 63 (2d Cir. 1952), *cert. denied,* 345 U.S. 935 (1953).

109 See text accompanying notes 87–90 *supra.*

110 Comm'r v. Wodehouse, 337 U.S. 369 (1949).

111 The court observed that "there seems to be some doubt that the lump-sum payment of $40,000 made here was not subject to withholding when made and not taxable as a royalty. . . ." 200 F.2d at 66. In light of the *Wodehouse* case, it is difficult to justify the distinction in the treatment of the lump-sum payments and periodic payments, and one judge, in a concurring opinion indicated his reservations. 200 F.2d at 66.

Factors restricting capital gain exemption. Unless a nonresident alien licensor is a resident of a country with whom the United States has a bilateral tax treaty, the Section 871(a)(2) exemption of capital gain payments to such licensors from United States taxing jurisdiction can frequently be an important consideration in deciding whether or not to exploit intangible property rights in the United States. However, a number of factors may operate to diminish and even preclude the exemption.

Presence in the United States by the nonresident alien licensor or mode of payment under the licensing contract may extinguish the capital gain exemption. For instance, the exemption is lost and the flat 30 percent rate is applicable on United States-source capital gain if the nonresident alien is physically present in the United States for a period or periods during the taxable year aggregating at least 183 days and the payments are not effectively connected with the conduct of a United States trade or business.[116] Where a nonresident alien falls within the "presence" requirement for taxation of capital gains, it is immaterial whether the nonresident alien is actually present in the United States when the sale or exchange of the intangible was effected or payments made.[117] Of course, the nonresident alien licensor may avoid the consequences of presence quite simply by making sure that the place of contract for the sale of all intangible capital assets occurs outside the United States, thereby generating foreign-source instead of United States-source income, except where contingent payments are involved.[118]

As previously pointed out, if the payments in exchange for the sale of an intangible capital asset by a nonresident alien are contingent upon productivity, use or disposition of the property, the resulting income is converted from capital gain to fixed or determinable periodical income under Section 871(a)(1)(D) provided the sale occurred after October 4, 1966. Under these circumstances, the capital gain exemption is lost via a recharacterization of the proceeds. On the

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[116] I.R.C. § 871(a)(2). For determination of the 183-day period see Prop. Reg. § 1.871-7(d)(3). Note, a nonresident alien individual is not considered to be present in the United States by reason of the presence in the United States of a person who is an agent or partner of such individual. Prop. Reg. § 1.871-7(d)(2)(iii).

[117] Prop. Reg. § 1.871-7(d)(2)(i). However, gains and losses emanating from sales or exchanges of intangible capital assets effected during a previous taxable year beginning after December 31, 1966, are also taxable at the 30 percent flat rate, *but only* if he was present in the United States for the requisite period during the previous taxable year.

[118] See discussion ¶ 4.1d *supra.*

ing no allocation provision, the result may be an unduly large administrative allocation of the total consideration to the service element constituting periodical income subject to taxation at the flat 30 percent rate. Instead, it is generally preferable for the foreign taxpayer to have a reasonable allocation spelled out in the licensing agreement or to transfer the property and service elements in separate contracts.

¶ 4.3d Licensing Payments Effectively Connected With a United States Trade or Business

[1] United States Trade or Business. In examining the application of the effectively connected concept to nonresident alien inventors and authors, a preliminary factor to be considered is the scope of the term "engaged in trade or business in the United States" as it affects a taxpayer involved in either the development or exploitation of intangible property such as patents, know-how, or copyrights. Although the judicial criteria for the term are somewhat fluid, each decision dependent upon its own facts, "engaged in trade or business" is generally viewed as conveying the notion of continuous and sustained commercial activity in active pursuit of profit.[126] The nonresident alien licensor has only the foregoing guidelines to evaluate whether an economic relationship with the United States is likely to constitute engaging in a trade or business.

The Code defines "engaged in trade or business within the United States" as expressly including the performance of personal services within the United States at any time during the taxable year. Personal services are excluded from the definition, however, where rendered by a nonresident alien for:

(1) A nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States, or

(2) An office or place of business maintained in a foreign country or in a United States possession by an individual citizen or resident of the United States or by a domestic partnership or corporation.

This is provided that the nonresident alien is only temporarily present in the United States for an aggregate period of no more than ninety

126 See Jorge Pasquel, 1954 P-H T.C. Mem. ¶ 54,002; Linen Thread Co. Ltd., 14 T.C. 725 (1950); European Naval Stores Co., S.A., 11 T.C. 127 (1948). The test is both a quantitative and qualitative one. Scottish Investment Co., Ltd., 12 T.C. 49, 59 (1949).

business, further determined that the partnership was engaged in a trade or business in the United States through those activities of the partner "under whose hat 80 percent of the business may be thought to reside." [133]

The domestication of a foreign corporation will not cause domestication of its nonresident alien shareholders to the extent of causing them to be deemed engaged in a United States trade or business.[134] However, if a domestic corporation is disregarded as a sham, the activities of the corporation will be considered the activities of its shareholders.[135] Moreover, if a foreign shareholder managed or operated the business of the corporation in the United States, he may be considered engaged in trade or business within the United States by virtue of his rendering services to the corporation.[136]

[2] The Effectively Connected Concept. Until 1966, a nonresident alien engaged in a trade or business within the United States was taxed on *all* income from United States sources on a net basis, whether or not actually generated by the trade or business.[137] This so-called force-of-attraction rule (which applied even if the United States business itself produced no income) meant that certain income items, such as capital gain from the sale of intangible property, which might not have otherwise been subjected to United States taxing jurisdiction [138] lost their exemption because the taxpayer engaged in a United States trade or business, notwithstanding the fact that receipt of the income was not connected with the business. The Foreign Investors Tax Act of 1966 virtually abandoned the force-of-attraction rule in favor of the effectively connected concept. Introduction of this new concept produced two major alterations:

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[133] 236 F.2d at 303.

[134] Estate of Bozo Banac, 17 T.C. 748 (1951).

[135] Cf. E.A. Neuman de Vegvar, 28 T.C. 1055, 1061 (1957), acq. 1958-1 C.B. 4.

[136] *Id.*

[137] I.R.C. §§ 871(c), 872, and 882 ch. 736, 68A Stat. 3. (before their amendment by the Foreign Investors Tax Act of 1966). Prior to the Revenue Act of 1936, United States tax law contained no distinction between foreign taxpayers engaged in trade or business in the United States and those not so engaged. Instead, the entire net income of all foreign taxpayers, including capital gains, was subject to United States taxing jurisdiction. See Revenue Act of 1934, ch. 277, 48 Stat. 680, §§ 11, 12(b), 13(a), 212(a), 213, 231(a). Since the 1936 Act, foreign taxpayers not engaged in business in the United States have been taxed only on fixed or determinable periodical income, a concept which has been part of the withholding provisions of the Code since 1913. Revenue Act of 1913, ch. 16, Section II, 38 Stat. 168.

[138] See discussion ¶ 4.3a *supra*.

or exchanges of intangible property are alternatively deemed effectively connected if:

(1) The income, gain, or loss is derived from assets used or held for use in the conduct of a United States trade or business; or

(2) The activities of the United States trade or business were a material factor in the realization of the income, gain, or loss.[143]

In applying the above tests, the regulations state that due regard will be given to whether or not the asset or the income, gain, or loss is accounted for through the United States trade or business. Although this circumstance is not controlling, consideration is given to the fact that the asset or the income, gain, or loss is carried on books of account separately kept for the United States trade or business.[144]

The current Treasury position is that the "asset use" test applies principally in effectively connected determinations regarding income or gain of a passive type, such as interest or dividends, where the trade or business activities as such do not directly give rise to the realization of the income.[145] The asset-use test is ordinarily employed if the asset is:

(1) Held for the principal purpose of promoting the present conduct of the United States trade or business,[146] or

(2) Acquired and held in the ordinary course of the trade or business conducted in the United States,[147] or

(3) Otherwise held in a direct relationship to the United States trade or business; [148] principal consideration being given to whether the asset is needed in the trade or business.[149]

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[143] I.R.C. § 864(c)(1)(A), (B).

[144] Reg. § 1.864-4(c)(4). However, as the examples under the other two tests indicate, accounting considerations are frequently ignored. See Regs. §§ 1.864-4(c)(2)(iv) and 1.864-4(c)(3)(ii). Hence, it appears the "due regard" or "consideration" accorded the accounting test may be very slight, further diminishing any meaningful guidance in interpreting "effectively connected."

[145] Regs. § 1.864-4(c)(2)(i).

[146] For example, in the case of stock acquired and held to assure a constant source of supply for the trade or business. Reg. § 1.864-4(c)(2)(ii)(a).

[147] For example, in the case of an account or note receivable arising from the trade or business. Reg. § 1.864-4(c)(2)(ii)(b).

[148] Reg. § 1.864-4(c)(2)(ii)(c).

[149] Reg. § 1.864-4(c)(2)(iii)(a). The Regulations state that a presumption

viewed separately, are not sufficient to constitute "engaging in a United States trade or business."

The Treasury considers the business-activities test to be of primary significance in the case of income, whether passive or not, where the operation is a licensing business and the income arises from these activities.[153] Under the business-activities test an "effective" connection of licensing income with a United States trade or business exists if the activities of such trade or business are a material factor in the realization of income. However, a probe of the Regulations discloses sketchy criteria for determining the material factor standard in regard to licensing activities. For instance, the Regulations promulgate a management and control criterion like the one employed in the asset-use test, yet provide no guidelines for its application except where the business activities relate to management of investment portfolios.[154] Although the Committee Reports accompanying the Foreign Investors Tax Act mention the management and control criterion in relation to the entire business-activities test, the commentary is concluded with the qualification that the criterion is applicable only if the management activities are significant in relation to the investments involved.[155] Finally, the Regulations provide the following example dealing with the application of the business-activities test to United States-source licensing income:

> "N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The business of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N in 1968 from these licenses are not effectively connected for

153 Regs. § 1.864-4(c)(3)(i).

154 *Id.*

155 Legislative History of H.R. 13103, 89th Cong., Foreign Investors Tax Act of 1966, 725 (U.S.G.P.O. 1967).

Effectively connected licensing income from foreign sources. The effectively connected concept extends United States taxing jurisdiction over nonresident aliens to foreign-source rents and royalties for the use of intangible intellectual property as well as sales and exchanges of such property. However, this extension of taxing jurisdiction arises only if all of the following conditions are met:

(1) The taxpayer must have an office or fixed place of business in the United States.[159]

(2) The income must be derived in the active conduct of a trade or business carried on by the United States office.[160]

(3) The income must be attributable to the United States office.[161]

(4) The United States office must be a material factor in the production of the income.[162]

(5) The activities of the United States office must be of the type which produces the particular income.[163]

The office or fixed-place-of-business test is similar to the permanent establishment standard contained in tax treaties.[164] Generally, as a condition to imposing United States tax on foreign-source income, the office or fixed-place-of-business test requires a greater level of activity within the United States by the foreign taxpayer than does the engaged-in-trade or business test. Thus, assume a foreign author or investor uses an independent United States agent acting in the ordinary course of his business (i.e., an agent economically independent of the foreign taxpayer), to solicit and negotiate United States and foreign licensing agreements for intellectual property produced abroad by the foreign taxpayer. The taxpayer might be considered engaged in a United States trade or business for purposes of applying the effectively connected concept to the United States-source income. However, he would not be considered to have an office or fixed place of business in the United

[159] I.R.C. § 864(c)(4)(B).

[160] I.R.C. § 864(c)(4)(B)(i) and (ii).

[161] I.R.C. § 864(c)(4)(B).

[162] I.R.C. § 864(c)(5)(B).

[163] *Id.*

[164] The legislative history to the Foreign Investors Tax Act indicated that the statutory test is "substantially similar to the permanent establishment concept in many of our income tax treaties." S. Rep. No. 1707, 89th Cong., 2d Sess. 20 (1966). However, there are a number of significant differences. See Roberts, "The Foreign Investors Tax Act: Income Tax Changes," 25 N.Y.U. Inst. on Fed. Tax. 1411 (1967).

carried on through the office or other fixed place of business.[169] United States office foreign licensing activities are not considered a material factor unless they provide a significant economic contribution to the foreign-source licensing income by being an essential economic element in its realization.[170] A significant economic contribution is deemed to occur if the office either actively participates in soliciting, negotiating, or performing other activities or significant services required to arrange the license or sale from which such income is derived. However, the following activities by a United States office are specifically excluded from consideration as material factors in a licensing operation if the United States office:

(1) Develops, creates, produces, or acquires and adds substantial value to, the property which is licensed or sold;

(2) Collects or accounts for the royalties or gains;

(3) Exercises general supervision over the activities of the persons directly responsible for carrying on soliciting and negotiating activities or services;

(4) Performs merely clerical functions incident to the license or sale; or

(5) Exercises final approval over the execution of the license or sale.[171]

The requirement that the income-producing activities of the United States office be regularly carried on by such office is intended to create a *de minimis* exception to taxation of foreign-source effectively connected income. United States taxation of foreign-source income is precluded if it is derived from occasional or casual activities of the United States office. For purposes of the exception the nature of the United States business is the primary determinative factor.[172]

[169] Reg. § 1.864-6(b)(1).

[170] However, it is not necessary that the activities of the United States office be a major factor in the realization of the income. Reg. § 1.864-6(b)(1).

[171] Reg. § 1.864-6(b)(2)(i). In an accompanying example the Treasury takes the view that clerical support as well as general supervision over employees of foreign offices conducting business negotiations is insufficient to trigger application of the effectively connected concept with respect to the resulting income. Reg. § 1.864-6(b)(2)(i) Ex. (2). Also, the fact that licensing agreements concluded by a foreign office of a foreign corporation are subject to approval by an officer of such corporation located in a United States office will not subject the resulting income to effectively connected characterization. Reg. § 1.864-6(b)(2)(i) Example (1).

[172] S. Rep. No. 1707, 89th Cong., 2d Sess. 21 (1966).

different taxable years; or a foreign tax tentatively reduced by a credit for taxes paid to other foreign countries or to the United States or to both. Moreover, where effectively connected licensing income is composed of income from several foreign countries (e.g., where North American copyrights are sold) it may be necessary to determine what portion is derived from each country for foreign tax credit purposes.

¶ 4.4 TAXATION OF FOREIGN CORPORATE LICENSORS

¶ 4.4a Introduction

The Internal Revenue Code denotes the outer definitional limits of the term "foreign corporation" in an indirect fashion. The law begins by defining a domestic corporation as one "created or organized in the United States or under the law of the United States or of any State or Territory," and similarly defining a foreign corporation as a corporation "which is not domestic." [178] Place of incorporation is thus the decisive factor. Moreover, the term "corporation" is itself given a broad interpretation for taxation purposes. For instance, it encompasses an "association" which is defined by the Treasury Regulations to include a business organization which more closely resembles a corporation than a partnership or trust.[179] Therefore, an organization which may be characterized as a trust or partnership or even a mere co-ownership or tenancy in common under the laws of a state or foreign country may nevertheless be classified as an association taxable as corporation.[180]

For United States taxation purposes, foreign corporations have historically been treated in much the same way as nonresident alien individuals. Accordingly, prior to 1967, foreign corporations were generally classed as either nonresident or resident foreign corporations depending upon whether or not they were engaged in trade or business within the United States.[181] Due to the reintroduction of

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[178] I.R.C. § 7701(a)(4), (5).

[179] Reg. § 301.7701-2(a).

[180] The Regulations describe two essential characteristics for "association" characterization: (1) associates, and (2) an objective to carry on business and divide the gains therefrom. Four other characteristics also considered are: continuity of life, centralization of management, limited liability, and free transferability of interests. Reg. § 301.7761-2(a)(1) and (2). See Roberts & Warren, *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens* ¶ II/2A (1966).

[181] See Abbot Laboratories Int'l Co. v. United States, 160 F. Supp. 321 (N.D.

With the exception of the sale of intangible property in exchange for payments based upon contingencies, a foreign corporate licensor is not subjected to United States taxation on United States-source capital gain arising from the sale of intangible property (basically lump-sum or installment contracts calling for a fixed price). Nevertheless, inasmuch as many foreign licensors find contingent payment contracts desirable, their characterization as fixed or determinable periodic income frequently produces serious tax consequences. For instance, a foreign corporate licensor not connected with a United States business is not generally [187] permitted an offset of expenses and other deductions.[188] Where the basis for the property or other expenses are high it may well be preferable to establish a United States trade or business to which the income is effectively connected in order to gain the advantage of taxation on a net income basis.

[2] Foreign Corporate Licensors Connected With United States Business. Since 1967 a foreign corporation engaged in trade or business in the United States during the taxable year is subject to the regular corporate tax on its net taxable income which is effectively connected with the conduct of the United States trade or business.[189] The varied and complex problems arising from application of the effectively connected concept to licensing payments made to nonresident aliens as discussed in ¶ 4.3d are equally pertinent to foreign corporations and should therefore be reviewed. Where foreign-source licensing income is concerned, however, there is one matter unique to corporate structures; that is, utilization of the shadow licensing subsidiary.[190]

Under pre-1967 law, a foreign corporation could establish its principal office in the United States and license patents or other intangible property to foreign licensees while remaining immune from United States taxing jurisdiction. All activities surrounding the solicitation, negotiation, and other arrangements leading to the

[187] Under many tax treaties a nonresident foreign corporation may elect to be taxed on a net basis, as though it were engaged in a United States trade or business through a permanent establishment. See Reg. § 1.882-3(a)(2).

[188] Reg. § 1.881-2(a)(2)(3).

[189] I.R.C. § 882(a)(1). Currently the rate is generally 48 percent on ordinary income [§ 11] and 30 percent on net long-term capital gain [§ 1201(a)].

[190] For an outstanding discussion of the area, see McCollom, "Limitations upon the use of 'Shadow' Foreign Subsidiaries as a Tax Shield for Intangible Property Under the Foreign Investors Tax Act of 1966," 21 Tax Lawyer 383 (1968).

Where the withholding rate is applied to a payment of gross income without the benefit of any deductions, [198] as in the case of royalties, determination of the actual amount to be withheld is relatively easy. For example, if a literary agent receives royalties on behalf of a foreign author, and pays over those royalties after deducting commissions, fees, and expenses, withholding is required at the 30 percent rate on the gross amount of the royalties received by the agent and not the net amount paid to the author.[199] On the other hand, where capital gain or contingent payments in exchange for the transfer of intangible property are involved, that portion of the payment which constitutes recognized gain may be more difficult to ascertain. If the withholding agent does not now the amount of the gain, he is then required to withhold an amount necessary to assure that the tax withheld will not be less than 30 percent of the gain.[200] However, as the total amount withheld may also not exceed 30 percent of the gain, the withholding agent may make adjustments in light of subsequent events or [201] the tax will be adjusted on the payee's income tax return or claim for refund.[202]

The general exemption from withholding of tax for effectively connected income is available under the Regulations only if the recipient of such income files a statement with the withholding agent stating that the income otherwise subject to withholding is effectively connected with the recipient's United States trade or business. A duplicate copy of the statement must be annually forwarded by the withholding agent to the Office of International Operations.[203] Finally, it should be noted that upon a demonstration of undue administrative burden and an absence of tax avoidance potential, a foreign partnership or corporation may receive an exemption from withholding on fixed or determinable periodic licensing income.[204]

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198 In certain instances, nonresident aliens are permitted a deduction for personal exemptions. Reg. § 1.873-1(b)(2)(iii) and (c)(3).

199 Cf. Rev. Rul. 67-197, 1967-1 C.B. 319.

200 I.R.C. §§ 1441(c)(5) and 1442(a). The gain is determined without regard to deducitons for 50 percent of long-term capital gains available under Section 1202. Reg. § 1.1441-3(d)(1).

201 Reg. § 1.1461-4.

202 Reg. § 1.1441-3(d)(1).

203 Reg. § 1.1441-4(a)(2).

204 Reg. § 1.1441-4(f). Unfortunately, the preconditions for exemption are so restrictive that the provision has little application.

able only in that State on gains from the sale or exchange of capital assets.

"(2) Paragraph (1) of this Article shall not apply if—

(a) The gain is received by a resident of one of the Contracting States and arises out of the sale or exchange of property described in Article 5 (income from real property) located within the other Contracting State or of the sale or exchange of shares or comparable interests in a real property cooperative or of a corporation whose assets consist principally of such property.

(b) The recipient of the gain, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with such permanent establishment, or

(c) The recipient of the gain, being an individual resident of one of the Contracting States—

(i) Maintains a fixed base in the other Contracting State and the property giving rise to such gain is effectively connected to such fixed base, or

(ii) Is present in the other Contracting State for a period or periods exceeding in the aggregate 183 days during the taxable year." [209]

It is apparent from the foregoing article that the United States has, to the greatest extent possible, attempted to synchronize the tax treaty capital gains exemption with the exemption available under the provisions of the Code. A foreign licensor who is a resident of a country with whom the United States has recently negotiated a tax treaty is entitled to an exemption of United States-source capital gain arising from the sale of intangible property only if:

(1) The sales transaction was not effectively connected with a fixed base or permanent establishment within the United States; and

(2) The taxpayer is an individual, not present in the United States for an aggregate period exceeding 183 days during the year.

However, "the fixed base and permanent establishment" concepts are slightly narrower in scope than the "engaged in trade or business" concept utilized by the Code.[210] Hence, a foreign licensor sub-

[209] Treaty with France, July 28, 1967, Art. 12, CCH Tax Treaties ¶ 2815.

[210] See discussion ¶ 4.3d[2] *supra*, and Roberts, "The Foreign Investors Tax Act: Income Tax Changes," 25 N.Y.U. Inst. on Fed. Taxation 1411 (1967).

States.[215] Except for the Sweden treaty, which grants an unqualified exemption for royalty income, older treaties provide that such an exemption shall not apply if the foreign licensor maintains a permanent establishment in the United States.[216] More recently negotiated treaties restrict the royalty exemption only if the royalty income is effectively connected with a permanent establishment.[217] The reduced withholding tax rates (or exemption from them) are applicable to all nonbusiness royalty income under newer treaties regardless of the foreign taxpayer's business relationship with the United States. Therefore, it may often be profitable for foreign taxpayers to circuitously route nonbusiness royalty income to take advantage of a treaty withholding rate reduction or exemption. For instance, if the United States levies a high withholding tax on payments to Country *C*, and, due to a tax treaty, levies a low rate or exempted withholding in relation to Country *B*, royalty income arising in the United States may be routed through Country *B* before arriving at its ultimate destination, Country *C*.

There is considerable variation among the treaties as to the types of royalties covered. In early treaties the broadest exemptions applied to "royalties and other amounts paid as consideration for the use of, the privilege of using, copyrights, patents, designs, secret processes and formulas, trademarks, and other like property." [218] Other past treaties are more restrictive, either including specific exclusions such as motion picture rentals,[219] or confining the exemption to royalties on literary or artistic works while merely providing a reduced rate on other types of royalties.[220] Where the broad term "other like property" is employed, it has created conflicting views regarding the outer scope of nonexclusive know-how within its purview. In response, recent treaty definitions include additional items such as

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215 E.g., Treaty with Norway, Dec. 3, 1971, Art. 10, CCH Tax Treaties ¶ 6063.

216 Treaty with Sweden, March 23, 1939, Art. VI, CCH Tax Treaties ¶ 7311. E.g., Treaty with Italy, March 30, 1955, Art. VIII, CCH Tax Treaties ¶ 4311.

217 E.g., Treaty with Finland, March 6, 1970, Art. 14(4), CCH Tax Treaties ¶ 2665.

218 Treaty with United Kingdom, July 30, 1946, Art. VIII(1), CCH Tax Treaties ¶ 8113. For similar, but not identical provisions see Treaty with Switzerland, Oct. 31, 1951, Art. VIII, CCH Tax Treaties ¶ 7411.

219 E.g., Treaty with Canada, March 4, 1942, Art. XIII C, CCH Tax Treaties ¶ 1222; Treaty with Australia, May 14, 1953, Art. X, CCH Tax Treaties ¶ 413; Treaty with Greece, Feb. 20, 1950, Art. VII, CCH Tax Treaties ¶ 3110.

220 E.g., Treaty with Canada, June 17, 1952, Art. XI, CCH Tax Treaties ¶ 1217 (limiting tax on all income not exempt to 15 percent).

Moreover, in the case of the treaty with the Federal Republic of Germany it is understood that the royalty exemption applies to licensing arrangements which, for United States tax purposes, are considered gains from the sale of capital assets.[227]

As previously mentioned, an important variation is incorporated in the few post-1966 United States tax treaties which only reduce instead of exempt the withholding tax on royalties. Included within the term "royalties" are gains derived from the sale or exchange of intangible property if the resulting payments are based upon contingencies.[228] The variation is reflective of the United States view that the royalty-capital gain controversy regarding varying structures for sales of intellectual property ought to be resolved, at least where contingent payments are involved, in favor of royalty characterization.[229]

The treaties contain other important variations besides the contingent payment variation. For example, under the treaties with Ireland and the United Kingdom the exemption is allowed only if the royalty is subject to tax by the foreign signatory.[230] Under some treaties the exemption applies only to payments not exceeding "fair and reasonable consideration" for the use of the property.[231] As to that portion of a royalty which exceeds an arm's length amount, some treaties expressly provide that it shall be characterized and taxed accordingly to the law of each contracting state, including the

[227] Hearings on S. Exec. Docs. G & I before a Subcomm. of the Senate Comm. on Foreign Relations, note 223 *supra*. Much of the above result derives from the divergent tax philosophies of the United States and the Federal Republic of Germany. There is no exact counterpart in German tax law of the capital gain concept applied in the United States. Instead, a distinction is drawn between business property and nonbusiness property. Gain from the sale of property which forms part of a resident business is taxed as business income. Gain from the sale of nonbusiness property is either taxed at the full individual rate, or is not taxed at all, depending upon the holding period. See Gumpel, "Revision of the Tax Convention Between the United States and the Federal Republic of Germany," 44 Taxes 383 (1966).

[228] Treaty with France, July 28, 1967, Art. 11(4)(b), CCH Tax Treaties ¶ 2814; Treaty with Japan, March 8, 1971, Art. 14(3)(b), CCH Tax Treaties ¶ 4393N. The only new treaty taxing royalties at a reduced rate and not containing the definitional variation is the Trinidad and Tobago treaty which also does not include a capital gain exemption provision. See Treaty with Trinidad and Tobago, Jan. 9, 1970, Art. 14, CCH Tax Treaties ¶ 7622.

[229] See discussion ¶ 4.3c[3] *supra*.

[230] Treaty with Ireland, Sept. 13, 1949, Art. VIII(1), CCH Tax Treaties ¶ 4111; Treaty with United Kingdom, July 25, 1946, Art. VIII(1), CCH Tax Treaties ¶ 8113.

[231] E.g., Treaty with Austria, Oct. 25, 1956, Art. VIII(1), CCH Tax Treaties ¶ 511; Treaty with Pakistan, July 1, 1957, Art. VIII(2). See OECD Draft Convention, Art. 12(4).

whether the property or right giving rise to the interest is effectively connected with the permanent establishment and not the determination of source under other rules.[237] Hence, licensing income is deemed to be from sources within a contracting state in which the permanent establishment is situated if the property or rights from which they arise are effectively connected with that permanent establishment, regardless of the source of such income under the specific source rules.

The treaty with Japan is the only treaty currently containing guidelines for application of the attribution concept. This treaty employs factors substantially the same as the corresponding factors enumerated under Section 864(c)(2) of the Code.[238] The factors taken into account in determining whether intangible property or rights are effectively connected with a permanent establishment generally include whether the property or rights are used, or held for use, in carrying on an industrial or commercial activity through such permanent establishment, and whether the activities carried on through such permanent establishment were a material factor in the realization of the licensing income derived from such property or rights. For this purpose, due regard is given to whether or not property rights or income are accounted for through the permanent establishment.[239]

Several additional considerations arise as a consequence of the Foreign Investors Tax Act (FITA). FITA provides that "no amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States." [240] On the other hand, Section 894(b) stipulates that for purposes of applying any tax exemption, or any reduced rate of tax, granted by a treaty with respect to income not effectively with a United States

[237] E.g., Treaty with Japan, March 8, 1971, Art. 15(1), CCH Tax Treaties ¶ 4394. See also, Treasury Department's Technical Explanation of the United States Income Tax Treaty signed March 8, 1971, CCH Tax Treaties ¶ 4397.

[238] Treaty with Japan, March 8, 1971, Art. 6(8), CCH Tax Treaties ¶ 4393F. However, attempts by the United States Treasury to have factual attribution standards inserted into other recently negotiated treaties as well as unilateral implementation of such standards where the treaties are silent regarding attribution rules suggests a strong preference by the United States for the factual standards method of income attribution. Moreover, the OECD Fiscal Committee commentary to Article 7(4) of the OECD Draft Convention seems to favor the use of specific factual standards, such as the activities of the permanent establishment, for attributing income to the permanent establishment.

[239] *Id.*

[240] § 110, Foreign Investors Tax Act, Title I of Pub. L. No. 89-809, § 110 80 Stat. 1539 (1966).

Although other older treaties do not contain an explicit source limit on the exercise of taxing jurisdiction by the United States it would seem such a limitation would be implicit in the treaty negotiations inasmuch as the United States never exercised such jurisdiction over foreign taxpayers prior to enactment of the Foreign Investors Tax Act.[247] Ultimately, it should be pointed out that the importance of the preceding problem is of a continually diminishing nature. As the United States continues to renegotiate older treaties, the Treasury insists on the inclusion of a provision which permits the United States to effectively tax foreign-source income generated by United States business activities of foreign taxpayers.[248]

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[247] E.g., Treaty with Canada, March 4, 1942, Art. III, CCH Tax Treaties ¶ 1207. For an interpretation of treaties generally, see Restatement (Second), Foreign Relations Law of the United States, pt. III, ch. 4 (1965).

[248] E.g., Treaty with Belgium, July 9, 1970, Art. 7(1), CCH Tax Treaties ¶ 588.

CHAPTER 5

Treatment of Acquisition and Development Costs

the useful life of a copyrighted work, the initial twenty-eight-year term may be used in determining the depreciation rate.[6]

The cost basis of a purchased patent or copyright must be determined before depreciation or amortization is allowable, with no depreciation being permitted on property held as stock in trade for sale to customers in the ordinary course of business.[7] For instance, an assignor who has not borne the risk of research and development must capitalize and depreciate the costs of obtaining the patent based on the efforts of the assignee.[8] Such costs include governmental fees, cost of drawings, models, attorneys' fees, and developmental expenses needed to perfect the invention so that the assignee may obtain a patent.[9]

A taxpayer is required to furnish full and complete information with respect to the cost or other basis recovered through depreciation allowances in prior years and such other information as the Commissioner may require.[10] Failure to prove an ascertainable cost basis may result in the loss of some or all of the depreciation or amortization for the property. For example, in *Lowell D. Ferris*[11] the court determined that a purchaser failed to establish a basis in a patent where the evidence demonstrated the parties to the sale did not intend to create a binding obligation for the purchase of the patent. In a slightly different context a taxpayer who entered into an agreement with an inventor was allowed to deduct advances made to the inventor after its execution inasmuch as the agreement effectively made the parties joint venturers who shared the risk of research and development. However, advances made prior to execution of the agreement were characterized as nondeductible loans be-

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[6] Although the initial life of a United States copyright is twenty-eight years from the date of first publication, it may be renewed for a further term of twenty-eight years. See Copyright Act, 61 Stat. 652 (1947).

[7] I.R.C. § 167(g); Reg. § 1.167(g)-1.

[8] See Rev. Rul. 66-30, 1966-1 C.B. 55, which deals with expenses incurred in obtaining foreign patents on inventions covered by United States applications and patents covered by United States applications and patents developed and owned by others.

[9] Reg. § 1.167(a)-6(a).

[10] William C. Gregory, T.C. Memo. 1954-12; Fromm Laboratories, Inc. v. Comm'r, 295 F.2d 790 (9th Cir. 1963), where the modification of the patent license to provide for a specific number of fixed payments rather than royalties based on gross receipts over the patent's life was held to create a fixed basis for the patent.

[11] T.C. Memo. 1968-192. See also Estate of Paulosky, 6 T.C. Memo. 1176 (1947); Globe Wernicke Co. v. United States, 8 F. Supp. 711 (Ct. Cl. 1934).

case, *Associated Patentees, Inc.*,[20] the Tax Court allowed a purchaser of patents to deduct as depreciation the annual payments based on income which were made to the sellers. Rejecting the Commissioner's contention that each annual payment was to be prorated over the remaining life of the patent the court declared:

> "[A]lthough this method of computation will give . . . aggregate theoretical deductions for depreciation equaling the ultimate cost, its practical result will be an entirely inadequate allowance for depreciation at the beginning of the term and excessive allowances at the end. Actually, in later years, the depreciation allowance would largely exceed income from the patents. Under such a method of computation the petitioner might not, in fact, recover its cost from income." [21]

Subsequently, the Commissioner agreed to follow the *Associated Patentees* decision.[22] In Revenue Ruling 61-136 [23] the Internal Revenue Service citing the *Associated Patentees* decision with approval, held that a purchaser of a United States patent and patent applications, where the invention covered by the patent application is one for which a patent will be issued in normal course, is allowed yearly depreciation deductions if the purchase price is fixed by the contract of sale as a reasonable percentage of the annual return derived by the purchaser from licensing the patents and patent applications over their remaining lives.

An exclusive license for the use of a patent or copyright during its life is subject to depreciation in the same manner as a patent or copyright.[24] As a nonexclusive license is not the equivalent of patent ownership, amortization of the cost of the licensed patents is unavailable in such a situation.[25] Additionally, unpatented inventions, copyrightable material, and applications for patents are in themselves generally not subject to depreciation inasmuch as they

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[20] 4 T.C. 979 (1945).

[21] *Id.* at 986.

[22] *Acq.* 1959-2 C.B. 3.

[23] 1967-1 C.B. 58.

