

FOREIGN LICENSING—UNITED STATES TAX ASPECTS

ROBERT B. FRASER*

American industry has for years been at the forefront of industrial technology and has been justifiably recognized for its development of industrial ideas and methods. Foreign markets are eager to acquire the ideas and processes developed by the American businessman. This article deals with the United States tax aspects of the exploitation abroad of American-developed intangible industrial property.

The decision to engage in foreign licensing is typically made in the light of the desire of the American company to earn an additional return on its intangible industrial property right by a means which does not involve it in substantial overseas commitments of capital, facilities, and personnel. In practice, foreign licensing activities are most often entered into by an American company after it has enjoyed substantial successful exporting experience.

Intangible industrial property takes a variety of forms. There are, of course, patented ideas and inventions. Not all inventions or processes, however, are patented or patentable. In addition to patent rights, intangible industrial property rights include unpatentable inventions, models, and designs, as well as secret processes and formulae (or "know-how"), trademarks and trade names. In fact, foreign licensees are apt to be more interested in acquiring "know-how" than patent rights.

"Foreign licensing," in the sense in which that term is used in this article, embraces the exportation of any of these items. As will be seen, tax considerations may vary according to which of these items is the subject of the license or transfer.

As used in this article the term "foreign licensing" includes exclusive and non-exclusive licensing and the sale of the item in question for a purchase price which may be payable in a fixed sum or sums, or may be payable over a period of time in contingent installments. There are a variety of forms which the consideration may take, including fixed annual payments, payments computed as a percentage of sales by the licensee, minimum and maximum payments, royalties increasing or decreasing over the period of the license, payments in stock, payments computed according to the licensee's production, and various combinations of the foregoing.

It will be convenient in this article to deal separately with direct

* LL.B. 1952, LL.M. 1955, Harvard Law School; Partner, Goodwin, Procter & Hoar, Boston.

licensing arrangements and indirect licensing arrangements. In a direct licensing arrangement, the American owner of the intangible industrial property rights transfers to a foreign entity, which may be unrelated or may be an affiliate, the right to make, use, and/or sell the item or process which is the subject of the intangible industrial property right. In an indirect licensing arrangement, the American owner of the intangible industrial property right first makes a direct transfer to a foreign entity, which may be an affiliated entity, and the foreign entity thereafter sublicenses the property right to another company.

DIRECT LICENSING

Capital Gain or Ordinary Income on Receipt of Royalties

The word royalties is used in two senses in this article. First, it is used generically in a non-tax sense to denote the consideration received by the American licensor from the foreign licensee for the former's grant to the latter of intangible industrial property rights, whether the grant is or is not a grant of all or substantially all of the American company's rights in the item. In the non-tax sense, the term royalties is more often applied to cases in which the consideration is received in periodic installments rather than in a single fixed sum. In a more technical tax sense, royalties represent the consideration where the grant is something less than a sale of all of the American company's rights in the item. In this article, the term will often be used in the generic non-tax sense.

In direct licensing arrangements, the principal tax question may be whether the royalties received by the American licensor are taxed to it at ordinary income rates or at capital gains rates. Given the wide disparity between the rates of tax on ordinary income and the rates of tax on capital gains, the answer to the question significantly affects the net return to the American licensor from the arrangement.

There are two principal questions which must be answered in determining whether the royalties receivable will be taxed at ordinary income rates or at capital gains rates. These are:

- (1) Whether the property which is the subject of the transfer is property which is a capital asset within the meaning of Section 1221¹ of the Internal Revenue Code, or property which is used in the transferor's trade or business within the sense of Section 1231² of the Code. A preliminary question is whether the transferred property is "property" at all within the meanings of these two sections.

¹ Int. Rev. Code of 1954, § 1221.

² Int. Rev. Code of 1954, § 1231.

- (2) Whether, once it has been determined that there is either a capital asset or a section 1231 asset, there has been a sale of such asset for United States tax purposes.

1. WHAT IS PROPERTY?

The Internal Revenue Code treats income or gain as ordinary income unless the income or gain falls into certain special classes. The only two special classes here relevant are gains from the sale of a capital asset as defined in section 1221 and gains from the sale of "property used in the trade or business" as defined in section 1231. Therefore, in order for the gain on the transfer of an intangible industrial property right to be taxed at capital gain rates, the intangible industrial property right must fall within one of these two categories. In order to do so, however, the item must first be classed as "property." Obviously, this depends on the nature of the item itself.

"Property" in the United States tax sense includes patents,³ patent applications,⁴ trademarks and trade names.⁵

However, when we move to "know-how," which term embraces a wide variety of items, matters are not so clear.⁶ "Know-how" may include unpatented or unpatentable inventions, or secret processes or formulae. It may include blueprints, drawings, models, and, generally, ideas reduced to tangible form. It may include ideas which are most readily susceptible to oral communication, and which therefore may be very much akin to services rather than property under tax terminology. There is tax authority that secret processes⁷ and unpatented inventions⁸ may be capital assets and hence "property." Moreover, there is authority outside of the capital gains area that processes and formulae are "property" for tax purposes.⁹

Early this year, the Treasury Department in Revenue Ruling 64-56¹⁰ laid down some guidelines for use in determining when items referred to as "know-how" (which is not a term with tax significance) would be considered property in the case of section 351¹¹ transfers

³ See, e.g., *Commissioner v. Celanese Corp. of America*, 140 F.2d 339 (D.C. Cir. 1944).

⁴ *Commissioner v. Hopkinson*, 126 F.2d 406 (2d Cir. 1942).

⁵ *Rose Marie Reid*, 26 T.C. 622 (1956); *Thomas D. Armour*, 22 T.C. 181 (1954).

⁶ See *Creed & Bangs*, "Know-How" Licensing and Capital Gains, 4 *Patent, Trademark & Copyright J. of Research and Education* 93 (1960); and *Brainerd*, *Income from Licensing Patents Abroad*, 38 *Taxes* 209, 229-34 (1960).

⁷ *E. I. duPont de Nemours & Co. v. United States*, 153 Ct. Cl. 274, 288 F.2d 904 (1961).

⁸ *Samuel E. Diescher*, 36 B.T.A. 732 (1937), *aff'd*, 110 F.2d 90 (3d Cir. 1940).

⁹ *Wall Prods., Inc.*, 11 T.C. 51 (1948).

