

INTERNATIONAL TAXATION: APPLICATION OF SOURCE RULES TO INCOME FROM INTANGIBLE PROPERTY

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I. INTRODUCTION

Income derived from the use of intangible property¹ has significantly increased over time with the evolution of technology and the growing number of commercial transactions between multinational enterprises. Use of intellectual property “spans the continuum of income-generating activities, ranging from technical, scientific research to the creative expression of artistic

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1. For purposes of applying the sourcing provisions of the Internal Revenue Code, intangible property is defined as “patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.” I.R.C. §§ 861(a)(4) and 862(a)(4) (2000). Unless otherwise specified, all references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

concepts.”² The imposition of U.S. taxes on certain income earned by foreign entities and the allowance of foreign tax credits to domestic entities requires identification of the geographic origin of income.³ In the realm of transactions involving intellectual property, identifying geographic origins of income “pose[s] particularly difficult conceptual issues.”⁴ This is primarily due to the problems associated with characterization and sourcing of income derived from intangible assets, as opposed to sourcing income generated from economic transactions involving tangible property.⁵ Therefore, expanding the use of intellectual property in cross-border transactions has invariably complicated the U.S. tax regime.

Intangible assets such as patents, copyrights, trade brands, and computer software are “gaining in importance relative to tangible assets by generating higher rates of return in an economy that emphasizes innovation” because “intangible assets have much greater international mobility.”⁶ The high-mobility aspect of intangible property creates the potential for entities to seek preferential tax jurisdictions. Specifically, because intangible assets are less dependent on any particular geographic location, utilization of high income-generating intangible assets in low tax jurisdictions ultimately results in increased tax savings – and thus, increased revenues – to the owner of the intangible.⁷

For example, in the 1976 Tax Reform Act, the Puerto Rico and Possession Tax Credit⁸ (PRPTC) was introduced by Congress to allow U.S. corporations to maintain the ability to receive credits for taxes paid on income generated in Puerto Rico and other U.S. possessions.⁹ In accordance with its provisions, U.S. corporations had the ability to elect to be wholly exempt from taxation on profits earned in Puerto Rico and U.S. possessions,

2. PHILIP F. POSTLEWATE et al, *FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS* ¶ 14.01[1] (2004).

3. See generally Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 235 (1981).

4. POSTLEWATE, *supra* note 2, at ¶ 14.01[1] (citing Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 235 (1981)).

5. POSTLEWATE, *supra* note 2, at ¶ 14.01[1].

6. Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws*, 34 CONN. L. REV. 333, 382 (2002).

7. Tom Neubig & Satya Poddar, *Blurred Tax Boundaries: The New Economy's Implications for Tax Policy*, 21 TAX NOTES INT'L 1203, 1207 (2000).

8. I.R.C. § 936 (1994).

9. Deborah S. DiPiero, Note, *Puerto Rico's Need for Corporate Incentives Following the 1996 Amendment to Section 936*, 15 B.U. INT'L L.J. 549, 549-50 (1997).

the purpose of which was to stimulate the economies¹⁰ in these jurisdictions.¹¹ Accordingly, high-profit, capital intensive industries were provided with an incentive to set up operations in Puerto Rico.¹² Companies used this seemingly favorable incentive to open branch offices in Puerto Rico and other U.S. possessions which, in turn, reduced their U.S. income tax liability.¹³ Specifically, throughout the 1960's, 1970's and 1980's, pharmaceutical companies took advantage of the PRPTC by increasing the use of high income-generating intangibles (namely, patents¹⁴) in Puerto Rico in connection with their manufacturing operations.¹⁵ The innate nature of intangible property to provide tax incentives, however, is not unlimited. Once the PRPTC became a scheme used by corporations to generate completely tax-free income from the use of intangible property, Section 936 was amended.¹⁶ Currently, companies that had previously elected under Section 936 to be exempt from tax on income derived from intangible property in Puerto Rico or other U.S. possessions are no longer able to benefit from this provision.¹⁷ As such, income from intangible property must be included in the computation of U.S. source income.¹⁸ Although such limitations have been imposed to curtail the evasion of tax liability on income derived from intangible property, too many incentives continue to exist that allow companies to transfer intangible property to low tax jurisdictions. Congress pointed out

10. *See id.* at 550.

11. I.R.C. § 936(a)(1)(A) (1994).

12. Symposium, *Poverty Law and Policy: Standing Rusty and Rolling Empty: Law, Poverty, and America's Eroding Industrial Base*, 81 GEO. L. J. 1757, 1777 n.63 (1993).

13. *See id.*

14. A patent is defined as a "grant by the government to an inventor or discoverer which allows sole use, manufacture, or sale of a new product or method. The government grants exclusive ownership rights to an inventor to encourage public disclosure of inventions so the general population can benefit from them." MODERN DICTIONARY FOR THE LEGAL PROFESSION (3rd ed. 2001). Two specific types of patents include design patents, which are "issued for a new, original, or ornamental design of a manufactured article. The patent protects the design for seventeen years and excludes others from making or selling articles of the same design during this time," and utility patents, which protect "a new, useful, and nonobvious machine, process, or manufactured item. A utility patent is often granted in conjunction with other forms of protection for the invention or item such as a trademark or copyright." *Id.*

15. *See* Symposium, *supra* note 12 at 1777 n.63.

16. The Small Business Job Protection Act implemented a 10-year-phase-out period for corporations that previously elected under § 936. Therefore, by the year 2006, no tax incentives will be available under § 936 for corporations operating in Puerto Rico or other U.S. possessions. DiPiero, *supra* note 9, at 552-53.