[24] Automatic Shifters, Inc., T.C. Memo. 1960-134; Lanova Corp., note 13 *supra;* Bendix Eng'r Works, Inc., 23 B.T.A. 1049 (1931); Service Recorder Co., 2 B.T.A. 96, *rev'd* (in effect) 24 F.2d 875 (N.D. Ohio 1927); J.M. & M.S. Browning Co., 6 B.T.A. 914 (1927). In the last case, the licensor was allowed to spread depreciation over the remaining life of the patents even though there was a possibility of the renewal of the contracts to cover the life of future patents. In Grelck Condensed Buttermilk Co., 7 B.T.A. 79 (1927), the cost of the license was exhausted over the remaining life of the basic patent.

[25] Raytheon Prod. Corp., 1 T.C. 952 (1943).

Moreover, in Revenue Ruling 67-136 [31] the Internal Revenue Service has recognized a limited useful life under similar circumstances with respect to patent applications, a correlative type of intangible property. Hence, there is every indication that a purchaser of a trade secret may obtain a current depreciation deduction if the sale contract price is fixed as a reasonable percentage of annual earnings from the property.

[3] Trademarks and Trade names. The costs of purchasing a trademark or trade name generally constitute nondeductible capital expenditures because, like a trade secret, the unlimited useful life of a trademark or trade name precludes an allowance for depreciation or amortization.[32] In *Harold M. Stiles* [33] a taxpayer contended unsuccessfully that the cost of purchasing a trademark was depreciable on the basis that what was actually acquired in its purchase was a limited market potential for the sale of equipment bearing the trademark. In reply, the Tax Court pointed out that it was not the limited market potential, but the right to the exclusive use of the trade name in the promotion and development of a market which was acquired. The taxpayer was therefore not entitled to depreciate the installment payments made in exchange for the trade name.

Section 177, enacted in 1956, permits amortization of trademark development and acquisition expenditures over a sixty-month period. However, the statute specifically precludes amortization treatment of expenditures that are a part of the consideration for the purchase of an existing trademark or trade name.[34] Due to the unavailability of amortization or depreciation of costs to an individual making an outright trademark purchase, a taxpayer acquiring such property from another will generally find it advantageous from a tax stance to, if possible, structure the resulting payments as deductible royalties for the use of the property or as purchase payments contingent on productivity or use which are deductible under Section 1253(d).

¶ 5.2b Deduction of Royalty Payments

[1] General Rule. Pursuant to Section 162, periodic payments for

[31] Note 27 *supra.*

[32] Reg. § 1.167(a)-3; Seattle Brewing & Malting Co., 6 T.C. 856 (1946), *aff'd* 167 F.2d 216 (9th Cir. 1948); Norwich Pharmacal Co., 30 B.T.A. 326 (1934).

[33] T.C. Memo. 1967-146. See also Marc Eidletz & Son, Inc., 18 B.T.A. 187, 192 (1929); Charles P. Limbert Co., 9 B.T.A. 1390, 1398 (1928).

[34] I.R.C. § 177(b)(3).

or whether the payments are determined on the basis of a percentage of production or sales.[39] Thus, a stipulated minimum royalty which must be paid each year as an annually recurring charge is deductible as a business expense in the same manner as rent.[40]

Lump-sum or one-time payments for the right to use intangible property are (except in the case of trademarks)[41] not currently deductible under Section 162 as ordinary and necessary expenses incurred in the conduct of a trade or business. Further, if such a payment is in exchange for exclusive rights for an indefinite duration, amortization may be precluded even though the property right is itself amortizable. For example, in *International Textbook Co.*,[42] it was held that a lump-sum payment for the right to sell copyrighted courses of study for an indefinite period was not deductible as an ordinary and necessary business expense, and not amortizable. Of course, if the right to use had been limited to a specific term the taxpayer could have probably amortized the lump-sum payment ratably over the term of the contract. Insertion of such a limitation also generally precludes characterization of the contract as a sale,[43] a critical consideration for royalty payment amortization purposes where intangible property with an indefinite life, such as trade secrets, is acquired.

[3] Royalty Arrangements With Related Persons. The Internal Revenue Service and the courts will carefully scrutinize royalty payments from a corporation to its shareholders. To the extent that payments to shareholders, including majority shareholders, are ordinary and necessary and reasonable in amount, the corporation may deduct them as a business expense.[44] A deduction is not allowed, however, where the payments are found to be unreasonable,[45] the

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[39] Webb Press Co., Ltd., 3 B.T.A. 247 (1925); Kentucky Elec. Lamp Co., 14 B.T.A. 603 (1928).

[40] Burnet v. Hutchinson Coal Co., 64 F.2d 275 (4th Cir. 1933), *cert. denied* 290 U.S. 652 (1933); Bogle & Co., inc. v. Comm'r, 26 F.2d 771 (7th Cir. 1928); Helvering v. Russian Fin. & Constr. Corp., 77 F.2d 324 (2d Cir. 1935).

[41] See I.R.C. § 1253(d)(2).

[42] 44 F.2d 254 (Ct. Cl. 1930).

[43] Of course, a sale would not be precluded if the term of the contract is contemporaneous with the remaining life of a patent or copyright.

[44] See Differential Steel Car Co., 16 T.C. 413 (1951); Webb Press Co., note 39 *supra;* Rev. Rul. 69-513, 1969-2 C.B. 29.

[45] E.g., Granbert Equip., Inc., 11 T.C. 704 (1948). Here, the alleged royalty payments were clearly excessive and were paid to derive a tax benefit for the corporation.

consisting of its major shareholders subsequently purchased the patents. The partnership then licensed Statham Instruments to use the patents in return for royalty payments. The Commissioner accepted the capital gain characterization of the payments by the shareholders,[54] but disallowed the deduction of the royalty payments by the corporation on the ground that the corporation was in substance the purchaser of the patents. However, the court determined that, on the evidence, the partnership was in substance the owner of the patents and that the royalty payments made thereto were reasonable in amount and thereby fully deductible as royalty payments.[55]

¶ 5.3 PATENT AND KNOW-HOW RESEARCH AND DEVELOPMENT EXPENDITURES: SECTION 174

¶ 5.3a Introduction

Prior to 1954, no Code provision specifically dealt with research and development expenditures. As a result, differing views arose as to their correct characterization. Taxpayers generally deducted research and development costs as Section 162 business expenses, except where the tax consequences were better served by capitalization. In contrast, the Internal Revenue Service allowed current deductions where a continuous research program was in effect and the taxpayer's established accounting procedure provided for such a deduction.[56] The Service rationalized its view on the basis that the tax result over the long run would not differ greatly where the current deduction was recognized or the expenditures were capitalized followed by deferred deductions. Further, the Service conceded that research expenses usually are a necessary part of most businesses and are consistently charged to expense by most taxpayers.[57] Although the courts were in some instances unwilling to override the current deduction approach, a majority of cases required capitalization of research and development expenditures.[58]

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[54] The Commissioner later challenged the capital gain characterization in Transducer Prods. Co., 58 T.C. 329, 342 (1972).

[55] The court noted that (1) the partnership was a separate business entity from that of the corporation, (2) it filed its own tax returns, and (3) the money used to purchase the patents came from the private resources of the individual partners and not from the corporations. *Id.*

[56] This policy was articulated by Commissioner Dunlop in a statement before the Joint Committee on Internal Revenue Taxation on April 4, 1952.

[57] *Id.*

[58] See, e.g., Red Star Yeast Co., 25 T.C. 321 (1955). Apparently, the multi-

development costs in the experimental or laboratory sense.[62] This definition of the term has been held to be consistent with congressional intent to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product.[63] Thus, the term generally includes all expenditures incident to the development or improvement "of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property. . . ."[64] The term also encompasses the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application,[65] including fees incurred in obtaining foreign patents on previously developed inventions for which the taxpayer owns or has applied for United States patents.[66] Excluded expenditures are the following amounts paid or incurred:

(1) For the ordinary testing or inspecting of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions;[67]

(2) By a corporation for professional services in getting a tax ruling and a rate ruling by a regulatory agency;[68]

(3) By an advertising agency in investigating the market problems of various industries so as to better approach prospective clients;[69] or

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62 Reg. § 1.174-2(a)(1).

63 Martin Mayrath, 41 T.C. 582 (1964), *aff'd* 357 F.2d 209 (5th Cir. 1966); Coors Porcelain Co., 52 T.C. 682 (1969).

64 Note 62 *supra*.

65 Reg. § 1.174-2(a)(1). Prior to enactment of Section 174 and in the initially proposed Section 174 regulations, the Internal Revenue Service took the view that all costs incurred with respect to prospective patents were properly characterized as capital expenditures. See Commissioner Dunlop's statement before the Joint Committee on Internal Revenue, 525 CCH ¶ 6170 (April 4, 1952).

66 Rev. Rul. 68-471, 1968-2 C.B. 38.

67 Reg. § 1.174-2(a)(1). In most cases, however, market development costs, as well as other non-Section 174 expenses, will qualify as currently deductible ordinary and necessary business expenses under the more general provisions of Section 162.

68 In Rev. Rul. 67-401, 1967-2 C.B. 123, the Service ruled that legal and accounting expenses incurred by a taxpayer in applying for a federal income tax ruling in connection with a research and development project and a determination of a regulatory commission with respect to the effect of the project on the taxpayer's rate structure are not deductible under Section 174 since they were not incurred in an experimental or laboratory sense.

69 Rev. Rul. 71-363, 1971-2 C.B. 156.

Example 1: *A* engages *B* to undertake research and experimental work in order to create a particular product. *B* will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, *A* pays to *B* in respect of the project the sum of $150,000, of which $25,000 represents an addition to *B*'s laboratory and the balance represents charges for research and exprimentation on the project. It is agreed between the parties that *A* will absorb the entire cost of this addition to *B*'s laboratory, which will be retained by *B*. *A* will treat the entire $150,000 as expenditures under Section 174.

Example 2: *X* Corporation, a manufacturer of explosives, contracts with the *Y* research organization to attempt, through research and experimentation, the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, *Y* is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project *Y* will transfer this tract, including any improvements thereon, to *X*. Section 174 does not apply to the amount paid to *Y* representing the costs of the tract of land and improvements.[76]

In conformity with its Regulations, the Treasury has ruled that contributions by an aircraft carrier to an aircraft manufacturer to help defray the research and experimental costs of developing a supersonic prototype are deductible as research and experimental expenditures where the payments could not be applied to the purchase price and the carrier had no right to a refund.[77] Most recently, in Revenue Ruling 73-20,[78] it was held that payments made directly or indirectly by a utility corporation to a nonprofit research and development organization formed to develop a model that would benefit the utility field are eligible for Section 174 treatment.

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[76] Reg. § 1.174-2(a)(3) Ex. (1), (2). Note that Example (1) suggests that for taxpayers who have adopted the current expense method under Section 174(a) it may be of advantage taxwise to purchase research rather than to undertake it directly. Under the current expense method the entire $150,000 expenditure may be deducted in the year in which the expenditures are incurred. (Due to the extended amortization period, this result does not apply equally to taxpayers electing Section 174(b).) By contrast, if the taxpayer had undertaken the project itself and spent $25,000 for an addition to existing facilities, the taxpayer's current deduction would be limited to $125,000. The $25,000 paid for new laboratory facilities would have to be capitalized and depreciated.

[77] Rev. Rul. 69-484, 1969-2 C.B. 38.

[78] 1973-2 I.R.B. 10. The deductibility of the payments was evidently premised on their end result rather than their actual form.

depreciable property which may be attributed to the research.[82] However, it is also stated that the research expenditures do not include the costs of the component materials of the depreciable property, the costs of labor, or other elements involved in its construction and installation.[83] Costs which fall within the "construction and installation" exclusion must be capitalized and recovered through depreciation deductions.

Unfortunately, the Regulations lack any factual standards for determination of a cut-off point between the termination of research and the construction of the end product, a problem which is especially acute where personnel at the same location work on both the research and production phase of a project. The only example in the Regulations is as follows:

> "[A] taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine)." [84]

The foregoing example evades the hard question of proper cost allocation by stating as part of the factual context how much is attributable to the machine and how much to the research. As a consequence of the lack of factual standards for allocation of project costs, taxpayers must be prepared to hammer out the matter with the Internal Revenue Service on a case-by-case basis during audit. Hence, the importance of maintaining detailed and accurate records to sustain the claim for a Section 174 deduction must again be emphasized.[85]

The Regulations also apply the foregoing rule, as to segregation of costs allocable to research, construction, and installation, where property is developed and constructed for the taxpayer by another.[86] Thus, a taxpayer must be prepared to deal with the same uncertainty as to the cut-off point between the termination of research

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82 Regs. § 1.174-2(b)(2) and (4).

83 Regs. § 1.174-2(b)(4).

84 *Id.*

85 Here, special attention should be given to justify every allocation to research instead of the account for newly constructed property.

86 Reg. § 1.174-2(b)(3) and (4).

type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and *if real doubt existed as to the capabilities of the process,* expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under Section 174(a)." [Emphasis added.] [91]

Unquestionably, the vague qualification, "if real doubt exists as to the capabilities of the process," generates substantial disagreement between revenue agents and taxpayers. Moreover, as some commentators have pointed out, this appears to go beyond the statute and represents an unwarranted extension of an otherwise reasonable rule.[92] For instance, if the taxpayer built a machine himself, there would be no doubt as to the deductibility of research costs incurred in connection with its development, whether or not the machine was certain to be successful. The result should be no different merely because the taxpayer hired another to do the work. Hence, a better view would seem to be one which simply requires that all economic risks be imposed on the taxpayer.[93] At present, however, the Internal Revenue Service on audit apparently intends to second-guess a taxpayer who has assumed all risks concerning a new process developed for him by another. Taxpayers who pay an outsider for research on a new process that the outsider utilizes in a turn-key plant for the taxpayer should therefore be prepared to substantiate that their doubts concerning the capability of the process are indeed real if a Section 174(a) deduction is sought.

[3] The Trade or Business Requirement. Section 174 treatment is specifically limited by statute to research and experimental expenditures paid or incurred by the taxpayer in his trade or business.[94] As might be expected, this requirement has engendered more litiga-

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[91] Note 87 *supra.*

[92] See, e.g., Blake, "Research & Experimental Costs," 16 N.Y.U. Inst. on Fed. Tax. 831, 839 n. 25 (1958).

[93] For example, in a reverse context, the Internal Revenue Service has recently ruled that a taxpayer's costs to design and develop a specially built automated manufacturing system for a customer's specific order at the taxpayer's risk are deductible under Section 174 even though each product design resulted in the production of only one machine system. Rev. Rul. 73-275, 1973-1 C.B. 134.

[94] I.R.C. §§ 174(a) and 174(b)(1)(A).

eral occasions the Tax Court has found amateur inventors engaged in the trade or business of inventing even though they were full-time employees of a university and corporation. The court attached significance to the scientific qualifications of the taxpayers and their sincere efforts to obtain a profit by actively trying to market their inventions and patents.[101] By contrast, in *Jack P. Stanton,*[102] the Tax Court determined that the taxpayer's activities with regard to the development of a novel boat were too sporadic and not of a sufficiently sustained character to show engagement in an inventing business. Considerable importance was attached to the fact that Stanton had made no serious effort to profitably exploit the invention nor was there any evident expection of profit.[103]

It appears the affirmative determination of what constitutes an inventing trade or business has been influenced by the following factors:

(1) Patent applications;

(2) Continuity and regularity of inventing activities;

(3) Generation of profit or strong indication of an intent to make a profit; and

(4) Lack of private benefit or utilization of an invention or ability to allocate costs of private and business uses.

The courts have consistently looked for the presence of patent applications in arriving at the conclusion of inventive trade or business status. The rationale behind patents as evidence was established as early as 1942 in *Harold T. Avery,*[104] where the court pointed out that "if pleasure were the only incentive and recompense sought by the petitioner in developing his mechanical ideas there was no necessity to go to the trouble and expense of procuring patents." [105] Patent application seems to be one of the strongest factors supportive of an inventive trade or business, although a mere preliminary

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[101] Nicholas A. Dodich, T.C. Memo. 1971-58, 30 T.C.M. 248; Johan A. Louw, T.C. Memo. 1971-326, 30 T.C.M. 1421.

[102] 26 T.C.M. 618 (1967), *aff'd* 399 F.2d 326 (5th Cir. 1968). The question was considered in a Section 162 context in William Tiffins Downs, 49 T.C. 533 (1968).

[103] Citing Mayrath v. Comm'r, 47 B.T.A. 538 (1942), the court further noted that there was a point beyond which the propensity to experiment with the boat must be viewed as taking on some of the characteristics of a hobby.

[104] 47 B.T.A. 538 (1942).

[105] *Id.* at 541–542.

roof drain. The jury's verdict was that the items were of an experimental nature and were used in part in the taxpayer's trade or business.[114] In another case, an electrical engineer operated a company which derived its income from the sale of plastic signs, electrical tapes, and electrical marine equipment. The Tax Court denied a Section 174 deduction for expenses incurred by the taxpayer in attempting to develop mathematical theories since the theories produced no income and were not sufficiently connected with his trade or business.[115]

Amateur inventors have enjoyed a measure of success in securing Section 174 deductions upon a demonstration of a profit-seeking motive or proximate connection with their regular business activities. In comparison, the Internal Revenue Service and the courts have taken a tougher position regarding independent financiers of research efforts in an attempt to restrict the unintended tax shelter that Section 174 may create for such individuals.[116]

The Tax Court considered the issue of Section 174 deductibility of research costs incurred by individual financiers in *John F. Koons*.[117] In *Koons* the taxpayer, an individual categorized as a promoter and financier of new enterprises, purchased an undeveloped invention and paid $45,000 to a research laboratory for services connected with perfecting the invention to a patentable and commercial state. The

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114 The court, in directing the jury, stated that all expenses incurred in the construction of an experimental house containing items of a research and experimental nature are deductible as Section 174 expenses to the extent they are connected with the taxpayer's trade or business. The court further stated that if the items in question were considered by the jury to be of an experimental nature and were used for both personal and business uses, the taxpayer would be entitled to deduct the difference between the cost of the experimental features and conventional systems. See also Mayrath v. Comm'r, 357 F.2d 209 (5th Cir. 1966), *aff'g* 41 T.C. 582 (1964) (allowed, as a Section 174 deduction, 35 percent of noncapitalized expenditures and 35 percent of the depreciation incurred in connection with a residence constructed by a partnership for the eventual use of one partner); *Contra* Kenneth Reiner, T.C. Memo. 1965-197 (denying a Section 174 deduction to a taxpayer who claimed that his home had been built as part of his trade or business of inventing farm implements, and that some of the expenses incurred in its construction were for research and experimentation.

115 Joe H. Cunningham, T.C. Memo. 1968-242. See also, Oliver B. Kilroy, T.C. Memo. 1973-7, holding an expenditure of a fee paid for a study on the feasibility of using lasers for deep mining operations to be nondeductible under Section 174 since the taxpayer was not engaged in the business of mining and an isolated research effort could not by itself create a trade or business.

116 As will be subsequently observed, the outcome of litigation in the area appears to have in some instances been influenced by courts' sensitivity to tax-shelter considerations.

117 35 T.C. 1092 (1961). See also William S. Scull, II, T.C. Memo. 1964-224.

to expense under Section 174(a); the taxpayer's share was about $9,000. In contrasting the instant case with *Cleveland,* the Tax Court observed that in the earlier case there had been a long history of research and experimentation and a patent application had already been applied for at the time of the creation of the joint venture. In 1966 the inventor had hardly begun experimentation on the trash burner, the application for a patent was not made until 1968, and no effort was made to market the device until several years after the funds were advanced by the taxpayer. Accordingly, the court held that the partnership "had as yet no trade or business in 1966 and the expenditures paid in that year were not 'paid in connection with' its trade or business but were preparatory to a business which came into existence after the taxable year." [122]

In affirming the lower court decision, the Sixth Circuit went further than the Tax Court in dealing with *Cleveland* by rejecting its reasoning altogether. It stated:

> "We are by no means certain that Cleveland involved any dispute over whether the joint enterprise therein concerned was engaged in a trade or business. If, however, it be read as in conflict with our view in this case, we prefer the logic of the later Fourth Circuit holding in Richmond Television Corp. v. United States, supra, to the Fourth Circuit's earlier holding in Cleveland." [123]

The conclusion of the Fourth Circuit in *Richmond Television Corp.*[124] was that expenses incurred prior to the obtaining of a broadcasting license by a television station were "pre-operating" expenses not deductible in carrying on a trade or business under Section 162(a). The Sixth Circuit felt that there was a similarity with *Richmond Television* in that the $36,000 of expenses were also pre-operating expenses nondeductible under Section 174. Additionally, however, the Sixth Circuit specifically considered the issue of whether Snow's investment activities in the partnership were enough to place the taxpayer in the trade or business of developing inventions. This possibility was rejected on the basis of the Supreme Court decision in *Whipple v. Comm'r*[125] which held that investing and managing investments are not sufficient to constitute a trade or business.

122 58 T.C. at 595.
123 482 F.2d at 1031.
124 345 F.2d 901, 907 (4th Cir. 1965).
125 373 U.S. 193 (1963).

Moreover, the ruling goes on to suggest that taxpayers may easily avoid any question being raised regarding the current expense method adoption by showing the research and experimental expenditures as a separate item on each income tax return.

As indicated by Revenue Ruling 70-637,[132] however, failure to deduct research and experimental expenditures on the return of the first taxable year in which they are incurred may prove to be a costly omission which can not be subsequently corrected without consent of the Commissioner. The ruling addressed itself to a factual context in which the taxpayer incurred research and experimental expenditures in 1964, 1965, and 1966, but failed to deduct them in 1964 (the first taxable year in which they were incurred), as well as the two later years. Expenditures incurred in 1967, 1968, and 1969 were deducted on the returns filed in those years. Even though claims for refund for the years 1964, 1965, and 1966 were timely filed, deduction was denied for those years. Although deductions on the returns were taken for the years 1967, 1968, and 1969, deductions for those years were also denied in view of the taxpayer's failure to adopt the current expense method on the return for the first taxable year in which the research and experimental expenditures were incurred. Hence, to be certain to meet the requirement that the current expense method is properly adopted in the first taxable year in which it is available, taxpayers might be well advised to, if possible, show the expenditures as a separate item on the income tax return.

Where the current expense method is adopted it applies to all qualified research and experimental expenditures of the taxpayer for the taxable year and all subsequent taxable years, unless authorization is secured from the Commissioner to use a different method with respect to certain projects or for all of such expenditures.[133] The opportunity to obtain permission to utilize the deferred expense method or capitalize expenditures with respect to particular projects is especially useful. As a result, in some instances a taxpayer may be able to defer the cost of a special project without losing the tax

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rules contained in the temporary rules relating to Section 174 which were issued shortly after enactment of the 1954 Code. 19 Fed. Reg. 5496 (Aug. 27, 1954). As originally published, the temporary rules called for an "election" to be made in a statement attached to the return which "shall specify the amount of each type of such expenditure and shall describe them in detail." The reversal of the Service's position is probably due to the technical difference between the use, within the statute, of the terms "adopt" and "elect" ("adoption" implying selection of a method which may be indicated merely by its use).

[132] 1970-2 C.B. 64.

[133] I.R.C. § 174(a)(3).

research and experimental expenditures and who wishes to change to the deferred method or capitalized expense method may do so only by filing a written application which must be approved by the Commissioner.[139] Further, a taxpayer originally electing to expense all research and experimental expenses except a specific project or projects must secure the Commissioner's permission before he can use the deferred expense method for any subsequent project or projects.[140] In all instances changes are effective only with respect to expenditures in the year of the change and subsequent years.[141] The application addressed in the same manner as explained in the preceding paragraph and filed not later than the last day of the first taxable year of the change, should contain the following:

(1) The name and address of the taxpayer;

(2) The first taxable year for which the change is requested;

(3) A statement as to whether the change is to apply to all research or experimental expenses paid or incurred by the taxpayer, or only to expenses incurred for a specific project or projects;

(4) Information sufficient to identify the project or projects to which the change is applicable;

(5) A statement as to the number of months (not fewer than sixty) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under Section 174(b);

(6) A statement that upon approval of the application, the taxpayer will make an accounting segregation on his books and

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139 Reg. § 1.174-3(b)(3).

140 In Revenue Ruling 68-144, 1968-1 C.B. 85, the taxpayer had properly elected to expense all research and experimental expenditures with the exception of those relating to two specific product development projects as to which the deferred method was elected. Subsequently, the taxpayer undertook new projects and "elected" to use the deferred expense method. The Service ruled that once the current expense method has been adopted by a taxpayer *all subsequent* expenditures are required to be deducted as current expenses, unless permission to utilize a different method as to some or all such expenditures is granted by the Commissioner.

Based on the foregoing ruling the Service held in Rev. Rul. 71-248, 1971-1 C.B. 55, that a corporation which had previously deducted computer software costs in accordance with Revenue Procedure 69-21, 1969-2 C.B. 303, in connection with an old computer, may not capitalize and amortize such costs with respect to a new computer, unless permission to adopt a different method is granted by the Commissioner.

141 I.R.C. § 174(b)(2).

election with respect to each project since the regulations indicate that a failure to so properly elect for each new project will force the taxpayer to employ the capitalization method for the unelected project.[148] To recapitulate, the elective privileges provided by the deferred expense method may be applicable in any of the following situations:

(1) Taxpayers not adopting the current expense method may;
  (a) Apply the deferred expense method to all research and experimental expenditures; [149] and
  (b) Apply the deferred expense method to specific projects and capitalize all other projects as though they were governed by prior law.[150]

(2) Where the current expense method has been adopted and the prior approval of the Commissioner has been obtained, the deferred expense method may be applied to specified projects.[151]

Requirements for election of the deferred expense method. Section 174(b)(1)(C) limits research and experimental expenditures eligible for the deferred expense election to those costs which are "chargeable to capital account." This restriction does not appear significant inasmuch as the statutory enactment seems to have been premised on the theory that all such expenditures would have to be capitalized in the absence of the statute.[152] The deferred expense election is unavailable, however, where an expenditure would fall within a current deduction category under prior law.[153]

Moreover, a large portion of the research and experimental expenditures which qualify as chargeable to capital account may fall within the depreciable property exclusion of Section 174(c) which is applicable to all of Section 174.[154] As a practical matter, the dividing line for purposes of applying the limitation is the factor of determinable

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148 Reg. § 1.174-4(b)(1)(iii).

149 *Id.*

150 *Id.*

151 Reg. § 1.174-1.

152 S. Rep. No. 1622, 83d Cong., 2d Sess. 215 (1954). Section 174(a), dealing with the current expense method, does not contain a "chargeable to capital account" requirement. However, such a requirement would seem to be implied in light of the underlying legislative intent.

153 See, e.g., Kent Mach. Co., 6 T.C.M. 441, *aff'd* 168 F.2d 68 (6th Cir. 1948) (development expenses incurred by a patent license deductible as current expenses, where the licensee has no interest in the patent).

154 See discussion ¶ 5.3a[2] *supra.*

sioner for any post-1953 year in which research or experimental expenditures are paid or incurred provided the current expense method has not been previously adopted.[159] As previously indicated, unlike the adoption of the current expense method, "election" of the deferred expense method is optional and need not be made in the first post-1953 taxable year in which the taxpayer has qualifying research and experimental expenditures. Further, the election has no retroactive effect and, once made, cannot be changed without the consent of the Commissioner.[160]

Pursuant to the Regulations, the election to use the deferred method is made by attaching a statement to the taxpayer's return for the taxable year in which the election is to take effect.[161] Additionally via Revenue Ruling 71-136[162] the Internal Revenue Service has held that notwithstanding a failure to file the written statement in the form required by the Regulations, a taxpayer is not precluded from adopting the deferred expense method of amortizing research and experimental expenditures where he treated the expenditures as if he had elected to defer them under the deferred expense method on the return for the first year in which the expenditures for a particular project were incurred.[163] Where a statement is filed, however, it must be signed by the taxpayer or his duly authorized representative and contain the following information:

(1) The name and address of the taxpayer;

(2) The first taxable year for which the election is to apply;

(3) A statement as to whether the election is to apply to all expenditures within its scope, or only to a particular project or projects, and, if the latter, such information as will identify the project or projects to which the election is applicable;[164]

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159 I.R.C. § 174(b)(1) and Reg. § 1.174-4(a)(1).

160 Reg. § 1.174-4(b)(2).

161 Reg. § 1.174-4(b)(1). The election must be filed no later than the time (including extensions) for filing the return.

162 1971-1 C.B. 97.

163 The ruling was based upon the result in Kentucky Util. Co. v. Glenn, 394 F.2d 631 (1968). There the court, in considering similar election under Section 266 (relating to taxes and carrying charges), held that the treatment of certain taxes on the tax return filed as if an election to capitalize had been made amounted to a sufficient election to capitalize rather than to expense the taxes in question.

164 If the election is to apply to all projects undertaken thereafter by the taxpayer it should be so stated. By contrast, if the election is made on a specific project basis, care should be taken to make another election each time a new project is started.

the absence of a showing to the contrary," a taxpayer will begin to realize benefits in the month in which he puts the property to which the expenditures relate to an "income producing" use.[169] On the other hand, the Regulations fail to indicate whether a process becomes income-producing at the moment it is utilized in manufacturing new products or at the time when the first sales of those products are made. Moreover, it would appear the income-producing test could also be satisfied by a machine or process which reduces costs or expenses. In this regard it may, depending upon the circumstances, be easier or more difficult to demonstrate when benefits are first realized. Where difficulty is experienced, the taxpayer should generally assume benefits are first realized at the earliest possible date in order to guard against a potential irrevocable loss of the amortization deduction due to an expired statute of limitations. If the earliest possible date is utilized and upon subsequent audit the "income producing" use date is determined to be a later year, the consequence is merely a shifting of income between taxable years.

A taxpayer who has elected the deferred method and realized benefits therefrom is required to continue ratable amortization of the research expenditures over the selected period even if benefits from a project cease prematurely.[170] If a project becomes worthless prior to the end of the amortization period, however, an application for change in accounting method requesting a shortened amortization period may be filed with the Commissioner.[171] Further, if no benefits are ever realized by the taxpayer, the Regulations suggest that a loss deduction for all deferred expenses with respect to the project is allowable in the year it becomes worthless and is abandoned.[172]

Finally, it should be noted that expenditures under Section 174(b) represent additions to basis under Section 1016(a)(1).[173] Conversely, as benefits are realized from the research and experimental expenditures, the statute provides that deferred expense deductions must be applied to reduce basis under Section 1016(a)(14).[174] Inasmuch as the statute requires that the foregoing reduction be not less

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[169] Reg. § 1.174-4(a)(3).

[170] Reg. § 1.174-4(a)(5).

[171] *Id.*

[172] Reg. § 1.174-4(a)(3). While this appears to be the proper result, it leaves the taxpayer in the often difficult position of attempting to properly identify the year of abandonment.

[173] I.R.C. § 174(b)(1).

[174] I.R.C. § 174(e).

a copy of the letter granting permission to his income tax return for the first taxable year for which the change is effective.[178]

[3] Factors Affecting the Choice of Method Under Section 174. Although the choice of method by each taxpayer may be governed by a number of subjective factors not susceptible to valuation, the following summary may prove useful in indicating the major advantages of both the current expense and deferred expense methods of treating research and experimental expenditures.

Advantages of the current expense method.

(1) The current expense method obviates the elaborate cost accounting systems required when expenditures are capitalized or deferred because the expenditures are deductible currently without regard to the success or failure of the projects to which they relate. Therefore, most taxpayers electing the current expense method will be able to use the same records for both financial and tax accounting purposes. By contrast, the project-by-project accounts necessary for the deferred expense method are cumbersome and produce additional overhead expense.

(2) The current expense method may be adopted by the simple act of deducting all research and experimental expenditures on the taxpayer's return. However, a faulty election of the deferred expense method will force the resulting expenditures to be capitalized.

(3) Research costs incurred in the development of depreciable property are deductible under the current expense method even though the project is clearly going to result in the acquisition or construction of such property for use in the taxpayer's trade or business. If, in the same situation, the deferred expense method had been elected, no Section 174 deduction would be possible until after the date on which the property resulting from the research achieves a depreciable status, and then all subsequent recoveries must be made via a depreciation deduction.

(4) Inasmuch as deductions under the current expense method are not dependent upon the success or failure of research projects, the realization of benefits and abandonment loss problems which may arise under the deferred expense method are avoided.

178 *Id.*

It is interesting to note that taxpayers involved in cases concerning the "trade or business" requirement of the statute had all adopted the current expense method. As the requirement is equally applicable to taxpayers who elect the deferred expense method, it strongly suggests that most taxpayers have adopted the current expense method.

¶ 5.4 TRADEMARK AND TRADE NAME DEVELOPMENT, ACQUISITION, AND PROTECTION COSTS: SECTION 177

Expenditures to create and develop the value of trademarks and trade names have long been considered ordinary and necessary business expenses deductible under Section 162. These costs would, for instance, include most expenses incurred to establish customer acceptance construed as goodwill accompanying a trademark.[180] By contrast, the lesser costs of actually acquiring a trademark registration including attorney's fees, design, and registration costs are generally considered to be expenses of obtaining a capital asset and as such necessitate capitalization.[181] Subsequent amounts expended to enjoin an infringer or defend the valadity of a trademark, as well as payments to a competitor in settlement of a controversy relating to the right to use the trademark, are also ordinarily treated as nondeductible capital expenditures.[182] Moreover, the unlimited useful life of a trademark or trade name precludes an allowance for amortization or depreciation of such capital expenditures.[183]

Section 177 affords the taxpayer an opportunity to treat many trademark or trade name expenditures of a capital nature as deferred expenses subject to amortizaton ratably over a period of not less than sixty months, beginning with the first month in the taxable year in which the expenditure was incurred or paid.[184] A qualifying Section 177 expenditure is one which is directly connected with the acquisi-

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[180] Thus, an expenditure for an advertising campaign to establish and promote a trademark would be currently deductible. For a discussion of Section 177, see Meyer & Creed, "Trademarks and Taxes," 8 PTC J. Res. & Ed. (Idea) 377 (1964).