¹⁰ *Rev. Rul. 64-56*, 1964 *Int. Rev. Bull.* No. 8, at 9.

¹¹ *Int. Rev. Code of 1954*, § 351.

to foreign corporations. The Revenue Ruling stated that "property" includes

anything qualifying as "secret processes and formulas" within the meaning of Sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for . . . , and without regard to whether it is patentable in the patent law sense. . . .

The fact that information is recorded on paper or some other physical material is not itself an indication that the information is property. . . .

It is assumed for the purpose of this Revenue Ruling that the country in which the transferee is to operate affords to the transferor substantial legal protection against the unauthorized disclosure and use of the process, formula, or other secret information involved. (Emphasis added.)

In addition, where services are performed which are merely ancillary and subsidiary to the transfer of property, the Revenue Ruling holds that section 351 treatment will be accorded to them, thus indicating that they, too, are property. Services which may be ancillary and subsidiary include services "in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective 'starting-up' of the property transferred, or by performing under a guarantee relating to such effective starting-up."¹²

Although Revenue Ruling 64-56 defines "property" for the purposes of section 351, presumably the Treasury should endorse similar tests for defining property for purposes of sections 1221 and 1231.

2. WHAT PROPERTY IS A CAPITAL ASSET OR A SECTION 1231 ASSET?

Property which would be properly includible in the inventory of the taxpayer if on hand at the close of its taxable year or which is held by the taxpayer primarily for sale to customers in the ordinary course of its business is neither a capital asset nor a section 1231 asset. If a patent, patent application, trademark, "know-how," or other intangible property right is held primarily for sale to customers, royalties received by the taxpayer from its grant to a foreign licensee will be taxed at ordinary income tax rates, even though the intangible property right is "property."¹³

The determination of whether an asset is held primarily for sale

¹² Rev. Rul. 64-56, 1964 Int. Rev. Bull. No. 8, at 9.

¹³ Lockhart v. Commissioner, 258 F.2d 343 (3d Cir. 1958).

to customers involves classifying the item according to the status of the taxpayer who owns it. Certainly the frequency with which the taxpayer enters into licensing arrangements is a major factor involved in this classification.¹⁴ For example, if the taxpayer is basically a research organization which historically has developed ideas and licensed them out, in all likelihood the intangible property right will be deemed to be held primarily for sale to its customers. On the other hand, if the American taxpayer has developed the intangible property primarily in connection with its own domestic and foreign manufacturing activities, the asset may well be deemed a section 1231 asset, particularly in the absence of a history of licensing activities by the taxpayers.¹⁵ The question is one of fact in each case.

3. WHAT IS A SALE OF A CAPITAL ASSET OR A SECTION 1231 ASSET?

Once it has been determined that the intangible industrial property right in question is a capital asset or a section 1231 asset, there must be a sale or exchange of the asset in order to obtain capital gain treatment. "Royalties" received as consideration for the sale are royalties only in non-tax terminology; in tax jargon, they are the sales price or the amount realized.

In the case of patents and patent applications, there is a substantial body of law indicating what is a sale for capital gains purposes. To begin with, it is clear enough that the transaction will be treated as a sale and that the consideration received will be eligible for capital gains treatment despite the fact that the consideration paid is in the form of percentage royalties payable over a fixed number of years, whose amount depends on sales or production by the transferee.¹⁶

In order to qualify the transaction as a sale, the transferor will have to transfer all substantial rights in the patent or patent application.¹⁷ Frequently, however, the transferor will want to reserve certain rights with respect to the transferred patent or patent application. Customarily, he will reserve the right to terminate the agreement and re-acquire the patent rights upon certain defaults, including failure to maintain a certain level of quality,¹⁸ failure to produce or sell a specified quantity,¹⁹ non-payment of royalties,²⁰ or bankruptcy or

¹⁴ Harold T. Avery, 47 B.T.A. 538 (1942).

¹⁵ But see *American Can Co. v. Commissioner*, 317 F.2d 604 (2d Cir. 1963).

¹⁶ 1958-2 Cum. Bull. 4, acquiescing in *Roy J. Champayne*, 26 T.C. 634 (1956); Rev. Rul. 58-353, 1958-2 Cum. Bull. 408.

¹⁷ See, e.g., *Storm v. United States*, 243 F.2d 708 (5th Cir. 1957).

¹⁸ *Dairy Queen v. Commissioner*, 250 F.2d 503 (10th Cir. 1957).

¹⁹ *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955).

²⁰ *Monie S. Hudson*, 15 CCH Tax Ct. Rep. 284 (1956); Rev. Rul. 58-353, 1958-2 Cum. Bull. 408.

receivership of the licensee.²¹ The licensor may wish to reserve the right to exploit the patent in other geographical areas²² or in other industrial uses.²³ The license agreement may contain restrictions upon sublicensing and assignment.²⁴ The transferor may want to participate in litigation involving the patent.²⁵ The cumulative effect of all of these reservations may prevent there being a sale or exchange. Fundamentally, however, if all of these reservations amount merely to the retention of a security interest by the transferor, the transfer will be deemed a sale or exchange.²⁶

Similar principles are involved in connection with the transfer of trademarks, although here a grant in perpetuity is necessary to have the transaction qualify as a sale.²⁷ By reason of this requirement, in spite of tax considerations, many licenses of trademarks will not be designed to qualify for capital gains treatment.

Difficult questions are involved in connection with the transfer of "know-how" of various types. In order to achieve capital gains results for "know-how" royalties, the transfer will probably have to be perpetual, and carry with it the right to prohibit unauthorized disclosures of the "know-how."²⁸ In any event, while the patent field case law is analogously helpful, such "know-how" transfers will have to be custom-built in order to maximize capital gain chances.

4. HOLDING PERIOD OF INTANGIBLE PROPERTY RIGHTS

A sale of a capital asset or a section 1231 asset will be taxed at the more favorable rates only if the selling taxpayer has held the property for at least six months prior to the sale. In the case of an intangible industrial property right developed by the taxpayer, the holding period commences when the property right has been reduced to practical application.²⁹

5. SECTION 1249³⁰

This section was incorporated into the Internal Revenue Code by the Revenue Act of 1962. It provides that gain from the sale or

²¹ *Commissioner v. Celanese Corp. of America*, supra note 3.

²² *Crook v. United States*, 135 F. Supp. 242 (W.D. Pa. 1955).