17. *Id.*

18. I.R.C. § 936(h)(1)(A) (1996).

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in the Tax Reform Act of 1986¹⁹ that such an incentive exists “particularly when the intangible has a high value relative to manufacturing or assembly costs.”²⁰ Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value in the related group.”²¹

In addition to potential tax benefits that stem from the mobile nature of intangible property, in the context of e-commerce transactions and other transfers of digitized information, creative international tax planners have the ability to structure certain activities in such a way that will effectively alter the characterization of the transaction. For example, if a transaction involves a license of intellectual property by a foreign entity, it will be subject to the U.S. withholding tax.²² However, by altering the characterization of the transaction, i.e. classifying the same transaction as a sale as opposed to a license, the foreign entity will completely avoid U.S. taxation.²³ As these problems indicate, characterization and sourcing rules do not reflect the realities of the effects of intangible property on modern day business transactions.

The purpose of this article is to examine the application of U.S. source rules to income derived from intangible property, and to consider some of the problems associated with the current taxing regime. Part II presents a brief overview of the current U.S. taxing regime including the U.S. withholding tax and the foreign tax credit mechanism. Part III examines in detail some of the difficulties associated with the characterization and sourcing of income derived from intangible property, and considers a number of inconsistencies in the application of the rules. Part IV undertakes a discussion of some of the proposed modifications to the current sourcing rules. Finally, Part V suggests that although international tax scholars have advocated for a simplified taxing regime, which would include applying the place of use source rule to all types of transactions, whether characterized as a sale, license, or other transfer, this mechanism could result in unintended tax consequences for U.S. and foreign

19. Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

20. Paul Dau & Rod Donnelly, *Globalization of Intangibles-Based Business: Tax Aspects*, 9 STAN. J.L. BUS. & FIN. 1, 24 n.69 (2003) (citing Pub. L. No. 99-514).

21. *Id.*

22. David S. Teske & Tia Arzu, *Considerations in International Intellectual Property Licensing*, 20 No. 8 COMPUTER & INTERNET LAW 10, 13 (2003).

23. *Id.*

taxpayers.

II. CURRENT U.S. TAXING REGIME

Under the general source rules, income is categorized as income from sources within the U.S.,²⁴ income from sources outside the U.S.,²⁵ or income from mixed sources.²⁶ Making a determination as to whether income is from sources within the U.S. or outside the U.S. is significant for the application of certain federal income tax provisions to U.S. citizens, resident aliens, domestic corporations, nonresident aliens, and foreign corporations.²⁷ While U.S. citizens, resident aliens, and domestic corporations are taxed on their worldwide income,²⁸ nonresident aliens and foreign corporations are generally taxed only on U.S. source income.²⁹

The distinction between U.S. source income and foreign source income is of critical importance to both sets of taxpayers. U.S. citizens, resident aliens, and domestic corporations are taxed on their worldwide income; however, the foreign tax credit is available to offset U.S. tax liability.³⁰ It must be noted that the extent of the foreign tax credit is limited.³¹ Specifically, the foreign tax credit cannot exceed the U.S. pre-credit tax on foreign source income, and cannot be in excess of foreign income taxes actually paid.³² Additionally, the regulations provide that a taxpayer must compute the foreign tax credit separately for nine different “baskets”³³ of income by using a ratio of foreign source income to worldwide income.³⁴ Therefore, to increase potential

24. I.R.C. § 861(a) (1994).

25. *Id.* § 862(a) (2000).

26. *Id.* § 863(b) (2000).

27. [2004] 11 Stand. Fed. Tax Rep. (CCH) ¶ 27,122.021.

28. *See* I.R.C. § 7701(a) (2000).

29. *Id.* § 871(a)(1) (2000).

30. *Id.* § 904(a) (1994).

31. *Id.*

32. *Id.*

33. Currently, the nine baskets of income are used to calculate foreign tax credits including passive income, high withholding tax interest, financial services income, shipping income, dividends received from non-controlled section 902 corporations, dividends from a Domestic International Sales Corporation (DISC) or former DISC, taxable income attributable to foreign trade income, distributions from a Foreign Sales Corporation or former FSC, and a general limitation basket. *Id.* § 904(d). H.R. 2806, The American Jobs Creation Act of 2003, proposes to reduce the foreign tax credit baskets from nine to two which would loosen the current restrictions on cross-crediting. Lee A. Sheppard, *Treasury Explains Foreign Tax Credit Proposals*, 33 TAX NOTES INT’L 513, 514 (2004).

34. I.R.C. § 904(d). The numerator in the equation includes income from foreign sources for each individual category of income, and the denominator is a total of

foreign tax credits, U.S. individuals and corporations typically structure their economic activities in a manner that increases foreign source income that is taxed at or below the U.S. tax rate, and limit deductions and expenses allocated to such foreign source income.³⁵ It should be noted at this juncture that the source must be determined for each item of income in order to ensure correct application of the foreign tax credit mechanism.³⁶

With respect to nonresident aliens and foreign corporations, U.S. source income that is “effectively connected” with a U.S. trade or business is taxed at the same graduated rates³⁷ that apply to U.S. citizens and domestic corporations.³⁸

Other U.S. source investment income and other fixed and determinable annual or periodical income (i.e. interest, dividends, rents, royalties) earned by nonresident aliens and foreign corporations is taxed at a 30 percent flat rate (or lower if a tax treaty is applicable) provided that the income is not effectively connected with a U.S. trade or business.³⁹ In the event that a foreign entity is subject to the 30 percent withholding tax, such tax will be withheld at the source of the income.⁴⁰ In contrast to U.S. source income, foreign source income earned by nonresident aliens and foreign corporations is generally exempt from U.S. taxation.⁴¹

Although the general framework for U.S. taxation of domestic and foreign entities appears to provide a simplistic method for determining whether certain types of income are taxable and what the tax rate should be,⁴² transactions that generate income from intangible property must first be characterized as a certain type of transaction, and the applicable source rules must be applied before a determination can be made regarding the ultimate tax liability of the parties to the

worldwide taxable income. *Id.*

35. See generally Jeffrey P. Cowan, Jr., *The Taxation of Space, Ocean, and Communications Income Under the Proposed Treasury Regulations*, 55 TAX LAW. 133, 140 (2001).