[181] See, e.g., Duesenberg, Inc., 31 B.T.A. 922 (1934), *aff'd* 34 F.2d 921 (7th Cir. 1936); Stuart Co., 9 T.C.M. 585 (1950), *aff'd per curiam* 195 F.2d 176 (9th Cir. 1952); Rev. Rul. 55-158, 1955-1 C.B. 319.

[182] See, e.g., Clark Thread Co. v. Comm'r, 100 F.2d 257 (3d Cir. 1938); Danskin, Inc., 40 T.C. 318 (1963), *aff'd* 331 F.2d 360 (2d Cir. 1964).

[183] Reg. § 1.167(a)-3; Seattle Brewing & Malting Co., 6 T.C. 856 (1946), *aff'd* 167 F.2d 216 (9th Cir. 1948); Norwich Pharmacal Co., 30 B.T.A. 326 (1934).

[184] I.R.C. § 177(a) (applicable to qualifying trademark expenditures incurred after December 31, 1955).

would appear the costs of effecting a registration might constitute a capital expenditure (instead of a current expense) amortizable under Section 177.[190]

In addition, the Senate Committee's example dealing with the difference in treatment of legal costs incurred with respect to trademark acquisition in small, as opposed to large, companies is also relevant. Obviously, many larger companies are able to currently deduct initial acquisition costs such as legal expenses, technical research, and advertising costs because they can be easily merged into other operating expenses. When such services for smaller companies are performed by outside law or public relations firms or advertising agencies, they may be more readily identifiable, necessitating resort to Section 177.

Section 177 specifically precludes amortization treatment for expenditures incurred as part of the consideration for the purchase of an existing trademark or trade name.[191] However, as previously noted, if in a post-1969 transfer, such payments are contingent upon the productivity or use of the property they are usually deductible pursuant to Section 1253(d).

[2] Expansion and Protection Costs. Although the Regulations are devoid of any examples dealing with expansion expenditures, it would seem the trademark expenditure should at least extend to amounts paid or incurred in extending a trademark to a different line of products or to a new geographic area. The costs involved closely parallel the expenditures incurred in acquiring a new trademark since an expansion of an existing trademark is, in reality, an acquisition of a new trademark in a new geographic area or product line.[192] On the other hand, some payments connected with trademark expansion will not qualify for Section 177 treatment since the statute specifically precludes consideration paid for a trademark, trade name, or business.[193] Hence, a taxpayer who, for instance, attached his trademark to a new product only to discover a similar mark is being employed by a manufacturer of a related product, may be precluded from using Section 177 to amortize any payment or payments made pursuant to an arrangement whereby the other

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[190] I.R.C. § 177(b); Reg. § 1.177-1(b).

[191] I.R.C. § 177(b)(3).

[192] For example, geographical expansion may require additional registrations with accompanying legal fees. The adaptation of a mark to a new product line may require additional design costs.

[193] Note 191 *supra*.

in a situation similar to *Clark Thread* if he is able to factually demonstrate that the amount of the compromise payment was computed by reference to the cost of the infringement litigation, and therefore should properly be treated as legal expense for purposes of Section 177. In *Sanymetal Products Co. v. Carey* [200] the taxpayer paid $15,000 to an alleged infringer which consented to a perpetual injunction and stipulated in the Patent Office that the trademark was canceled. In characterizing the payment the court stated:

> "In order to be fair, it must be conceded that [taxpayer] paid the $15,000 not as a purchase of a substantial right but only as a compromise. If the case had come to trial, [taxpayer] undoubtedly would have prevailed, but the legal expenses would have been greater than they were. Therefore, in order to properly analyze this matter, we should treat the $15,000 payment as if it were an additional expense connected with the lawsuit rather than as a payment of the kind involved in the *Clark* case." [201]

A matter of considerable importance regarding the amortization of trademark expenditures under Section 177 concerns the proper treatment of litigation expenses. On a practical basis, difficulty has arisen in classifying litigation expenses as current deductions under Section 162 or as capital expenditures amortizable pursuant to Section 177.[202] Generally if the primary purpose of a particular piece of litigation is to perfect or defend title, the expenses are considered capital in nature. If title is not the primary purpose of the litigation, even though it may be involved, the expenditures may qualify as business expenses under Section 162. However, a taxpayer should be quite certain a current deduction is the proper treatment. If the claim for a current deduction is subsequently disallowed, Section 177 may also be unavailable since use of the section is dependent upon an election being made within the period for filing the return for the taxable year during which the expenses are paid or incurred. In such a situation, the result would be loss of any deduction until ultimate disposition or abandonment of the trademark.

A representative case involving litigation expenses of a capital

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[200] 57-2 U.S.T.C. ¶ 9865 (N.D: Ohio 1957).

[201] *Id.*

[202] Prior to enactment of Section 177, capital expenditures could not be written off in any way against current income as long as the trademark continued in use. For an in-depth treatment of the area see, Kragen, "Tax Aspects of Trademarks and Patents," 58 TMR 810 (1968); Mann, "Tax Treatment of Trademark Litigation Expenses," 55 TMR 39 (1965).

of a competitor was so similar to the taxpayer's mark that, when used in association with the respective goods, it would likely cause confusion and deceive purchasers. The Danskin Company sought both treble damages and an injunction requiring the defendant to stop using the Danskin trademark. Several months after a preliminary injunction was granted a settlement was negotiated whereby the defendant agreed to stop using the trademark and pay all court costs. In concluding that the litigation expenses incurred by Danskin, Inc., were not ordinary and necessary business expenses, the Commissioner did not argue that the expenses were incurred to defend or perfect title. Instead, the government insisted that the expenses should be capitalized because the effect of the legal costs was removal of an impending future loss of income by elimination of a competitor's mark, hence the benefit derived would be enjoyed over an extended period of business operations.

In affirming the Tax Court's position which supported the Commissioner, the Second Circuit pointed out that "the financial gain which [Danskin, Inc.] realized from these legal proceedings, through enhancement of the value of its registered trademark, is an increment of the sort which will endure for many years to come. . . ."[210] Moreover, the court employed Section 177 as a bulwark for its view that the expenses were capitalizable, saying that Section 177 made clear the legislative intent that the expenses of trademark litigation were to be classified as capital in nature.[211] On the other hand, the taxpayer was denied the right to deduct the expenses under Section 177 inasmuch as the election to use the section must be made within the period provided in the Code (i.e., the period for filing the return for the taxable year during which the expenses were paid or incurred).[212] As a result, Danskin, Inc., lost not only the advantage of a current deduction under Section 162, but also the advantage of amortization under Section 177.

Some commentators have urged that extension of the "duration of benefits" criterion to the area of trademark litigation expenses produces arbitrary results unless consideration is also given to the question of whether the complaint would support a judgment based

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210 331 F.2d at 361.

211 Neither Section 177 nor the relevant legislative history thereunder mentions litigation expenses connected with an infringement action. The only references to such costs are in the Regulations (Reg. § 1.177(b)(1) and § 1.177-1(b)(3) Ex. (3)). Thus, there is no clear indication by Congress that it intended to cover trademark infringement litigation expenses under Section 177.

212 I.R.C. § 177(c).

elections can be made for separate trademark expenditures relating to the same trademark.

> Example: *X* incurs design costs of $10,000 in 1973 in developing a trademark for a new product. In 1975 *X* incurs further legal expense amounting to $6,000 in defending the trademark against infringement. It would appear that a separate election can be made and a different amortization period used for the $6,000 legal expense as opposed to the design costs.

A separate election would probably not be permitted where various expenditures are an integral part of a specific transaction. For instance, if *X* incurred attorney's fees, filing fees, and other related costs in the registration of a trademark in 1973, *X* may not be allowed to segregate the costs and make a separate election for each. Nevertheless, the aggregate costs would constitute a separate trademark expenditure.

¶ 5.4c Time and Manner of Making the Election

Section 177(c) requires that the election be made within the time prescribed by law, including extensions thereof, for filing the return for the taxable year in which a qualifying expenditure is paid or incurred. It appears that neither an administrative nor judicial extension of the time period for election is available. For instance, Section 6081 states that "the secretary or his delegate may grant a reasonable extension of time for filing any return, declaration, statement or other document required . . ." by the 1954 Code. Yet, the Internal Revenue Service, in Revenue Ruling 60-183,[221] took the position that Section 6081 does not grant the Commissioner authority to extend the time for filing a Section 177 election because the election is an option provided by the Code and does not constitute a return, declaration, statement, or document required by the Internal Revenue Code or the Regulations.

Danskin, Inc.[222] is the only instance of judicial consideration regarding the right of a taxpayer to elect under Section 177. As an alternative contention, the taxpayer in that case alleged that, if the court should find that certain litigation expenses were capital expenditures, then it could elect to amortize such expenditures under the provisions of Section 177. Upon finding that the trademark litigation costs were "capital outlays," the Tax Court considered and held

[221] 1960-1 C.B. 625; William Pestcoe, 40 T.C. 195 (1963).
[222] 40 T.C. 318 (1963).

property having a determinable useful life must be amortized or depreciated, or may be deducted as a loss if the endeavor becomes worthless and is abandoned. Where the resulting property has no determinable useful life, as with secret processes, formulas, and trademarks, the costs are recoverable through a loss deduction only upon proof of worthlessness.

Expenditures which, in the absence of an elective provision, have required capitalization are as follows:

(1) Patents and Trade Secrets

(a) Engineers' salaries, rent, traveling expenses, costs of electricity, and laboratory materials paid in maintaining a research laboratory which resulted in obtaining a number of patents; [225]

(b) Legal fees for obtaining a patent and fees for the commercial testing of a patented process; [226]

(c) Costs of investgating a patented process and of obtaining a license to use it in manufacturing operations; [227]

(d) Costs of trying title to a patent or clearing title to an invention.[228]

(2) Copyrights

(a) Fees expended in connection with the issuance of a copyright; [229]

(b) Costs such as art work and the preparation of an index which are frequently paid for by the publisher, but are charged to the author's royalty account.

(3) Trademarks

(a) Costs incurred in registering a trademark; [230]

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[225] Claude Neon Lights, Inc., 35 B.T.A. 424 (1937).

[226] Patterson v. United States, 122 F. Supp. 770 (S.D. Ala., 1954).

[227] Forest Prods. Chem. Co., 27 B.T.A. 638 (1933), *acq.* XII-1 C.B. 5.

[228] Wilma M. Imno, T.C. Memo. Op. Dkt. 25736 (1952); Safety Tube Corp., 8 T.C. 757 (1947), *aff'd* 168 F.2d 787 (6th Cir. 1947); George Gordon Urquhart, 20 T.C. 944 (1953), *rev'd* 215 F.2d 17 (3d Cir. 1954).

[229] In most instances such costs are negligible. The Commissioner has held that a different rule applies in the event an author is forced to publish his own work. In such a case the costs incurred, regardless of the term of the copyright, are to be apportioned to each book in the edition in determining the profit realized on the sale of each book. I.T. 1287, I-1 C.B. 28.

[230] Rev. Rul. 55-158, 1955-1 C.B. 319.

¶ 5.5b Deduction for Loss of Value

Section 165(a) of the 1954 Internal Revenue Code provides a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." The present Regulations dealing with losses provide further elaboration:

> "A loss incurred . . . from the sudden termination of the usefulness . . . of any nondepreciable property, in the case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the year in which the overt act of abandonment or the loss of title to the property occurs." [238]

By contrast, the depreciation provision states that "there shall be allowed as a depreciation a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)." [239] The Regulations further provide that "if a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year." [240] Hence, it is clear that the factors considered in the deduction of an issued copyright or patent are dictated by the standards dealing with depreciable property. Loss in value of nondepreciable property such as trade secrets, patent applications, and trademarks not subject to elective sections is governed by the loss provision of the Code.[241] As the following discussion indicates, in most cases this distinction has little practical effect. Yet, the area has generally remained a source of confusion for taxpayers especially with respect to the proper timing of deductions arising from loss of value.

[1] Loss of Value: Obsolescence and Worthlessness.

Patents and copyrights. The depreciation provision and accompanying regulations, dealing with loss of value with regard to patents

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[238] Reg. § 1.165-2(a).

[239] I.R.C. § 167(a).

[240] Reg. § 1.167(a)-6(a).

[241] However, the elections to currently expense or amortize research and experimental expenditures, and to amortize trademark expenditures must also be considered inasmuch as such elections in many instances permit amortization of otherwise nondepreciable intangible assets.

United States patent even though the patents might become obsolete before their expiration.[248] By contrast, the depreciation regulations under the 1954 Code suggest that a United States patent may initially be depreciated over less than its full legal life of seventeen years [249] and further that obsolescence may be reflected in a shortened estimated useful life at any time during the depreciable period.[250] In part, this change was probably influenced by enactment of Section 174 granting taxpayers the election to deduct or amortize research and experimental expenditures. The simple fact that since 1954 total losses in value of depreciable property, such as patents and copyrights, have been governed solely the depreciation provisions instead of being controlled concurrently by the loss statute dealing with abandonment and the depreciation provisions (which was the case at the time of the *Hazeltine* decision) is also responsible for this change.[251] The present Regulations could also be interpreted as allowing a reduction in a patent's or copyright's useful life only when abnormal obsolescence is clearly foreseeable.[252]

As indicated, the current depreciation regulation concerning deductions for the unrecovered cost of a patent or copyright in the year in which it becomes "valueless" must encompass abandonment as well as obsolescence losses. However, unlike total obsolescence which may occur upon loss of commercial or economic usefulness of property (an event beyond the taxpayer's control) the following dis-

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[248] 89 F.2d 513, 519–20 (3d Cir. 1937), *rev'g* 32 B.T.A. 110 (1935).

[249] Reg. § 1.167(a)-6(a). This Regulation states: "The cost or other basis of a patent . . . shall be depreciated over its remaining useful life." The pre-1954 Code Regulations stated that the period is the "life of the patent." See Reg. 118, § 39.23(1)-7.

[250] Reg. § 1.167(a)-9. However, there is no specific judicial authority under present law for depreciating a patent or copyright over less than its legal life. Although there is some conflict, pre-1954 Code decisions indicate that a shortening of the useful life of a patent due to obsolescence would be proper under some circumstances. See Geroge H. Wolfe, T.C. Memo. Op. Dkt. 15,299 (May 15, 1953); Jordahl & Co., 35 B.T.A. 1136 (1937). The lack of litigation suggests that the question is generally resolved at the audit level.

[251] Prior to the adoption of the Regulations concerning losses on January 15, 1960, a deduction for the sudden termination of useful value of both depreciable and nondepreciable assets was allowed a loss deduction. The present regulations only allow such a deduction for nondepreciable property. (Reg. § 1.165-2(a).) In fact, some taxpayers in the past have unsuccessfully attempted to establish a right to deductions under both the loss and depreciation sections on the same sets of facts. (E.g., Eastern Bldg. Corp., 3 T.C.M. 267 (1944).) The courts have also rejected any deduction unless the loss of value was total. For instance, a deduction was denied for loss of the value of patents, the value of which had been reduced but not destroyed by court decrees. (Rae v. Comm'r, 147 F.2d 204 (3d Cir. 1945).)

[252] I.R.C. § 174; Reg. § 1.167(a)-9.

or some other sort of cost which is currently deductible or can be capitalized and depreciated. Thus, as with purchased trade secrets and trademarks, the only time that developmental costs associated with such property might be capitalized (and deductible only upon worthlessness) is either as a result of an Internal Revenue Service audit or where the costs are very clearly identified with the product.

[2] Determining the Year of the Loss. For many taxpayers, the most perplexing problem regarding loss deductions for obsolescence or abandonment of intangible property concerns the choice of the correct taxable year in which to take the loss deduction since a deduction for worthlessness is allowable only in the year in which the property, whether depreciable or nondepreciable, actually becomes worthless or valueless.[258] The statutory and regulatory framework is especially confusing where there is complete obsolescence of intangible depreciable property such as copyrights and patents. Recently, in *Coors Porcelain Co.*,[259] the Tax Court pointed out that due to 1960 regulatory changes, the pertinent regulation governing total obsolescence losses of depreciable assets is depreciation regulation Section 1.167(a)-8.[260] However, the appropriate statutory authority for the allowance of a deduction for an extraordinary obsolescence loss of depreciable property occurring within one year is the loss provision, Section 165(a).[261] Unfortunately, the foregoing rather complex regulations are directed primarily toward tangible depreciable property.[262] However, in a conceptual compli-

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[258] Reg. §§ 1.167(a)-6, 1.165-2; see Phillip A. Hennis, T.C. Memo. 1968-236 (cost of franchise is deductible in year business terminates); Earl J. Carroll, T.C. Memo. 1971-59 (agreement to exchange patents for stock).

[259] 52 T.C. 682 (1969), *aff'd* 429 F.2d 1 (10th Cir. 1970).

[260] The regulations under Section 165 were not adopted until 1960. Section 1.165-2, proposed July 3, 1956, withdrawn and reproposed October 8, 1959, finally adopted January 15, 1960, by T.D. 6445, provides:

> "(b) *Exceptions.* This section does not apply to . . . losses sustained upon the obsolescence of depreciable property. . . .
>
> (c) *Cross References.* For allowances under *Section 165(a)* of losses arising from the permanent withdrawal of depreciable property from use in the trade or business . . . see § 1.167(a)-8. For provisions respecting the obsolescence of depreciable property, see § 1.167(a)-9. . . ." [Emphasis added.]

Section 1.167(a)-9, as amended by T.D. 6445, filed January 15, 1960 provides: "For rules governing the allowance of a loss when the usefulness of a depreciable asset is suddenly terminated, see § 1.167(a)-8."

[261] 52 T.C. at 692.

[262] Regulation Section 1.167(a)-8 covers "retirement" which is defined as "the permanent withdrawal of depreciable property from use in the trade or business or in the production of income." Rules are also provided for the de-

act of abandonment, or the loss of the title to the property, occurs."[266]

Essentially, the regulations indicate that although abandonment must, of necessity, involve nonuse of the property, evidence of the nonuse alone is not enough to support an abandonment loss deduction. An actual intent to abandon, coupled with an act or acts of abandonment must be present. Actually, it appears the intent element is one of the most important factors on the question of the determination to abandon. Consequently, the kind of surrounding facts and circumstances which are acceptable for purposes of sustaining the subjective abandonment intent factor often become critical. For instance, the question arises as to whether a taxpayer can delay an abandonment loss deduction until a more advantageous tax year by intentially retaining on the balance sheet intangible property which otherwise might have been permanently discarded from use. It is at this point that the positions of the Internal Revenue Service and the courts diverge.

The Internal Revenue Service has attempted to thwart such a postponement of abandonment loss deductions by providing in the Regulations that the taxable year in which the loss is actually sustained is not necessarily the same taxable year in which an overt act of abandonment occurs.[267] By contrast, judicial decisions, in fixing the year of abandonment indicate more willingness to rely upon the unilateral acts of the taxpayer. For instance, in *Hazeltine Corp. v. United States*[268] the taxpayer discontinued the use of certain trademarks in 1930 because patented inventions with which they were associated became obsolete. However, the taxpayer continued to

[266] *Id.*

[267] Reg. § 1.165-2(a). Further, in Rev. Rul. 54-581, 1954-2 C.B. 112, the Internal Revenue Service pointed out that even though property is not abandoned until a later year, the deduction may properly belong in an earlier year in which the property in fact becomes worthless. Hence, the Service suggested that a taxpayer should amend his return for a prior year when it appears that a loss based on an event for such year should have been, but was not, taken on the earlier return.

[268] 170 F. Supp. 615 (Ct. Cl. 1959). But see A.J. Indus., Inc. v. United States, 388 F.2d 701 (Ct. Cl. 1967), *cert. denied* 393 U.S. 833 (1968), denying a deduction for a worthless gold mine in 1958 even though the mine was not written off the books pursuant to a resolution of the corporation's board of directors until that year when it had not been operated since 1944 and had not been maintained since 1948. Thus, it is apparent that in chosing the correct year the test to be applied is an objective one and in making a determination a rule of reason must be followed. See Boehm v. Comm'r, 326 U.S. 287 (1945); Minneapolis, St. P. & S. Ste. M. Ry. v. United States, 164 Ct. Cl. 226 (1964).

donment (self-serving as it may be), the Service is then faced with the burden of going forward with affirmative evidence to substantiate its contention. Unquestionably, such a burden is difficult to discharge inasmuch as there is ordinarily a lack of evidence if the taxpayer has done nothing other than terminate the use of the intangible property in an earlier year.

Although the taxpayer may exercise limited control in determining the year of an abandonment loss deduction, such as a deduction cannot be delayed indefinitely. An unduly long delay in claiming the allowance risks the loss of an otherwise clearly deductible item. Moreover, when a taxpayer does decide to formalize the intent to abandon intangible property he should carefully document that desire and promptly perform those acts necessary to effectuate the intention in order to establish a strong evidential record supporting the deduction in the desired year should an audit occur and litigation ensue.

The regulations are of little assistance in describing the sort of actions which might evince an intent to abandon intangible property since they seem to be aimed only at tangible property.[272] Nevertheless, in the case of nondepreciable property, it has been suggested that publication of a former trade secret, or in the case of a trademark, publication of notice of abandonment in a trade journal or newspaper of adequate circulation would be helpful. Advising persons to whom prior sales have been made or persons who might be interested in the abandonment is also important. Further, notifying the Patent Office of an abandonment of a trademark may be of some use. In the case of patents and copyrights, dedication to the public might well be a critical factor. Additionally, in all abandonments there should be the appropriate entries in the books of the taxpayer, a resolution of the board of directors, and the approval or at least notification to the shareholders. If any doubt exists as to the proper year for an abandonment loss deduction, both judicial and regulatory authority[273] indicate the deduction should be taken in the earliest defensible tax year. The deduction year and all subsequent years

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[272] Reg. § 1.167(a)-8(a). The Regulation states:

"The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account."

[273] See discussion, notes 267, 268 *supra.*

the taxpayer's country of residence (or elsewhere) to United States-source licensing income for purposes of determining the base against which United States tax is assessed.[278] In most instances the effect will be a significant reduction of United States tax liability on such licensing income.[279] The proposed regulations are set out in full and analyzed in Chapter 7. Their importance suggests that they should receive careful consideration from the foreign licensor whose United States licensing income is effectively connected with a United States trade or business.

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[278] Prop. Reg. § 1.861-8(e)(3).

[279] If a foreign taxpayer also has royalty or capital gain income from patents or trade secrets, a part of the allocation advantage is lost since research and development expenditures must also be either attributed to income items excluded from United States taxing jurisdiction or taxed on a gross basis. Prop. Reg. § 1.861-8(d)(2).

PART II.

THE TAX TREATMENT OF LICENSING INCOME ARISING FROM FOREIGN OPERATIONS

Introduction

The following material deals with the tax considerations encountered in the direct and indirect licensing of technology, trademarks, and copyrights in foreign operations with particular emphasis on:

(1) Transfers of intellectual intangible property to and from controlled foreign corporations;

(2) Determination and taxation of foreign source licensing income by the United States and foreign countries; and

(3) Extension or limitation of United States tax liability, imposition of special marginal tax rates and deemed dividend distributions applied to licensing income received by certain corporations from foreign operation.

Although the material pertains primarily to foreign operations, some topics, for instance, transfers to corporations, are also relevant to domestic licensing.

CHAPTER 6

Transfers To and From Foreign Corporations

¶ 6.1 INTRODUCTORY

Frequently, United States taxpayers initially export intangible property via a license agreement with an unrelated foreign licensee.[1]

[1] Exporters usually attempt to protect the potential royalties and profit participation in such property by inserting specific limitation clauses in the license agreement. At a minimum, these clauses limit the exclusiveness of the license to a specified period of time and provide for the reversion of all licensed rights to the transferor upon the occurence of certain contingencies. Common "snap-back" clause contingencies include: (1) the expropriation or nationalization

use in foreign investment. Moreover, if a bona fide sale of technology could be demonstrated, installment payments to the United States parent corporation would be taxed as long-term capital gain.[3]

In 1962 Congress enacted Section 1249 in order to foreclose the foregoing tax avoidance possibilities. Essentially, Section 1249 provides that any gain from the sale or exchange of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right to a foreign corporation controlled by a United States person[4] shall be taxed at ordinary income rates instead of capital gain rates.[5] The Regulations point out that sales of trademarks and trade brands are not covered by the statute,[6] but, since 1969 the application of Section 1253 to such sales or exchanges effectively precludes capital gain treatment if the amount of consideration received is dependent upon such contingencies as sales, productivity, etc.[7]

For purposes of Section 1249, the term "control" means the ownership directly, indirectly (through foreign entities), or constructively (under the attribution rules of Section 318, with certain modifications)[8] of more than 50 percent of the total combined voting power of all classes of stock entitled to vote.[9] This 50 percent control requirement may, at times, be a factor in the initiation of a planning process known as "creeping control." For example, a United States corporation may wish to protect its technology by acquiring a substantial equity interest in an unaffiliated foreign corporation to which it grants an exclusive license. The license agreement may

[3] See Pugh, "Sales and Exchanges of Foreign Patents," N.Y.U. 20th Inst. on Fed. Tax. 1305, 1319 (1962); Eckstrom & Slowinski, "Tax Planning for Foreign Licensing of United States Industrial Property Rights," N.Y.U. 19th Inst. on Fed. Tax. 969, 988 (1961).

[4] A United States person is defined as a United States citizen, resident domestic corporation, domestic partnership, estate, or trust. I.R.C. §§ 1249(a); 7701(a)(3).

[5] I.R.C. § 1249(a). Revenue Act of 1962, Pub. L. No. 87-834, § 16(c), 76 Stat. 960, *as amended* (effective for transfers after December 31, 1962), Pub. L. No. 89-809, § 104(m)(3), 80 Stat. 1539 (1966).

[6] Reg. § 1.1249-1(a).

[7] See discussion ¶ 1.3c *supra.*

[8] See I.R.C. § 958. In general, the rules of Section 318(a) apply, but there are important exceptions, notably that the family attribution rules do not apply to stock actually owned by a nonresident alien individual. See I.R.C. § 958(b)-(1); Reg. § 1.958-2(b)(3).

[9] I.R.C. § 1249(b). However, even though a foreign corporation is a "controlled foreign corporation" for deemed distribution purposes under Subpart F, Section 1249 will not apply to the sale of intangible property to such a corporation unless the seller controls more than 50 percent of the foreign corporation. See ¶ 8.1b[1] *infra.*

results from all transfers of technology and copyrights to controlled foreign corporations unless:

(1) The seller does not own more than 50 percent of the voting stock at the time of the sale;

(2) A sale or exchange has not occurred; [12] or

(3) The transfer qualifies for nonrecognition treatment under Sections 351 and 367.

¶ 6.3 NONTAXABLE TRANSFERS TO FOREIGN CORPORATIONS

Often, it is either advantageous or essential that a United States licensor transfer technology, copyrights, or trademarks to a foreign corporate entity in exchange for shares in such other entity rather than a cash royalty. In the case of a new venture, the investors may frequently not want the burden of a royalty payment and would therefore prefer the transferor of intangibles to accept dividends. Moreover, there may be a distinct advantage in a transfer of intangibles for stock instead of receiving royalty income if:

(1) The value of the intangibles can be amortized for local tax law purposes by the foreign transferee;

(2) The transaction is tax-free for United States income taxation purposes; or

(3) Less than a full payout of earnings from the intangibles would be the case due to limitations by the foreign government on the deductibility, remittance, or amount of royalty payments.

If a transfer of intangible property to a corporation in exchange for equity participation is agreed upon, and all the parties concerned are domestic, for taxation purposes a tax-free transfer will be deemed to occur if the transfer meets the requirements of Section 351. Under Section 351 property may be transferred to a corporation by one or more persons solely in exchange for its stock or securities without recognition of gain or loss if, immediately after the exchange,

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[12] For instance, no sale or exchange will occur for purposes of Section 1249 if members of a controlled group can demonstrate participation in a "bona fide cost sharing arrangement" with respect to the development of intangible property. See Reg. § 1.482-2(d)(4) and ¶ 7.4c[4] *infra.*

ferred in order to qualify as a "property" transfer for purposes of Section 351 has been the subject of recent extensive consideration by both the Internal Revenue Service and the courts. Clearly, a transfer of all patent rights by shareholders to their controlled corporation is an exchange of property for stock or securities of the corporation.[18] In Revenue Ruling 69-156 [19] the government took the position that the grant to a corporation of less than all patent rights in exchange for stock or securities will constitute a transfer of property within the meaning of Section 351 only if the grant would otherwise constitute a sale or exchange of the property rather than a license for purposes of determining gain or loss. Such a grant cannot constitute a sale or exchange, however, unless all substantial rights to the patent are transferred. Hence, the Internal Revenue Service, by requiring the equivalent of a "sale or exchange" under the capital provisions of the Internal Revenue Code, has indirectly limited the nature of intangible property which will qualify for Section 351 purposes.

In the first judicial consideration of the ruling the court of claims in *E. I. duPont de Nemours & Co. v. United States* [20] strongly disagreed with the Internal Revenue Service's position. There, duPont & Co. in 1959 transferred a royalty-free nonexclusive patent license to a wholly owned subsidiary to make, use, and sell certain products in France. Prior to the transfer, the taxpayer requested rulings from the Internal Revenue Service as to whether the proposed transaction would comply with the requirements of Sections 351 and 367. The Service ruled that the demands of Section 367 were met, but not those of Section 351 inasmuch as all substantial rights in the patents were not transferred. However, duPont proceeded with the transaction. At trial, the Treasury again claimed, on the basis of Revenue Ruling 69-156, that there was not the required transfer of property in exchange for stock necessary for a tax-free exchange under Section 351. However, the court pointed out that the concepts of non-

429 F.2d 1209 (2d Cir. 1970), *aff'g* 50 T.C. 145 (1968), *cert. denied* 400 U.S. 1008 (1971). *Contra* Rev. Rul. 64-155, 1964-1 C.B. 138.

[18] See Hertwig v. United States, 66-1 U.S.T.C. ¶ 9440 (D.C. Ga. 1966), *rev'd* 398 F.2d 452 (5th Cir. 1968); Clement O. Dennis, 57 T.C. 352 (1971), *aff'd* 473 F.2d 274 (5th Cir. 1973).

[19] 1969-1 C.B. 101.

[20] 471 F.2d 1211 (Ct. Cl. 1973).

control. However, the court pointed that there may be situations where claims of continued control may be too attenuated; for example, a large number of individual transferors may collectively retain a minimum degree of control necessary to justify Section 351 nonrecognition. Although the amount of continued control considered essential was not articulated, it is likely that a transfer of a nonexclusive patent license to a corporate joint venture would not be looked upon favorably.

(2) The decision stated that while there seemed to be no possibility of tax avoidance in the current factual context, the Service possessed the availability of Section 367 to thwart improper tax avoidance.

(3) Even if a favorable Section 367 ruling is given by the Internal Revenue Service for the transfer, any subsequent unjustified tax advantage from such a transfer may be frustrated by use of either judicial doctrines such as assignment of income or income reallocation under Section 482, a provision which the Service has recently made extensive use of with respect to patent development costs.

As a practical matter, it is unlikely that the rationale of the *duPont* decision will have extensive application beyond situations which have a similar factual context involving both nonexclusive licenses and a substantial continuation of control by the transferor via equity participation. By contrast, even if the Internal Revenue Service's "all substantial rights" standard involving the sale of patents for capital gains purposes is accepted as applicable to Section 351 transfers, recent taxpayer victories in the capital gains area concerning transfers of fragmented interests and restrictive clauses, such as protection against contingencies,[24] suggests the presence of those limitations will not preclude a qualified transfer of such property for Section 351 purposes.

[2] Special Problems Concerning Know-How. Often, transfers of technology to controlled foreign corporations of necessity consist not only of a foreign patent, but also the know-how required to convert the ideas contained in the patent into a profitable commercial operation. However, uncertain tax results may be produced by such transfers because of the uncertain nature of know-how and the fact that "know-how" is given no legal definition or separate recognition for Section 351 purposes. As used commercially, know-how encom-

[24] See discussion ¶¶ 1.3b[1], [2] *supra.*

(1) The know-how must be secret;

(2) The transfer must be exclusive and include all substantial rights within the territory of one or more countries;

(3) The grant must be in perpetuity; and

(4) The country in which the transferee operates must afford substantial legal protection to the transferor against the unauthorized disclosure and use of the secret know-how.

To the extent that technical assistance is transferred along with know-how, but is not merely ancillary thereto, the technical assistance is to be treated as services rendered. Therefore, any compensation received for such assistance is treated as ordinary income to the transferor. For instance, a portion of the stock received in an exchange of both know-how qualifying as property and nonqualifying technical assistance would be considered as received for services.[29]

Many taxpayers were surprised with the narrowness of the ruling's interpretation of what portion of know-how is includable as property under Section 351. The trade secret limitation seems especially limiting in light of much broader definitions used for usual licensing purposes in connection with the allocation of income among affiliated companies [30] and in tax treaties.[31] Also, the test for qualification of services rendered in the form of technical assistance was considered modified from past practices. Formerly, services performed in relation to know-how were excluded only to the extent of their value apart from the know-how license.[32] By contrast, Revenue Ruling 64-56 restricts services qualifying as property to those merely ancillary and subsidiary to the know-how transfer.

Additionally, the Revenue Ruling adds an abstruse requirement

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[29] Reg. § 1.351-1(a)(1)(i) and (2) Ex. (3).

[30] Reg. § 1.482-2(d)(3)(iii) which deal with transfers of technology by controlled entities treat such transfers in a broader classification known as "intangibles." Intangible property is divided into various categories which include:

(1) Patents, inventions, formulas, processes, designs, patterns;
(2) Franchises, licenses, contracts;
(3) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, and technical data.

For a detailed consideration of the area see ¶ 7.4b *infra*.

[31] See ¶ 7.3b[2] *infra*.