²³ *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958); *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955); *First Nat'l Bank v. United States*, 136 F. Supp. 818 (D.N.J. 1955).

²⁴ *Watson v. United States*, supra note 19.

²⁵ *Ibid.*

²⁶ *Bailey, The Inventor*, N.Y.U. 15th Inst. on Fed. Tax 285, 301 (1957).

²⁷ *E. I. duPont de Nemours & Co. v. United States*, supra note 7; *Thomas D. Armour*, supra note 5.

²⁸ *Ibid.*

²⁹ *Kronner v. United States*, 126 Ct. Cl. 156, 110 F. Supp. 730 (1953); *Samuel F. Diescher*, supra note 8.

³⁰ Int. Rev. Code of 1954, § 1249.

exchange of a patent, invention, model, design (whether or not patented), copyright, secret formula or process, or any other similar property right to any foreign corporation by any United States person who controls the foreign corporation shall, if such gain would otherwise be gain from the sale or exchange of a capital asset or a section 1231 asset, be considered as gain from the sale or exchange of property which is neither a capital asset nor a section 1231 asset. In other words, the gain will be taxed at ordinary income rates. This section is relevant where there is direct licensing by the American company to a controlled foreign affiliate. It is treated in more detail in a later portion of this article.

Foreign Taxes and the United States Foreign Tax Credit

Where royalties are paid by a foreign company to its American licensor, the country of the licensee will frequently impose a tax, typically a withholding tax, on the royalty payments. If the foreign tax is treated as imposed on the *licensor* (the withholding from the licensee's payment being merely a collection device), the foreign tax may be credited by the American licensor against its United States taxes,³¹ whether the royalties are treated as ordinary income or capital gain by the United States.³² If the foreign tax is imposed on the *licensee*, no United States foreign tax credit is allowed.³³ Moreover, a foreign tax imposed on the American licensor is creditable only if it is an income tax.³⁴ To determine whether such a foreign tax is or is not creditable, an examination of the tax law of the relevant country is required unless the question has been resolved by case law or by a Treasury ruling.

In practice, license agreements often embody what are referred to as net royalty arrangements. Under such an arrangement, the licensee agrees to pay the tax and to remit the royalty to the licensor free of tax. Under such circumstances, the American licensor will on its tax return report a gross amount of consideration received consisting of the royalties actually received plus the foreign tax paid by the licensee, and claim a foreign tax credit for the tax. Although in litigation the Commissioner has argued that an arrangement of this type means that the tax is not imposed on the licensor and that hence a foreign tax credit is not allowable,³⁵ this argument violates the

³¹ Treas. Reg. § 1.901-2(a)(1957); Rev. Rul. 273, 1953-2 Cum. Bull. 58.

³² *Freeport Sulphur Co. v. United States*, 172 F. Supp. 462 (Ct. Cl. 1959), addendum to 143 Ct. Cl. 111, 163 F. Supp. 648 (1958).

³³ See *Irving Air Chute Co. v. Commissioner*, 143 F.2d 256 (2d Cir. 1944); *Trico Prods. Corp.*, 46 B.T.A. 346 (1942).

³⁴ *Eitington-Schild Co.*, 21 B.T.A. 1163 (1931).

³⁵ *Trico Prods. Corp.*, supra note 33.

economics of the situation. Undoubtedly, if the American licensor were to be responsible for the tax, it would have negotiated higher royalty payments. What authority there is supports the proposition that the American foreign tax credit is allowable in such a case.³⁶

The amount of the foreign tax credit is subject to either an overall or per-country limitation, depending on the taxpayer's method of reporting. The taxpayer may not take a foreign tax credit in excess of that proportion of the foreign tax which its taxable income from sources within that country (in the case of the per-country limitation) or from all foreign sources (in the case of the overall limitation) bears to its entire taxable income.³⁷ In computing the limitation, it is obviously necessary to determine the amount of foreign source income. This will vary according to whether the royalties received are "royalties" in the tax sense or are sales proceeds. "Royalties" (tax sense) for the foreign use of patents, copyrights, secret processes, formulas, good will, trademarks, trade brands, franchises, and other like properties are income from the foreign country where the property is used.³⁸ If the royalties are sales proceeds, they are allocated 100% abroad if the property was produced *and* the sale took place abroad; they are allocated 100% to the United States if the property right was produced and the sale took place in the United States; and they are allocated partly to the United States and partly abroad if the property was produced in the United States and the sale took place outside the United States.³⁹ Where the property was produced here, and its transfer is being treated as a sale (*i.e.*, as a capital gain transaction), the sale should take place abroad in order to minimize the effect of the limitation on the allowable foreign tax credit.

INDIRECT LICENSING NOT INVOLVING A CONTROLLED FOREIGN CORPORATION

By definition, an indirect licensing arrangement involves first, a transfer by the American owner of the intangible industrial property right to a foreign corporation, and, secondly, another transfer or sublicense by the foreign corporation to a third party. United States tax problems are involved in each of these two steps. The problems are significantly different depending upon whether the foreign corporation is a "controlled foreign corporation." A controlled foreign corporation is a foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote is owned

³⁶ See Rev. Rul. 57-106, 1957-1 Cum. Bull. 242; Rev. Rul. 54-600, 1954-2 Cum. Bull. 164.

³⁷ Int. Rev. Code of 1954, § 904(a).

³⁸ Treas. Reg. §§ 1.861-5, 1.862-1(a)(4) (1957).

³⁹ Treas. Reg. §§ 1.861-7, 1.862-1(a)(6), 1.863-3 (1957).

by United States shareholders.⁴⁰ In most instances in practice, the question is whether the foreign corporation is or is not a more than 50% owned subsidiary of the American owner of the intangible industrial property rights.

Because of the different problems which arise depending upon whether or not a controlled foreign corporation is involved, this article treats the two cases separately.

On the first phase of an indirect licensing arrangement not involving a controlled foreign corporation, namely the transfer by the American company of the intangible industrial property rights to the first foreign corporation, the United States tax problems are largely those outlined in the earlier portion of this article devoted to direct licensing arrangements. The basic problem is whether the consideration received is ordinary income or capital gains.

On the second phase, namely the sublicense by the first foreign corporation, no United States income tax problems are normally involved. United States jurisdiction will not usually permit United States taxation of the first foreign corporation's receipt of the sublicense royalty income. Moreover, the provisions of Subpart F of Subchapter N of the Code⁴¹ do not reach out to achieve a similar result by taxing the United States shareholder of the first foreign corporation.