36. STAFF OF JOINT COMM. ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, 102ND CONG., BACKGROUND AND ISSUES RELATING TO TAXATION OF INVESTMENT OUTSIDE OF THE UNITED STATES BY U.S. PERSONS, at 143-44 (Joint Comm. Print 1991).

37. The applicable graduated rates applied to net income effectively connected to a U.S. trade or business are set forth in I.R.C. §§ 1, 11, 871(b), and 882(a) (2000).

38. I.R.C. §§ 871(b) and 882(a).

39. I.R.C. §§ 871(a) and 881(a).

40. I.R.C. § 1442(a) (2000).

41. I.R.C. § 871.

42. See generally RUFUS VON THÜLEN RHOADES & MARSHALL J. LANGER, U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 25.10 (2004).

transaction.⁴³ Notably, the source of income derived from intangible property is based principally on the characterization of a transaction as a license of a right to use the asset, a sale of all rights in the asset for fixed or contingent payments, a contract for the manufacture and sale of goods using intellectual property, a contract for servicing intellectual property used to manufacture other property that is sold, a contract for personal services, or as a transaction involving the use of intellectual property in connection with space and ocean activities.⁴⁴ Thus, characterizing a transaction into a certain category elicits a corresponding source rule that, in turn, invokes particular tax treatment.

III. CHARACTERIZATION OF TRANSACTIONS AND APPLICATION OF SOURCE RULES TO INCOME FROM INTANGIBLE PROPERTY

Historically, the characterization rules were ambiguous.⁴⁵ Having been developed in the courts, the rules were primarily fact-based.⁴⁶ As a result, the rules were applied inconsistently in different countries.⁴⁷ In addition, these rules were structured to apply to transactions involving tangible property as opposed to intangible property.⁴⁸ Currently, the general characterization rules are less ambiguous and “lie[] at the heart of both our statutes and treaties.”⁴⁹ However, the rules applicable to intangible property require further clarification and refining. This is primarily due to the fact that the nature of intangible property makes it difficult to distinguish sales from licensing transactions and services contracts.⁵⁰

Transactions involving the license, sale, or other uses of intangible property may generate different types of income in a number of different ways, depending on the ownership interest of

43. *Id.*

44. POSTLEWATE, *supra* note 2, at ¶ 14.01[1]; John J. Cross, III, *Taxation of Intellectual Property in International Transactions*, 8 VA. TAX REV. 553, 556 (1989). It is important to note, however, that although a particular transaction appears to fit within a certain characterization, in some instances the characterization may be altered for tax policy reasons. For example, gains received from the sale of intangible property that are contingent on productivity, use, or disposition of the property will be sourced as royalties. See I.R.C. § 865(d)(1)(B) (2000).

45. Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 277 (2003).

46. *Id.*

47. *Id.*

48. *Id.*

49. Charles I. Kingson, *The David Tillinghast Lecture: Taxing the Future*, 51 TAX L. REV. 641, 643 (1996).

50. Brauner, *supra* note 45, at 277.

the holder of the asset.⁵¹ Payments derived from transactions involving intangible property may take the form of royalties, gains, or compensation income.⁵² An examination of the transferor's ownership rights in the intellectual property is critical making a determination as to the character of the transaction. The basic concept of property ownership is typically thought of as a bundle of rights.⁵³ Accordingly, a sale involves a transfer of all rights, while a license involves a transfer of something less than all rights because *use* is considered as one of the many "sticks" in the bundle.⁵⁴ As previously mentioned, this distinction is important due to the fact that different types of income will differ significantly in tax treatment. For example, if a foreign entity receives a royalty payment for the license of a patent in the U.S., the royalty will be subject to a 30 percent U.S. withholding tax absent treaty provisions that may reduce or eliminate the withholding tax altogether.⁵⁵ Conversely, if a foreign entity receives a payment for the sale of all of its rights in a patent, the income derived will be foreign source and not subject to U.S. income tax.⁵⁶ The above issues, coupled with recent technological trends including the introduction of e-commerce and the use of intangibles in cross-border transactions, further underscore the need for improved characterization rules applicable to intangible property.

In 1996, in one of its first efforts to provide guidelines for the characterization of income from sales, licensing, leasing, and services transactions involving intangible property, the Treasury Department promulgated the "software regulations."⁵⁷ These regulations are specifically applicable to computer software.⁵⁸ Although the purpose of the software regulations was to attain neutrality by treating functionally equivalent transactions similarly, the regulations have been criticized as being "too cautious and narrow in scope, both in their application to a limited number of tax provisions and in the types of software covered."⁵⁹ Furthermore, a number of scholars have suggested that Treasury's unilateral "attempt to regulate international

51. POSTLEWATE, *supra* note 2, at ¶ 14.01[1].

52. Lokken, *supra* note 3, at 236.

53. *Id.* at 237.