[32] In Rev. Rul. 55-17, 1955-1 C.B. 388, dealing with Section 351 transfers of know-how contracts which included technical service provisions to controlled foreign corporations the Service stated:

"The payments made under the contract are applicable both to the specific rights therein granted, i.e., the right to use the 'know-how,' and to services become public knowledge. Once a trade secret becomes public knowledge, it is no longer a legally protectable property interest. Accordingly, Revenue Ruling 71-564 [36] was issued to modify and amplify Revenue Ruling 64-56 by holding that an unqualified transfer of exclusive rights to use a trade secret until it becomes public knowledge qualifies as a "property" transfer under Revenue Ruling 64-56 even though it is not a transfer in perpetuity.

Finally, although rights in know-how may be retained in other countries without disqualifying a transfer, Revenue Ruling 64-56 contains no clarification of what the term "all substantial rights" embraces in the country to which the know-how is transferred. For instance, the transferor may retain a contingent right to terminate an exclusive license for failure to develop the territory or to meet industry needs. Frequently, the primary reason for granting an exclusive know-how license in exchange for stock is to give this sort of protection to the transferor's interest. The revenue ruling leaves this important area in an unsettled state. Yet, recent decisions in the capital gains area regarding transfers of fragmented interests and restrictive clauses suggest such restrictions should not preclude qualification of proprietary know-how from qualifying as property for Section 351 purposes.[37]

The characterization of know-how as property or services is usually quite important to a taxpayer when making a Section 351 transfer. Thus, many transfers are dependent upon the transferor's obtaining a favorable Section 351 ruling from the Internal Revenue Service prior to the actual transfer. However, a favorable Section 351 ruling does not necessarily preclude recognition of gain, for in any case involving the transfer of property to a foreign corporation, gain will be recognized if an advance ruling is not also obtained under Section 367, regardless of the status of the transferred technical information under Section 351. On the other hand, a favorable Section 367 ruling that a transfer does not have avoidance of United States income taxes as one of its principal purposes does not automatically mean that it qualifies as a tax-free exchange of property for stock under Section 351. Thus, if possible, two favorable rulings should be obtained, one for each statutory section.

As a practical matter, a United States taxpayer may make a know-how transfer without recognition of gain if it obtains a prior favorable ruling only under Section 367. However, if a prior favorable Section 351 ruling is not obtained, the know-how portion of the trans-

[36] 1971-2 C.B. 179.

[37] See discussion ¶¶ 1.3b[1], [2]; 6.3a[1] *supra.*

(b) The country or countries in which the transferee will be granted rights to use the trademark or trade name.

(c) Is the transferor the registered user of the trademark or trade name in those countries referred to in (b) above? Describe the rights granted to the transferor in each country in which it is a registered user, if the transferor is not the registered user in any of the countries, if any, which the transferor has with respect to use of the trademark or trade name in that country and the laws under which such rights are granted and protected.

(d) Will the transferee have the exclusive rights to use in perpetuity the trademark or trade name in each case?

(e) Will the transferee be granted all those rights granted to the transferor by each country in which the transferor claims rights exist which can be transferred? Describe any limitations on the use of the trademark or trade name, including the right to sublicense or subassign.

(f) Describe the circumstances under which the rights granted to the transferee may be revoked or otherwise terminated.[42]

(3) For information and statements required to be included in an application involving an agreement which purports to furnish technical know-how in exchange for stock in a transfer within the meaning of Section 351 review Revenue Procedure 69-19.[43]

(4) If services (i.e., technical assistance) are to be transferred, the ruling request must fully describe all services to be performed by the transferor or other party for or on behalf of the corporate transferee in connection with the transaction and the consideration to be received in exchange therefore.[44]

¶ 6.3b Section 367 Guidelines

[1] General Statutory and Regulatory Scheme. As previously indicated, an application for a Section 367 ruling prior to the transfer of intangible property to a controlled foreign corporation is essential to satisfy the Internal Revenue Service that the proposed exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. An advance ruling must be secured *prior* to the exchange. The Service has no authority to issue a Section 367 ruling after the exchange has taken place, even

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[42] Note 39 *supra,* § 3.02(5).

[43] 1969-2 C.B. 301. See also discussion ¶ 6.3a[2] *supra* and ¶ 6.3b[2] *infra.*

[44] Note 39 *supra,* § 3.02(2).

avoidance and non-tax avoidance components with the tax avoidance portion toll charged as though it were a taxable exchange.[50]

[2] Guideline Requirements for Section 351 Transfers of Patents, Trademarks, and Copyrights. The guidelines provide that a favorable Section 367 ruling will be issued when property is transferred to a controlled foreign corporation where:

(1) Such property is devoted to the active conduct of a trade or business in any foreign country,

(2) The foreign corporation will be engaged in either the purchase or sale abroad of manufactured goods or will have need for a substantial investment in fixed assets, or

(3) The foreign corporation is a less-developed country corporation holding company described in Section 902(d)(2) of the Code.[51]

Although the foregoing conditions for a favorable ruling are fairly easy to meet with respect to the transfer of most types of property, where intangible property is concerned the guidelines impose the following additional restrictions and prohibitions which must be carefully considered when requesting a ruling.

Copyrights constituting Section 1221(3) property. Section 3.02(1)(a)(i) of the guidelines provides that a favorable Section 367 ruling will not be issued for a Section 351 transfer of a copyright that qualifies as Section 1221(3) property, that is, a copyright held by a transferor whose basis in the property is determined by reference to the basis of such property in the hands of the creator. The only apparent reason for denial of a ruling for copyright transfers appears to be a desire to prevent unjustified deferral of United

[50] See Guidelines § 3.02(1)(d).

[51] Guidelines § 3.02(1). It is understood that the Service will issue a favorable Section 367 ruling in regard to the transfer of depreciable trade or business property without requiring depreciation recapture under Sections 1245 or 1250 if the transfer otherwise meets the tests of the Guidelines. Presumably, a similar result may occur with respect to the transfer of other property, such as patents and trademarks for which the transferor has previously taken deductions under Sections 174 and 177 prior to the proposed Section 351 transfer. However, the currently proposed Section 1.861-8 regulations relating to the allocation and apportionment of deductions to gross income suggest that in many instances the foreign tax credit may well be lost with respect to the operating income arising from Section 351 transfers of such intangible property to controlled foreign corporations. See discussion ¶ 7.1b *infra*.

Property transferred for sale or license by the foreign corporation. Two other types of property transfers to controlled foreign corporations that will be denied a favorable Section 367 ruling are: (1) property to be transferred under circumstances which make it reasonable to believe the property transferred will be licensed by the transferee foreign corporation after such transfer,[55] or; (2) that its sale by the transferee foreign corporation is one of the principal purposes of the transfer.[56]

Property transferred to a controlled foreign corporation for subsequent sale by the corporation is one of the classic examples of the kind of tax avoidance to which Section 367 was intended to apply. For United States taxation purposes, there is often little economic difference between the licensing of intangible property and an installment or conditional sale of the property.[57] Hence, it seems reasonable to treat intangible property transferred to a controlled foreign corporation for sale and property transferred for license similarly for purposes of Section 367 rulings.

Intangible property used in connection with United States Activities. The guidelines prohibit the issuance of a favorable Section 367 ruling in the case of:

(1) Transfers of United States patents, trademarks, and similar intangibles to be used in connection with (a) conduct of a trade or business in the United States, or (b) the manufacture in the United States or a foreign country of goods for sale or consumption in the United States,[58] or

(2) Transfers of foreign patents, trademarks, and similar intangibles to be used in connection with the sale of goods manufactured in the United States.[59]

The first rule is premised on the view that no valid reason other than tax avoidance can justify a Section 351 transfer of intangible property to a foreign corporation where the transferee will use such

[55] Guidelines § 3.02(1)(b)(ii).

[56] Guidelines § 3.02(1)(a)(iv).

[57] See Rev. Rul. 55-540, 1955-2 C.B. 39. See also the legislative history of Section 1235 which states that the purpose of the section was to "obviate the uncertainty" caused by the Commissioner's ruling in Mim. 6490, 1950-1 C.B. 9, that indeterminate payments precluded sale of the property in question; Comm'r v. Wodehouse, 337 U.S. 369 (1949) (lump-sum payments to non-resident aliens for exclusive serial of book rights in the United States held taxable as "in the nature of royalties"). See also discussion ¶ 2.1 *supra.*

[58] Guidelines § 3.02(1)(b)(iii).

[59] Guidelines § 3.02(1)(b)(iv).

a foreign trademark or patent to a controlled foreign corporation where the product covered is to be manufactured in the United States and sold abroad.

Additionally, it has become evident that the Internal Revenue Service strictly construes the phrase "to be used in connection with the sale of goods manufactured in the United States." A United States transferor can therefore anticipate difficulty in securing a favorable Section 367 ruling regarding the transfer of a foreign patent or trademark until the transferee is self-sufficient in production of the resulting product or at least has an adequate source of foreign production available to it.[63] Yet, while waiting for foreign production to become self-sufficient, the only desirable recourse may be either a delay in the transfer of the patent or trademark with a licensing agreement covering the foreign manufacture during the interim, or foreign production with sales being made for the account of the United States owner of the patent or trademark.[64]

[3] Requirements for the Section 351 Transfer of Know-How: Revenue Procedure 69-19. Revenue Procedure 69-19[65] specifies the conditions under which the Internal Revenue Service will issue favorable Section 367 rulings on Section 351 transfers of know-how to controlled foreign corporations. The procedure to be followed reflects the policies in Revenue Ruling 64-56[66] which set forth the criteria for the qualification of know-how as property for purposes of Section 351. Moreover, requests for all Section 367 rulings are also affected by Revenue Procedure 68-23,[67] discussed in the preceding subsection, which provides the general guidelines for the issuance of such rulings.

Revenue Procedure 69-19 states that a ruling request must specifically satisfy the requirements of Revenue Ruling 64-56. Accordingly, a Section 367 ruling request involving know-how should include the following information:

(1) The know-how being transferred is "property" within the

[63] See Sitrick, "Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines," 25 Tax. L. Rev. 429, 451 (1970).

[64] If appreciated tangible property is also to be transferred to the controlled foreign corporation in order to commence foreign operations, it may be necessary to secure two separate Section 367 rulings. Moreover, the interim licensing agreement should be drafted to provide for an arm's length basis in order to foreclose a possible contention that a transfer of the intangible occurred.

[65] 1969-2 C.B. 301.

[66] 1964-1 C.B. 133. See also discussion ¶ 6.3a[2] *supra.*

[67] 1968-1 C.B. 821. See discussion ¶ 6.3b[1] *supra.*

Revenue Procedure 69-19 substantially clarifies the position of the Internal Revenue Service concerning the protection afforded know-how by the jurisdiction in which the transferee is located.[70] If the request contains the information requested in the foregoing criteria, the Service will consider that the country in which the transferee operates provides the transferor with substantial legal protection against unauthorized use and disclosure of the know-how. Hence, for purposes of securing a Section 367 ruling on know-how transfers, a transferor no longer has to furnish the Internal Revenue Service with a memorandum describing the remedies available to the transferor under the laws of the country or countries in which the transferee operates in the event of an authorized disclosure or use; an opinion letter from counsel in that country (or countries) as to the accuracy of the memorandum is sufficient.[71] However, the substantive provisions and requirements of Revenue Ruling 64-56, including the "legal protection" language remain in effect and unmodified.[72]

Although Revenue Procedure 69-19 may have made the legal protection requirement easier to meet, the procedure's criterion that the know-how "represents a discovery and, while not necessarily patentable, the 'information' is original, unique and novel," is a serious deviation from trade secret law.[73] Such a requirement imposes a standard of discovery which is not required by the courts, and which is contrary to controlling state common law under which trade secrets are recognized,[74] as well as state court decisions governing

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[70] Subsequent to the issuance of Rev. Rul. 64-56, the Internal Revenue Service somewhat clarified its position regarding protection afforded by the jurisdiction in which the transferee is located via the issuance of a questionnaire known as Attachment A. However, after convincing criticism Attachment A was later withdrawn and finally displaced by Rev. Proc. 69-19. See Hilinski, "Is the IRS Blocking the Tax-Free Transfer of Know-How to Foreign Corporations," 23 J. Taxation 305, 306 (1965).

[71] Previously, the National Office required substantiation of factual representations before issuing a ruling. Frequently, this time-consuming process made know-how rulings difficult to obtain. By comparison, Rev. Proc. 69-19 expedites the issuance of rulings in that factual representations are now accepted as valid when submitted; although they may later be subject to review when the taxpayer is examined. See Block & Terzian, "IRS Issues Section 367 Guidelines for Know-How Transfers," 48 Taxes 691, 694 (1970).

[72] See ¶ 6.3a[2] *supra.*

[73] 1969-2 C.B. 302.

[74] United States Mineral Prods. Co., 52 T.C. 177, 197 (1969); Wall Prods., Inc., 11 T.C. 51, 57 (1948). Both decisions indicate that property rights exist where a formula is simple and where it may readily be broken down into its constituent elements by a competent chemist.

tain whether nonrecognition treatment is available for the transfer under the fiscal laws of the transferee country, and, if so, the conditions under which nonrecognition treatment is extended. For instance, under the Indian Income Tax Act, the assignment or exclusive license of an industrial property right, including know-how, in exchange for stock results in a capital gain that is taxed at a rate of 30 percent. By contrast, there is no Indian tax liability if know-how is transmitted or technical services are rendered outside India.

Most bilateral income tax treaties negotiated by the United States do not contain specific provisions dealing with the tax consequences of the transfer of property rights in exchange for equity participation in a corporation. Only the proposed treaties between the United States and Thailand and the United States and Israel incorporate clauses deferring tax on the value of stock acquired in exchange for patents, know-how, and related technical skills until such time as the stock is sold.[78] A similar provision was eliminated from the recently concluded treaty with Trinidad and Tobago due to the United States balance of payments conditions at the time.[79] On the other hand, in conformance with the OECD Draft Treaty,[80] many newer United States taxation treaties with developed countries contain clauses exempting from taxation gains on the sales of intangible property, including copyright, patents, know-how and trademarks, which are derived from sources within one contracting country by a resident of the other country, if the resident does not maintain a permanent establishment in the source country.[81] In the foregoing factual context, a United States transferor of copyrights, patents, know-how, or trademarks to a foreign corporation residing in a treaty-partner country will be subjected only to United States taxing jurisdiction with the consequence that the gain realized from the transfer will not be recognized if Sections 351 and 367 are applicable. However, in the absence of such a treaty clause, the country of incorporation or residence of the transferee corporation

[78] Proposed Treaty with Thailand, March 1, 1965, Art. 6(1), CCH Tax Treaties ¶ 7509; Proposed Treaty with Israel, June 29, 1965, Art. 8(1), CCH Tax Treaties ¶ 4211.

[79] Report of the Senate Foreign Relations Committee on the Convention between the United States and Trinidad and Tobago, Signed at Port of Spain, Jan. 9, 1970.

[80] OECD Draft Double Taxation Convention on Income and Capital (1963) Doc. No. C (63)87.

[81] E.g., Treaty with Finland, March 6, 1970 Art. 14(5), [1971] 1 U.S.T. 40, T.I.A.S. No. 7042, CCH Tax Treaties ¶ 2665; Treaty with France, July 28, 1967, Art. 11(3), [1968] 4 U.S.T. 5280, T.I.A.S. No. 3133, CCH Tax Treaties ¶ 2814.

would be free to apply its own domestic tax structure to the gain resulting from the transfer.[82]

¶ 6.4 SALE AND LIQUIDATION OF FOREIGN CORPORATIONS

¶ 6.4a Sales of Foreign Corporations—Section 1248

A United States taxpayer, who in a transaction qualifying under Section 351 has previously transferred intangible property such as patents or know-how to a foreign corporation in return for an equity interest, may ultimately decide to sell or exchange its equity interest, thereby causing recognition of the gain or loss for United States taxation purposes. Although the income arising from the foregoing transaction would usually be classed as capital gain, where a foreign corporation is concerned, Section 1248 may operate to convert part or all of the gain into ordinary income.

Prior to enactment of Section 1248 in 1962,[83] a foreign corporation whose earnings might have been subject to a very low foreign income tax rate could be liquidated with only a United States capital gain tax. A United States corporate shareholder additionally had a choice between receiving a dividend and claiming a deemed-paid credit or taking capital gain treatment on the sale proceeds. By contrast, Section 1248 imposes taxation at ordinary income rates on deferred foreign earnings when they are ultimately realized by a United States shareholder through disposition of its stock in a foreign corporation. Pursuant to the statute, a United States shareholder,[84] either individual or corporate, must report as dividend income that portion of the gain from the sale of its stock that is attributable to

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[82] A provision is included in all recent double taxation conventions negotiated by the United States which (in conformance with the OECD Draft Treaty) provides that any income within a contracting state to which the provisions of the convention are not expressly applicable shall be taxable by that state according to its own law. E.g., Treaty with France, note 81 *supra,* Art. 22.

[83] Revenue Act of 1962, Pub. L. No. 87-834, 79 Stat. 960, effective for sales or exchanges occurring after December 31, 1962. For a discussion see Irell & Stone, "Understanding Section 1248 – The New Tax Law Regarding Sales or Liquidations of Foreign Corporations," 1964 So. Cal. Tax Inst. 321; Gifford, "Controlled Corporations – Section 1248," BNA Tax Mgmt. Portfolio No. 240 (1970).

[84] A parent corporation qualifies as a United States shareholder if it owns 10 percent or more of the combined voting power of the subsidiary's stock at any time within the five-year period ending with the date of the sale. See IRC §§ 1248(b)(1)(A) and 951.

trade secrets.[75] A more appropriate criteria for deciding whether "property" has been transferred might be a determination of whether the conveyance of the know-how also conveys a competitive advantage on the transferee.

[4] Two-Part Section 351 Transfers Involving Intangibles. Due to foreign legal considerations, it may be necessary in certain situations to effect the transfer of an intangible, such as a patent or trademark, to a controlled foreign corporation in two parts. Initially, the United States company acquires stock in the foreign entity for cash. Thereafter, the proceeds of the foregoing stock purchase are used by the foreign company to acquire property rights from the United States transferor. For instance, the two-step transaction might involve a Japanese joint venture. The United States company agrees that it will contribute its patents and know-how for 50 percent of the stock (worth $500,000) of a new Japanese company. The joint venturer contributes $500,000 worth of buildings and equipment for its 50 percent equity interest. Technically, in the first step the United States company contributes $500,000 in cash to the new Japanese joint venture in return for 50 percent of the stock. Subsequently, the Japanese company acquires the $500,000 worth of patents and know-how from the United States company, using the $500,000 paid in by the United States company. The Treasury, consistent with judicial precedents,[76] will issue a favorable Section 367 ruling for this two-step transaction, fully understanding that in reality the two transactions constitute related steps of a single transaction; an exchange of property for stock in the Japanese company.[77]

¶ 6.3c Effects of Foreign Taxation and Tax Treaties

Where a United States transferor assigns its patent and other rights in exchange for equity shares in a foreign subsidiary in lieu of royalties or technical fees, the assignment, even if entitled to nonrecognition treatment under Sections 351 and 367 for United States taxation purposes, may have current tax consequences in the foreign country. Therefore, the transferor should be careful to, if possible, ascer-

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[75] See, e.g., K&G Oil Tool & Serv. Co. v. G&G Fishing Tool Serv., 158 Tex. 594, 314 S.W.2d 782, *cert. denied* 358 U.S. 898 (1958); International Indus. Inc. v. Warren Petroleum Corp., 248 F.2d 696 (3d Cir. 1957), *aff'g* 99 F. Supp. 907 (D. Del. 1951); Wilson v. Seng Co., 194 F.2d 399 (7th Cir. 1952). Apparently the Internal Revenue Service has mistakenly applied the "novelty" standard required for patents to trade secrets for Section 367 purposes.

[76] See, e.g., Aqualane Shores, Inc. v. Comm'r, 269 F.2d 116 (5th Cir. 1959); May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953).

[77] See Davis, *Practical Patent Licensing* 187 (1969).

meaning of Revenue Ruling 64-56. Thus, the laws of the country from which it is being transferred must provide substantial legal protection against its unauthorized use or disclosure.

(2) Any services performed by the transferor in connection with the transfer of the know-how are merely ancillary and subsidiary to the transfer. In the event the services to be performed by the transferor for the transferee are more than subsidiary and ancillary their value must be determined on an arm's length basis and not paid for with stock or securities of the transferee, unless such stock or securities are identified.

(3) A description of the know-how and statements that (a) the know-how is secret since it is known only to its owner and those designated employees who must be familiar with the know-how to carry out the activities to which it relates; (b) adequate safeguards have been taken to guard against its unauthorized disclosure; and (c) though not necessarily patentable, the know-how represents a discovery which is original, unique and novel.[68]

The foregoing representations must be based upon the following criteria, and the ruling request must affirmatively state the presence or absence of such criteria:

(1) The know-how is not revealed by the patent and 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;

(2) It does not merely represent the transferor's knowledge, or efficiency resulting from experience, or skill in manipulation, or total accumulated experience and skill;

(3) It is not merely the right to tangible evidence of information, such as blueprints, drawings, or other physical material on which it is recorded;

(4) It has not been developed especially for the transferee;

(5) It is not in the form of assistance in constructing a building or advising on the layout of equipment;

(6) It is not providing the transferee's employees with training that is essentially educational in nature; and

(7) The transferor is adequately compensated on an arm's length basis if related technical information such as current developments is furnished on a continuing basis.[69]

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68 Rev. Proc. 69-19, § 3.02, 1969-1 C.B. 821.

69 *Id.* at § 3.03.

property to conduct a trade or business in the United States. Moreover, as the following example from the guidelines illustrates, a toll charge is required for the transfer of such property even if the transferee intends to purchase the product for an arm's length price which will assure the transferor an appropriate profit margin.

> "X, a domestic corporation, produces a product in the United States which it sells to unrelated parties in the United States and abroad for a stated price per unit without X's trademark affixed . . . and for a higher price per unit with X's trademark affixed. X organizes foreign corporation Y to sell the product to parties to which X had previously sold the product with X's trademark affixed, and X proposes to transfer its United States and foreign trademark to Y in a transaction described in section 351 of the Code. Irrespective of the extent of or the absence of any price differential, a favorable ruling under section 367 of the Code will be denied in respect of such a transfer since the principal purpose for the transfer will be considered to be the avoidance of Federal income taxes by means of the purchase and resale by Y of a product produced in the United States." [60]

Similarly, a toll charge is required for the transfer of a United States trademark or patent to a controlled foreign corporation which intends to manufacture the resulting product in a foreign country and sell directly to United States consumers or to transfer for resale to United States consumers, Once again, purchase of the product for an arm's length price will not relieve the transferor of liability for the toll charge.[61]

The second rule, relating to foreign patents and trademarks to be used in connection with the sale of goods manufactured in the United States, was included in the guidelines primarily to prevent the tax-free transfer of appreciated intangible property to a controlled foreign corporation under circumstances which would, in effect, also permit the transferor to transfer to the foreign corporation a major portion of the income arising from the sale of the transferor's goods.[62] Hence, a toll charge is required for the transfer of

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[60] Guidelines § 3.02(1)(c)(i).

[61] Guidelines § 3.02(1)(c)(ii).

[62] For instance, if a favorable Section 367 ruling were issued, a major share of the sales income generated from sales of the transferor's goods would be shifted to the controlled foreign corporation inasmuch as the Section 482 regulation have the effect of allocating the major share of the price derived from the sale of a product to the corporation owning intangible property which adds value to such product. See Reg. § 482-2(e)(2)(ii) Ex. 2; Reg. § 482-2(d)(2) Ex. 2. See also discussion ¶ 7.4c[1] *supra*.

States taxation.[52] Frequently however, the guideline is not applicable in the case of commercial operations either because the transferor is one who has previously acquired a copyright in a transaction in which gain was recognized or the copyright qualifies as Section 1231 property.

Property in respect of which the transferor is a licensor at the time of the transfer. Under the guidelines, a favorable Section 367 ruling will be denied for the transfer of property to a foreign corporation if the transferor is a licensor of the property at the time of the transfer. However, this restriction does not apply to property with respect to which the foreign transferee corporation is the prior licensee.[53]

In reality, the preceding guideline creates a difficult predicament when coupled with Revenue Ruling 69-156 [54] which requires that all substantial rights to a patent be transferred in order to qualify the transfer as an "exchange" for Section 351 purposes. For instance, assume corporation *X* has granted a nonexclusive license on a foreign patent to an unrelated party, *Y*, for the sale of a product in country *C*. When the license has only a year remaining prior to expiration, *X* decides to form a wholly owned foreign subsidiary *Z* in country *C* to manufacture and sell the product in that country. To meet the requirement of Revenue Ruling 69-156, *X* must transfer all the substantial rights to the patent, including the remainder of the previously granted nonexclusive license to *Y*. *X* would also satisfy the foregoing Section 367 guideline by transferring the nonexclusive license. Yet, as the guideline in the following subsection indicates, such property will be considered tainted for Section 367 ruling purposes inasmuch as the transferee, corporation *Z*, will become a licensee of the property. Under these circumstances, an exception appears proper if the value of the nonexclusive license to be transferred is insubstantial in comparison to the total value of the patent. However, perhaps the best solution to the problem is fragmentation of the patent transfer with only that portion of the value attributable to the nonexclusive licensing agreement considered to be tainted.

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[52] Such a transfer is substantially similar to the transfer of other appreciated types of intangible property, such as patents and know-how, to a foreign controlled corporation for sale or leasing by the transferee.

[53] Guidelines § 3.02(1)(b)(i).

[54] 1969-1 C.B. 101. See also discussion accompanying note 19 *supra*.

if the transaction is one in which tax avoidance is not a possibility.[45] Where no advance ruling is requested or an unfavorable ruling is given by the Service, the consequence will generally be current taxation of any income resulting from the transfer. Moreover, a ruling will not render a transaction tax-free if the transaction is not carried out in strict accordance with the plan submitted.[46]

Prior to 1968 the Internal Revenue Service had substantially untrammeled discretion in determining those transactions which should be accorded tax-free treatment under Section 367, and the conditions under which such tax-free treatment should be granted. At times, harsh consequences resulted due to taxpayer ignorance of the rules applied in issuing such rulings. To ameliorate the problems encountered in administering Section 367, the Treasury published comprehensive guidelines in Revenue Procedure 68-23.[47] The procedure includes standards for Section 351 transfers of all intangible property to controlled foreign corporations except know-how which is dealt with in Revenue Procedure 69-19.[48]

The guidelines list various types of transactions covered by Section 367 and describe circumstances for each type of transaction which will generally result in either the issuance of a favorable or adverse ruling. An adverse ruling will usually occur if a transfer would include property which presumably might divert income otherwise subject to United States taxation.[49] Essentially, the guidelines view such property as "tainted" for purposes of Section 367. However, the presence of tainted property in a proposed transfer need not foreclose a favorable Section 367 ruling if the taxpayer is willing to pay a "toll charge" in order to neutralize the inference of tax avoidance. In substance, the transaction is fragmented into its tax

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[45] See Texas-Canadian Oil Corp., Ltd; 44 B.T.A. 913 (1951).

[46] Reg. § 1.367-1. If a change is to be made in the plan before the exchange occurs, a supplemental ruling should be obtained which holds that the change has no effect upon the original ruling and remains in full force and effect. See § 5.01, Rev. Proc. 68-23, 1968-1 C.B. 821.

[47] 1968-1 C.B. 821 (hereinafter cited as "Guidelines").

[48] 1969-2 C.B. 301.

[49] The Guidelines do not indicate that an adverse ruling will result merely because tax deferral is possible due to an effective foreign tax rate which is lower than the applicable United States rate. Evidently, the Internal Revenue Service is content to issue a Section 367 ruling and rely on the deemed distribution provisions of Subpart F (§§ 951–964) and the foreign personal holding company (§§ 551–558) structures to determine the amount, if any, of unjustifiably deferred income of the transferee that should be subject to current United States taxation.

action will be examined by the Service on audit to determine if it constituted property or services. If an advance Section 351 ruling is obtained, the transaction may still be examined on audit, but the examination will likely be limited to determining if the transfer was carried out in accordance with the plan and facts included in the ruling request.

[3] Advance Section 351 Rulings—Requirements. In the event a taxpayer decides to seek an advance ruling from the Internal Revenue Service regarding a proposed Section 351 transfer of intangible property to a controlled corporation, Revenue Procedures 70-17 [38] and 73-10 [39] should be carefully reviewed to determine exactly what information should be included in such a request. In addition to various general requirements, it should be noted that the following specific information is required in a ruling request where proposed transfers of intangibles are concerned:

(1) If patents or patent applications are to be transferred:
- (a) The country issuing the patent or in which an application has been filed;
- (b) The number of each patent or patent application;
- (c) Describe the product or process which the patent covers;
- (d) Is the transferee granted the exclusive right to make, use, and sell the product, or the exclusive right to use the process, in the issuing country for the life of the patent? [40]
- (e) Are the rights granted to the transferor by the issuing country being transferred? Describe any limitations on the use of the patent by the transferee, including the right to sublicense or subassign; and
- (f) Describe the circumstances under which the patent rights granted to the transferee may be revoked or otherwise terminated.[41]

(2) If trademarks or trade names are to be transferred:
- (a) The trade name and a description of the trademark.

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[38] 1970-2 C.B. 490.

[39] 1973-17 I.R.B. 37.

[40] Note, Rev. Proc. 73-10 was issued after the *E.I. duPont de Nemours & Co. v. United States* decision (see discussion ¶ 6.3a[1] *supra*) holding that "all substantial rights" in a patent need not be transferred in order to qualify as an "exchange" of "property" for purposes of Section 351. Hence it appears the Internal Revenue Service will adhere to its position taken in Rev. Rul. 69-156, 1969-1 C.B. 101, that the requirements for a sale or exchange of property for capital gain purposes and a transfer for Section 351 purposes are co-extensive.

[41] Note 39 *supra*, § 3.02(4).

for know-how qualification by stating that the transferee country must afford substantial legal protection against unauthorized use and disclosure to the transferor in order to qualify the property as know-how. However, exactly what constitutes substantial legal protection is not at all certain.[33] Perhaps, in recognition of this difficulty, the Service, in Revenue Procedure 69-19[34] dealing with Section 367 rulings regarding know-how transfers, expressed its willingness to issue rulings in the interest of sound tax administration provided taxpayers are able to make certain "good faith representations" one of which is that the know-how is afforded substantial legal protection in the transferee country. The Service's willingness to rely on taxpayers' good faith representations is explained somewhat by the presence of a set of strict proprietary know-how criteria set out in the revenue procedure.[35]

Even if the know-how transferred to a controlled foreign corporation constitutes property, Revenue Ruling 64-56 further indicates that the transfer will not qualify under Section 351 unless there is an unqualified transfer in perpetuity of all substantial rights to the property within the territory of one or more countries. Nevertheless, the Service has recently recognized that trade secrets do not last in perpetuity, but rather for an unascertainable period of time until they

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performed abroad in instructing and training the employees or technicians of the domestic corporation. Such payments should therefore be allocated between the license to use the 'know-how' and the personal services. Since the personal services have only a nominal value apart from the license to use such 'know-how,' all but a nominal sum should be allocated to the licensee."

[33] For instance, is an availability of an action in damages enough or is injunctive or similar relief also necessary for "substantial legal protection" to exist? Moreover, even if injunctive relief is available it may not be an adequate remedy for transferors especially where a third party is involved. This situation may occur where the transferee in a country reveals know-how to a third party in another foreign country. While the original transferor can prevent the transferee from further disclosure through damages or injunctive relief, he may not be able to prevent the third party from manufacturing the copied product and selling it in the licensee country. As a practical matter, the only feasible remedy available to the transferor might be a contract to prohibit the transferee from disclosing the know-how and to provide its best efforts to prevent its employees and suppliers from making similar disclosures. For an excellent discussion of the area see Note, "Transfers of Technical Know-How to Controlled Foreign Corporations," 5 Va. J. Int'l L. 81 (1964).

[34] 1969-2 C.B. 301.

[35] Yet, one substantive effect of the "good faith" standard is to afford the Internal Revenue Service a potential retrospective veto of its ruling if hindsight proves the taxpayer's basis for its conclusions to be incorrect. Thus both before and *after* the transfer, the ultimate burden of demonstrating that substantial legal protection exists for the transferred know-how rests upon the taxpayer.

passes a bundle of industrial property rights and services ranging from secret processes, which are clearly property for Section 351 purposes, to nonsecret commercial processes and technical assistance or services whose transfer is not eligible for tax-free treatment under Section 351.[25] Thus, know-how has become a special problem of its own with regard to its characterization as property for purposes of Section 351.

In early rulings, the Internal Revenue Service frequently held that the transfer of know-how to a controlled foreign corporation constituted a tax-free transaction under Section 351.[26] However, in 1960 the Service suspended rulings on Section 351 transfers involving know-how pending completion of a study to determine what types of know-how constituted property.[27] Not until the issuance of Revenue Ruling 64-56[28] did the Service make public its policy position on transfers of know-how to controlled foreign corporations. The Service noted that the most frequent situation regarding the issue of whether know-how constituted property for purposes of Section 351 involves a domestic manufacturer (the transferor) who agrees to assist a newly organized foreign corporation (the transferee) about to enter upon a business abroad of making and selling the same kind of products the transferor makes domestically. 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 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.

The ruling is particularly important in that it outlines the Service's views as to the distinctions between the transfer of property and the rendering of personal services. Essentially, the Service listed four requirements which must be present for know-how to be considered as property in a Section 351 transfer:

[25] I.R.C. § 351(a).

[26] Duffy, "Doing Business Abroad: Use of American Know-How," N.Y.U. 20th Inst. on Fed. Tax. 1269, 1298 (1962).

[27] The Service announced that it had suspended rulings under Section 351 with respect to "what part, if any, of a transaction in which a domestic corporation furnishes consideration (including secret processes, technical assistance, technical information, diagrammatics, designs, etc.) to a foreign corporation in exchange for stock pursuant to what is commonly called a 'know-how' agreement, constitutes a non-taxable transaction within the meaning of this section." T.I.R. 308, March 2, 1961.

[28] 1964-1 C.B. 133.

taxable transfers under Section 351 and sales or exchanges of capital assets under Section 1221 are co-extensive.