Prior to the Revenue Act of 1962,⁴² these same United States tax results usually followed even in cases where the first foreign corporation was a 100% owned subsidiary of the American company which developed the property rights. In the pre-1962 days, a common practice was for the American corporation to form a 100% owned subsidiary under the laws of an appropriate foreign country, a foreign "base" country.⁴³ An appropriate foreign base country was one (1) which itself imposed little or no tax on the base company upon its receipt of royalties from licenses of intangible property rights for use in other foreign countries, and (2) which was party to a treaty with the foreign country of ultimate use of the licensed property, which treaty provided for the elimination of withholding taxes of the foreign country of ultimate use on the royalties paid to the base company. Among appropriate base countries were Switzerland and the Netherlands Antilles. Thus, for example, the American parent

⁴⁰ Int. Rev. Code of 1954, § 957(a).

⁴¹ Int. Rev. Code of 1954, §§ 951-64.

⁴² The major changes were brought about by addition of §§ 951-74, 1249, to the Internal Revenue Code of 1954.

⁴³ For a general discussion of the tax considerations involved in the use of "tax-haven" companies, see Gibbons, *Tax Factors in Basing International Business Abroad*, Harvard Law School International Program in Taxation (1957).

would create a wholly-owned foreign base company in Switzerland and would transfer to it the industrial property rights. The Swiss company would license these to an unrelated French company, which would make royalty payments to the Swiss company. There would be no French or United States taxes and minimal Swiss taxes on the royalties, which would thereby accumulate in the Swiss company practically free of tax. The accumulated royalties could be used in connection with other foreign activities controlled by the American parent or at least could be ultimately brought home on a capital gains basis upon the liquidation of the Swiss company.

This is not to say that there were no United States tax problems with arrangements of this kind. On the transfer to the Swiss subsidiary for cash, there was at least a capital gains tax payable and, arguably, ordinary income taxes (on the theory that less than all substantial rights to the property were transferred by reason of the 100% parent's ability to cause a rescission of the sale). If the transfer was for additional shares of stock, or even as a capital contribution,⁴⁴ the same problems existed in the absence of an advance section 367⁴⁵ ruling by the Treasury (which was a difficult thing to get) qualifying the transfer as tax-free under section 351.⁴⁶ All or part of the royalties received by the base company could arguably be allocated to the American parent on the theory that the base company was a sham,⁴⁷ or that under the authority of section 482⁴⁸ such an allocation was necessary to reflect clearly the parent's income.⁴⁹ One was never sure whether, or how, section 269⁵⁰ might be applied.⁵¹ And the base company might be classified as a foreign personal holding company, with the result that the royalty income would be taxed directly to the American stockholder.⁵²

If a similar indirect licensing arrangement were entered into today with a more than 50% owned foreign base company subsidiary, the United States tax advantages just enumerated would not exist.

⁴⁴ Rev. Rul. 64-155, 1964 Int. Rev. Bull. No. 21, at 17.

⁴⁵ Int. Rev. Code of 1954, § 367.

⁴⁶ Int. Rev. Code of 1954, § 351.

⁴⁷ *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943) is a landmark authority for determining when the corporate entity may be disregarded. The foreign corporate entity was disregarded in *Kaspere Cohn Co.*, 35 B.T.A. 646 (1937), and in *Hay v. Commissioner*, 145 F.2d 1001 (4th Cir. 1944), but respected in *Hazelton Corp.*, 36 B.T.A. 908 (1937).

⁴⁸ Int. Rev. Code of 1954, § 482.

⁴⁹ *Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961).

⁵⁰ Int. Rev. Code of 1954, § 269.

⁵¹ In *I. T. 3757*, 1945 Cum. Bull. 200, it was ruled that there was no tax avoidance in the creation of a Western Hemisphere trade corporation for the purpose of obtaining the special tax benefits accorded to such companies.

⁵² Int. Rev. Code of 1954, §§ 551-57.

If such an arrangement were entered into through the medium of a less than 50% owned foreign base company (with the balance of its stock being owned by an unrelated foreign partner), the pre-1962 United States tax advantages would continue to be present, and many of the problems enumerated in the preceding paragraph would diminish or disappear. On the transfer to the foreign base company, section 351 would not be relevant since by its terms it applies an 80% ownership test immediately after the transfer. The dangers of a reallocation of income under section 482 would diminish (although that section does not contain a statutory definition of ownership or control), and with an unrelated stock ownership of at least 51% in the foreign base company, there is substantially less danger of a sham transaction theory. The Commissioner would hardly be able to contend that the American transferor, solely because of its ability to cause rescission of the transfer to the foreign base company, had transferred less than all substantial rights to the intangible industrial property. Section 269 would not apply because of its 50% control test. Finally, the foreign base company would not be a foreign personal holding company because less than 50% of its stock would be directly or indirectly owned by or for United States individuals.

Accordingly, indirect licensing arrangements through foreign base companies which are not controlled foreign corporations continue to be feasible and attractive from a tax standpoint. The objection to such arrangements on the part of the American owner of the intangible industrial property right is the necessity of having at least 50% ownership of the base company in the hands of an unrelated foreigner. This objection may not be insuperable. The foreign partner in the enterprise may be someone having commercial relationships with the American company, such as a distributor of its products. While some such relationship is possible without causing the foreign base company to become a controlled foreign corporation, the Treasury Regulations contain provisions designed to guard against sham ownership arrangements ostensibly placing control of the base company in outsiders but in reality reserving effective control in the American company.⁵³

INDIRECT LICENSING INVOLVING A CONTROLLED FOREIGN CORPORATION

An indirect licensing arrangement involving a controlled foreign corporation involves, first, a transfer of the intangible industrial property right from the American company which owns the right to the controlled foreign corporation, and, secondly, a sublicense of the

⁵³ Treas. Reg. §§ 1.957-1(b), (c) (1963).

property right by the controlled foreign corporation to another foreign organization. The United States tax problems occurring upon each of these two steps are in large part problems created by the provisions of the Revenue Act of 1962.

Transfer to Controlled Foreign Corporation

The transfer of the property right by the American company to its controlled foreign corporation may be for a variety of forms of consideration. These include a fixed amount of cash or of cash and notes, cash royalties computed on a contingent and percentage basis payable over a period of time, or additional stock of the controlled foreign corporation. The transfer may take the form of a contribution to the capital of the controlled foreign corporation by the American company.