54. *Id.*

55. I.R.C. §§ 861(a)(4) and 1441(a).

56. I.R.C. § 862(a)(4).

57. Treas. Reg. § 1.861-18 (2005); Brauner, *supra* note 45, at 277.

58. Brauner, *supra* note 45, at 277.

59. Michael J.A. Karlin, *Computer Program Prop. Regs. Are a Good but Cautious Start*, 8 J. INT'L TAX'N 64, 68, 73 (1997).

copyright transactions [created] the potential for double taxation.⁶⁰ Moreover, scholars are of the opinion that if other nations do not adopt a similar approach, the regulations “may create a discrepancy in income characterization between the U.S. and other countries.”⁶¹ If such a discrepancy in characterization exists, two countries could apply the same source rules, each of which would yield a different tax result.⁶² Unfortunately, the inevitable possibility for double taxation will remain absent uniform modification of the existing rules. Although the software regulations represent a significant effort in addressing some of the problems associated with the characterization of intangible property, resolution of these issues will require substantial modification in the form of additional intangible property-specific regulations. Such regulations would provide a more comprehensive solution.

In the early 1920’s, a team of economists submitted information in a report to the League of Nations regarding the basic concepts of international taxing jurisdiction.⁶³ The report suggested that imposing an income tax based on the ability of an entity to pay offers no solution as to *which* entity’s ability to pay should be considered in each taxing jurisdiction.⁶⁴ To provide a solution to the problem, the report proposed the “doctrine of economic allegiance,” which has become fundamental in the context of jurisdiction to tax.⁶⁵ Essentially, the doctrine of allegiance was comprised of four bases⁶⁶ for validating the imposition of tax, two of which are considered most important.⁶⁷ The first is source-based jurisdiction, or territorial jurisdiction, which is the primary focus of this article.⁶⁸ Source-based jurisdiction effectively enables the source country to impose taxes on income earned by nonresidents within its territory.⁶⁹ The

60. John K. Sweet, *Comment: Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles*, 146 U. PA. L. REV. 1949, 1958 (1998).

61. *Id.*

62. *Id.*

63. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303–06 (1996); see *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F. 19, 19, 23, 25 (1923).

64. See *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F.19, 18–20.

65. *Id.* at 20–22.

66. The four bases for economic allegiance identified in the report include: the source of wealth, the location of wealth, the place where rights to wealth can be enforced, and the location where wealth is consumed or disposed of. *Id.* at 25. The source and residence bases were considered to be of primary importance. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

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second is residence-based jurisdiction, which enables a country to impose taxes on the worldwide income of its residents irrespective of the source of income.⁷⁰

In addition to introducing the doctrine of allegiance, the report to the League of Nations considered the issue of double taxation that would inevitably arise between the source and residence jurisdictions.⁷¹ Specific questions arose with respect to double taxation, such as, a) which jurisdiction would have priority to tax income derived from one jurisdiction by a resident of another jurisdiction; and b) which of the two jurisdictions would have the obligation to prevent double taxation by surrendering its claim to assert taxing jurisdiction.⁷² The report suggested that although the source jurisdiction should have priority to tax because it has the ability to impose taxes on income derived in its territory first, a more plausible recommendation would be to assign income items to the source country or residence country based on where “the primary economic activity giving rise to the income takes place.”⁷³ Furthermore, the report explained that once the income items are assigned, the right to impose taxes on the income would be divided between the countries.⁷⁴

These fundamental principles support the modern evolution of allocating taxable income among jurisdictions.⁷⁵ Despite the fact that the source country retains priority to impose tax on all income and the residence country has a corresponding obligation to prevent double taxation, this does not evidence the most favorable allocation.⁷⁶ Rather, the purpose inherent in the international tax regime is to impose taxes on active business income in the country of source, and to tax passive income in the country of residence.⁷⁷ The U.S., like many other countries, “asserts jurisdiction to tax based on principles of both source and residence.”⁷⁸ In contrast to methods of characterization, where problems exist due to the lack of statutory guidance, with respect to sourcing, such guidance does exist. However, substantial

70. *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F.19, 25.

71. *Id.* at 40.

72. *Id.*

73. *Id.*

74. *Id.* at 40–42.

75. See Avi-Yonah, *supra* note 63, at 1306.

76. *Id.*

77. See Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 600 (1994).

78. OFFICE OF TAX POLICY, DEPT OF THE TREASURY, *Selected Tax Policy Implications of Global Electronic Commerce*, § 7.1.5 (1996), available at <http://www.treas.gov/offices/tax-policy/library/internet.txt>.

areas of concern remain which, if not modified, could undermine the viability of the existing regulations.

A. Licenses

Owners of intellectual property typically prefer to license property, as opposed to selling it, to maximize profits from the property's commercial use or exploitation.⁷⁹ If a property owner transfers the right to exploit the intellectual property "for a period less than its remaining legally protected life,"⁸⁰ or transfers "anything less than substantially all of the bundle of rights representing an item of intellectual property for the legal life of the property,"⁸¹ the IRS takes the position that the transaction will be characterized as a license.⁸² These approaches to characterizing intangible property in the context of licensing are illustrated in *Pickren v. United States*⁸³ and Revenue Ruling 84-78.⁸⁴

In *Pickren*, joint owners of secret formulas and trade names⁸⁵ entered into an agreement to transfer "certain rights" in the formulas and trade names to a third party.⁸⁶ To determine what specific rights had been granted to the third party, the court examined the language of the contract.⁸⁷ The court found that the contract granted the third party the exclusive right and license to "manufacture, or have manufactured, use and sell, or have sold, the products derived from such secret formulas and the exclusive right to use the . . . trade names throughout the United States and foreign countries."⁸⁸ The court discovered that although such rights to "manufacture or have manufactured, use

79. Cross, *supra* note 44, at 572.

80. Peter H. Blessing, Foreign Income: Source of Income Rules, 905 TAX MGMT. PORT. (BNA) A-49 (1993) (citing Rev. Rul. 60-226, 1960-1 C.B. 26).