> "In order to qualify . . . 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." [21]

In view of the difference in statutory purpose the court held that there was a compelling purpose for putting aside capital gains formations in applying Section 351. Accordingly, it rejected the "sale or exchange" requirement of Revenue Ruling 69-156 and held that the grant of the nonexclusive patent license which constituted property qualified as a transfer under Section 351.

The Treasury further argued that allocating a basis to the transfer of nonexclusive patent licenses would be extremely difficult and could open opportunities for improper tax avoidance. In reply, the court noted that in other cases involving similar problems of proper allocation between retained and transferred value, the courts were able to reach satisfactory results.[22] As for improper tax avoidance, the court pointed out that Section 367 is adequate protection where the transfer is to a foreign corporation. Moreover, there are other principles, such as those relating to assignment of income, step transactions, and the power to allocate income under Section 482 which are available to thwart tax avoidance.[23]

Although the *duPont* decision represents a taxpayer success against an unduly narrow interpretation of Section 351 with respect to intangible transfers, it is no panacea to the tax planner for the following reasons:

(1) The court stressed the fact that the transfer in question was to a wholly owned subsidiary and therefore clearly met the statutory objective of Section 351 with respect to continued

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[21] *Id.* at 1214.

[22] *Id.* at 1220, n. 2. The court referred to Welsh Homes, Inc. v. Comm'r, 279 F.2d 391, 393–395 (4th Cir. 1960); Claude Neon Lights, Inc., B.T.A. 424, 442–443 (1937).

[23] *Id.* at 1220, n. 25.

such person or persons are in control of the corporation.[13] The degree of control required is specified as:

> "[T]he ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." [14]

Tax-free transfers of intangibles to a *foreign* corporation differ, however, in that successful implementation of Section 351 is predicated upon its integration with Section 367. Essentially, Section 367 provides that where property is exchanged for stock of a controlled foreign corporation, the corporation is not to be treated as a corporation unless it is established to the satisfaction of the Internal Revenue Service that the exchange was not undertaken pursuant to a tax avoidance plan.[15] Thus, failure to obtain a ruling prior to an exchange will generally produce current taxation.[16] Moreover, under a 1971 amendment, a contribution to an already existing controlled foreign corporation is considered as an "exchange" requiring a section 367 ruling regardless of whether the shareholders received anything in return.[17] Where transfers of intangibles to qualifying controlled foreign corporations do occur, the major obstacles to successful compliance with Sections 351 and 367 are:

(1) The requirement that technology, especially know-how, qualify as "property" and that there be an "exchange" within the meaning of Section 351;

(2) The transfer is not one which the Internal Revenue Service will regard as tainted under Section 367 due to tax avoidance motives.

¶ 6.3a Meeting the Section 351 "Property" and "Exchange" Requirements

[1] Transfers of Less Than All Substantial Rights in Patents. The question concerning how much of a patent right must be trans-

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[13] I.R.C. § 351(a).

[14] I.R.C. § 368(c). Section 351 does not apply to joint venture agreements between unrelated domestic and foreign corporations. Rev. Rul. 70-522, 1970-2 C.B. 81.

[15] I.R.C. § 367(a), as amended by Pub. L. No. 91-681, 84 Stat. 2065 (Jan. 12, 1971).

[16] The only exception to the above rule is a transaction involving a mere change in form by a foreign subsidiary in the second or lower tier under Section 367(b) (applicable to transfers made after Dec. 31, 1967).

[17] Section 367(d) is applicable to transfers made after Dec. 31, 1970. The subsection was enacted to overrule a prior court decision. Abegg v. Comm'r,

provide for a transfer of the technology in exchange for 50 percent or less of the voting stock, which in most cases would produce current United States taxation of the resulting gain at capital gain rates. The agreement would further provide that as royalties are earned they could be used to purchase voting stock thus assuring the United States corporation of eventual control of the foreign corporation. Developing countries, which are acutely aware of balance of payments difficulties, may be willing to substantially reduce withholding taxes on payments of such royalties. Additionally, such countries may approve of larger royalty payments in relation to the amount of technology transferred. Most significantly, for United States taxation purposes, the application of Section 1249 is avoided by shifting the acquisition of control to a point in time beyond the date of the sale of the technology to the foreign corporation. Of course, a United States licensor would have an interest in such an arrangement only if current repatriation of royalty profits is unimportant and the effective marginal rate and amount of its other foreign-source income is sufficient to prevent current United States taxation on the recontributed royalty income.

Perhaps the most important aspect of the Section 1249 structure is its pervasive coverage. Unless specifically exempted, all transfers of technology and copyrights to controlled foreign corporations, whether base companies or operating subsidiaries, fall within the ambit of Section 1249.[10] The only transfers manifestly exempted by Congress from Section 1249 exposure are those which qualify as tax-free under Section 351.[11] Hence, ordinary income treatment

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[10] This result was a compromise of conflicting legislation passed by the House and Senate. Under the original House bill (H.R. 10,650), income derived by a controlled foreign corporation from the licensing, sublicensing, sale, exchange, use, or other means of exploitation of patents and trade secrets substantially developed, created, or produced in the United States had to be included in the gross income of United States shareholders of such corporations without regard as to how the income was reinvested. The House approved this method of taxation on the theory that were it not for the lower foreign taxes abroad, the domestic company would have directly licensed the use of such rights on a royalty-producing basis and the income would, therefore, have been immediately subject to United States taxation. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 61 (1962). The Senate version of the bill was identical to the final statute with the important exception that operating subsidiaries would have been eliminated from applicability. However, the latter provision failed to survive the conference committee. H.R. Rep. No. 2508, 87th Cong., 2d Sess. 40 (1962).

[11] Section 351 provides that no gain or loss shall be recognized where transfers of property are made to corporations in which the transferors control at least 80 percent of the combined voting power immediately after the transfer. See ¶ 6.3 *infra*.

If the unrelated foreign licensee has developed a profitable market prior to termination of the license, or if contingencies require its termination, the United States taxpayer may conclude that a foreign subsidiary corporation is the best vehicle for further exploitation of the property. Moreover, there are many instances in which initial exploitation of foreign intellectual property rights may be most appropriately accomplished through the use of a controlled foreign corporation.

Generally the form rather than the timing of an intangible property transfer to a foreign subsidiary is determinative for taxation purposes. The form may be influenced by a multitude of factors including: (1) the expected difference in return from exclusive versus nonexclusive licenses; (2) whether the foreign subsidiary is an operating corporation or merely a holding company; (3) the marginal rates of tax imposed by foreign jurisdictions on different classes of income; (4) fluctuation in currencies and exchange controls; (5) the creation of a potentially powerful competitor for the worldwide market; and (6) local patent laws which may protect only "working" patents. Finally, the transferor must be cognizant of the United States income tax consequences of such transfers.

¶ 6.2 SALES OF INTANGIBLE PROPERTY TO FOREIGN CORPORATIONS

Prior to 1962, United States taxpayers often found the most profitable method of transferring technology to affiliated foreign corporations was arrived at by indirection. This entailed selling patent rights and know-how on an installment basis to a wholly owned base company in tax-haven countries such as Switzerland or Belgium [2] for relicensing to actual operating subsidiaries in other foreign countries. Such transactions, when properly structured, provided a permanently tax-deferred fund of accumulated foreign licensing profits for

of the operations of the licensee; (2) the filing of a petition for bankruptcy or insolvency by the licensee or the appointment of a receiver; or (3) the sale of the controlling interest of the stock of the licensee to a buyer not approved by the licensor. However, where a snap-back clause encompasses too much within its perimeters, there exists a clear danger that all substantial rights have not been transferred and a denial of capital gain treatment of the proceeds results. See discussion ¶ 1.3b[1] *supra.*

[2] At that time both countries taxed foreign-source royalties at relatively low rates. Additionally, Switzerland and Belguim were parties to significant networks of tax treaties which effectively exempted royalties from income taxes which would otherwise have been withheld at the source (provided the licensor had no permanent establishment in the source country).

ought to be kept open until the loss deduction issue has finally been settled.

¶ 5.6 DEDUCTIONS AVAILABLE TO NONRESIDENT ALIEN AND FOREIGN CORPORATE LICENSORS

Nonresident alien and foreign corporate licensors of intangible property, subject to United States taxing jurisdiction, are divided into two groups for deduction purposes. This division is made on the basis of whether or not the licensor is engaged in a trade or business in the United States to which the licensing receipts are effectively connected. Generally, no deductions are available to the first group of foreign licensors who are not engaged in a United States trade or business.[274] Where a foreign taxpayer is engaged in a United States trade or business, deductions are available to the extent they are allocable to income which is effectively connected to the United States trade or business. For foreign licensors, such deductions may include depreciation, acquisition, and research and development expenses. Moreover, the foreign licensor whose licensing income is effectively connected with a United States trade or business is entitled to avail itself of the Section 174 and 177 elections.[275]

For the foreign licensor, one of the most significant elements in the determination of the tax base against which United States tax will be imposed is the method for determining what deductions are "allocable" to income effectively connected with the taxpayer's United States trade or business. Until quite recently, the Treasury regulations failed to provide any definitive guidelines with respect to expense allocation.[276] However, on June 18, 1973,[277] the Treasury issued proposed regulations dealing with the allocation of research and development expenditures which appear quite favorable to foreign licensors whose United States-source licensing income is effectively connected with a United States trade or business. Essentially, the proposed regulations permit the foreign taxpayer to allocate a portion of the research and development expenditures incurred in

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[274] There are two exceptions, (1) losses taken into account in determining the excess of capital gains over capital losses taxable under Section 871(a)(2), and (2) deductions are allowed against real property income where the taxpayer has elected under § 871(d) (individuals) or § 882(d) (corporations) to treat such income as effectively connected with the conduct of a United States trade or business.

[275] I.R.C. §§ 873(a), 882(c)(1).

[276] See Reg. § 1.161-8.

[277] 38 Fed. Reg. 15840 (1973).

carry the trademarks on its books as an asset. In 1943, the Board of Directors considered the approaching expiration of the federal registration and adopted a resolution not to re-register the trademarks, but instead to abandon them. Although registration expired in 1943, affirmative action was not taken by the taxpayer until December 1944, when a second resolution was adopted to abandon the trademarks and instructing the officers to make appropriate adjustments on the books. The court of claims determined no abandonment occurred in 1943, the year the trademarks expired, because the ownership of trademarks is not based upon registration, but exists independently of such act by reason of priority of use by the taxpayer. However, the act of making adjustments on the books in 1944 to reflect the abandonment as well as public notice of the abandonment in the trade journal was sufficient to justify the abandonment loss allowance at that time.

The more recent case of *I. Lewis Corp.*[269] provides a further illustration. There the taxpayer was a cigar manufacturer who had little or no use for certain brand names for about forty years. In 1954 the board of directors passed a resolution to abandon 374 trademarks and brand names. Lewis made no disposition of the brands nor did it take any other action. The Tax Court, after discussing a large number of general abandonment cases, held that the abandonment took place in 1954 when the formal act of abandonment (i.e., the resolution of the board of directors) was adopted.

Although there are no specific decisions considering the matter, the courts have generally indicated that the same specific acts of abandonment will support an abandonment loss allowance for patents as well as trademarks. Thus, the Tax Court has refused to allow an abandonment loss where the taxpayer's only act was to stop pouring money into the development of a patent.[270] Further, the Tax Court has frequently pointed out that past decisions have generally refused to allow mere nonuse of patents as evidence of abandonment.[271]

Despite the Regulations, the case development in the abandonment area has placed the Internal Revenue Service in a somewhat vulnerable position. If the Service contends that an abandonment occurred in a year other than the year in which the deduction was claimed and the taxpayer replies by introducing evidence of aban-

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[269] 22 T.C.M. 35 (1963).

[270] Wilton Bentley, 11 T.C.M. 1196 (1952).

[271] Hazeltine Corp. v. Comm'r, 170 F. Supp. 615 (Ct. Cl. 1959).

ance with the *Hazeltine*[263] "commercially useless" approach, the regulations state that an obsolescence deduction may be taken at such time as depreciable property is withdrawn from the production of income.[264] In light of the spirit of the regulations and judicial decisions, it seems difficult to justify continuance of the Internal Revenue Service's view that although a patent may become "economically useless" prior to its expiration, only straight-line depreciation over the legal term of the property is permissible. Yet, to avoid potential conflict, the prudent taxpayer may wish to specifically abandon any patent or copyright which becomes valueless through economic obsolescence.

Much like complete obsolescence losses of depreciable intangible property, the appropriate statutory authority for allowance for an abandonment loss of a patent or copyright appears to be Section 165(a). On the other hand, the pertinent statutory regulation seems to be Section 167(a)-6 which provides a deduction may be taken for the complete loss of value of a patent or copyright in any year. Unlike the depreciation regulation dealing with obsolescence, however, the above regulation gives no guide as to what evidence is required to show complete loss in the value of the property. Hence, the taxpayer is forced to rely on prior case law and an analogy to the loss regulations governing abandonment of nondepreciable intangible property which are more detailed.[265]

In dealing with abandonment losses from nondepreciable property the relevant Regulations state:

> "A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt

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duction of losses and the nonrecognition of gain in the case of certain types of "normal" and "abnormal" retirement. Although general in nature, the rules should be considered relevant to the Internal Revenue Service's general position on such matters, especially since the regulation concerning the valuelessness of patents and copyrights (Reg. § 1.167(a)-6) is brief and provides no such guidelines.

263 89 F.2d 513 (3d Cir. 1937), *rev'g* 32 B.T.A. 110 (1935).

264 Reg. § 1.167(a)-9.

265 Reg. § 1.165-2(a).

cussion suggests that abandonment requires both a cessation of useful value and permanent withdrawal from use by the taxpayer.[253]

Trademarks and trade secrets. For nondepreciable intangible property such as trademarks and trade secrets, an ordinary loss deduction is permitted only in the event of abandonment.[254] The amount of the deduction is limited to the extent of the taxpayer's adjusted basis in the property at the time of such abandonment.[255] Moreover, the taxpayer is entitled to an abandonment loss deduction only in the taxable year in which the loss is actually sustained.[256]

In the case of intangible assets, the most frequently troubling aspect of an abandonment loss deduction is the fixing of the year in which the loss is sustained, because in contrast to the demolition of a building, for example, there is no obvious event. However, a common additional problem encountered which is primarily characteristic of nondepreciable property is determination of the basis, if any, for purposes of arriving at the amount of the loss. For example, a taxpayer who acquires a trade secret or trademark in purchasing a going business will ordinarily attribute as little of the purchase price as possible to such an asset, preferring to instead assign capital outlays to depreciable property. If the trade secret or trademark is ever capitalized it will probably be done as a consequence of an Internal Revenue Service audit. The only situation in which a high capital cost must necessarily be assigned by the taxpayer himself is the separate purchase of a trade secret or trademark.[257]

Most of the costs incurred in developing trade secrets or trademarks in the ordinary course of business are either currently deductible under Section 174 (in the case of trade secrets) or amortizable under Sections 174 or 177. If the foregoing provisions are not elected, the reason is often that the developmental costs of the property may also be reasonably viewed as general legal fees, start up expenses

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[253] Note, the terms "obsolescence" and "abandonment" are at times used interchangeably with the term "worthlessness." For instance, Regulation Section 1.165-2 is entitled "Obsolescence of nondepreciable property," yet it requires permanent cessation of use of such property for loss deduction purposes. The regulation also states that the taxable year of the "overt act of abandonment" is not necessarily the proper year in which to deduct the loss. Nevertheless, the terms actually connote different concepts. Abandonment is usually evidence of obsolescence or worthlessness; yet, property may be obsolete without being abandoned.

[254] Reg. § 1.165-2.

[255] I.R.C. § 165(a).

[256] Reg. § 1.165-2(a).

[257] See discussion ¶ 5.2a[2], [3] *supra.*

and copyrights, are framed in terms of obsolescene and valuelessness. No specific depreciation allowance is permitted for normal obsolescence as it is deemed an integral part of depreciation.[242] Further, no separate allowance for abnormal obsolescence is provided; rather the Regulations state that if obsolescence should be larger than provided for, an appropriate adjustment should be made to the depreciation rate and useful life of the property.[243] Hence, the only instance in which loss of value in a patent or copyright, due to either economic obsolescence or abandonment, may be entirely deducted currently is in a year in which the property becomes "valueless."[244]

The foregoing regulatory standards are in large measure reflective of the leading case dealing with deductions for economically obsolescent patents, *Hazeltne Corp. v. Comm'r.*[245] There, the taxpayer introduced evidence that although a patented circuit still had "technical utility" in the radio field, no one would commercially exploit it due to the advent of a superior circuit and screen grid tube. The Board of Tax Appeals disallowed a claimed deduction for obsolescence, evidently because the technical utility of the circuit did not, in the board's view, render the patent completely obsolete. However, the Third Circuit observed that "obsolescence is quite different from wear and tear. It is the process of falling into disuse and relates primarily to commercial usefulness and public acceptance, rather than to what one of the witnesses in this case termed technical utility."[246] Thus, the court of appeals concluded the obsolescense deduction was properly taken for the year in which commercial use ceased, although back royalties were received in the two succeeding years.[247]

The present Regulations follow the *Hazeltine* holding, except in one regard. In *Hazeltine,* the Third Circuit recognized that under the Revenue Act of 1928 depreciation of a patent could not occur more rapidly than ratably over the seventeen-year legal life of a

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242 Reg. § 1.167(a)-9.

243 Reg. § 1.167(a)-9. Therefore, a taxpayer is precluded from accumulating abnormal obsolescence and claiming a loss for worthlessness or abandonment at a later time. Instead, he must apparently take the additional depreciation when abnormal obsolescence occurs or lose the benefit of it under the regulatory restriction where allowable, but unclaimed, depreciation cannot be offset by a larger subsequent deduction, and that basis for loss must be reduced for all allowable depreciation. Reg. § 1.167(a)-10.

244 *Id.*

245 89 F.2d 513 (3d Cir. 1937), *rev'g* 32 B.T.A. 110 (1935).

246 *Id.* at 521.

247 *Id.*

(b) A payment made to induce another to refrain from using a trademark similar to the one in use by the taxpayer; [231]

(c) Payment for the sole and exclusive right to use a trademark and the goodwill attached to it via negotiable promissory note payable in eighteen monthly installments and overriding payments for two years if gross sales exceeded a specified amount; [232]

(d) A lump sum paid for the exclusive and perpetual right to use certain trade names.[233]

The preceding subsections dealing with Sections 174 and 177 should also be reviewed for other examples of capitalizable expenditures.

¶ 5.5a Amortization and Depreciation—Patents and Copyrights

As previously indicated, capital expenditures incurred with regard to trade secrets and trademarks are ineligible for depreciation under Section 167 inasmuch as they generally have an indeterminable useful life. On the other hand, nonqualifying Section 174 capital expenditures relating to patents and all expenditures of a capital nature with respect to copyrights are depreciable over their useful lives.[234]

As in the case of purchased patents and copyrights,[235] determination of basis for depreciation purposes may be a difficult matter, especially where an allocation of costs must be made between patents and trade secrets. Failure to establish an ascertainable cost basis may result in the loss of some or all of the depreciation or amortization for the property.[236] Moreover, selecting an estimated useful life may also prove a troublesome affair. Patents are usually depreciable over their seventeen-year useful life, whereas the upper time limit for the writeoff of a copyright is twenty-eight years.[237] In many instances, however, the factor of obsolescence may dictate the adoption of a shorter estimated useful life.

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231 Sanymetal Prods. Co., Inc. v. Cary, 57-2 U.S.T.C. ¶ 9865 (N.D. Ohio 1957).

232 Harold M. Stiles, T.C. Memo. 1967-106.

233 Seattle Brewing & Malting Co., 6 T.C. 856 (1946), *aff'd* 167 F.2d 216 (9th Cir. 1948).

234 Reg. § 1.167(a)-6.

235 See discussion ¶ 5.2a[1] *supra.*

236 *Id.*

237 This is so even though, under certain circumstances, a copyright may be renewed for a second twenty-eight-year term.

against the taxpayer with respect to its alternative contention. The Tax Court observed that from the language of the statute "it is apparent that Congress has set forth the specific terms by which an election to amortize trademark expenditures can be made." [223] Thus, an incorrect determination by a taxpayer that a trademark expenditure is a deductible expense forecloses amortization under Section 177 unless a protective election is filed with the return.

There is no printed form for purposes of making the Section 177 election. However, the Regulations provide that the statement attached to the taxpayer's return and signifying his election must contain the following information:

(1) The name and address of the taxpayer, and the taxable year involved;

(2) An identification of the character and amount of each expenditure to which the election applies and the number of continuous months (not less than sixty) during which the expenses are to be ratably deducted; and

(3) A declaration by the taxpayer that he will make an accounting segregation on his books and records of the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of each such expenditure and the amortization period selected for each expenditure.[224]

¶ 5.5 CAPITALIZATION OF EXPENDITURES

Expenditures incurred in the development, acquisition, expansion, or protection of an intangible asset, which are not currently deductible under Sections 162 or 212, are subject to capitalization in any of the following situations:

(1) Expenditures for the development of patents and trade secrets which do not qualify for Section 174 treatment, as well as expenditures for their expansion or protection;

(2) Trademark and trade name expenditures of a capital nature where a taxpayer does not elect Section 177; or

(3) Expenditures of a capital nature relating to copyrights.

Capitalized costs related to an endeavor producing intangible

[223] *Id.* at 324.
[224] Reg. § 1.177-1(c)(1).

on loss of past profits.[213] Yet, in other decisions courts have applied the doctrine on a blanket basis to allow full deduction for taxpayers where litigation activities were unsuccessful.[214] Thus, prudence dictates that potential trademark and trade name litigants seriously consider handling legal costs as capital expenditures and electing Section 177 treatment.

¶ 5.4b Method of Amortization

A trademark or trade name expenditure may be amortized over a period of not less than sixty consecutive months.[215] The amortization period commences with the first month of the taxable year in which the expenditure is paid or incurred regardless of the period selected by the taxpayer.[216]

> Example: *X*, an accrual basis calendar year taxpayer, incurs design costs of $10,000 in March 1973 in developing a trademark for a new product. Pursuant to Section 177, *X* elects to amortize the charge over sixty months. January 1973, the first month in the taxable year in which the expense was incurred, will begin the amortization period. *X* will be entitled to deduct $2,000 or 12/60 of the $10,000 expense in 1973.

Once made, the election under Section 177 is irrevocable insofar as it applies to a particular trademark or trade name expenditure.[217] As a result, the period designated by an electing taxpayer for a particular trademark expenditure cannot be subsequently changed.[218] On the other hand, a taxpayer is permitted to make separate elections for other trademark and trade name expenditures.[219] Thus, a taxpayer may choose an amortization period for each trademark expenditure. Moreover, Section 177 treatment need not be elected for certain separate trademark expenditures arising during the taxable year.[220]

Although the Regulations are not entirely clear, it would also seem that, in the absence of an indication to the contrary, separate

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213 E.g., Kragen, note 202 *supra* at 814.

214 J.R. Wood & Sons, Inc. v. Comm'r, T.C. Memo. 1962-189; Urquhart v. Comm'r, 125 F.2d 17 (3d Cir. 1954).

215 I.R.C. § 177(a); Reg. 1.177-1(a)(1).

216 Reg. § 1.177-1(a)(2).

217 Reg. § 1.177-1(a)(1).

218 Note 214 *supra.*

219 Reg. § 1.177-1(a)(3).

220 *Id.*

nature is *Food Fair.*[203] There, the taxpayer brought suit to enjoin another from using its trade name, alleging that it had established the trade name in Virginia and held the exclusive right to use it in that state. The suit was dismissed in accordance with an agreement between the parties in which the competitor agreed to discontinue the use of the trade name in Virginia. The taxpayer contended that the resulting legal expenses were incurred primarily for the purpose of protecting and maintaining its income by estopping a competitor from employing a trade name which resulted in a loss of income. The Tax Court rejected the view of the taxpayer concluding from the evidence that the suit was primarily "one to defend or protect the petitioners' title to or property right in the trade name. . . ."[204] The court further pointed out that the property settlement between the parties in no way detracted from the fact that the primary purpose of the litigation was to obtain a judicial determination as to ownership and that the attorney's fee was incurred in defense thereof.[205]

Where, as in the foregoing situation, the purpose of a suit is to determine which party has the right to use a particular trademark or trade name, the legal costs incurred by the unsuccessful party are deductible.[206] Where such litigation extends beyond the taxable year, however, legal fees incurred in years prior to the year of resolution are capital in nature and, accordingly, should be entitled to Section 177 treatment.[207] In the event the outcome is unfavorable to the taxpayer, the fees incurred in the year the final decision is rendered, as well as the unamortized portion of fees incurred in prior years, would then become fully deductible.[208]

A more serious problem of interpretation arises either when title is involved, but its defense or protection is only incidental to the primary reason for retention of counsel, or where the validity or title of the taxpayer in the trademark is not challenged by the alleged infringer. In *Danskin, Inc.,*[209] the issue was whether the trademark

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203 14 T.C. 1089 (1950).

204 *Id.* at 1093.

205 *Id.*

206 I.R.C. § 162(a); see Kornhauser v. United States, 276 U.S. 145 (1928); Ruoff v. Comm'r, 277 F.2d 222 (3d Cir. 1960).

207 Reg. § 1.177-1(b)(1).

208 I.R.C. § 1016(a)(16) requires an adjustment to basis for amounts allowed as deductions for expenditures treated as deferred expenses under Section 177.

209 331 F.2d 360 (2d Cir. 1964) *aff'g* 40 T.C. 318 (1963); see also Georater Corp. v. Comm'r, 32 A.F.T.R. 2d 73-6018 (4th Cir. 1973).

user agrees to desist from further use of the trademark.[194]

Similarly payments of a like nature for protection of an existing trademark are vulnerable to exclusion from the benefits of Section 177 on the basis that they are in effect in exchange for the purchase of additional trademark rights. For instance, in implementing the statute, the Regulations state that Section 177 is not applicable to expenditures paid or incurred for an agreement to discontinue the use of a trademark or trade name if the effect of the agreement is the purchase of a trademark or trade name.[195] An early pre-Section 177 case, *Aluminum Products Co.*,[196] is illustrative of a protection expenditure which would fall within the present regulatory exclusion from the definition of a trademark expenditure. There, a controversy arose between the taxpayer and a competitor regarding the use of the word "LIFETIME" in connection with aluminum ware. An agreement was reached whereby the competitor agreed to immediately discontinue use of the word in exchange for a $15,000 by the taxpayer. The Board of Tax Appeals observed that "by obtaining the promise to discontinue the use of the word 'LIFETIME' the [taxpayer] acquired the right to the unmolested use of the trademark."[197] Thus, the expenditures were capital in nature.

In another case, *Clark Thread Co. v. Comm'r*,[198] the taxpayer initiated equity proceedings to perpetually enjoin the use of a competing mark. In accordance with a pretrial settlement agreement, the taxpayer paid the user of the competing mark $500,000, which was based on the earnings of the recipient over a period of ten years. The court concluded that the payment was in exchange for an intangible asset of indefinite duration on the basis of the substantiality of the payment and the fact that it was founded upon the earnings of the purported infringer. Significantly, the decision also noted a long line of prior cases holding that the cost of eliminating competition is a capital asset, thus negating any assertion by the taxpayer that the payment was merely to preserve and protect the value of its existing mark.[199]

A recent case suggests that a taxpayer may yet be able to prevail

[194] See J.I. Case Co. v. United States, 32 F. Supp. 754 (Ct. Cl. 1940) (involving a $700,000 payment to a competitor to discontinue use of a confusing and conflicting trademark).

[195] Reg. § 1.177-1(b)(1).

[196] 24 B.T.A. 420 (1931).

[197] *Id.* at 424.

[198] 100 F.2d 257 (3d Cir. 1938), *aff'g* 28 B.T.A. 1128 (1933), *nonacq.* XII-2 C.B. 18; *accord* J.I. Case Co. v. United States, note 194 *supra.*

[199] 28 B.T.A. at 1149.

tion, protection, expansion, registration, or defense of a trademark or trade name; is chargeable to the capital account; and does not constitute the consideration paid for a trademark or trade name.[185]

In considering Section 177, the Senate Finance Committee indicated that the purpose of the section was to remove the undue advantage enjoyed by large corporations over small corporations where, for instance, the former employ their own legal staffs whose compensation was ordinarily deducted in connection with the acquisition of trademarks. Smaller companies unable to maintain their own legal staffs had to employ nondeductible outside counsel.[186] Therefore, the stated purpose of Section 177 is to provide equality of tax treatment among similarly situated taxpayers.

¶ 5.4a Qualifying Expenditures

[1] Acquisition Costs. The Regulations state that Section 177 will generally apply to expenditures such as legal fees and other costs in the connection with the acquisition of a certificate of registration of a trademark from the United States or other government, artist's fees, and similar expenses connected with the design of a distinctive mark for a product of service.[187] Although the Regulations do not elaborate on the scope of "other costs" it would seem the term could include a number of expenditures of an otherwise capital nature.

The construction of an effective trademark usually requires material outlays for advertising and other promotional costs. Such advertising expenditures may produce a benefit extending beyond the taxable year, yet the courts have generally considered such costs to be deductible in the year paid or incurred, inasmuch as the indefinite period over which such benefits extend precludes deferral of the expenses to future years.[188] However, where expenditures are extraordinary and obviously designed to reap benefits over several years in the future, a portion of the cost has been allocated to the capital account, thus requiring use of Section 177 if amortization is desirable.[189] Similarly, if a trademark is afforded protection via a secondary meaning acquired primarily through extensive advertising, it

[185] I.R.C. § 177(b).

[186] S. Rep. No. 1941, 84th Cong., 2d Sess. 8 (1956).

[187] Reg. § 1.177-1(b)(1).

[188] Reg. § 1.162-15(c)(1); see, e.g., Scheldon & Co. v. Comm'r, 214 F.2d 655 (6th Cir. 1954); Three-in-One Oil Co. v. United States, 35 F.2d 987 (Ct. Cl. 1929).

[189] Best Lock Corp., 29 T.C. 389 (1957), *superceded* 31 T.C. 1217 (1959); X-Pando Corp., 7 T.C. 48 (1946).

(5) Current expenditures may be deducted against current income from all sources. In the case of individuals in high tax brackets, especially those persons who are members of partnerships with income from other sources, this feature may be of great significance.

(6) Finally, the possibility of a capital loss as opposed to a deduction against ordinary income is avoided under the current expense method. If the deferred expense method is in effect and a capital asset is developed as a result of the research and experimentation, its tax basis is equal to the net balance in the deferred expense account attributable to that property. A sale of the property at a loss would produce a capital loss, (unless section 1231 is applicable) [179] which may be of limited tax utility. The current expense method avoids this problem since all expenditures in respect thereof will have been previously written off and the taxpayer will, hence, have a zero basis for the property.

Advantages of the deferred expense method.

(1) The greatest use of the deferred expense method occurs in the case of a new enterprise where it may be advantageous to delay the tax benefits of the deduction for research and experimental expenditures until such time when they can be offset against ordinary income.

(2) It is conceivable that a personal holding company which expects royalty income from current research work will benefit from the deferred expense election because the net operating loss deduction does not apply in arriving at undistributed income.

Summary of relevant factors. In general, taxpayers would be well advised to adopt the current expense method for the bulk of their research expenditures and to reserve use of the deferred expense method for a particular project or projects calling for such treatment. The current expense method is simple to adopt, relatively simple to use, and presents fewer possibilities for controversy with the Internal Revenue Service upon audit. In no event should the deferred expense method be elected unless it can reasonably be anticipated that the project will be successful and unless the related costs can be reasonably ascertained.

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[179] The reasoning is that a Section 174(b) asset is not "properly used in the trade or business" within the meaning of Section 1231(b) because it is not subject to depreciation under Section 167.

than the amount allowable, it is important to be certain that the full amount of available amortization deductions are claimed by the taxpayer in each year.[175]

Change from the deferred expense method to a different method. A taxpayer who has elected the deferred expense method and wishes to change from that method to a different method, or to a different period of amortization for deferred expenses, must obtain the permission of the Commissioner. The requested change may apply to all projects or to selected projects.[176] Additionally, permission is required to make an election to use the deferred expense method for a project undertaken and capitalized in a prior year since this is a change in method from capitalization of the expenditures. A request for permission to change methods or amortization periods, addressed in the same manner as explained in the previous subsection, and filed not later than the end of the first taxable year in which the different method or amortization period is to be used must include the following:

(1) The name and address of the taxpayer;
(2) The first taxable year to which the change is to apply;
(3) The total amount of research or experimental expenditures attributable to each project;
(4) The amortization period applicable to each project;
(5) The amortized expenses attributable to each project at the beginning of the taxable year in which the application is filed;
(6) The new method of treatment proposed for each project (whether current expense method, deferred expense method, or capitalization under prior law) and proposed new amortization period, if any;
(7) Such information as will idenitfy the project or projects to which the expenditures affected by each change relate; and
(8) The reasons for each change.[177]

The request must be signed by the taxpayer or his duly authorized representative. If permission is granted the taxpayer must attach

[175] As reduction of basis is required only to the extent that amortization results in a reduction of taxes, alertness in record-keeping is essential.

[176] Reg. § 1.174-4(b)(1).

[177] Reg. § 1.174-4(b)(1) and (2).

(4) The amount of all research or experimental expenditures paid or incurred in the taxable year for which the election is made;

(5) The number of months (not fewer than sixty) selected for amortization of the deferred expenses for each project; and

(6) A statement that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.[165]

It should be borne in mind that the taxpayer has the burden of satisfying the Internal Revenue Service that only items properly includable in the deferred expense method have been so treated. Moreover, the expenditures covered by a deferred expense election may include capital items whose cost could not otherwise be recovered through depreciation deductions. It is therefore essential that all taxpayers utilizing the benefits of Section 174 maintain careful and accurate records.