A transfer for cash or notes, whether payable in a lump sum or in fixed or contingent installments, is clearly within section 1249⁵⁴ and results in ordinary income taxation to the American company.

A transfer for additional stock of the controlled foreign corporation may be a transfer within section 351⁵⁵ if the 80% test of that section is met, subject to the provisions of section 367.⁵⁶ Section 367 provides that various of the subchapter C non-recognition provisions, including section 351, are not applicable to transactions involving foreign corporations unless prior to the property exchange it has been established to the satisfaction of the Secretary of the Treasury or his delegate that the proposed exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. In practice, this means that an advance section 367 ruling has to be obtained from the Commissioner of Internal Revenue. If no advance section 367 ruling is obtained, the receipt of additional stock of the controlled foreign corporation is a taxable transaction and is likewise subject to the ordinary income provisions of section 1249. In determining the amount of ordinary taxable income realized by the American transferor in such a case, presumably the value of the intangible property transferred will be highly relevant.⁵⁷

The Internal Revenue Service takes the position that a transfer of property to a foreign corporation in the form of a contribution to capital involves the constructive receipt of additional shares of the foreign corporation by the American transferor. This means, in the view of the Service, that such a transfer is equivalent to a section

⁵⁴ Int. Rev. Code of 1954, § 1249.

⁵⁵ Int. Rev. Code of 1954, § 351.

⁵⁶ Int. Rev. Code of 1954, § 367.

⁵⁷ See *United States v. Davis*, 370 U.S. 65 (1962).

351 transfer, and an advance section 367 ruling must be obtained in order for the transaction to be tax-free.⁵⁸

Therefore, whether a proposed transfer is for additional stock of the controlled foreign corporation or is a contribution to the capital of the controlled foreign corporation, it is important to take into account the circumstances under which section 367 rulings will or will not be issued. Unfortunately, guidelines for the issuance of section 367 rulings are not published in any revenue ruling or other official authority. This means that direct communication with the Internal Revenue Service in a particular case is necessary in order to determine the attitude of the Service. It is understood that section 367 rulings are unlikely to be granted where the controlled foreign corporation proposes to sublicense in countries other than its country of organization. It is further understood that in any request for a section 367 ruling in such a case, the Service will require data as to the tax law and tax rates of the foreign countries concerned in order to satisfy it that tax avoidance, consisting of tax advantages resulting from a differential between United States and foreign tax rates, is not a motive for the proposed transfer.

Where intangible property other than patents is involved, *i.e.*, property not having a fixed and determinable life, the Service requires a grant in perpetuity as a condition of the issuance of a favorable section 367 ruling on a section 351 transaction.⁵⁹ Apparently the Service has incorporated into this area practically the same test as is applied in the ordinary income-capital gains area where patents are involved. It is perhaps difficult to justify such a test as a condition to the application of section 351, which does not itself require the transfer of all substantial rights in the property involved.

As indicated earlier in this article, in early 1964, the Internal Revenue Service issued Revenue Ruling 64-56,⁶⁰ which provides some guidelines in determining what kind of intangible property may be the subject of a favorable section 367 ruling. The primary thrust of this revenue ruling is that the Service will require that the property be such as to afford to its owner substantial legal protection against its unauthorized disclosure and use under the laws of the country in which the transferee is to operate.

Sublicense by Controlled Foreign Corporation

Assuming that the intangible industrial property rights have been successfully transferred to the controlled foreign corporation, it in

⁵⁸ Rev. Rul. 64-155, 1964 Int. Rev. Bull. No. 21, at 17.

⁵⁹ Rev. Rul. 64-56, 1964 Int. Rev. Bull. No. 8, at 9.

⁶⁰ *Ibid.*

turn will sublicense to and receive income from foreign sublicensees. At this stage, the primary question is whether, and to what extent, income realized by the controlled foreign corporation will be taxed to the American licensor.

1. THE STATUTORY SCHEME IN GENERAL

The Revenue Act of 1962 made revolutionary changes in the tax law in this area. The provisions of that act require, subject to certain exceptions, that a United States shareholder in a controlled foreign corporation be taxed by the United States directly and currently on certain categories of income realized by the controlled foreign corporation, whether or not such income is distributed to the American shareholder.⁶¹ By this means, the United States has attempted to do by indirection what, for lack of jurisdiction over foreign corporations, it could not do directly—namely, tax the income realized by the foreign corporation.

Only certain categories of income realized by the controlled foreign corporation under these provisions are taxed directly to the American shareholder. The statutory scheme of the 1962 provisions is to impose this system of taxation upon the so-called subpart F income⁶² realized by the controlled foreign corporation. Included within the statutory definition of subpart F income is foreign personal holding company income as defined in the foreign personal holding company sections, and this definition in turn includes royalties.⁶³ Subpart F income also includes foreign base company sales income, which embraces income from the purchase of personal property (whether tangible or intangible) from a related person, followed by its resale to any person, where the property is produced outside the country of organization of the controlled foreign corporation.⁶⁴ Thus, the initial approach of the statute is to tax to the American shareholder directly on a current basis most royalties earned by its controlled foreign corporation (whether royalties in the tax sense or proceeds from the resale of the intangible property rights) because they are subpart F income.

2. EXCEPTION: THE 70%-30% RULE

If the gross foreign base company income of the controlled foreign corporation (which includes foreign personal holding company income, foreign base company sales income, and foreign base com-

⁶¹ Int. Rev. Code of 1954, § 951(a).

⁶² Int. Rev. Code of 1954, §§ 951-64.

⁶³ Int. Rev. Code of 1954, §§ 954(a), (c).

⁶⁴ Int. Rev. Code of 1954, §§ 954(a), (d).

pany services income) is less than 30% of the entire gross income of the controlled foreign corporation, none of its gross income is treated as foreign base company income; and, if foreign base company income exceeds 70% of gross income, the entire gross income is treated as foreign base company income.⁶⁵ Under such circumstances, either none or all of the controlled foreign corporation's net income is taxed to the American shareholder. If foreign base company income represents between 30% and 70% of gross income, then just the amount of the foreign base company income (less deductions properly allocable thereto) is taxed to the American shareholder. Thus, this rule allows for the insulation of a certain amount of royalty or other foreign base company income from immediate United States tax where the amount of gross income of other types (for example, gross income from manufacturing activities) is substantial.