81. Cross, *supra* note 44, at 572.

82. Blessing, *supra* note 80, at A-49 (citing Rev. Rul. 60-226, 1960-1 C.B. 26).

83. *Pickren v. U.S.*, 378 F.2d 595, 598 (5th Cir. 1967).

84. Rev. Rul. 84-78, 1984-1 C.B. 173.

85. Historically, a distinction was made between *trademark* and *trade name*. See generally 1 J. MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 4.2-4.5 (4th ed. 2004). A trademark was defined as an arbitrary, fanciful, or suggestive name of, or symbol for, a product or service that was protected under trademark laws. See 3 CALLMANN, UNFAIR COMPETITION, TRADEMARKS, AND MONOPOLIES § 17.5 (4th ed. 2004). A trade name was defined as a descriptive, personal, or geographical name or symbol protected under the law of unfair competition. *Id.* Today these distinctions are obsolete, and the term *trademark* includes all names and symbols, while *trade name* is a symbol distinguishing a company, partnership, or business (as opposed to a product or services). *Id.*

86. *Pickren*, 378 F.2d at 596-97.

87. *Id.* at 600.

88. *Id.*

and sell, or have sold” were limited to 25 years, “the secret formulas had a useful life that would extend beyond 25 years.”⁸⁹ Because the agreement constituted *a transfer for less than the remaining legally protected life* of the secret formulas, the court held that the transaction was a license rather than a sale.⁹⁰

Revenue Ruling 84-78 involved a transfer of less than an entire interest in intangible property.⁹¹ In the ruling, the IRS examined a situation where a domestic corporation granted an exclusive right to a foreign corporation to broadcast a live boxing match taking place in the U.S. to a foreign audience via closed-circuit television.⁹² The issue in the ruling was whether the source of payment received in exchange for the grant of the right to broadcast the fight was U.S. or foreign source income.⁹³ The determination was wholly dependent on the characterization of the income as compensation for personal services, income from the sale of personal property, or royalties for the use of or for the privilege of using a copyright or other like property, or some other type of income.⁹⁴ In Situation 1, the IRS ruled that the foreign corporation was merely granted the right to broadcast the fight in the event that it occurred, and the activities of the domestic corporation were not performed exclusively for the benefit of the foreign corporation, such that the foreign corporation owned the products of the domestic corporation’s labor.⁹⁵ Therefore, the IRS concluded that the payment received by the domestic corporation did not constitute compensation for personal services.⁹⁶ In Situation 2, the IRS explained that although the right to broadcast was exclusive, the right was not granted for the remaining life of the copyright, thus payments received were not from a sale of personal property.⁹⁷ Therefore, the IRS ruled that, because the transfer of the live broadcasting right was *a transfer of less than the entire copyright interest*, the transaction should be characterized as a license.⁹⁸ Consequently, the payment received was foreign source income from the use of or privilege of using property outside the U.S.⁹⁹ As these

89. *Id.*

90. *See id.* at 601.

91. Rev. Rul. 84-78, 1984-1 C.B. 173.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. Rev. Rul. 84-78, 1984-1 C.B. 173.

98. *Id.*

99. *Id.*

examples illustrate, the duration for which the intellectual property right is transferred, and the extent of the rights transferred play a significant role in characterizing transactions involving intangible property as a license rather than a sale.

After a transaction is characterized as a license, the source of income must be determined before tax liability is imposed. Section 861(a)(4) provides that U.S. source income includes rentals or royalties from property “located in the United States,” specifically including income “from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.”¹⁰⁰ The source rule for royalty income derived from a license is determined by the place where intellectual property is located or used.¹⁰¹ Unlike income derived from tangible property, which is typically sourced where the property is physically located, the source of income from intangible property is generally considered to be the place that provides legal protection for the use of the intangible assets.¹⁰² It is interesting to note that the source rules embrace the notion that royalty income is determined by the intangible property’s economic situs alone, irrespective of where the property is created, where the income is paid or received, the residence of the licensee, or where the contract was entered into.¹⁰³ Although application of the place of use rule will ultimately determine whether the royalty income derived is U.S. source or foreign source, the place of use is not always obvious.¹⁰⁴ The ambiguity associated with determining the place of use creates a myriad of problems.

The “cascading royalties” issue is one of the problems directly arising from the difficulty of determining the place of use of intangible property. More than twenty years ago, the IRS considered the issue of cascading royalties which is based on “the theory that the source of income for a royalty remains the country of original exploitation even though the royalty may be paid through a series of entities in different countries.”¹⁰⁵ In Revenue Ruling 80-362, a nonresident alien from a foreign country with which the U.S. had no income tax treaty licensed