Period of deferral and length of write-off. As indicated above, the statement attached to the return for the year in which the taxpayer elects to defer the expenditures must designate the number of months (not less than sixty) selected for amortization of the deferred expenses for each project. However, unless the taxpayer standardizes by using the minimum five-year period for all projects, selection of varying periods may become a difficult matter. The amortization period originally selected must be adhered to in the absence of an authorization to change to a different period.[166]

Expenditures deferred under Section 174(b) are deductible ratably [167] over a period selected by the taxpayer (which may be not less than sixty months) beginning with the month in which the taxpayer first "realizes benefits" from the expenditures.[168] As the election must be made shortly after the expenditures are incurred, a substantial period of time may elapse between the taxpayer's election and his first enjoyment of benefits from the expenditures. Therefore, it is important to comprehend when benefits are assumed to have been realized. The Regulations take the position that, "in

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165 Reg. § 1.174-4(b)(1).

166 See Reg. § 1.174-4(b)(2) and subsequent discussion for requirements governing applications for change from the deferred expense method to a different or for a change of amortization period.

167 An example from the Regulations indicates that the word "ratably" should be construed to mean "straight-line." Reg. § 1.174-4(c).

168 I.R.C. § 174(b)(1).

useful life since it determines depreciability. Thus, the cost of non-patented end products of research, such as secret processes and formulas whose life is indefinite, qualify for the deferred expense election.[155] Research expenditures which produce a patent or other property having a determinable useful life must be capitalized and depreciated.

Where a deferred expense election is in effect and research is undertaken on a project which eventually produces depreciable property, the Regulations provide a "cut-off" rule which reverses the deferred expense treatment prospectively.[156] Under the Regulations when property (for instance, a patent issued in respect of a developed process) takes on a depreciable character, the balance in the deferred account attributable to that property becomes its remaining tax basis for the purpose of subsequent depreciation deductions.[157]

> Example: A manufacturer develops a special process which is marketable. He elects under Section 174(b) to defer the research costs related to the process. A patent is applied for, which is granted two years after the manufacture. While the patent is pending, the manufacturer is entitled to defer costs. On the date the patent is granted, amortization under Section 174(b) ceases because the statute expressly makes the deferred expense method inapplicable. However, deductions under the deferred method are permitted for all periods prior thereto and depreciation allowances are allowable thereafter.[158] If the process had been developed, but no benefits had been realized prior to the issuance of a patent, the issuance of the patent would merely convert the amounts previously credited to the deferred-expense account into the cost basis of a thereafter depreciable asset.

Electing the deferred expense method. The deferred expense may be elected by the taxpayer without the consent of the Commis-

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[155] Section 174 is particularly helpful for these expenditures since there was no satisfactory treatment for them under prior law. Under prior case law no deduction was allowed unless and until such an asset was effectively abandoned. See Reg. § 1.174-2(b)(1).

[156] Reg. § 1.174-4(a)(4).

[157] The treatment of patent development expenses described above appear reflective of the Treasury view with respect to the entire matter. When depreciation Regulation Section 1.167(a)(6)(a) was proposed the 1939 Code regulatory reference to "development or experimental expenses" was replaced by an allusion to research and experimental expenditures under Section 174.

[158] Reg. § 1.174-4(a)(4).

records of the research or experimental expenditures to which the change in method is to apply; and

(7) A statement of the reasons for the change.[142]

The request must be signed by the taxpayer (or his duly authorized representative) and filed not later than the last day of the first taxable year for which the change in the method is to apply.[143] If permission to make the change is granted, the taxpayer must attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.[144]

[2] Adoption of the Deferred Expense Method. Under Section 174(b), a taxpayer who has not adopted the current expense method may elect to defer the cost of some or all of his research and experimental projects and amortize them ratably over a period, to be selected by the taxpayer, of not less than sixty months beginning with the month in which the taxpayer first realizes benefits. In contrast to adoption of the current expense method under Section 174(a), an election of the deferred expense method need not be of fixed scope. If the taxpayer elects to bring all of his research projects under Section 174(b), he is bound by that election in future years.[145] On the other hand, the taxpayer may prefer to limit his election to certain specified projects. Projects not covered by the election would be capitalized and governed by prior law.[146]

As a taxpayer who follows the individual project approach does not become frozen under Section 174(b) with respect to subsequent projects and needs no consent to elect the deferred expense method or to capitalize, he has a new choice for each new project.[147] Hence, it would seem prudent to not make a broad election under the deferred expense method, but rather to confine the election to individual projects even where in a given year the election to use Section 174(b) eventually encompasses all projects started during the year. Nevertheless, the taxpayer utilizing the deferred expense election on a project-by-project basis should be careful to make the

142 *Id.*

143 *Id.*

144 Reg. § 1.174-3(b)(3).

145 Reg. § 1.174-4(a)(5).

146 *Id.*

147 However, the choice is limited to the deferred expense method or capitalization. The current expense method under Section 174(a) can only be elected with the Commissioner's consent under the foregoing circumstances. (See discussion in the preceding subsection.)

benefit to be derived from currently deducting the remainder of his research costs.[134]

To the extent the current expense method is in effect, all expenditures qualifying thereunder must be deducted in the proper taxable year. For instance, in Revenue Ruling 58-74 [135] the Internal Revenue Service warned that amounts not deducted on the original return or by means of a timely filed amended return or refund claim will be irrevocably lost upon the running of the statute of limitations. As the current expense method can not be altered, except with the permission of the Commissioner, alternative tax methods of treating such expenditures, either as deferred expenses under Section 174(b) or as capital expenditures are not available to the taxpayer.

Adoption with consent. A taxpayer who fails to adopt the current expense method in the first taxable year in which he could have done so may apply for the Commissioner's consent to adopt the method in a subsequent year.[136] The request to adopt the current expense method must be submitted in writing to: Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224. The request shall include:

(1) The name and address of the taxpayer;
(2) The first taxable year for which the adoption of the method is requested; and
(3) A description of the project or projects for which research and experimental expenditures are to be, or have already been, paid or incurred.[137]

The request must be signed by the taxpayer (or his duly authorized representative) and filed not later than the last day of the first taxable year for which adoption of the method is requested. If the change is granted, it is applicable to that year and all subsequent years. Prior years remain unaffected.[138]

Change from the current expense method to a different method. A taxpayer who has adopted the current expense method of treating

[134] Reg. § 1.174-3(a). On the other hand, the Regulations make it clear that permission will not be granted to utilize the two different methods in the same taxable year in respect to portions of the expenses on a single research project.
[135] 1958-1 C.B. 148.
[136] I.R.C. § 174(a)(2)(B); Reg. § 1.174-3(b)(1).
[137] Reg. § 1.174-3(b)(2).
[138] *Id.*

However, the final sequel to *Snow* is the very recent decision in the case by the Supreme Court which reversed both the Tax Court and Sixth Circuit and allowed Snow the deduction under Section 174(a).[126] The decision is good news for individuals looking for tax shelters, but it is not very helpful to tax practitioners who hoped the Supreme Court would set out some definitive guidelines for the determination of at what point an individual is considered to be engaging in a trade or business. In concert with *Cleveland,* the Court correctly recognized the distinctions between the Sections 174 and 162 criteria and based its decision on the legislative history of Section 174, especially the fact that Section 174 was intended to be an incentive to small and growing businesses to engage in research and development. Moreover, the court apparently concluded that the strong legislative history favoring Section 174 deductions also overrode any tax shelter or avoidance considerations.[127]

¶ 5.3c Election of Research and Experimental Expenditure Treatment

[1] Adoption of the Current Expense Method.

Adoption without consent. As previously indicated, Section 174(a)(1) permits the taxpayer to deduct research or experimental costs as a current expense of the year in which incurred or paid. A taxpayer wishing to deduct his expenses currently must "adopt" the method in his return for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which he has research or experimental expenditures.[128] Pursuant to the Regulations, adoption of the method merely requires that a deduction for the expenditures be claimed in the return.[129] As a further clarification of the Regulations, the Internal Revenue Service, in Revenue Ruling 58-356,[130] essentially held that where research and experimental expenditures are deducted in the income tax return of a taxpayer for the first taxable year (after 1953) during which such expenditures are paid or incurred, the current expense method shall be deemed to have been effectively adopted by the taxpayer although such deduction is not shown as a separate item in the return.[131]

126 94 S. Ct. 1876 (1974).

127 *Id.* at 1879.

128 I.R.C. § 174(a)(2)(A).

129 Reg. § 1.174-3(b)(1).

130 1958-1 C.B. 104.

131 The case of adoption represents a considerable relaxation of the formal

Tax Court rejected the taxpayer's attempt to deduct the payment to the research laboratory under Section 174. The court pointed out that the undertaking was separate from any existing business during the tax year in question. Therefore, the expenditure was connected with preparations to enter into a new business rather than with the conduct of an existing business.[118]

On the other hand, under some circumstances the formation of a joint venture may bring a financier's contributions within the range of the Section 174 election. In *Cleveland v. Comm'r*,[119] a financier-attorney did not personally participate in the development of an invention involving an inorganic binding material. However, for a period of years the taxpayer did make extensive loans to the inventor (Kerla) to finance the research, carried on negotiations leading to the proposed transfer of rights to the invention, and prepared legal documents concerning such transfers. After all this the financier and inventor entered into an agreement creating a joint venture. Reversing the Tax Court, the Fourth Circuit held that expenditures for research and development made by the taxpayer after the effective date of the agreement were deductible under Section 174. The court stated that "Cleveland was thereafter engaged with Kerla in the trade or business of promoting the commercial development of the invention in which Cleveland was the owner of a participating one-half interest." [120]

Although not entirely clear from the opinion in *Cleveland*, it strongly appears that the basis of the appellate court's decision was that execution of the joint venture agreement effectively placed the taxpayer in a pre-existing inventing business as an equal participant with the inventor, notwithstanding the fact that the taxpayer himself was not directly involved in the inventing process. This approach to Section 174 deductibility of expenditures by financiers was rejected by the Sixth Circuit in *Snow v. Comm'r*.[121] In *Snow* the taxpayer was a highly paid executive who in 1966 invested $10,000 in the Burns Investment Company, a limited partnership. In return for the investment in Burns, the taxpayer received a 4 percent interest in the profits of the partnership. The inventor had a 50 percent interest as general partner and a 34 percent interest as a limited partner. Burns Investment Company spent some $36,000 during 1966 to develop a trash burner which the company elected

118 *Id.* at 1100–1101.

119 297 F.2d 169 (4th Cir. 1961), *rev'g* 34 T.C. 517 (1960).

120 *Id.* at 173–174.

121 482 F.2d 1029 (6th Cir. 1973), *aff'g* 58 T.C. 585 (1972).

patent search will probably have little effect.[106] Another factor, continuity and regularity of inventive activities, combats the notion that costs incurred by the taxpayer were preparatory to entrance into a trade or business. In *Johan A. Louw*,[107] evidence that the taxpayer spent twenty-five hours a week in inventive activities was deemed continuous and extensive activity that characterizes a business despite the fact the taxpayer also maintained other full-time employment. Further, most decisions have held that a taxpayer need not have received income from his inventions; however, the profit motive must be present although not necessarily reasonable.[108] The lack of profits was deemed conclusive in *Henry P. White*[109] when linked to the taxpayer's independent wealth, long history of losses, and disproportion of receipts to expenditures. Moreover, more than a mere statement of intent must be shown. In *Myron E. Cherry*,[110] the Tax Court found that although the taxpayer's stated intent was to make a profit, his overt intentions were contra. Finally, less significant factors that appear to have influenced court decisions as to what constitutes an inventing trade or business seem to hinge on the presence of business mannerisms such as record-keeping selling activities, and market research. For instance, in *Charles H. Schafer*[111] the taxpayer presented no record of costs. The court also noted a lack of initiative in marketing the product as an indication of no serious business enterprise. By contrast, in *Johan A. Louw*[112] the court was impressed by the fact that the taxpayer pursued his activities in a businesslike manner.

Where inventing activities are not sufficient to constitute a separate trade or business, individuals seeking Section 174 treatment in connection with such activities must demonstrate a proximate relationship to their regular business activities. For instance, in *Stone v. United States*,[113] a consulting engineer installed in his residence, part of which was devoted to his trade or business, certain fixtures including a therapeutic bath, an air-conditioning system, and a concealed

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106 E.g., Myron E. Cherry, T.C. Memo. 1967-137, Eugene G. Magee, T.C. Memo. 1973-271.

107 Note 101 *supra*.

108 E.g., Joe H. Cunningham, T.C. Memo. 1968-242; Erwin G. Bailey, 22 T.C.M. 1255, T.C. Memo. 1963-251.

109 23 T.C. 90 (1954), *aff'd* 227 F.2d 779 (6th Cir. 1956), *cert. denied* 351 U.S. 939 (1956).

110 26 T.C.M. 557, T.C. Memo. 1967-137.

111 23 T.C.M. 997, T.C. Memo. 1964-156.

112 T.C. Memo. 1971-326, 30 T.C.M. 1421.

113 70-2 U.S.T.C. ¶ 9631.

tion than any other provision of Section 174, primarily with respect to the question of whether the taxpayer seeking a deduction for research and experimental expenditures was engaged in a trade or business to which such expenditures were reasonably connected.

As corporations are by definition considered to be engaged in trade or business, the restriction has had little significance for corporate taxpayers. However, in *Best Universal Lock Co., Inc.*,[95] the Commissioner contended that Section 174 was not intended to cover research and development expenditures where a corporation was seeking to develop a new product unrelated to its past line of products.[96] In allowing the deduction, the Tax Court rejected the Commissioner's view that a corporation's trade or business, like an individual's trade or business, should be considered, for Section 174 purposes, to be confined to current activities.[97] Moreover, the court stressed that the congressional purpose for enactment of Section 174 "was to encourage taxpayers to carry on research and experimentation."[98]

Individuals, in particular amateur inventors and independent financiers, have found the trade or business requirement to be a more difficult obstacle. Individual professional inventors with a long history of inventing for profit have been allowed to deduct their expenses on the grounds that they are engaged in the trade or business of inventing and expected to make a profit on the venture.[99] Amateur inventors have had to deal with decisions under prior law which held that such individuals were not engaged in the business of inventing and selling their patents.[100] Recently, however, on sev-

95 45 T.C. 1 (1965), *acq.* 1966-2 C.B. 4.

96 *Id.* at 10.

97 The Internal Revenue Service, by its acquiescence in the *Best* decision and a subsequent ruling, Rev. Rul. 71-162, 1971-1 C.B. 97, has apparently concluded that corporations with established research programs (and individuals with a long history of inventing for profit) meet the trade or business requirement of Section 174.

98 See S. Rep. No. 1622, 83rd Cong., 2d Sess. 33 (1954).

99 See, e.g., Best Universal Lock Co., Inc., 45 T.C. 1 (1965), where the controlling shareholder, Frank E. Best, conducted research concerning an "isothermal air compressor," even after the corporation dropped the project. He was then over eighty years old and had been engaged in the trade or business of inventing for at least forty-five years. He held over 100 patents, most of them in the locking art. The Tax Court allowed Best to deduct his expenses incurred in the isothermal air compressor project under Section 174 on the grounds that he was clearly engaged in the trade or business of inventing and expected to make a profit on the venture. See also Erwin G. Bailey, T.C. Memo. 1963-251.

100 See, e.g., Henry P. White, 23 T.C. 90 (1954); Beach v. Shaughnessy, 126 F. Supp. 771 (N.D.N.Y. 1954).

and the construction of the end product.[87] Moreover, where property is developed and constructed for the taxpayer by another there is a further restraint placed upon the availability of the Section 174 election by the Regulations. A taxpayer is permitted a deduction for research expenditures only if the depreciable property constructed for the taxpayer by another has been "made upon the taxpayer's order and at his risk."[88] This limitation is more fully explained in the Regulations as follows:

> "No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production."[89]

The limitation that the deduction be permitted only if the performance or economic utility of a new plant or product be at the taxpayer's risk seems consistent with the policy that a taxpayer should be prevented from deducting research costs incurred by an outsider on his own behalf rather than on behalf of the taxpayer. Although the requirement that no performance guarantee be "express, implied, or imposed by local law" also appears reasonable, the only practical way of meeting the requirement is insertion of a clause in the research agreement which specifically disclaims all guarantees or warranties in terms that satisfy local law.[90]

Finally, the Regulations set forth two examples of the above mentioned limitations which only tend to foster further confusion, especially in the area of process guarantees:

> "For example, if a taxpayer orders a specially built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new

[87] However, the taxpayer must rely on the cost breakdown provided by the contractor which should be acceptable if reasonably made.

[88] Reg. § 1.174-2(b)(3).

[89] *Id.*

[90] Of course, many purchasers would rather have the guarantees than a Section 174(a) deduction.

[2] Nonallowable Expenditures.

Purchase of depreciable property for use in research. In addition to the constraints placed upon the term "research and experimental expenditures" by the Regulations, the statute also specifically excludes from treatment thereunder all expenditures for the acquisition or improvement of land, or for the acquisition of property to be used in connection with research or experimentation which is subject to depreciation or depletion, and to which beneficial title is taken and held in the taxpayer's name.[79] The purpose of the exclusion seems to be to prohibit current deductions for land, buildings, equipment, and similar assets that will continue to have a use even after the experimental use for which they were originally acquired, or for permanent research property which may be utilized for a number of research projects. Thus, a taxpayer is precluded from employing Section 174 to currently expense the full cost of an entire laboratory building or building site in the year of acquisition. Moreover, normal depreciation allowances may not be avoided by electing to amortize the cost over a period of not less than sixty months.[80]

Although expenditures for the acquisition of depreciable property to be used in research and experimental activities are precluded from Section 174 treatment, annual depreciation allowances under Section 167 generally constitute research and experimental expenditures under Section 174 which may be either currently deducted or treated as deferred expenses.[81] Hence, the foregoing treatment has tax significance only where the deferred expense method is elected since both Sections 167 and 174(a) give rise to current deductions. If the deferred expense method is elected, depreciation would be accumulated as a deferred cost until the point at which benefits are derived.

Depreciable property resulting from research. In many instances, research conducted by a taxpayer or by others for a taxpayer results in depreciable property as an end product which is or can be used in the taxpayer's trade or business. Where the research is conducted by the taxpayer, the Regulations authorize the deduction of that portion of the expenditures connected with the development of the

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79 I.R.C. § 174(c).

80 I.R.C. § 174(b)(1).

81 Note 78 *supra.*

(4) In acquiring another's patent model, production, or process.[70] For instance, the Internal Revenue Service has ruled that the Section 174 election is not available for costs incurred in obtaining foreign patents where the inventions are covered by United States patents and patent applications owned and developed by others.[71]

A difficult factual question concerning proper segregation of costs arises where expenditures relate to both experimentation and product market development costs.[72] Under such circumstances the burden is upon the taxpayer to demonstrate what portion of the expenses are properly deductible under Section 174. Although no important tax results will ordinarily occur if the expenses are otherwise deductible under Section 162 as ordinary and necessary business expenses,[73] a subsequent reclassification of research and experimental expenses as capital expenditures may produce serious consesequences.[74] Thus, if a Section 174 election is anticipated, the taxpayer should be careful to make the necessary segregation of costs as they occur and further be prepared to support the basis of the allocation.

The cost of research and experimentation performed on behalf of the taxpayer by independent organizations can qualify for the Section 174 election provided the taxpayer does not gain ownership of the assets and they remain the property of the outside research organization after the research for the taxpayer has been completed.[75] The Regulations provide the following examples:

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[70] Reg. § 1.174-2(a)(1).

[71] Rev. Rul. 66-30, 1966-1 C.B. 55. Apparently, the Treasury views any expenses incurred in connection with the costs of acquiring patents of others as nondeductible under Section 174.

[72] For instance, an allocation question might arise with regard to costs connected with the construction of an experimental model where the model is used as a sales promotion demonstrator or where more than one model is constructed. In such an event, a factual determination would be essential to ascertain if all or part of the original construction costs qualify for Section 174 treatment.

[73] Correct characterization of expenses may become relevant where the deferred expense method has been elected under Section 174(b). Deductibility of deferred costs which are subsequently reclassified as Section 162 expenses will be precluded if the proper year for deduction is barred by the statute of limitations and the Section 1311–1315 mitigation provisions are unavailable.

[74] E.g., Coors Porcelain Co., 52 T.C. 682, 698 (1969).

[75] Reg. § 1.174-2(a)(3). With respect to ownership of depreciable assets and its effect on Section 174 deductibility. See discussion in the following subsection.

In an effort to give relief to taxpayers who might not otherwise recover their costs and also to remove confusion from the area, Congress enacted Section 174 in 1954. The section permits taxpayers an election to treat patent and know-how research and experimental expenditures incurred in connection with a trade or business as follows:

(1) As currently deductible in the year in which they are paid or incurred; [59] or

(2) As referred expenses amortizable over a sixty-month period commencing during the year the invention or product begins to produce income.[60] The foregoing method is most useful in the case of a new business where a deduction from operating income constitutes part of an operating loss during the first few years of operation which might not be fully utilized later in profitable years.

If the taxpayer does not exercise either of the two elections described in Section 174, he must capitalize the full amount of the research and experimental expenditures and depreciate them over a longer time period in the case of patent expenditures, or recover them upon the asset's sudden termination of usefulness if know-how is involved.[61]

¶ 5.3b Section 174—Election Prerequisites

[1] What Constitutes Research and Experimental Expenditures. Section 174 contains no general definition of research and experimental expenditures and makes no effort to distinguish between basic and applied research. The Regulations, however, make an effort to delineate the area by limiting the term "research and experimental expenditures" to expenditures which represent research and

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plicity of reactions to research and development expenditures were a result of conflicting characteristics of the expense. On one hand, amounts expended during a tax year to attain future benefits should be capitalized. However, research and development also represents a cost whose benefits are unpredictable and as such require an immediate write off. See Blake, "Research and Experimental Costs," N.Y.U. 16th Inst. on Fed. Tax. 831, 832 (1958).

[59] I.R.C. § 174(a)(1).

[60] I.R.C. § 174(b). When the deferred expense election is made, the expenses are added to the basis of the property [§§ 174(b)(1), 1016(a)(1)], and as the deductions are allowed ratably, the amounts are subtracted from the basis of the property [§§ 174(e), 1016(a)(14)].

[61] See discussion ¶ 5.5 *infra.*

corporation has no obligation to pay them,[46] or they are paid as part of the purchase price for the asset.[47]

Another basic requirement of deductibility is that there must be some kind of right owned and transferred by the shareholder to the corporation to which the corporation would not otherwise be entitled. For instance, amounts paid for the use of a shareholder's patentable secret formula were allowed as a deduction where the formula was not patented for fear that a workable competing formula might be developed.[48] By contrast, deductions were denied for royalty payments by corporations to shareholders for the use of an unpatentable selling idea[49] or expired patents[50] since the stockholders had no property rights which supported the payments. Moreover, in *Thomas Flexible Coupling Co.*[51] a deduction was denied for additional royalties applicable to subsequent improvements covered by the original licensing agreement. However, a deduction for such payments was allowed after the parties entered into a supplementary agreement which a state court found created new rights and liabilities.[52]

In at least one context, the Tax Court has recognized capital gain characterization for shareholders receiving royalty payments while also permitting the related corporation a deduction for the royalties as an ordinary and necessary business expense. In *Ransom W. Chase*[53] the Statham Instrument Corporation entered into negotiations with Curtiss Wright Corporation to secure the future use of certain vital patents. During the negotiations, Curtiss Wright proposed a sale of the patents in lieu of a license. Even though Statham Instrument turned the offer down for business reasons, a partnership

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46 E.g., Thomas Flexible Coupling Co. v. Comm'r, 158 F.2d 828 (3d Cir. 1946), where an inventor for stock and royalties had assigned patents to a corporation and agreed to assign all future improvements to it. In fact, some years later improvement patents were issued to the inventor and assigned to the corporation for cash, and additional royalties were voluntary payments without consideration, hence nondeductible. But see Comm'r v. Thomas Flexible Coupling Co., 198 F.2d 350 (3d Cir. 1952), *aff'g* 14 T.C. 802 (1950); Myron C. Poole, 46 T.C. 392 (1966).

47 Nassau Suffolk Lumber & Supply Corp., 53 T.C. 280 (1969); Edward W. Reid, 50 T.C. 33 (1968); J. Strickland & Co. v. United States, 352 F.2d 1016 (6th Cir. 1965); Kimble Glass Co., 9 T.C. 183, 190 (1947).

48 Wall Prods., Inc., 11 T.C. 51 (1948), *acq*. 1949-1 C.B. 4.

49 L. Schepp Co., 25 B.T.A. 419 (1932), *acq*. XI-1 C.B. 6.

50 Differential Steel Co., T.C. Memo. 1966-65.

51 3 T.C.M. 620, *aff'd* 158 F.2d 828 (3d Cir. 1946).

52 Comm'r v. Thomas Flexible Coupling Co., 198 F.2d 350 (3d Cir. 1952), *aff'g* 14 T.C. 802 (1950), *nonacq*. 1950-2 C.B. 6.

53 T.C. Memo. 1965-202.

the use of intangible property (royalties) are deductible if the payments are:

(1) Paid or incurred in the course of the taxpayer's trade or business;

(2) Ordinary and necessary (reasonable in amount);

(3) Are in reality expenses and neither installment payments on a purchase nor disguised dividends to shareholders.

A nonexclusive licensee who has no equity and acquires no title in the property is generally entitled to deduct royalty payments as an ordinary and necessary business expense.[35] All payments which are legally required are deductible, but voluntary payments for which no consideration is received are disallowed.[36]

The grant of an exclusive license to use intangible property may constitute a sale even though the payments take the form of royalties. Such a royalty will ordinarily be considered payment of a purchase price and not a deductible expense. Nevertheless, as previously indicated, the purchaser of a copyright or patent may be able to deduct all or part of the payment under the rules governing depreciation and amortization.[37] An attempt to shape a pre-1970 purchase of a trademark as a license with option to buy in order to secure a deduction for royalties (due to the unavailability of a depreciation on such property) was unsuccessful. The court correctly viewed the transaction as a purchase of property and denied the royalty deduction.[38] On the other hand, payments for the post-1969 transfer of a trademark which are contingent upon productivity or use are deductible as ordinary expenses under Section 1253(d)(1).

[2] Form of Payment. Deductible royalties may take the form of monthly or even yearly payments. Deductions are allowed whether the royalty agreement calls for the payment of a fixed annual sum

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[35] I.R.C. § 162(a)(3). See also Edward W. Reid, 50 T.C. 33 (1968); Francis H. Shepard, 57 T.C. 611 (1972).

[36] See Tussard's Wax Museum, Inc., T.C. Memo. 1966-211; Hickett Eng'r, Inc., T.C. Memo. ¶ 16,185 (1947); Thomas Flexible Coupling Co., T.C. Memo. ¶ 14,008 (1944), *aff'd* 158 F.2d 828 (3d Cir. 1946), *cert. denied* 329 U.S. 810 (1947).

[37] See discussion ¶ 5.2a[1] *supra.*

[38] Strickland & Co. v. United States, 352 F.2d 1016 (6th Cir. 1965), *cert. denied* 384 U.S. 950 (1965).

have no definite life.[26] Rather, they are inchoate rights which mature into depreciable property beginning with the date the patent or copyright is issued.[27] However, as previously indicated, Revenue Ruling 67-136 provides that current depreciation deductions may be obtained where the purchase price of a patent application is contractually fixed as a reasonable percentage of annual earnings from property.

[2] Trade Secrets. The assignment of purchase costs to trade secrets raises a serious problem for the purchaser of such property. Trade secrets, like patent applications, are generally not depreciable because they lack an ascertainable useful life.[28] The taxpayer has the burden of offering convincing proof that a trade secret has a limited life at the time of purchase. Yet, a taxpayer did enjoy success in demonstrating a limited useful life in *M.E. Cunningham Co.*[29] where the Tax Court applied the *Associated Patentees* principle to an unpatented design for a machine, a circumstance typical of a trade secret. There an inventor developed a new idea in 1939. Shortly thereafter, an experimental machine and five other machines were built which incorporated the idea. However, no patent was ever obtained. Under a later contract transferring the machine designs, the inventor was entitled to receive a percentage of sale proceeds derived from sales of the products produced on the machines. The issue before the Tax Court was the current deductibility of the percentage payments by the purchaser. In its opinion the court declared:

> "If the payments are to be regarded as part of the cost of the machine, then it seems reasonable to allow a corresponding deduction for each year because the payments are measured by the profitable use of the machine in each year and will continue to be so measured during any year in which payments are made." [30]

[26] Hershey Mfg. Co., 14 B.T.A. 867, (1928), *aff'd* 43 F.2d 298 (10th Cir. 1930); Twin Disc Clutch Co., 2 B.T.A. 1327 (1925); Max A. Burde, 43 T.C. 252 (1964), *aff'd* 352 F.2d 995 (2d Cir. 1965).

[27] Hershey Mfg. Co. v. Comm'r, note 26 *supra;* Sarkes Tarzian, Inc. v. United States, 140 F. Supp. 863 (S.D. Ind. 1956), *rev'd and remanded on other grounds* 240 F.2d 467 (7th Cir. 1957).

[28] Reg. § 1.167(a)-3. "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life."

[29] 10 T.C. Memo. 276 (1951).

[30] *Id.* at 278.

cause "there was nothing enforceable" between the parties at the time.[12]

If a group of patents or copyrights is acquired in a single purchase, it may be impossible to allocate portions of the purchase price to individual property interests. In a case of this kind, depreciation has been permitted on the basis of the average life of the patents.[13] This treatment has been permitted even when the earlier patents expired before the last taxable year involved,[14] and is most clearly allowable where the patents are interdependent.[15] Depreciation of the cost of a group of patents dependent upon the life of a basic patent has been allowed over the remaining life of the basic patent.[16] Finally, the Tax Court has accepted a depreciation formula based on a percentage of the aggregate life of a group of patents expiring each year where the cost basis of the individual patents could not be determined.[17]

Determination of the depreciation basis for a patent or copyright may also be difficult where the intangible property is purchased either as part of a bundle of assets of a going business or in exchange for stock having no fair market value. Under such circumstances the courts have suggested that the most accurate method of valuing patents and copyrights is by capitalization of their respective earnings.[18] Purchase of the intangible property as part of a going business requires an additional allocation of total consideration among the properties acquired in proportion to their value.

In the past, the Treasury has taken the view that the cost or other basis of a patent or copyright shall be depreciated over its remaining useful life using the straight-line method.[19] However, in an early

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[12] Cleveland v. Comm'r, 297 F.2d 169 (4th Cir. 1961), *rev'g in part* 34 T.C. 517 (1960).

[13] Lanova Corp., 17 T.C. 1178 (1952), *acq.* 1952-1 C.B. 3; Florence Mfg. Co., 25 B.T.A. 676 (1932); Syracuse Food Prods. Corp., 21 B.T.A. 865 (1930), *acq.* X-2 C.B. 69; Deltox Grass Rug Co., 7 B.T.A. 811 (1927); Union Metal Mfg. Co., 4 B.T.A. 287 (1926).

[14] Standard Conveyor Co., 25 B.T.A. 281 (1932), *acq.* X-1 C.B. 6.

[15] Lanova Corp., 17 T.C. 1178 (1952).

[16] National Piano Mfg. Co., 11 B.T.A. 46 (1928), *aff'd* 50 F.2d 310 (D.C. Cir. 1931).

[17] Kraft Foods Co., 21 T.C. 513 (1954), *acq.* 1954-1 C.B. 5, *rev'd on other grounds* 232 F.2d 118 (2d Cir. 1956).

[18] See Elrod Slung Casting Mach. Co. v. O'Malley, 57 F. Supp. 915 (D. Neb. 1944), where stock having no fair market value was assigned in exchange for patents on an unmarketed invention. The cost basis of the patents assigned to the corporation was computed by reference to the earnings.

[19] Tax Guide for Small Business, I.R.S. Pub. No. 334, 1963 ed., p. 46.

¶ 5.1 INTRODUCTORY

For taxation purposes the treatment of costs incurred in the acquisition or development of intangible property is in large measure dependent upon the following factors:

(1) Do the rights created or purchased extend beyond the taxable year?

(2) Are expenses connected with the rights currently deductible or must they be capitalized?[1]

(3) If expenses must be capitalized are they eligible for depreciation or amortization over a set time period, or must realization for taxation purposes be contingent upon some future event, such as the disposition or worthlessness of the asset? [2]

Where depreciation or amortization is appropriate the basis and useful life factors receive the greatest attention.

¶ 5.2 PURCHASE COSTS

¶ 5.2a Depreciation and Amortization

[1] Patents and Copyrights. The election to amortize patent development costs as research and experimental expenditures is not applicable to the cost "of acquiring another's patent, model production or process. . . ." [3] However, the purchase price of a patent or copyright may be capitalized and recovered by depreciation or apportionment of the cost over useful life of the property.[4] United States patents are usually depreciable over their seventeen-year life, unless a shorter life can be established.[5] If there is no way of estimating

[1] Cf., I.R.C. § 174; ¶ 5.3 *infra* (deduction of research expenditures); Reg. § 1.167(a)-3.

[2] I.R.C. § 165(a); Reg. § 1.165-2(a).

[3] Reg. § 1.174-2(a)(1).

[4] Reg. § 1.167(a). This regulation omits the pre-1954 rule that the depreciation period is the "life of the patent." Reg. 118, § 39.23(1)-7. The change may be influenced by the new 1954 Code provision for special treatment of research and experimental expenditures. I.R.C. § 174.

[5] Reg. § 1.167(a)-6(a). The regulations make no reference to a deduction for obsolescence of a patent due to loss of usefulness before the expiration of its seventeen-year life, except to permit a loss deduction in the year the patent became entirely valueless. However, the regulations on obsolescence provide that abnormal obsolescence is to be reflected by an adjustment of the depreciation rate and useful life. Reg. § 1.167(a)-9.

business, a nonresident alien or foreign corporation shall not be deemed to have a United States permanent establishment.[241] However, suppose that under an older treaty an item of licensing income would produce a lower tax if treated as permanent establishment income instead of investment income subject to a reduced withholding rate.[242] It would seem the statute should not be employed to abrogate the permanent establishment force-of-attraction rules if a lower tax results from their application.[243] Otherwise, the United States would be unilaterally changing its tax treaty obligations.