3. EXCEPTION: FOREIGN CORPORATIONS NOT AVOIDED OF FOR TAX REDUCTION

Foreign base company income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary of the Treasury or his delegate with respect to such item that the organization of the controlled foreign corporation under the laws of its country of domicile does not have the effect of substantial reduction of income or other taxes.⁶⁶ Under this provision, a subjective intent to avoid or not to avoid taxes is irrelevant; the test is geared to whether in fact a substantial reduction is achieved. The application of this exception, as is clearly spelled out in detail by the implementing Treasury Regulations, is dependent on the foreign tax situation.⁶⁷ It applies if the foreign taxes are at a level nearly equivalent to the relevant United States taxes.

4. EXCEPTION: EARNINGS AND PROFITS LIMITATIONS

Since the approach of subpart F is to treat subpart F income on a basis similar to a dividend remittance, subpart F income cannot exceed the earnings and profits for the year of the controlled foreign corporation less net deficits in earnings and profits incurred after 1959.⁶⁸ Earnings and profits of the controlled foreign corporation are computed in accordance with United States tax concepts.⁶⁹

⁶⁵ Int. Rev. Code of 1954, § 954(b)(3).

⁶⁶ Int. Rev. Code of 1954, § 954(b)(4).

⁶⁷ Treas. Reg. § 1.954-1(b)(3) (1964).

⁶⁸ Int. Rev. Code of 1954, § 952(c).

⁶⁹ Int. Rev. Code of 1954, § 964(a).

5. EXCEPTION: ROYALTIES FROM ACTIVE CONDUCT OF TRADE OR BUSINESS

Royalties from the sublicense of intangible industrial property may be royalties in the tax sense or sales proceeds, depending on the nature of the sublicense. Royalties in these two senses are treated somewhat differently in subpart F. If they are royalties in the tax sense, they are treated as subpart F income because they represent foreign personal holding company income. If they are sales proceeds in the tax sense, they are treated as subpart F income because they represent foreign base company sales income.

(A) Royalties in the Tax Sense

Royalties are excluded from foreign personal holding company income and hence from subpart F income if they are derived from the active conduct of a trade or business and are received from an unrelated person.⁷⁰ The Treasury Department has issued proposed regulations setting forth the Treasury views as to what constitutes the active conduct of a trade or business for this purpose.⁷¹ Under the proposed regulations, this is basically a question of fact.

Under the proposed regulations, royalties (in the tax sense) are derived in the active conduct of a trade or business by the controlled foreign corporation if the industrial property right was developed, created, or produced by the controlled foreign corporation, or the controlled foreign corporation acquired it by purchase and added substantial value to it. Thus, there is no problem in connection with property rights developed, created, or produced by the controlled foreign corporation. Under the general philosophy of subpart F, this is as it should be. The fundamental approach of subpart F is to exclude income resulting from active foreign operations as opposed to largely passive income accruing to the controlled foreign corporation. Thus, if the controlled foreign corporation maintains its own research facilities and independently develops intangible industrial property, royalty income from the exploitation of such property quite properly is not taxed directly to the American parent.

Where the controlled foreign corporation has acquired the industrial property from its parent, the first question is whether the acquisition has been by purchase. If the acquisition occurred as a result of a section 351 transaction,⁷² there is a question as to whether the acquisition was by purchase. In other areas in the Internal Revenue Code, acquisition by purchase has been construed to mean acquisition

⁷⁰ Int. Rev. Code of 1954, § 954(c)(3).

⁷¹ Proposed Treas. Reg. § 1.954-2(d)(1)(iii), 29 Fed. Reg. 6404 (1964).

⁷² Int. Rev. Code of 1954, § 351.

by a procedure resulting in a new cost basis, rather than a carryover cost basis in the property, to the acquiring entity.⁷³ In order to qualify the acquisition of the intangible property right as an acquisition by purchase, it may be advisable for the controlled foreign corporation to pay cash for the property right to the American parent, despite the ordinary income tax consequences to the parent upon its receipt of such payment.

Assuming that there has been an acquisition by purchase, the question of fact posed by the proposed regulations is whether the controlled foreign corporation has added substantial value to the intangible industrial property in question. In this connection, the fact that the performance of marketing functions adds substantial value is not considered. Thus, advertising, sales, and distribution activities by the controlled foreign corporation do not count.

What does count is the addition of improvements to the property. This, in effect, requires that the controlled foreign corporation employ scientists, technicians, or other personnel capable of making such improvements. To aid in the determination of whether there has been a substantial improvement, the proposed regulations contain a formula which defines a substantial addition of value as existing in a case where the controlled foreign corporation has incurred ordinary and necessary business expenses, properly allocable to the royalty income from the property right, in an amount equal to or in excess of 25% of the net royalty income (by which is meant gross royalty income received from the sublicensee less amounts paid under the original license).

(B) Royalties Which Are Sales Proceeds

Subpart F income includes "foreign base company income,"⁷⁴ which in turn includes "foreign base company sales income."⁷⁵ Foreign base company sales income includes income derived from the purchase of personal property (tangible and intangible) by the controlled foreign corporation from a related person (for example, its American parent) followed by resale to any person, where the property is manufactured or produced outside the country of organization of the controlled foreign corporation. By Treasury Regulation, there is excluded from foreign base company sales income the income of the controlled foreign corporation derived from the sale of personal property manufactured or produced by the controlled foreign corporation in whole or in part from personal property which it has purchased. The test in determining that the controlled foreign corporation is the manufacturer

⁷³ Int. Rev. Code of 1954, § 382(a)(4).

⁷⁴ Int. Rev. Code of 1954, § 952(a).

⁷⁵ Int. Rev. Code of 1954, § 954(a)(2).

or producer is whether or not the property sold is in effect the property which it purchased.⁷⁶

Purchased personal property will be treated as having been manufactured or produced by the controlled foreign corporation if it is substantially transformed prior to its sale.⁷⁷ The regulations give three examples of what amounts to a substantial transformation, but they all relate to tangible personalty. Purchased personal property will also be treated as having been manufactured or produced by the controlled foreign corporation if its operations conducted in connection with the property "are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property."⁷⁸ Its operations will be considered to amount to manufacturing if its conversion costs in connection with the property account for 20% or more of the total cost of goods sold.