100. I.R.C. § 861(a)(4).

101. I.R.C. §§ 861(a)(4), 862(a)(4).

102. CHARLES H. GUSTAFSON ET AL., U.S. TAXATION OF INTERNATIONAL TRANSACTIONS 66 (2001).

103. Blessing, *supra* note 80, at A - 48.

104. Lokken, *supra* note 3, at 237.

105. RHOADES, *supra* note 42, § 25.10.

the U.S. rights on a patent to an unrelated Dutch corporation.¹⁰⁶ Thereafter, the Dutch corporation sub-licensed the patent to a U.S. corporation for use in the U.S.¹⁰⁷ The royalty payments made on the license between the Dutch corporation and the U.S. corporation were exempt from U.S. tax liability under the U.S.-Netherlands income tax treaty then in effect.¹⁰⁸ However, the IRS ruled that the royalties paid by the Dutch corporation to the nonresident alien were also U.S. source income, thus subject to withholding by the Dutch corporation.¹⁰⁹ The IRS explained that because the Dutch corporation *used* the patent in the U.S. by sub-licensing the patent for use in the U.S., the royalties paid were for the use of the patent in the U.S.¹¹⁰ As a consequence, cascading royalties could be subject to U.S. income tax absent applicable treaty provisions.¹¹¹

The conduit regulations were promulgated in 1995 to confront issues similar to the “cascading royalties” scenario in Revenue Ruling 80-362.¹¹²

Specifically, the regulations allow for recharacterization of multi-party “financing arrangements,” which include, but are not limited to, licenses that have been structured for purposes of tax avoidance.¹¹³ The result is that intermediate entities will be disregarded for purposes of determining U.S. taxes,¹¹⁴ and the determination of tax will be based on royalty payments made directly between unrelated parties.¹¹⁵ The IRS will consider the following key factors¹¹⁶ prior to exercising its power to recharacterize such transactions:

Does the participation of the intermediate entity or entities reduce the tax imposed by Section 881?

Is such participation “pursuant to a tax avoidance plan?”

Is the intermediate entity related to the financing or financed entity, or would the intermediate

106. Rev. Rul. 80-362, 1980-2 C.B. 208.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. Blessing, *supra* note 80, at A-48.

112. RHOADES, *supra* note 42, § 25.10. I.R.C. § 7701(l) was added to the Code in 1993 to authorize the promulgation of the conduit regulations which are effective for payments made after September 10, 1995. I.R.C. § 7701(l) (2000).

113. Treas. Reg. § 1.881-3 (2005).

114. *Id.*

115. *Id.*

116. GUSTAFSON, *supra* note 102, at 215.

entity not have participated in the financing arrangement but for the fact that the financing entity engaged in the transaction with the intermediate entity?¹¹⁷

Additionally, the regulations identify factors¹¹⁸ to indicate whether a tax avoidance purpose underlies the structure of the transaction.¹¹⁹

Is there a “significant reduction” in the tax otherwise imposed under Section 881?

Did the conduit have the ability to make the advance without advances from the related financing entity?

What was the period of time between the respective transactions?

Did the financing transactions occur in the ordinary course of business of the related entities?

As stated above, if the conduit entity is disregarded, the royalty payments will be deemed paid in a transaction between unrelated parties and therefore subject to tax.¹²⁰ However, if such parties are residents of treaty countries, the 30 percent withholding tax may be eliminated or reduced.¹²¹

Example 10 of the conduit regulations presents an interesting scenario.¹²² It provides that if entity A licenses to entity B the rights to use intellectual property in the U.S. to manufacture product X under which B agrees to pay A a fixed amount in royalties each year under the contract, and during the subsequent year, entity B sublicenses the same right to entity C under which C agrees to pay B royalties based on the amount of product X manufactured by C, royalties paid by C to B are not subject to U.S. withholding tax.¹²³ The example provides, however, that royalties paid by B to A are income from U.S. sources, thus subject to the 30 percent U.S. withholding tax.¹²⁴ The example further states that because the rate of tax imposed on royalties paid by B to A is identical to the rate that would have been imposed on royalties paid by C to B, the transactions between A to B to C do not involve a conduit arrangement, thus

117. Treas. Reg. § 1.881-3(a)(4).

118. GUSTAFSON, *supra* note 102, at 215.

119. Treas. Reg. § 1.881-3(b)(2).

120. *Id.*

121. GUSTAFSON, *supra* note 102, at 215.

122. Treas. Reg. § 1.881-3(e), Ex. 10.

123. *Id.*

124. *Id.*

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not subjecting royalties paid from C to B to the U.S. withholding tax.¹²⁵

The Tax Court was confronted with similar issues in *SDI Netherlands BV v. Commissioner*.¹²⁶ In *SDI Netherlands*, at issue was the sourcing and taxation of certain royalty payments made by a Dutch corporation to a related Bermudian corporation.¹²⁷ The Bermudian corporation held worldwide rights to systems software for IBM computers that it licensed to the Dutch Corporation.¹²⁸ Subsequently, the Dutch corporation sub-licensed the U.S. portion of the rights to a U.S. corporation (all of the companies were related).¹²⁹ The IRS took the position that because a portion of the royalty payments made by the Dutch corporation were attributable to payments received from a related U.S. licensee, a portion of the payments should “retain their character” as U.S. source income.¹³⁰ The Tax Court disagreed with the IRS and explained that the royalties paid by the U.S. licensee to the Dutch corporation “became merged with the other royalties received” by the Dutch corporation “from non-U.S. sources and consequently lost their character as U.S. source income.”¹³¹ In a widely criticized decision, the Tax Court explained that the position taken by the IRS could lead to multiple withholding taxes being imposed on the same income stream, and determined that the royalty payments from the license and sub-license were separate and distinct transactions.¹³² Therefore, the Tax Court held that the payments made by the Dutch corporation to the Bermudian corporation were not received from sources within the U.S.¹³³ The controversy surrounding the Tax Court’s opinion was due to the fact that the decision essentially suggested that the source of a royalty payment could be changed by passing the royalty through a foreign company.¹³⁴

125. *Id.*

126. *SDI Netherlands BV v. Comm’r*, 107 T.C. 161 (1996).