If a foreign licensor is affected by an older treaty, the aspect of FITA that may cause the greatest difficulty is the effectively connected provision for taxing foreign-source income of United States offices of foreign persons and corporations.[244] Some less recent treaties seem to specify that a national of the treaty country will be taxable by the United States only on United States-source income.[245] Where a treaty contains this type of provision, the legislative history of the FITA expressly states that taxpayers of the foreign treaty country are not subject to tax on foreign-source income effectively connected with the conduct of a United States trade or business.[246]

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[241] The currently proposed Regulations dealing with Section 894(b) state that the provision is not considered to be contrary to any United States treaty obligation. Nevertheless, the examples accompanying the regulation, although not treating a licensing situation, fail to take account of the continuing viability of tax treaty force of attraction rules. Prior to issuance of the Proposed Regulations the Treasury, citing Section 894(4) held that a United Kingdom corporation qualified for the lower withholding rate on investment income, which was not effectively connected with the conduct of a trade or business in the United States. Rev. Rul. 71-302, 1971-2 C.B. 267. The above view is of course consistent with the approach later taken in the proposed regulations.

[242] For instance, under the treaty with Australia, patents, know-how, and trademarks receive no reduction in the 30 percent United States withholding rate. Under such circumstances the presence of a United States permanent establishment owned by an Australian resident could be of major benefit where such a taxpayer is receiving United States source licensing income. Treaty with Australia, May 14, 1953, Art. X, CCH Tax Treaties ¶ 413.

[243] In this event, the statute may be considered to take away a benefit accorded by treaty, assuming the force of attraction principle was part of the treaty obligation. It might be argued that the treaty provisions causing an item of licensing income to be taxed to the permanent establishment simply lead to the item being taxed under internal law which is always subject to change. It would then follow that the force of attraction rule was not part of the treaty obligation. However, this seems too technical a view of the treaty provisions.

[244] I.R.C. § 864(c). See discussion ¶ 4.3d[2] *supra*.

[245] E.g., Treaty with Australia, May 14, 1953, Art. III, CCH Tax Treaties ¶ 406.

[246] H. Rep. No. 1450, 89th Cong., 2d Sess. 121 (1966).

other provisions of the treaty.[232] For example, an excessive royalty paid to a parent corporation would be taxed as a dividend.[233]

¶ 4.6b Licensing Income Effectively Connected With a United States Permanent Establishment

It is a basic rule of treaty law that foreign taxpayers, including foreign licensors, are subjected to taxing jurisdiction by a treaty country in which they derive income attributable or effectively connected with a permanent establishment. Such foreign taxpayers are taxed by the United States on a net income basis in the same manner as domestic taxpayers.[234]

In addition to the definitive aspects of "permanent establishment" [235] mentioned above, the foreign licensor with a permanent establishment in the United States must be concerned with other factors, especially where recently negotiated tax treaties apply. For instance, an important consideration is the divergent methods of applying the source-of-income rules to the effectively connected concept under tax treaties in comparison with the Code. Under Section 864(c), royalties and capital gain of a nonresident alien or foreign corporation from sources both within and without the United States may be effectively connected with the conduct of a United States trade or business, depending upon the application of various factors.[236] Thus, under the Code, the determination of the source of income is separate from and preliminary to the determination of whether licensing income is effectively connected with the conduct of a United States trade or business. By contrast, under tax treaties, source of income depends on whether income is attributable to a permanent establishment. Attribution of licensing royalties or capital gain to a permanent establishment is dependent upon

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232 E.g., Treaty with the Federal Republic of Germany, July 22, 1954, Art. VIII(5), CCH Tax Treaties ¶ 3011.

233 See Surrey, "United States System and International Tax Relationship," XVII Tax Executive 104, 110–111 (1965). Presumably, the same result would not occur in the absence of an express treaty provision to that effect.

234 E.g., Treaty with the Netherlands, April 29, 1948, Art. III(1), CCH Tax Treaties ¶ 5807. Moreover, all United States tax treaties include a nondiscrimination article which provides that a permanent establishment which a resident of one contracting state has in the other contracting state shall not be subject in that other contracting state to more burdensome taxes than a resident of that other contracting state carrying on the same activities. See, e.g., Treaty with Norway, Dec. 3, 1971, Art. 25(2), CCH Tax Treaties ¶ 6078.

235 See discussion ¶ 4.6a[1] *supra.*

236 For an analysis of the factors see discussion ¶ 4.3d[2] *supra.*

"scientific works, plans and models"[221] which are not necessarily protectable by virtue of either law or secrecy. Still other treaties have gone further and expressly exempt "industrial, commercial, or scientific equipment, knowledge, experience, skill, or know-how,"[222] including therein items which have, on a unilateral basis, been construed as services rather than property.[223] As these definitions are unquestionably more realistic in viewing the outer limits of industrial proprietary technology they provide an incentive for importation of such technology into the United States.[224]

An additional definitional problem may be encountered in determining whether a particular payment falls within the scope of a royalty or sale for tax treaty purposes. Most older treaties refer to "royalties" without distinguishing those to be treated as capital gains. Under at least one treaty, that with Luxembourg, it appears that capital gain royalties definitely do not fall within the term "royalty" for treaty purposes. The exemption for royalties is therefore not construed to grant an exemption from United States tax on payments for the sale or exchange of the property or rights involved.[225] On the other hand, one proposed treaty expressly includes the term "royalties" as income derived from the alienation of any right or property described in the article dealing with royalties.[226]

221 Treaty with Austria, Oct. 25, 1956, Art. VIII (1), CCH Tax Treaties ¶ 511; Treaty with the Federal Republic of Germany, July 22, 1954, Art. VIII(3)(a), CCH Tax Treaties ¶ 3011.

222 E.g., Treaty with Luxembourg, Dec. 18, 1962, Art. VII(b), CCH Tax Treaties ¶ 5310; Proposed Treaty with the Union of Soviet Socialist Republics, June 20, 1973, Art. III, CCH Tax Treaties ¶ 8002E.

223 See S. Exec. Rep. No. 10, 88th Cong., 2nd Sess. 21 (1964); Hearings on S. Exec. Docs. G & I Before a Subcomm. of the Senate Comm. on Foreign Relations, 89th Cong., 1st Sess. 33 (1965). But cf. S. Exec. Doc. I, 89th Cong., 1st Sess. 4 (1965), which may imply that this result obtains under earlier treaties not expressly including payment for know-how.

224 The broadened definition which encompasses nonexclusive proprietary know-how expands the range of tax-exempt activity a foreign licensor may engage in within the United States. Where such activities were not exempted under prior treaties the full 30 percent United States withholding rate was often applicable.

225 S. Exec. Rep. No. 10, note 223 *supra* (referring to Article VII of the Luxembourg treaty). Although the statement definitely restricts capital gain royalties, it appears the main thrust of the statement was aimed specifically at know-how transfers.

226 Proposed Treaty with Thailand, March 1, 1965, Art. 11(3), CCH Tax Treaties ¶ 7514. The effect created for capital gains royalties in the proposed Thailand treaty results from a unique source-of-income position relating to the sale of technology (technology sale income is generally considered derived from the country in which the sale took place). However, the resulting gain is taxed on a net rather than gross basis.

ject to a United States tax treaty is allowed a greater level of commercial activity within the United States before losing the capital gains exemption than is a foreign licensor who is a resident of a country not a party to a tax treaty with the United States.

A significant definitional variation is inserted in newer treaties where the withholding rate on royalties is not removed completely. In order to equate the tax treaty with the Internal Revenue Code concept regarding contingent payments,[211] such treaties are careful to define receipts from sales of intellectual assets based upon contingencies as royalty income which is not available for total source country taxation exemption under the capital gains article.[212] This variation resolves in part the important question of whether or not the capital gains treaty exemption includes gains considered to be sales or exchanges of capital assets under the Code, even though what was sold was not a capital asset, by deeming Section 1235 "contingency payments" royalties subject to the reduced withholding rate. A still unanswered issue concerns the availability of a capital gain treaty exemption provision for the sale of patents or copyrights used in a trade or business and qualifying as Section 1231 assets where the withholding rate on royalties is not completely exempted under a tax treaty. However, it would seem that the capital gain exemption would be available since most treaties provide that terms not otherwise defined in the treaty are to be interpreted under the laws of the country imposing the tax.[213] As previously noted, in another context the Internal Revenue Service has ruled that Section 1235 contingent payments are to be considered proceeds from a sale or exchange of a capital asset for purposes of the pre-1967 withholding provisions relating to nonresident aliens.[214]

[2] Exemption of Royalties. United States tax treaties provide that royalty income, for the use of certain types of intangible intellectual property, derived from within the United States by a nonresident alien or foreign corporation of the treaty country, shall be exempt from taxation or taxed at a substantially reduced rate by the United

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[211] See ¶¶ 4.2e, 4.3b *supra*.

[212] E.g., Treaty with Japan, March 8, 1971, Article 16, CCH Tax Treaties ¶ 4394a. The only recently negotiated treaty not containing a capital gain exemption article is the Trinidad and Tobago treaty which also imposes a 15 percent withholding rate on royalties. See Treaty with Trinidad and Tobago, Jan. 9, 1970, Art. 14, CCH Tax Treaties ¶ 7622.

[213] See, e.g., Treaty with France, July 28, 1967, Art. 2(2), CCH Tax Treaties ¶ 2805.

[214] Rev. Rul. 71-2, 1971-1 C.B. 59; see also ¶ 4.3c[3].

¶ 4.6 EFFECT OF TAX TREATIES

Income tax treaties or "conventions" tend to reduce the amount of tax that a taxpayer of one country must pay to another country. Where foreign licensors are involved, tax treaty relief usually takes the form of either a United States withholding reduction or exemption, or taxation on a net rather than a gross basis. Moreover, income tax treaty obligations generally take precedence over Code provisions which are in effect on the date of its enactment.[205] Hence, the importance of interpretive problems in the Code is sometimes substantively diminished where tax treaties are applicable.

¶ 4.6a Licensing Income Not Effectively Connected With a United States Permanent Establishment

[1] Exemption of Capital Gains. Relatively few older United States tax treaties include an article granting an exclusion from United States taxation of United States-source capital gains derived by nonresident aliens or foreign corporations not engaged in a United States trade or business.[206] Although some treaties not exempting capital gains are still in force,[207] recently negotiated United States treaties reflect the concepts contained in the 1963 Organization for Economic Co-operation and Development (O.E.C.D.) draft convention on double taxation[208] and the Foreign Investors Tax Act of 1966. The provision in the France treaty is typical:

"(1) A resident of one of the Contracting States shall be tax-

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205 I.R.C. § 7852(d). Further, under Section 894 income is exempted from United States taxation to the extent required by any treaty obligation of the United States. See also Flensburger Dampfercompagnie v. United States, 59 F.2d 464, 468 (Ct. Cl. 1932). However, Section 964(a) of the Revenue Act of 1962 impliedly amends Section 7852(d) with respect to the Subpart F provisions.

206 Treaty with Canada, March 4, 1942, Art. VIII, CCH Tax Treaties ¶ 1213 (currently the Couaslian treaty is the subject of renegotiation); Treaty with Sweden, March 23, 1939, Art. IV, CCH Tax Treaties ¶ 7314; Treaty with United Kingdom, April 16, 1945, Art. XIV, CCH Tax Treaties ¶ 8119.

207 E.g., Treaty with Switzerland, May 24, 1951, CCH Tax Treaties ¶ 7403; Treaty with Australia, May 14, 1953, CCH Tax Treaties, ¶ 403. However, such treaties generally exempt royalty payments for the "use" of intangible property from taxation in the country of source. Hence, thoughtful drafting of a licensing agreement may still be rewarded by a United States withholding tax exemption even where a nonresident alien does not qualify for exemption under the Code provisions.

208 Draft Double Taxation Convention on Income and Capital, O.E.C.D. Doc. no. c(63)87.

conclusion of such licensing agreements could occur in the United States office of the foreign corporation. The resulting income generated was deemed foreign-source income if the intangible property was located and used by the licensee abroad and the latter was a foreign person.[191] Inasmuch as United States taxing jurisdiction did not formerly extend to foreign-source income of foreign corporations, no United States tax liability could result.[192] By contrast, reintroduction of the effectively connected concept in the Foreign Investors Tax Act of 1966 and its consequent extension of United States taxing jurisdiction to foreign-source income subjects such licensing income to United States taxation provided the license generating the income is made by or through an office or other fixed place of business maintained by the foreign taxpayer within the United States.[193] Some important ministerial and managerial functions regarding licensing agreements may still be performed by a United States office without triggering United States taxation.[194] On the other hand, under the present law a foreign-shadow subsidiary whose United States office is a substantial economic factor in generating foreign-source licensing income can no longer escape United States taxation on such income.[195]

¶ 4.5 WITHHOLDING OF TAX

A licensing payment to a nonresident alien or foreign corporation, if characterized by the Code as fixed or determinable periodic income, is generally subject to a 30 percent withholding tax.[196] The withholding rates for both nonresident aliens and foreign corporations may be reduced by an applicable tax treaty between the United States and the foreign recipient's country. Moreover, no withholding is, of course, required if the item of income (other than compensation for personal services) is effectively connected with the conduct of a trade or business within the United States and is included in the gross income of the nonresident alien or foreign corporation for the taxable year.[197]

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191 S. Rep. No. 1707, 89th Cong., 2d Sess. 18; ¶ 4.2d *supra.*

192 I.R.C. § 882(b) ch. 736, 68A Stat. 282 (now I.R.C. § 882(b)).

193 Reg. § 1.864-6(b). ¶ 4.3d[2] *supra.*

194 *Id.*

195 *Id.*

196 I.R.C. §§ 1441(a), (b), and 1442(a).

197 I.R.C. §§ 1441(a), 1441(c)(1), and 1442(a).

the "effectively connected" concept by the Foreign Investors Tax Act of 1966, the preceding classifications were redesignated as Foreign Corporations Not Connected with United States Business and Foreign Corporations Connected with United States Business.[182]

¶ 4.4b Current Taxing Pattern

[1] Foreign Corporate Licensors Not Connected With United States Business. Foreign corporations, unless affected by a tax treaty, are taxed at a flat 30 percent rate on United States-source fixed or determinable periodic income not effectively connected with a United States trade or business.[183] Hence, if a foreign corporation is engaged in a United States trade or business, it must segregate its income into two categories, namely, effectively connected and not effectively connected income.[184] The types of not effectively connected licensing income subject to the flat 30 percent rate include:

(1) Royalties paid to a foreign corporation for the use of intangible property in the United States;[185] and

(2) United States-source gain from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of such property or interest sold or exchanged, or from payments treated as being so contingent under Section 871(e).[186]

Ill. 1958), *aff'd per curiam* 267 F.2d 940 (7th Cir. 1959) (Argentinian and Colombian, *sociedad de responsibiledad limitada*); William F. Buckley, 22 T.C. 1312 (1954), *aff'd per curiam* 231 F.2d 204 (2d Cir. 1956) (Venezuelan *sociedad anonima,* "anonymous company"); Haussermann v. Burnet, 63 F.2d 124, 126 (D.C. Cir. 1933) (Philippine *sociedad anonima*); G.C.M. 9067, X-1 C.B. 337 (1931) (German *kommandilgesellschaft auf aktien*). In Aramo-Stiftung v. Comm'r, 172 F.2d 896 (2d Cir. 1949), it was assumed but not argued that the Swiss *stiftung* was a corporation. But cf. Estate of Swan v. Comm'r, 247 F.2d 144, 147 n.3 (2d Cir. 1957).

182 I.R.C. §§ 881, 882.

183 I.R.C. § 881(a).

184 Prop. Reg. § 1.882-1(a). A segregation must also been made between treaty and nontreaty income. Reg. § 1.883-1(b).

185 Pursuant to Regulation Section 1.881-2(b), fixed or determinable periodical income is defined to include royalties for the use of patents, copyrights, secret processes and formulas, and other like kind property.

186 I.R.C. § 881(a)(4). For a discussion of some important problems arising from the recharacterization of such sales income, see ¶ 4.3b *supra.*

One major category of income not specified for extended United States taxing jurisdiction of nonresident aliens and foreign corporations is service income; presumably because the source of service income is the place where the services are rendered.[173] Indeed, income from services rendered in the United States will be taxable by the United States even though there is no office or fixed place of business. Nevertheless, difficult allocation problems could be raised if a United States office or fixed place of business sells know-how for use outside the United States. The receipt could well represent partly service income and partly rental or royalty income.[174] If so, the rental or royalty income would be taxed by the United States, while the service income would not be taxed if the services were rendered abroad.[175] A contract provision segregating the consideration for the transfer of the proprietary know-how and services or separate licensing agreements for each of the above elements provides a relatively simple solution in such a situation.

As effectively connected foreign-source licensing income is subjected to United States taxing jurisdiction, Section 906(a) provides a credit against the resulting United States tax liability for foreign taxes imposed and paid on such income. The credit is for taxes paid directly and also for those deemed paid.[176] Creditable taxes include all income, war profits, and excess profits imposed on income.[177] The operational structure of the foreign tax credit is discussed in detail in Part II dealing with the income tax treatment of intangible intellectual property in foreign operations. Here, it should be briefly pointed out, however, that allocating the proper amount of foreign tax to the effectively connected foreign-source income may at times involve extremely complex considerations. For instance, the determination of the amount of the foreign tax paid or accrued with respect to effectively connected income may be quite difficult where the foreign tax is imposed not only upon the effectively connected income, but also upon other income. This problem can be particularly acute where differing income tax structures or concepts collide, such as different classes of income taxed at different rates;

173 I.R.C. § 861(a)(3). See also discussion ¶ 1.2a[3] *supra.* and Rev. Rul. 64-56, 1964-1 C.B. (Part 1) 133.

174 See discussion ¶ 4.2b *supra.*

175 Subpart F covers services income in Section 954(e), and could be applicable if the services were rendered abroad for or on behalf of a related party.

176 I.R.C. § 906. The provision incorporates the rules of Section 901 to 905 by reference (including the Section 902 denied paid credit), but then allows the credit pursuant to Section 901.

177 Note 176 *supra;* I.R.C. § 903.

States.[165] Accordingly, the foreign-source income of the taxpayer, even though attributable to the taxpayer's United States trade or business would not be subjected to United States taxation under the effectively connected concept.

Another definitional question relates to the use of the term "active conduct of a trade or business." Although the term is undefined by the Code, the Regulations provide the following criteria:

> "Whether or not such an item of [licensing] income, gain or loss is derived in the active conduct of a trade or business in the United States shall be determined from the facts and circumstances in each case. The frequency with which a nonresident alien individual or foreign corporation enters into transactions of the type from which the income, gain, or loss is derived shall not of itself determine that the income, gain, or loss is derived in the active conduct of a trade or business." [166]

The foregoing provision is a carbon copy of a Subpart F regulation designed to exclude certain active business income from treatment as passive tax haven income.[167] The relatively narrow interpretation of the active conduct of a trade or business standard for Subpart F purposes would by analogy appear quite helpful to nonresident aliens and foreign corporations seeking to avoid "effectively connected" characterization of foreign-source licensing income.[168]

Where licensing income is concerned, possibly the most troubling of the five preconditions for effectively connected status are the material factor and attribution considerations. However, the present regulations contain some instructive guidance regarding these difficult matters. Pursuant to the Regulations, income is attributable to a United States office or other fixed place of business *only* if (1) such office is a material factor in the realization of the income; and (2) the income is realized in the ordinary course of the trade or business

[165] Section 864(c)(5)(A) provides an important guide on the effect of an agent in the United States. "An office or other fixed place of business of an agent is disregarded unless such agent: (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority . . . and (ii) is not a general commission agent, broker *or* other agent of independent status acting in the ordinary course of his business. . . ."

[166] Regs. § 1.864-5(b)(1)(iii).

[167] Regs. § 1.954-2(d)(1). See also discussion ¶ 8.1b *infra.*

[168] See I.R.C. § 954(c)(3)(A). By contrast, the "active trade or business" standard for Section 864 purposes includes certain active business income as foreign-source tax haven income (hence, subject to United States taxing jurisdiction) within the effectively connected concept.

that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income." [156]

In some respects the foregoing example is conceptually narrow. It clearly indicates that some activity on the part of the United States branch (e.g., participation by branch employees in licensing contract negotiation) may cause such income to be treated as effectively connected with the United States branch. On the other hand, the example fails to qualitatively set out the type of activities which would trigger application of the effectively connected concept in a licensing business context. For instance, as a practical matter it may be extremely difficult for a foreign taxpayer to prove that branch employees have not taken part in licensing negotiations. If so, how substantial must the participation be to assure effectively connected treatment? In this regard, it would be helpful if minor contact such as setting up meetings, typing of papers, and so forth were permissible. Such activities may have been regarded as too insignificant to mention in the example, yet a taxpayer would hardly wish to rely on such an inference. The example is also unclear from a quantitative prospective. One wonders how much activity in negotiating licenses by branch employees will destine the licensing operation to effectively connected status.[157]

The Regulations dealing with the preceding problems in a foreign-source income context provide some useful and generally favorable guidelines in the area.[158] It would appear these guidelines are in principle equally applicable to domestic-source licensing income. However, the foreign licensor desiring assurance of effectively connected treatment on United States-source licensing income would be well advised to thoroughly integrate licensing operations with other United States business activities. Effectively connected characterization may be absolutely avoided only by completely separating licensing operations from other United States business activities.

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[156] Regs. § 1.864-4(c)(3)(ii) Ex. 2.

[157] See Ross, "United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments," 22 Tax L. Rev. 277, 326 (1967). Note, the current regulations dealing with foreign-source effectively connected income state that the frequency of licensing transactions by a nonresident alien or foreign corporation is not of itself determinative of the fact that the resulting income is derived in the active conduct of a United States trade or business. Regs. § 1.864-5(b)(1).

[158] See Regs. § 1.864-6(a)(2)(i) and discussion in the following subsection.

Clearly, if there is no direct relationship between the United States trade or business and the holding of an intangible asset, such asset will not generally be considered used in, or be held for use in, such business, and the income from the asset will not be considered effectively connected with the conduct of the trade or business.[150] Where there is an integregation of an intangible asset with a United States trade or business, however, the regulatory asset-use test guidelines are of little predictive value.

> Example: Nonresident alien, *N*, owns one-half of a limited domestic partnership, *X*. *X* engages in the domestic manufacture and sale of light motors for the electrical industry pursuant to patent licensing agreement with *N* whereby *X* acquired the exclusive right to make, use, and sell the patented product in the United States. Due to an unexpected demand for the motor by the marine industry, which *X* is unable to meet, *X* grants a sublicense to *Y*, an unrelated third party, to manufacture and sell the motor for such purposes. Pursuant to the original licensing agreement, *N* is entitled to one-half of all royalties derived from sublicensing.

An attempt to apply the asset-use test criteria to the foregoing example reveals their ineptitude in defining the relationship of the effectively connected concept to the domestic exploitation of intellectual property by a nonresident alien in a trade or business context.[151] Possibly in anticipation of such difficulties, the business-activities test is engrafted onto the asset-use test if the activities are an important factor in contributing to the realization of the income.[152] Hence, in most instances involving intangible intellectual property exploitation by a nonresident alien through a United States trade or business, it appears that the business-activities test assumes a predominant importance in ascertaining the application of the effectively connected concept, even though the licensing activities, if

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of "direct relationship" will exist if (1) the asset was acquired with funds generated by the trade or business, (2) the income from the asset is retained or reinvested in the trade or business, and (3) United States personnel actively involved in the conduct of the trade or business exercise significant management and control over the investment of the asset. Reg. § 1.864-4(c)(2)-(iii)(b).

150 H.R. Rep. No. 1450, 89th Cong., 2d Sess. 59 (1966).

151 The criteria are especially difficult to apply where fragmented parts of an intangible asset, e.g., a patent, are put to different uses both within and without the trade or business.

152 Regs. § 1.864-4(c)(2)(i).

(1) Nonresident aliens, formerly taxable only on United States-source income are now also subject to United States taxing jurisdiction on a few categories of foreign-source income if it is effectively connected with a United States trade or business.[139] This expansion of United States taxing jurisdiction is especially important for nonresident alien licensors, inasmuch as one of the included categories of taxable foreign source effectively connected income includes rents and royalties from the use of intangible personal property as well as sales and exchanges of such property.[140]

(2) From a substantive perspective, the effectively connected concept attempts to make a rough distinction between taxation of business income and investment income of nonresident aliens. Only income effectively connected with a United States trade or business is now taxed on the net income regular rate basis.[141] Items of a fixed or determinable income nature, such as royalties and taxable gain on the sale of intangible property are taxed at the 30 percent flat rate on a gross basis even if the nonresident alien has a United States trade or business, if they are not effectively connected with it.[142]

As the preceding discussion indicates, the effectively connected concept serves entirely different functions with regard to foreign-source and United States-source licensing income. As to United States-source licensing income, its function is to determine whether nonbusiness investment income will be taxed at the ordinary domestic rates or at the flat 30 percent rate. As to foreign-source licensing income, its function is to determine whether or not such income is to be subjected to United States taxing jurisdiction. Hence, the tests for determination of "effectively connected" are separate and different for domestic- and foreign-source income. Moreover, operationally if United States-source income is effectively connected with a United States business to any extent, the taxation of the entire amount is affected. Effectively connected foreign-source income is subjected to United States taxing jurisdiction only to the extent that it is allocable to a United States office or other fixed place of business.

Effectively connected licensing income from United States sources. United States-source licensing payments to nonresident aliens classed either as fixed or determinable periodic income or as gain from sales

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139 I.R.C. § 864(c)(4).
140 I.R.C. § 864(c)(4)(B)(i), (iii).
141 I.R.C. § 871(b).
142 I.R.C. § 871(a)(1).

days during the taxable year and whose compensation for such services does not exceed more than $3,000 in the aggregate.[127]

The regular collection of royalties from a license to use a patent or copyright in the United States does not fall within the definition of "engaged in a United States trade or business."[128] By contrast, it would seem that the ownership of licensed intangible property in the United States that is actively managed by a United States resident agent who has the power to negotiate licenses, etc., could amount to a United States trade or business.[129] Further, an author who is regularly engaged in writing books and articles in the United States may be considered engaged in a trade or business.[130]

The mere fact that a nonresident alien author or inventor is a member of a licensing joint venture or partnership will not cause him to be considered engaged in a United States trade or business where the activity of the venture in the United States is a single and isolated transaction.[131] On the other hand, a sufficient involvement in United States transactions by one partner may cause the partnership to be deemed engaged in trade or business in the United States. For instance, in *United States v. Balanovski*[132] an Argentine partnership was composed of an 80 percent partner, who conducted activities in the United States, and a 20 percent partner who remained in Argentina. The Second Circuit, upon finding the activities of the partner in the United States sufficient to constitute a United States trade or

[127] I.R.C. § 864(b)(1). However, the Regulations provide that the United States-source investment income of a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing services in the United States shall not be treated as effectively connected with such trade or business unless there is a direct economic relationship between his holding of the asset from which the income results and the trade or business (for example, where the individual purchases stock in a domestic corporation to assure the opportunity of performing personal services in the United States). Regs. § 1.864-4(c)(6)(i).

[128] Rohmer v. Comm'r, 153 F.2d 61 (2d Cir. 1946) (by implication), *cert. denied* 328 U.S. 862 (1946).

[129] Cf. Jan Lewenhaupt, 20 T.C. 151 (1953), *aff'd* 221 F.2d 227 (9th Cir. 1955) (per curiam); Inez de Amodio, 34 T.C. 894, *aff'd on other grounds* 299 F.2d 623 (3d Cir. 1962) (acts of his agents are attributable to the taxpayer). The activities of the agents were beyond the scope of mere ownership of property and receipt of income; they were considerable continuous, and regular. Such activities of a nonresident alien through his agents in the United States constitutes engaging in business in the United States.

[130] Cf. Georges Simenon, 44 T.C. 820 (1965), *appeal dism'd,* (2d Cir. 1966); Rev. Rul. 68-498, 1968-2 C.B. 377.

[131] Jorge Pasquel, 1954 P-H T.C. Mem. ¶ 54,002.

[132] 236 F.2d 298 (2d Cir. 1956), *rev'g in part* 131 F. Supp. 898 (S.D.N.Y., 1955), *cert. denied,* 352 U.S. 968 (1957).

other hand, in Revenue Ruling 71-231[119] the Service was recently asked to rule on the question of whether a pre-October 5, 1966, sale of a patent outside the United States for use within the United States constitutes a sale or fixed periodic income for taxation purposes contingent upon production of the patented product. Although under the factual context of the ruling the transferor was not subject to the provisions of Section 1235,[120] the Service held that the transfer constituted a sale (not fixed or determinable periodic income subject to withholding) notwithstanding that the payments in issue were contingent on the productivity of the resulting product.

The nonresident alien licensor who is willing to sell intangible capital assets for use in the United States in a fixed-sum contract need not be concerned about total recharacterization of the proceeds as fixed or determinable periodic income under Section 871(a)(1)(D), however he still may be subjected to a partial loss of the capital gain exemption resulting from the operation of the Section 483 imputed interest rules. Under that section, if the sales price of property is payable more than one year after the date of the sale or exchange, and if the deferred purchase price does not bear simple interest of at least 4 percent,[121] then a 5 percent interest rate will be imputed,[122] with the result that part of the purchase price will be treated as interest for all purposes of the Code[123] including fixed or determinable annual or periodic income.[124]

The nonresident alien licensor may also experience restriction of the capital gain exemption where a patent or know-how licensing contract calls for rendition of services in the United States in connection with the conveyance of the intangible property rights in a fixed sum agreement, because labor or personal services is attributable under the Code to the country in which the services are rendered.[125] If services are more than an insubstantial part of a licensing agreement contain-

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119 1971-1 C.B. 229.

120 Under the facts assumed in the ruling the nonresident alien transferor of the United States patent owned more than 25 percent of the transferee corporation, hence disqualifying the transfer from Section 1235 application under Section 1235(d). Of course, for a nonresident making a pre-October 5, 1966, patent transfer Section 1235 status would have resulted in the proceeds being unfavorably characterized as fixed or determinable periodical income under former Section 871(a)(1) (presently accorded the same treatment under Section 871(a)(1)(B)).

121 Reg. § 1.483-1(d).

122 Reg. § 1.483-1(c)(2).

123 Reg. § 1.483-2(a). See also Reg. § 1.483-1(a)(1) and discussion ¶ 1.4c *supra*.

124 Reg. § 1.1441-2(a)(1).

125 I.R.C. § 871(a)(1)(A).

proper criteria to be employed in interpreting the nonresident alien and foreign corporation capital gain taxing provisions. For instance, the *Bloch* case was distinguished in Revenue Ruling 57-317.[112] The ruling involved a nonresident foreign corporation granted an exclusive license to make, use, and sell certain products in the United States and Canada in consideration for an initial payment and future annual payments measured by exploitation, but with a minimum payment each year. Pointing to cases dealing with retained economic interests in domestic contexts [113] the Service held that the transfer was a sale, which did not result in fixed or determinable periodic income. Recently, Revenue Ruling 57-317 was modified by Revenue Ruling 69-156 [114] since the factual context of the prior ruling included a nonassertion clause whereby the grantee agreed not to assert its right to prevent the foreign licensor or its licensees from importing products covered by the patents into the United States. The ruling applied the "all substantial rights" test employed interpreting the capital gains statutes where domestic licensors are concerned.[115] Revenue Ruling 57-317 was changed to remove therefrom the conclusion that the rights reserved by the grantor via the nonassertion clause did not detract from the exclusiveness of the rights granted to the transferee and also to remove the implication that a sale of patent rights can occur in instances in which the grantor through such a clause has retained substantial rights in the patent. Therefore, the transaction was held to constitute a grant of a nonexclusive license and not a sale.

Unquestionably, in both the retained economic rights and fragmented interest areas, the government currently views the criteria for distinguishing capital gain and fixed or determinable periodic income in the taxation of nonresident alien licensors, as synonymous with the standards for determination of whether payments received by domestic licensors are ordinary income or capital gain. Nonresident alien licensors should, therefore, find recent domestic changes in the foregoing areas to be of considerable instructive value.

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[112] 1957-2 C.B. 909.

[113] *Id.* at 912. The decisions cited were Comm'r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944); General Aniline & Film Corp. v. Comm'r, 139 F.2d 759 (2d Cir. 1944); Kimble Glass Co. v. Comm'r, 9 T.C. 183 (1947).

[114] 1969-1 C.B. 101. Recently, the Court of Claims in E.I. duPont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973), refused to follow the ruling in its application of capital gain principles to Section 351 transfers. However, the analogy of domestic capital gain criteria to the nonresident alien tax structure has not been questioned.

[115] See discussion ¶ 1.2b *supra.*

by the Supreme Court's decision in *Comm'r v. Wodehouse.*[98] In addition to holding that the payments received by the taxpayer (a nonresident alien author who had sold domestic serial rights in the United States) were royalties rather than sales proceeds, the majority opinion, without any real discussion of the question, assumed that it was well established that a transfer of partial rights was to be treated for tax purposes as a license, resulting in royalties, rather than a sale.[99] However, when the fragmentation question was specifically litigated in a domestic context, the indivisibility doctrine was rejected.[100] Subsequently, in Revenue Ruling 54-409[101] the government abandoned its position by conceding that for domestic taxation purposes an exclusive grant of a fragmented right for a lump-sum consideration qualifies as a sale. However, at the end of the ruling the Service cautioned that the taxability of assignments by a nonresident alien was a separate and distinct question from the qualification of a citizen for capital gains treatment.[102] In a later pronouncement extending the sale characterization to (pre-October 4, 1966) exclusive grants of fragmented rights, even where the consideration was contingent, no mention was made of the caveat issued in the earlier ruling.[103] Moreover, the ruling referred to "sales" for "Federal income tax purposes."[104] Hence, it would appear that the Internal Revenue Service now regards the criteria for the determination of whether a fragmented intangible interest is a sale for capital gain purposes as the same for both the domestic and nonresident

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were sales. O.D. 988, 5 C.B. 117 (1921); I.T. 1231, I-1 C.B. 206 (1922); I.T. 2169, IV-1 C.B. 13 (1925). Although I.T. 2735 concerned source of income, its reasoning was later applied in other questions involving assignments of patents and copyrights.