Although the examples of the regulations in this area relate to the transformation or conversion of tangible property, the regulations fail to provide clear guidelines applicable to intangible industrial property rights. Presumably, however, to achieve the exclusion of sales proceeds royalties from subpart F income, the controlled foreign corporation will be obliged to achieve marked improvements in the intangible property through the medium of its own staff of technical personnel and its own technical facilities. Thus, although there is not in so many words an "active conduct of a trade or business" test for sales proceeds royalties, there is what amounts to very much the same thing, *i.e.*, a requirement of significant developmental activity by the controlled foreign corporation itself.

6. EXCEPTION: ROYALTIES WHERE THE PROPERTY IS USED IN THE COUNTRY OF DOMICILE OF THE CONTROLLED FOREIGN CORPORATION

(A) Royalties in the Tax Sense

Royalties (in the tax sense) are not foreign personal holding company income if they are received by the controlled foreign corporation from a related person for the use of the property within the country of organization of the controlled foreign corporation.⁷⁹ The principles operating here, as in so many of the provisions of subpart F, are that the new rules of the Revenue Act of 1962 should be applied primarily in tax avoidance cases, and that there is, in effect, presumptive tax avoidance where the foreign corporation is created in one foreign

⁷⁶ Treas. Reg. § 1.954-3(a)(4)(i) (1964).

⁷⁷ Treas. Reg. § 1.954-3(a)(4)(ii) (1964).

⁷⁸ *Ibid.*

⁷⁹ Int. Rev. Code of 1954, § 954(c)(4)(C).

country but operates in another. This approach was apparently occasioned by the use or misuse of so-called tax haven subsidiaries organized under the laws of low tax rate countries but functioning, presumably at less than a normal tax burden, in the more commercial or industrialized and, hence, the higher tax rate countries. This general approach, one notes in passing, is an attempt to penalize the avoidance not only of United States taxes but also of foreign taxes, which is a somewhat novel approach for a United States Congress to take.

A related person for purposes of this exception is a person or corporation controlled by the controlled foreign corporation or by the same persons who control the controlled foreign corporation. Once again, control means direct or indirect ownership of over 50% of the total combined voting power of all classes of stock entitled to vote.⁸⁰

Thus, under this exception, royalty income derived from related persons within the country of organization of the controlled foreign corporation is not subpart F income. However, royalties from unrelated persons for use of the property in the controlled foreign corporation's country of domicile are not excluded unless the active conduct of a trade or business test is met. This result is inconsistent with the treatment accorded to royalties which are sales proceeds in tax terminology, *infra*.

(B) Royalties Which Are Sales Proceeds

Foreign base company sales income (and hence subpart F income) does not include income derived from the purchase of personal property from a related person followed by resale to an unrelated person except where the property is resold for use, consumption, or disposition outside the country of domicile of the controlled foreign corporation.⁸¹ Accordingly, even where the controlled foreign corporation is reselling the same intangible industrial property which it purchased from its American shareholder without substantially modifying or improving it, it does not receive subpart F income where its purchaser or licensee intends to use the property in the country of domicile of the controlled foreign corporation. This result is inconsistent with the approach where the sublicense is a license rather than a sale in tax terms. Thus, under appropriate circumstances it will be preferable for the controlled foreign corporation to transfer the property right by sale rather than by a limited sublicense.

7. FOREIGN TAX CREDIT ASPECTS

The subpart F rules treat an amount includible in the United

⁸⁰ Int. Rev. Code of 1954, § 954(d)(3)(C).

⁸¹ Int. Rev. Code of 1954, § 954(d)(1).

States shareholder's gross income as a dividend for purposes of the derivative or "deemed" foreign tax credit.⁸² Thus, the American parent will be entitled to take a credit against its United States taxes of foreign taxes paid by the controlled foreign corporation in the same manner (and subject to the same limitations) as it would where an actual dividend distribution had been made to it by the controlled foreign corporation.

TECHNICAL ASSISTANCE

Technical assistance services are often rendered on an ancillary basis by licensors or grantors of intangible industrial property rights. Sometimes the services are purely ancillary to the grant of the property right, and under these circumstances the Internal Revenue Service will apparently regard the technical assistance on the same footing for tax purposes as the industrial property right itself.⁸³ More often, however, the services performed are so substantial or are so divorced from the property right itself as to be obliged to stand on their own character in determining their United States tax aspects. This portion of the article deals with the tax aspects of technical service income which is severable from the income from the property right.

In Direct Licensing Arrangements

Technical service income is compensation for services taxable at ordinary rates. Where this income is not allocated by the parties separately from the royalty income, an allocation will have to be made where the tax results attributable to this income differ from the tax results attributable to the royalties.⁸⁴ An example would be where the royalties received are taxable on a capital gains basis.

Technical assistance income of the United States licensor, being service income, is deemed derived from within the country or countries where the services are performed.⁸⁵ This determination of the source of this income becomes important when the American corporation claims a foreign tax credit for foreign income taxes imposed on its receipt of such income and has to determine its foreign source income to compute the applicable limitations on the allowable foreign tax credit (whether the per-country or the overall limitation applies).

The most difficult problem in this area is that of arriving at an appropriate allocation between technical assistance income and royalty income. Conceivably, the Internal Revenue Service's interest in the allocation will vary according to the taxpayer's position. For example,

⁸² Int. Rev. Code of 1954, § 960.

⁸³ See Rev. Rul. 64-56, 1964 Int. Rev. Bull. No. 8, at 9.

⁸⁴ Rev. Rul. 55-17, 1955-1 Cum. Bull. 388.

⁸⁵ Int. Rev. Code of 1954, §§ 861(a)(3), 862(a)(3).

if the royalties are taxable at capital gains rates, the Service will wish to weight the service income.⁸⁶ On the other hand, if additional royalty income would cause the American taxpayer to be classified as a personal holding company with consequent high surtax results, the Service will wish to allocate most of the income to royalties.⁸⁷ A proper allocation involves a careful study of the facts of the case.

In Indirect Licensing Arrangements

If the indirect licensing arrangement is through the medium of a foreign base company which is not a controlled foreign corporation, neither the foreign base company nor the American transferor of the intangible industrial property right will be taxable on technical assistance income legitimately earned by the base company abroad.