127. *Id.* at 162.

128. *Id.* at 163

129. *Id.* at 164-66

130. *Id.* at 171.

131. *Id.* at 172.

132. *SDI Netherlands*, 107 T.C. at 175-77.

133. *Id.* at 176-77. Noteworthy is Judge Tannenwald’s comment in the opinion regarding the absence of congressional intent in the statutory provisions: “We are not disposed to conclude, in the absence of any legislative expression on the subject, that Congress intended the statutory provisions to permit “cascading” with the question of relief left to the mercy of respondent.” *Id.* at 176.

134. Michael J. McIntyre, *The Royalty Source Rule, Treaty Shopping, Cascading Effects, and the U.S. Tax Court’s Indefensible Decision in SDI Netherlands*, 15 TAX NOTES

For a number of years, commentators have emphasized that the Tax Court's holding was questionable because it was in direct conflict with the language of section 861(a)(4) which provides that the source of a royalty payment is where the intangible property is used.¹³⁵ In *SDI Netherlands*, the royalty payments made by the Dutch corporation to the Bermudian corporation for the use of intangible property in the U.S. were unquestionably U.S. source income, and thus fully taxable to the Bermudian corporation and subject to the 30 percent withholding tax under section 1442.¹³⁶ Considering the direct conflict that exists between the holding in *SDI Netherlands* and the language of section 861(a)(4), any reliance on *SDI Netherlands* could likely produce undesirable results. Furthermore, taking into consideration the scenario presented in Example 10 of the conduit regulations and the holding in *SDI Netherlands*, it is unclear whether the U.S. withholding tax liability can be imposed on any party to an *SDI*-type transaction.

Determining the place of *actual* use of intangible property presents significant additional problems with respect to the place of use rule. With respect to *use* of intellectual property, the rule provides for allocation of royalty payments to the country(ies) in which the licensee is granted the right to use – and is legally protected in using – the property, provided that the intangible property is *actually* used there.¹³⁷ Therefore, identifying the place of *actual* use is fundamental to the application of the place of use rule. The IRS has been required to determine the place of *actual* use of intangible property in a multitude of transactions involving patents, copyrights, trademarks, and other similar property.¹³⁸ However, a number of cases and rulings have evidenced a preference with respect to utilizing the place of consumption as the basis for the application of the place of use rule.¹³⁹

In the context of applying the source rules to royalties derived from licenses of copyrights,¹⁴⁰ “the Tax Court has

INT'L 2031, 2031 (1997).

135. *Id.* at 2033.

136. *Id.*; I.R.C. § 1442 (2000).

137. Blessing, *supra* note 80, at A-48. If rights to use the property are granted in multiple countries, however, only the countries in which the intellectual property is actually used are considered for purposes of applying the source rules for royalty payments. *Id.*

138. *Id.*

139. *Id.*

140. A copyright is defined, subject to limitations, as the exclusive rights to do and to authorize any of the following: (a) to reproduce the copyrighted work in copies or phonorecords; (b) to prepare derivative works based upon the copyrighted work; (c) to

occasionally assumed, without expressly recognizing the issue, that a copyright is used where products embodying the copyright are sold or consumed¹⁴¹ which often is not the place of *actual* use of the copyright. In *Ferenc Molnar v. Commissioner*, a foreign individual authored a play and a short story, both of which were protected by U.S. copyrights, for which he licensed the sole and exclusive motion picture rights to a U.S. producer.¹⁴² The individual sought to deduct a portion of the royalty payments received as attributable to foreign sources, but the Tax Court denied the deduction based on insufficient evidence that the play and short story were used in any motion pictures exhibited in foreign countries.¹⁴³ The court's decision "rest[ed] on an unexpressed assumption that royalties under a license to use a novel or story in a motion picture originate where the movie is *shown*, not where the licensee produced it."¹⁴⁴

One scholar has argued that royalties derived from licenses are "more closely associated with the places of consumption of the goods produced under the license" because the place of consumption "makes the larger contribution to the licensee's income."¹⁴⁵ In a case similar to *Molnar*, *Rohmer v. Commissioner*, a nonresident alien author of short stories granted serial publication rights to a U.S. literary agent.¹⁴⁶ The stories were published in magazines that were sold in the U.S. and Canada.¹⁴⁷ The Tax Court apportioned the royalty payments between the U.S. and Canada because it was determined that both places, the places of *consumption* of the goods produced with the intellectual property, were the places of actual use.¹⁴⁸ Notably, the location of printing of the magazines and the place of title passage of the magazines were of no issue.¹⁴⁹ This case was "most consistent with the idea that royalties originate at the places of

distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending; (d) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly; and (e) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.

17 U.S.C. § 106 (2000).

141. Lokken, *supra* note 3, at 280.

142. *Molnar v. Comm'r*, 156 F.2d 924, 924-25 (2d Cir. 1946).

143. *Id.* at 925-97.

144. Lokken, *supra* note 3, at 280 (emphasis added).

145. *Id.* at 277-78.

146. *Rohmer v. Comm'r*, 5 T.C. 183, 184 (1945), *cert. denied*, 328 U.S. 862 (1946).

147. *Id.* at 185.

148. *Id.* at 188-90.