98 337 U.S. 369 (1949). See text accompanying notes 87–90, *supra.*

99 *Id.* at 401 (Frankfurter, J., dissenting).

100 As a matter of dictum in Goldsmith v. Comm'r, 143 F.2d 466 (2d Cir. 1944), Judge Learned Hand stated that where the grant of a copyright (which in the taxable year in question qualified as a capital asset) is exclusive, perpetual, and in a particular medium, the author is required to protect the license against other infringement; the right of the assignee to exclude others is property within the capital gains provisions and its grant is a sale. The dictum subsequently found favor in Herwig v. United States, 105 F. Supp. 384, 389 (Ct. Cl. 1952), which ruled that the "exclusive and perpetual grant of any one of the 'bundle of rights' which go to make up a copyright [is] a 'sale' of personal property rather than a mere 'license.'"

101 1954-2 C.B. 174.

102 *Id.* at 176.

103 Rev. Rul. 60-226, 1960-1 C.B. 26, 27.

104 *Id.*

was readily withholdable.[90] As a consequence, the content of "sales of personal property" was left unclear. Although the Court conceded that the sale of an entire copyright interest was exempt from United States taxation, it seemed to also accept the notion that a transfer of fragmented copyright interests in return for a lump-sum payment is in essence nothing more than a royalty agreement for the use of property, correctly classed as fixed or determinable periodic income.

In light of subsequent administrative pronouncements, however, aspects of the *Wodehouse* decision unfavorable to the taxpayer retain little force. In Revenue Ruling 57-317,[91] the Internal Revenue Service reaffirmed its understanding that the Supreme Court in *Wodehouse* did not intend to overturn the well-settled rule that the exclusive grant of all rights under a copyright or a patent was a sale of the copyright or patent with the tax consequences attendant upon the sale of any personal property by a nonresident alien. In the latest word from the Treasury regarding the question of the sale of "other" property, Revenue Ruling 60-226,[92] it was held that the consideration received for the exclusive right to exploit a copyrighted work in a medium of publication throughout the life of the copyright is to be treated as "proceeds from the sale of property," even if measured by use or sale of the copyrighted work.[93] In adopting its current position the Service apparently went further than Congress or the courts required it to go. As it is unlikely that this position will be reexamined, nonresident alien authors and developers of proprietary

[90] "The legislative history of the Revenue Act of 1936 confirms the special meaning thus apparent on its face. It emphasizes the policy which expressly marked the enactment of this Amendment. The practical situation was that it had been difficult for United States tax officials to ascertain the taxable income (in the nature of capital gains) which had been derived from sales of property at a profit by nonresident alien individuals, or by foreign corporations, when the respective taxpayers were not engaged in trade or business within the United States. . . . This difficulty was in contrast to the ease of computing and collecting a tax from certain other kinds of income, including payments for the use of patents and copyrights, from which the United States income taxes were being, wholly or partially, withheld at the source. The Congressional Committee Report expressed a purpose of Congress to limit future taxes on nonresident alien individuals to those readily collectible." [H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9–10 (1936).]

[91] 1957-2 C.B. 908.

[92] 1960-1 C.B. 26. Cf. Cory v. Comm'r, 230 F.2d 941 (2d Cir. 1956), stating that the criteria for deciding whether a transaction is a "sale or exchange" for capital gains purposes are not necessarily the same as those determining whether it gives rise to fixed or determinable income.

[93] Of course, pursuant to Section 871(a)(1)(D) transfers in return for contingent payments have, since 1967 been treated as fixed or determinable periodical income. However, the statutory change does not disturb the thrust of Revenue Ruling 60-226 where fixed-sum contracts are involved.

employ the "sale or exchange" requirement for the task of defeating capital gains on property which does not fall within one of the statutory exclusions from "capital asset." In the nonresident alien taxation structure, demarcations between fixed or determinable periodic income and capital gains have frequently been burdened with comparable conceptual considerations.

[2] Sale of Property Versus Capital Assets. Domestically, a sale or exchange of property is characterized either as the sale of a capital asset qualifying for capital gain treatment or the sale of "other" property thus generating ordinary income. The nonresident alien taxation scheme also includes a system for taxation of gain arising from the sale of capital assets by a nonresident alien within the United States, but it lacks a framework for taxation of sales of other property unless such sales generate fixed or determinable periodic income, or income effectively connected with the conduct of a United States trade or business. Hence, a preliminary question arises of whether United States sales by nonresident aliens of "other" property are subjected to United States taxing jurisdiction, and if so, the manner in which such sales are taxed.

The class of "other" intellectual property sales by nonresident aliens which causes possible concern is actually quite small. Proceeds from the vast majority of intellectual property sales in the United States by nonresident aliens are normally characterized as capital gain, fixed or determinable periodic income (including sales of most intangible property in return for contingent payments), or income effectively connected with the conduct of a United States trade or business.[84] Yet, fixed-sum United States-source sales of copyrights, and possibly contingent payment as well as fixed-sum sales of non-trade secret elements of know-how, appear to qualify within the other property sales designation.[85]

[84] The proceeds from most licensing transfers of patents, trade secrets, trademarks, and copyrights in the United States by nonresident aliens qualify as:

(1) Capital gain if a fixed-sum sale of a capital asset is involved [I.R.C. § 871(a)(2)];

(2) Fixed or determinable income if a royalty agreement for the use of the property or a sale with payments contingent upon use is involved [I.R.C. § 871(a)(1)(A), (D)]; or

(3) Income effectively connected with the active conduct of a United States trade or business taxed pursuant to the domestic United States taxing structure [I.R.C. § 871(b)].

[85] Copyrights, unless acquired by purchase, are excluded from the definition of a capital asset. I.R.C. § 1221(3). See discussion ¶ 1.2b[3] *supra*. Moreover, the Internal Revenue Service maintains that the nonsecret portion of

gible property which qualify as proceeds from the sale or exchange of a capital asset and are not contingent on the productivity, use or disposition of the property[75] are taxed as follows:

(1) No United States tax is imposed upon a nonresident alien's capital gains from United States sources (except contingent payments) which are not effectively connected with the conduct of a United States trade or business, unless the nonresident alien has been present in the United States for a period or periods aggregating at least 183 days during the taxable year;[76]

(2) Where the nonresident alien has been present in the United States for a period or periods aggregating at least 183 days, his capital gains which are not effectively connected with the conduct of a United States trade or business are subject to United States tax at the flat 30 percent rate.[77] In determining the amount of gains subject to the 30 percent tax the nonresident alien is allowed to "net" his capital gains and losses from United States sources during the taxable year;[78] and

(3) If recognition of any capital gain during the taxable year is effectively connected with the conduct of a United States trade or business, such gain is subject to United States taxation as provided under the domestic capital gain rules.[79]

The present structure is a significant change compared to the scheme existing prior to 1967, in which the mere conduct of a trade or business in the United States was a factor in determining tax

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of his patent or copyright. To the very limited extent that his monopoly rights are "granted" by the sale of the product, and to the extent that profit from the sale of the product is theoretically attributable to the patent or copyright monopoly, rather than to his efforts and capital in producing and marketing the tangible product, it is disregarded as de minimis. Theoretically, the income attributable to the patent or copyright could be segregated from the income attributable to the capital and effort expended in producing and marketing the product and this income could be allocated and taxed under different criteria. These practical difficulties, however, require that such income be treated as merged in the income from the goods and that it be taxed under the same criteria. Of course, some intangible rights are not capable of being fully exploited by conversion into tangible goods which are then sold, e.g., plays and movies.

[75] For taxability of contingent payments see discussion ¶¶ 4.2e, 4.3b *supra.*

[76] I.R.C. § 871(a)(2).

[77] *Id.*

[78] Note 76 *supra.* Regs. § 1.871-7(b)(4)(iii), (vii). However, neither the Section 1201 alternative tax on capital gains nor the Section 1202 deduction with respect to capital gains are available. Regs. § 1.871(b)(3)(iii).

[79] I.R.C. § 871(b)(1). For a discussion of the domestic United States capital gain structure see discussion ¶ 1.2 *supra.*

resident alien transferor qualifies as a Section 1235 holder, the Section 483 imputed interest rules may apply to recharacterize a portion of the payments as interest.[72] Some of the minimum annual payment is thus converted into fixed or determinable periodical income taxable at the flat 30 percent rate. More importantly, however, such recharacterization may, in some circumstances, reduce the noncontingent portion of the payment below 50 percent, transforming the entire payment into United States-source fixed or determinable periodical income.

For the patient taxpayer, however, it is possible to secure a modicum of relief from the section 871(e)(1) 50 percent contingency rule via a minimum-maximum payment provision in the licensing contract. For instance, assume *A*, a nonresident alien individual holds a United States patent which he developed through his own efforts. *A* enters into an agreement with *M* Corporation, a domestic corporation, whereby *A* assigns to *M* Corporation all of his United States rights in the patent. In consideration for the sale, *M* Corporation is obligated to pay a royalty in the amount of 2 percent of the gross sales of the products manufactured by *M* Corporation under the patent. The sales contract further provides that in all events *M* Corporation shall make a minimum payment of $50,000 annually and in no event shall annual payments exceed $100,000. However, at the end of every fifth year of the contract's term *M* Corporation shall make an additional payment to *A* in an amount equal to 2 percent of gross sales of the products which exceed the $100,000 maximum annual payment during the prior five-year period. Employment of the minimum-maximum contract provision, coupled with a balloon catch-up payment on a staggered basis, together with appropriate adjustments for the Section 483 imputed interest rules, guarantee that for four out of every five years noncontingent payments to *A* under the sales contract will equal or exceed 50 percent of the total payments. The result would generally be no United States tax to *A* on that portion of the payments.

Whereas the 1966 amendments erased most of the confusion regarding the proper characterization of licensing contracts calling for contingent payments, there remains the much broader issue of whether payments from licensing contracts containing provisions reserving some economic rights or fragmented interests should be appropriately classified as fixed or determinable periodical income, or income from the sale of personal property. The tax ramifications of such classifications may be highly significant, at times spelling the difference

[72] See discussion ¶¶ 1.5e, 2.4, 2.6d *supra*.

types of licensing income subject to this tax treatment include:

(1) Royalties paid to a nonresident alien for the use of intangible property in the United States;[62]

(2) Amounts paid to a nonresident alien on transfers of patent rights described in Section 1235, but only as to transfers made on or before October 4, 1966;[63] and

(3) Gain from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or any interest in such property, but only to the extent that such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged, or from payments which are treated as being contingent under Section 871(e).[64] Only the contingent element is subject to taxation as fixed or determinable periodical income if 50 percent or less of the gain for any taxable year is from contingency payments. If more than 50 percent of the gain for any taxable year is attributable to contingency payments, all the gain from the sale or exchange during the taxable year is treated as being from such contingency payments.[65]

Unquestionably, aside from the introduction of the effectively connected concept, the greatest change wrought by the Foreign Investors Tax Act of 1966 for nonresident alien licensors of intangible property was the recharacterization of all contingent payments for the use of intangible property within the United States as fixed or determinable periodical income regardless of whether the payments resulted from a sale or nonsale transfer of the intangible property. The alteration eliminated prior uncertainty as to whether some transfers of intan-

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[62] See Reg. § 1.871-7(b)(2). Further, Prop. Reg. § 1.871-6(b) states that the term "royalties" includes royalties for the use of patents, copyrights, secret processes and formulas, and other like property. Compensatory damages for patent infringement, based upon reasonable royalties for the use made of the invention by the infringer constitute fixed or determinable annual or periodical income. Rev. Rul. 64-206, 1964-2 C.B. 591.

[63] I.R.C. § 871(a)(1)(B).

[64] I.R.C. § 871(a)(1)(D). Note, the proposed regulations state that a sale or exchange for section 871(a)(1)(D) purposes includes a transfer by an individual which by reason of Section 1235, relating to the sale or exchange of patents, is considered the sale or exchange of a capital asset. The provisions of Section 1253 relating to transfers of franchises, trademarks, and trade names do not apply. See Prop. Reg. § 1.871-11(c).

[65] I.R.C. § 871(e)(1).

Finally, Section 871(e)(2) is applicable only to the sale of intangibles in return for contingent payments which occur after October 4, 1966.[52] Sales of intangibles in return for contingent payments made before the effective date of the statute are subject to the uncertainties of the prior law.

¶ 4.3 TAXATION OF NONRESIDENT ALIEN LICENSORS

The United States structure for taxing nonresident aliens, including authors and inventors, is based on the source and characterization of income, as well as certain types of relationships, such as physical presence or the conduct of a trade or business, which the alien has with the United States. As the following discussion will indicate, the form in which a transfer of intangible property is cast by a nonresident alien author or inventor and his relationship with the United States may produce widely disparate United States tax consequences.

¶ 4.3a Statutory Development

Prior to 1966, the Internal Revenue Code of 1954 divided nonresident aliens into basically three classes for taxation purposes:

(1) Nonresident aliens not engaged in trade or business in the United States were taxable at the rate of 30 percent on gross fixed or determinable annual or periodical income from United States sources, including service income and rents and royalties from the use of intangible property or its sale if it was described in Section 1235.[53] Further, if the alien was present in the United States for a period aggregating ninety days or more during the taxable year he was subject to a tax of 30 percent on net capital gains derived from United States sources during the taxable year.[54] If he was present in the United States for less than ninety days during the taxable year, the 30 percent tax on net capital gains was applicable only to gains recognized during his presence;[55]

(2) Nonresident aliens engaged in a trade or business in the United States were taxed at the regular rates on all income derived from United States sources;[56] and,

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[52] October 4, 1966, is the effective date of §§ 871(a)(1)(D) and 881(a)(4).

[53] I.R.C. § 871(a)(1); I.R.C. (1939) § 211(a). The tax is in lieu of the normal and surtax payable by other taxpayers.

[54] I.R.C. § 871(a)(2)(A).

[55] I.R.C. § 871(a)(2)(B).

[56] I.R.C. § 871(c).

relaxed and royalty income from the use of intangible property was allocated on the basis of the place where the product of such right was sold, if the taxpayer could demonstrate a foundation for such apportionment.[42] For instance, in *Sax Rohmer*,[43] income from copyright licenses to American publishers was allocated between foreign and domestic sources on the basis of the domestic and foreign circulation figures of the magazine, as well as the testimony of a literary agent as to the relative values of the domestic and foreign rights.[44]

Clearly, however, the taxpayer bears the burden of showing a basis for the apportionment; if he fails to introduce evidence to establish such a basis, all income will be treated as from sources within the United States.[45] To avoid the difficult task of having to sustain such a burden, or the risk of a potential administrative or judicial estimation and reallocation of the value of foreign rights,[46] it is generally preferable for the foreign taxpayer to have a reasonable allocation spelled out in the licensing agreement or to transfer United States and foreign rights in intellectual property in separate contracts.[47]

¶ 4.2e Sales in Exchange for Contingent Payments

Prior to 1966, considerable uncertainty existed with respect to whether contingent payments received by a nonresident alien or foreign corporation in return for the transfer of intellectual property should be characterized as fixed or determinable income subject to withholding or nontaxable income from the sale of personal prop-

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[42] Sax Rohmer, 14 T.C. 1467 (1950). See also Wodehouse v. Comm'r, 178 F.2d 987 (4th Cir. 1949), *remanded* 15 T.C. 799 (1950).

[43] 14 T.C. 1467 (1950).

[44] It appears the type of evidence introduced by the taxpayer was not substantially different from that which the courts found to be insufficient in earlier cases. Compare Pelham G. Wodehouse, 8 T.C. 637 (1947); Sax Rohmer, 5 T.C. 183 (1945), *aff'd* 153 F.2d 61 (2d Cir. 1946), *cert. denied,* 328 U.S. 862 (1946).

[45] Misbourne Pictures Ltd. v. Johnson, 90 F. Supp. 978, 983 (S.D.N.Y. 1950).

[46] See generally Ferene Molnar, 14 P-H T.C. Mem. 1057 (1945), *aff'd* 156 F.2d 924 (2d Cir. 1946); Pelham Wodehouse, 8 T.C. 637, 654 (1947); cf. Estate of Marton, 47 B.T.A. 184, 186 (1942): "It would have been a simple matter for the parties to have segregated the purchase of the domestic from the foreign rights. This they did not do and we cannot supply that omission by surmise."

[47] Of course, the Internal Revenue Service is not bound by the parties' evaluations, and there is evidence that the Service is not reluctant to rely on surmise in this area. See Rev. Rul. 55-17, 1955-1 C.B. 388 (allocation between license of know-how by a foreign corporation and services rendered abroad).

or where the royalties are paid, but on the geographical area of use or right to use the property.

Neither the statute nor the regulations give any clue regarding the scope of the term "place of use." However, in the relatively few rulings that have directly dealt with the issue, both the Internal Revenue Service and the courts have attempted to apply some economic common sense to the matter by looking primarily to the markets actually exploited by the licensee. For instance, in Revenue Ruling 72-232[37] the Service recently restated its view that royalties paid to a nonresident alien by a domestic corporation for books printed in the United States and sold exclusively in a foreign country under that country's copyrights are income from sources without the United States. The Service ruled on the fact that no commercial publication of the textbooks occurred within the United States in that no textbooks were sold within the United States. Without such commercial publication the licensee is engaged solely in the printing or manufacturing of books within the United States. In the vending of such books in a foreign country, copyrights of the foreign country, rather than the United States' copyrights, are used. Similarly, Revenue Ruling 68-443[38] concluded that royalties for the use of a foreign trademark on products that are ultimately used in foreign countries are income from sources without the United States even though the manufacture and initial sale of the products took place in the United States. The Service reasoned that a royalty is from foreign sources where products bearing such trademark are ultimately used in a foreign country where their trademark is protected. The initial sale of the trademarked products to foreign shippers is merely 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.

In contrast to the foregoing view of the Internal Revenue Service regarding the significance of the place of sale, the Tax Court in *Sanchez v. Comm'r*[39] attached far greater importance to the place of sale of patented products for source determination purposes. In *Sanchez*, the taxpayer, a nonresident alien, invented a new process for refining sugar which involved the use of a special chemical. He

[37] 1972-1 C.B. 276, superseding I.T. 3296, 1939-2 C.B. 133.

[38] 1968-2 C.B. 304.

[39] 6 T.C. 1141 (1946), *aff'd* 162 F.2d 58 (2d Cir. 1947), *cert. denied*, 332 U.S. 815 (1947).

reluctantly reinstated the title-passage rule with the caveat that sales arranged to avoid taxes would be treated as consumated where the substance of the sale occurred.[29]

Transfers of tangible intellectual property, such as some forms of know-how, would appear to fit comfortably within the title-passage rule since risk of economic loss, an important criterion in applying the title-passage rule, remains in the transferor until title passes.[30] On the other hand, the propriety of the title-passage rule where transfers of intangible property such as patents, copyrights, and trademarks are involved is much less certain.[31] In such cases, the courts and Internal Revenue Service appear to have recognized the irrelevance of the title-passage test and, as an alternative, they have employed a place-of-contract standard.[32] For instance, in *Sabatini v. Comm'r,*[33] the taxpayer, a nonresident alien, granted various rights in his literary works to American corporations. The Board of Tax Appeals held that lump-sum payments for worldwide movie rights in various books were proceeds from the sale of personal property without the United States, apparently because the author was in

[29] G.C.M. 25,131, 1947-2 C.B. 85, later embodied in Reg. § 1.861-7(c). After several unsuccessful attempts to apply the substance of the sale rule to Western Hemisphere Trade Corporations, the Commissioner has conceded the exclusiveness of the title-passage rule in this limited area. See, e.g., Comm'r v. Pfaudler InterAmerican Corp., 330 F.2d 471 (2d Cir. 1964); Rev. Rul. 64-198, 1964-2 C.B. 189. Left as unanswered is the appropriativeness of the Commissioner's view utilizing the substance of the sale in other areas, particularly in regard to transfers of intangible property. See generally Chao, "'Substance of the Sale' Test: From the Balanovski Case Up to Date," 48 Taxes 68 (1970).

[30] "[T]he sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss." Reg. § 1.861-7(c).

[31] If the location of property where title passes is to be determinative for source purposes, a highly technical controversy ensues regarding the situs of intangible property. Other criteria, such as the presently used place of contract test, or the location of the performance of the single task necessary to "pass" title, also fail to comport with the economic realities of intangible property transfers. For instance, if registration of a patent, copyright, or trademark is assured to be the last event necessary to complete the sale, what will be the effect for source-of-income purposes if the property is sold and exploited though never registered?

[32] I.T. 1231, I-1 C.B. 206 (1922); O.D. 988, 5 C.B. 117 (1921); Rohmer v. Comm'r, 153 F.2d 61 (2d Cir. 1946), *cert. denied,* 328 U.S. 862 (1946).

[33] 32 B.T.A. 705 (1935). The case was decided under pre-1936 law which taxed the nonresident alien on all income from United States sources. Since 1954 the question arises less frequently inasmuch as United States-source capital gains are not taxable to nonresident aliens unless (1) the foreign taxpayer is engaged in a United States trade or business to which the gain is effectively connected; (2) the alien is physically present in the United States 183 days or more during a taxable year, or (3) the transfers are described in Section 1235. See I.R.C. § 871 and the subsequent discussion.

example, in *Karrer v. United States*[20] a Swiss chemist-inventor entered into a special employment contract with a Swiss company whereby he would perform basic research in return for a percentage of the proceeds of any inventions which might ensue. When the chemist discovered a new process for synthesizing vitamins, he applied for United States patents which he then assigned to an American company with whom the Swiss company had a contract. Although not required to do so, the American company paid royalties due under its contract with the Swiss company directly to the inventor. The Court of Claims ruled that Karrer had no income from United States sources inasmuch as he owned no interest in the patents. It was determined that the Swiss company owned the patents and the contract with the inventor was in the nature of an employment contract since Swiss law characterized it as such.[21]

Decisions concerning copyrights render little additional guidance with respect to source of income. Generally, the courts have tended to fall back on the domestic capital gain criterion of whether the taxpayer owned an "interest" in the property. Some decisions have also attached importance to the taxpayer's obligation or lack thereof to produce an actual product, suggesting that the tax treatment may sometimes turn on whether the property created was already in existence before the agreement was made.[22] Most recently, in another context, the Internal Revenue Service even attempted to advance the argument that the mere creation of an intellectual product is fatal

[20] 152 F. Supp. 66 (Ct. Cl. 1957). On the issue of whether the taxpayer "sold" a patent for capital gains purposes, or earned compensation for personal services, see Arthur N. Blum, 11 T.C. 101 (1948), *aff'd sub nom*, Blum v. Comm'r, 183 F.2d 281 (3d Cir. 1950); William B. Stout, 8 T.C.M. 988 (1949), *aff'd* 185 F.2d 854 (6th Cir. 1950).

[21] A determination which bases source of income upon a characterization under foreign law of a contract as one of "employment" hardly provides much future predictibility for taxpayers.

[22] In Ingram v. Bowers, 57 F.2d 65 (2d Cir. 1932), Enrico Caruso received "royalties" from records made by Victor Co., some of which were sold abroad. It was determined Caruso's income was entirely from personal services rendered in the United States; he owned no interest in the records and the character of this compensation was not determined by the character of the money received by Victor. I.T. 2735, XII-2 C.B. 131 (1933) ruled that "royalties" received by a nonresident alien author were not income from personal services where the author agreed with a domestic publisher that the publisher would have the serial rights in all works to be produced in the future. *Ingram v. Bowers* was distinguished on the ground that Caruso had agreed to sing; whereas here the taxpayer merely agreed that if he did write books or stories the publisher would have the right to publish them. But cf. E. Phillips Oppenheim, 31 B.T.A. 563 (1934), where a nonresident alien granted exclusive book rights in the United States and Canada "in all novels by him published" and agreed to deliver at least two novels per year. The publisher agreed to pay him advances against

income derived from intangibles such as patents, copyrights, and know-how, which are not purchased by the taxpayer, are much less certain. Section 863(b)(2) states that property "produced (in whole or part) by the taxpayer without and sold within the United States" or vice versa shall be treated as derived partly from both domestic and foreign sources, and shall be apportioned as prescribed by the Secretary.[10]

As the term "produced" is defined by Section 864(a) to include "created," an inventor's or author's gain would ab initio seem to be apportionable under Section 863(b)(2). Yet, there exists a much commented upon, though unresolved, question as to where a patent or copyright is "produced" or "created" for purposes of Section 863(b)(2).[11] For instance, in another context it has been argued that the source apportionment statute is not applicable to foreign patents on inventions produced in the United States on the ground that foreign rights are "created" under the law of the foreign country.[12] The better position would seem to be, however, that at least some of the underlying property resulting in protectable rights is produced or created where the inventor or author does the work which results in the invention or literary product.[13] Nevertheless, the Internal Revenue Service, to date, has not attempted to apply the source apportionment rule to patent and copyright transfers, possibly due to the unsatisfactory structure of the statute itself[14] or the mitigating effects of tax treaties which occur in many instances.

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apparently too obvious to require statement, since the implication is clear that the place of purchase is immaterial in determining the origin of income. See Carding Gill, Ltd., 38 B.T.A. 669 (1938); Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939); Reg. § 1.861-7(a). Most countries do not attribute any income to the country of purchase. See Carroll, "Methods of Allocating Taxable Income," IV Taxation of Foreign and National Enterprises 117, 129 (League of Nations Doc. ch. 425(b), M. 217(b) 1933).

[10] See Reg. § 1.863-3(b)(2) which specifies alternative methods for the allocation of such income.

[11] I.T. 1231, I-1 C.B. 206 (1922), held that the income of a nonresident alien author who "sold" his novels and manuscript to an American publisher was entirely from United States sources. However, this ruling was under the 1918 Act which contained no provisions for apportionment. The question appears to have never been litigated.

[12] See Pugh, "Sales and Exchanges of Foreign Patents," N.Y.U. 20th Inst. on Fed. Tax. 1305, 1316 (1962).

[13] Duke, "Foreign Authors, Inventors and the Income Tax," 72 Yale L.J. 1093, 1139 (1963).

[14] Section 863 was apparently intended to serve as a method of allocating those items of income not specifically covered by Sections 861 and 862. In effect, however, because Section 863 contains no general rules of allocation or apportionment and is effective only through regulations issued under its au-

¶ 4.1 INTRODUCTORY

The income tax effects of licensing payments to nonresident aliens and foreign corporations turn sequentially upon:

(1) The United States' concepts of taxing jurisdiction;

(2) The United States' unilateral statutory scheme for substantively taxing nonresident aliens and foreign corporations; and

(3) The modifying effects of bilateral income tax treaties upon the above structure.

However, the following discussion will reveal that the present unilateral structure is generally not well-tailored to the licensing of intangible property, effecting some tax unpredictability in licensing transactions.

¶ 4.2 TAXING JURISDICTION—SOURCE OF INCOME

The United States bases its taxing jurisdiction collectively upon citizenship, residence, and source of income.[1] However, nonresident aliens and foreign corporations are taxed by the United States only upon income derived from sources within the United States, and from foreign sources if effectively connected with the conduct of a United States trade or business.[2] Sections 861 to 864 of the Internal Revenue Code of 1954 govern the determination of source of income. The source rules are definitional in character, but since they govern the threshold question of taxing jurisdiction, they have operational results which affect a variety of substantive tax provisions.[3]

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[1] I.R.C. § 1 imposes a tax on "every individual" and § 61(a) defines gross income to include "income from whatever source derived." Further, § 11 of the Code imposes a tax on the income of "every corporation." I.R.C. § 7701-(a)(2)-(5) defines and distinguishes between domestic and foreign corporations.

[2] I.R.C. § 871 (nonresident aliens), §§ 881, 882 (foreign corporations).

[3] In analyzing the source-of-income rules, however, it should be kept in mind that the domestic statutory scheme is often determinative of the initial nature of the transaction.

success.[30] For the successful inventor or author, other planning procedures such as the deferred payment contract or intrafamily assignments usually provide greater tax planning flexibility.

¶ 3.4 INCOME SPLITTING

Another form of relief from the tax effects of concentrated income entails the use of multiple taxing entities. In the case of individual authors and inventors the goal is usually to make part or all of the income from an invention or literary work taxable to members of his family who are in a lower tax bracket. As compared with income spreading, income splitting has the advantage of present enjoyment of the funds. On the negative side, income splitting compels a loss of ownership over the property interest and the income which it generates.

Regardless of whether the transfer of an invention or literary work is made by outright gift or in trust, as the following examples indicate, for income splitting purposes it is essential that the transfer constitute an assignment of the income-producing property instead of merely the income from such property.

(1) Inventor, *T*, conveys an unexploited patent to his son, S, by gift. Subsequently, *S* transfers the patent in return for a royalty interest. The entire income component of the resulting payments would clearly be taxable to *S* inasmuch as the gift occurred prior to generation of any income from the patent.

(2) Assume *T*, a taxpayer-author enters into a contract with a publisher to sell his book for a lump sum. *T* gives the book to his son, *S*, to complete the contract and directs the publisher to pay the proceeds to the son. As the donor-author has taken all the necessary steps to generate the resulting income he may be treated as the proper taxpayer when the donee-son realizes the income.[31]

(3) In the most common factual context, an inventor or author transfers his creation in return for a royalty contract and sub-

[30] Note that such persons are kindly treated by the "major accomplishment rule" of Section 1303(c)(2)(b) which permits eligibility for income averaging even if the taxpayer was not a member of the labor force during the base period. See also Reg. § 1.1303-1(c)(3).

[31] See Doyle v. Comm'r, 145 F.2d 769 (4th Cir. 1945); Stephen S. Townsend, 37 T.C. 830 (1962) (holding the postponement in time of taxation did not prevent allocation of the gain to the donors since it was their activity that created the profit); Rev. Rul. 63-66, 1963-1 C.B. 13 (donor taxable on intra-

would seem the multiple uncertainties involved in the exploitation of know-how, trademarks, and, in many instances, patents and copyrights often qualify their sale as one of the "rare and extraordinary" instances referred to in the Regulations.[20] Naturally, if the contract can be valued it is considered the equivalent of cash, hence the gain will ordinarily be recognized in the taxable year of the sale.

¶ 3.3 INCOME AVERAGING—SECTIONS 1301–1305

Income averaging is designed to ease the effect of the graduated income tax rates when extraordinary fluctuations occur in an individual's income from year to year. During the past decade the availability of such provisions to the licensor has increased markedly. For instance, although the income averaging statutes have always allowed relief to inventors and authors, prior to 1964 the conditions for obtaining relief were often such that the spreadback was in effect unavailable.[21] Moreover, prior to 1970 the statutes provided that averaging was, in effect, not available for long-term capital gains by establishing a series of rules making it unprofitable to use averaging. However, the foregoing restrictions have been removed[22] and income averaging is now available to inventors and authors regardless of whether the payments they receive are characterized as ordinary income or capital gain.

¶ 3.3a Statutory Scheme

The following discussion is a brief summary of the statutory scheme relating to income averaging. Nevertheless, the actual computations

income collected from the contract or claim after a sale or exchange could potentially be converted into a tax on capital gains via the open transaction doctrine.

[20] See Parr, "The Impact of Section 483 on patent licensing by corporations," 26 J. Taxation 194 (1967).

[21] Prior to December 31, 1963, authors and inventors were granted limited tax relief under the spreadback provisions of former Section 1302. However, Section 1302(a)(3) required that in the case of an invention or artistic works, the amount received in the year in question must be not less than 80 percent of the gross amount received with respect to the invention or artistic work in the taxable year, all prior years, and the succeeding twelve months. The classification of advances was particularly crucial under this provision. See, e.g., James Gould Cozzens, 19 T.C. 663 (1953).

[22] Pub. L. No. 88-272, § 232(a) (Feb. 26, 1964); known as the Revenue Act of 1964, effective for taxable years beginning after December 31, 1963. Pub. L. No. 91-172, § 311(b) known as the Tax Reform Act of 1969, applicable to taxable years beginning after December 31, 1969.

author was not considered part of the payments since it was made independently of the delivery of the manuscript and called for repayment whether or not the manuscript was delivered.

Moreover, although contracts calling for contingent payments are ineligible for installment method reporting,[10] the Internal Revenue Service has permitted some flexibility with respect to changes in set sum installment contract payments without loss of Section 453 benefits. In Revenue Ruling 55-429,[11] the Service was asked to determine whether the modification of licensing agreement installment payments, in light of developments subsequent to the signing of the agreement, constituted a disposition or satisfaction of the installment obligation, effecting an immediate realization of the remaining unreported gain.[12] The ruling held that modification of the contract to reduce the selling price and installment payments to meet the potential sales and profits established by experience in the manufacture of the product covered by the patent is not such a disposition. Hence, a licensor may build into a licensing agreement a post contract look flexibility regarding the final set sum to be paid under the agreement without losing the installment reporting privilege, as long as the contract does not in effect provide that individual installment payments are contingent upon later events (such as sales or production of the patented product).

¶ 3.1b Election of the Installment Method

It is not necessary to receive permission from the Internal Revenue Service to elect the installment method of reporting income.[13] The Regulations provide that all a taxpayer need do to elect the installment method for a particular transaction is set forth in his return for the year of sale of other disposition the computation of gross profit under the installment method.[14] If the election is not made in a timely filed return, it may be made in a late or amended return for the year of the sale if the year is not yet barred by the statute of limitations.[15] However, once the installment method election is made

[10] Rev. Rul. 56-587, 1956-2 C.B. 303. The Treasury's position is that a contract must provide for the payment of fixed amounts at stated intervals to be eligible for the installment election.

[11] 1955-2 C.B. 252.

[12] Under Section 453(d) a disposition or satisfaction of an installment obligation gives rise to taxation of the remaining unreported gain.

[13] See Rev. Rul. 60-31, 1960-1 C.B. 174; Rev. Rul. 234, 1953-2 C.B. 29.

[14] Reg. § 1.453-8(b); for taxable years ending after December 17, 1958.

[15] Rev. Rul. 65-297, 1965-2 C.B. 152, overruling Rev. Rul. 93, 1953-1 C.B. 82.