If the indirect licensing arrangement is through a controlled foreign corporation, the matter is much more complex since the provisions of subpart F are involved. Included in subpart F income of the controlled foreign corporation, which is taxed as earned to the American parent even though not distributed, is "foreign base company services income"; and foreign base company services income includes income "derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."⁸⁸ Such technical assistance income, in order to be subpart F income, must be performed for or on behalf of a related person (such as the American parent of the controlled foreign corporation), and must be performed outside the country of domicile of the controlled foreign corporation.⁸⁹

In determining the place where the controlled foreign corporation performs its services, the physical location of the personnel whose services earn the income is determinative. If some services are performed within and some without the country of domicile, an allocation must be made. In the allocation, the value of the functions performed by the different personnel involved must be weighted so as, for example, to assign greater value to the services of highly-skilled people, such as scientists, and less value to the services of less skilled people, such as clerical workers.⁹⁰ Once again, therefore, the United States Congress has made an exception to the application of the provisions of subpart F in cases where the activity of the controlled foreign corporation is within its country of domicile, preferring to focus its attack on the use of foreign base companies to avoid foreign taxes.

⁸⁶ *Spence v. United States*, 140 Ct. Cl. 362, 156 F. Supp. 556 (1957); but see *Raymond M. Hessert*, 6 CCH Tax Ct. Rep. 1190 (1947).

⁸⁷ *Portable Indus., Inc.*, 24 T.C. 571 (1955).

⁸⁸ Int. Rev. Code of 1954, § 954(e).

⁸⁹ *Ibid.*

⁹⁰ Treas. Reg. § 1.954-4(c) (1964).

The technical service income is included in or excepted from classification as subpart F income depending upon whether the services were or were not performed on behalf of a related person. For example, if the American parent has sold property to an unrelated foreign company, and if as part of the transaction the controlled foreign corporation is obliged to perform installation or maintenance services on the property, income realized by the controlled foreign corporation on account of such services becomes foreign base company services income and is taxed directly to the United States parent.⁹¹ Where, however, the controlled foreign corporation performs technical assistance services on its own account in connection with its sublicenses or other grants of industrial property rights acquired by it from its American shareholder, whether those services are performed within or without the controlled foreign corporation's country of organization, they should not be considered to have been performed on behalf of a related person (*i.e.*, the United States shareholder). Accordingly, they should not be subpart F income.

The Regulations except service income if (1) the services directly relate to the sale or exchange of personal property (tangible or intangible) by the controlled foreign corporation, (2) the property sold or exchanged was manufactured or produced by the controlled foreign corporation, and (3) the services were performed *before* the sale or exchange of the property by the controlled foreign corporation.⁹² They also except income from services if the services directly relate to a successful or unsuccessful offer or effort to sell or exchange personal property manufactured or produced by the controlled foreign corporation.⁹³ Two comments are pertinent to these provisions. First, they indicate that, if the taxpayer seeks to come within this exception, it may be preferable to dispose of the intangible industrial property right in a transaction qualifying as a sale under United States tax concepts (rather than by a sublicense short of a sale), since the technical service income collateral to the sale is more likely to be excepted from subpart F income. Secondly, it is not clear why this provision excepts only income from pre-sale activities. It would seem equally appropriate to extend it to post-sale activities, particularly if income from the sale itself is excepted from subpart F income.

In a limited class of cases, the so-called export trade income exception will be applicable. Even if technical services income is foreign base company services income, it will not be included in subpart F income (subject to certain limitations) if and to the extent that it is

⁹¹ Treas. Reg. § 1.954-4(b) (1964).

⁹² Treas. Reg. § 1.954-4(d) (1964).

⁹³ *Ibid.*

so-called "export trade income."⁹⁴ The export trade exception was included in the Revenue Act of 1962 to encourage American exports. Among the several classes of export trade income is technical assistance income from services performed by the controlled foreign corporation in connection with the use by an unrelated person outside the United States of intangible property rights owned by the manufacturer of export property if the controlled foreign corporation also earns income with respect to such export property.⁹⁵ To clarify this, suppose the American parent develops certain intangible industrial property rights. It sells to an unrelated foreign company tangible property embodying such intangible property rights, and its controlled foreign corporation receives a sales commission as a result of such sales. If the controlled foreign corporation also provides technical assistance for a fee, either to the foreign company which purchased the tangible product or to another foreign company, neither that fee income nor the sales commission is subpart F income.

Export trade income also includes technical assistance income attributable to the use of export property by an unrelated person. Suppose the American manufacturer sells export property (a computing machine, for example) to the controlled foreign corporation. If the controlled foreign corporation subleases that property, or if it uses that property to furnish technical services to an unrelated person, neither the rental income from the sublease nor the fees realized from the use of the property are subpart F income.⁹⁶

INCREASE OF CONTROLLED FOREIGN CORPORATION'S INVESTMENT IN UNITED STATES PROPERTY

In addition to subpart F income, there is also included in the income of the United States shareholder of a controlled foreign corporation any increase in the investment of the controlled foreign corporation in "United States property" during the taxable year.⁹⁷ Where there is such an increase in investment in United States property, such exceptions as the 70-30 rule and the export trade income provisions have no relevance (although the amount of earnings and profits of the controlled foreign corporation limits the includible amount). This provision would apply whenever the controlled foreign corporation became entitled to the use within the United States of intangible property rights. Suppose, for example, that the controlled foreign corporation discovers a special process and either proceeds to patent it in the United States or to license its use to its United States share-

⁹⁴ Int. Rev. Code of 1954, § 970(a).

⁹⁵ Int. Rev. Code of 1954, § 971(b)(2); Treas. Reg. § 1.971-1(b)(iv) (1964).

⁹⁶ Int. Rev. Code of 1954, § 971(b)(3); Treas. Reg. §§ 1.971-1(b)(v), (vi) (1964).

⁹⁷ Int. Rev. Code of 1954, § 951(a)(1)(B).

holder. The cost of the United States rights with respect to this property will be included in the income of the United States shareholder on the theory of a disguised dividend remittance. Moreover, if the parent should pay royalties to the controlled foreign corporation on this account, the royalty income of the controlled foreign corporation would be taxed to that corporation by the United States by a combination of section 881⁹⁸ or section 882⁹⁹ and the source of income rules. Accordingly, where the controlled foreign corporation or its American parent is in a position to uncover intangible industrial property which may have United States uses, the United States rights should be developed and perfected by the American parent at its own cost and expense rather than by its controlled foreign subsidiary.

⁹⁸ Int. Rev. Code of 1954, § 881.

⁹⁹ Int. Rev. Code of 1954, § 882.