149. Lokken, *supra* note 3, at 280.

consumption of goods produced under the license.”¹⁵⁰

Intellectual property is considered to be a monopoly right because it “yields income to the holder of the property where competition is restrained.”¹⁵¹ This premise is used to demonstrate that the place of consumption is of more importance than the place of production or manufacture for purposes of determining the place of actual use of intellectual property.¹⁵² Specifically, at least one scholar has suggested that if intellectual property restrains competition in several countries that contribute to the licensee’s income, “the income should be assigned to the place of the restraint that is most important to the income earning process.”¹⁵³ Although making a choice between the places of manufacture and consumption of the goods to determine which is more important to the income earning process is difficult, it has been suggested that this determination should be based on “a weighing of the relative importance” of each location.¹⁵⁴ The following example is provided to illustrate this concept:

Assume a license is granted under patents issued in Countries A, B and C covering a particular invention, and the licensee uses the invention to manufacture goods in Country A and sells the goods in country B to a purchaser that resells them to consumers in Country C. The licensee uses each patent in the country that issued it and could not do business in precisely this way if it lacked rights under any of the patents. A loss of rights under the Country A patent would require that the manufacturing be done elsewhere; the licensee could not sell in Country B without his rights there; and a loss of Country C rights would block the final sales to consumers. A shift in the place of the first sale, that is, the place at which the manufacturer conveys title to its purchaser, most likely would not significantly disrupt the business. The monopoly enjoyed at this place therefore is not crucial to the income earning process and is not the primary economic source of the income.¹⁵⁵

150. *Id.*

151. *Id.* at 277.

152. *Id.*

153. *Id.* at 277-278.

154. *Id.* at 278.

155. Lokken, *supra* note 3, at 278.

Thus, the narrow issue is whether the manufacturing right in Country A or the right to sell in Country C makes a larger contribution to the licensee's income.¹⁵⁶ Some scholars advocate that the right to sell for consumption in a particular country is probably most often of greatest importance.¹⁵⁷ The premise advocated for is "that intellectual property is used at the place of consumption of any good or service produced with the property."¹⁵⁸ Moreover, it is argued that this concept should apply whether royalty payments are "fixed independently of usage" or "vary with usage" because both types of payments obtain the same result.¹⁵⁹

In Revenue Ruling 68-443, the IRS actually took the position that intellectual property is used at the place of consumption.¹⁶⁰ The ruling addressed the place of use of a trademark¹⁶¹ that was licensed by a foreign corporation to a domestic corporation.¹⁶² Specifically, the license granted to the domestic corporation the right to affix the foreign trademark on the domestic corporation's products as well as the right to sell the trademarked products.¹⁶³ The products were manufactured in the U.S., and sold by the domestic corporation in the U.S. to a foreign buyer for subsequent resale.¹⁶⁴ The IRS held that the royalties were foreign source because they were "paid for the use of the trademarks in the foreign countries."¹⁶⁵ Incidentally, the IRS disregarded the place of initial sale of the trademarked products as having no effect on the determination of the source of income.¹⁶⁶ The place of initial sale was disregarded because the licensee was not authorized to sell the trademarked products for consumption in the U.S., and any such use would have infringed the U.S. trademark held by another party.¹⁶⁷ The decision was

156. *Id.*

157. *Id.*

158. *Id.* at 281.

159. *Id.*

160. *Id.* at 278.

161. A trademark is defined as "a distinctive word, name, symbol, or device used by a manufacturer, merchant, or business to identify goods or services and distinguish them from those manufactured or sold by other entities." MODERN DICTIONARY FOR THE LEGAL PROFESSION 921 (3rd ed. 2001); *see also supra* note 85.

162. Rev. Rul. 68-443, 1968-2 C.B. 304 (1968).

163. *Id.*

164. Lokken, *supra* note 3, at 278.

165. *Id.* at 279 (citing Rev. Rul. 68-443, 1968-2 C.B. 304).

166. *Id.* (citing Rev. Rul. 68-443, 1968-2 C.B. 304).

167. *See* Rev. Rul. 68-443, 1968-2 C.B. 304. This decision raises an interesting issue of whether the place of infringing use of intellectual property is the place of actual use for purposes of applying the source rules. Notably, the IRS has relied on the source rule for royalties in determining the source of a payment received in settlement of a patent

based on the fact that the foreign corporation only owned the foreign rights to the trademark.¹⁶⁸

More recently, the IRS confirmed its position with respect to its assumption that intellectual property is actually used at the place of consumption.¹⁶⁹ In Field Service Advice 200222011, a foreign corporation licensed software to a related U.S. corporation.¹⁷⁰ The U.S. corporation subsequently licensed the software to an unrelated U.S. computer manufacturer. The manufacturer then incorporated the licensed software into the computers and sold them in the U.S. and in foreign countries.¹⁷¹ The IRS suggested that the intellectual property was used in the U.S., thus the royalty payments made by the U.S. corporation to the foreign corporation were U.S. source income.¹⁷² Notably, the IRS rejected the U.S. corporation's argument that payments attributable to the computer sales in foreign countries were foreign source income.¹⁷³

In addition to the issues previously discussed, the place of use rule raises other concerns. Specifically, because intellectual property may enjoy certain rights in numerous countries, but might only be used in one country, to an unspecified degree in various countries, or may not be actually used at all, complex issues arise with respect to the allocation and apportionment of royalty payments derived from intellectual property.¹⁷⁴ When royalties are received for multinational uses of intellectual property, the place of use rule apportions such royalty income derived among countries of *actual* use.¹⁷⁵ Under these circumstances, in the absence of a contract specifying apportionment, the taxpayer has the burden to prove apportionment based on the facts.¹⁷⁶ If no specific allocation is provided for by agreement or contract, or cannot be determined

infringement suit. In Field Service Advice 200139022, the IRS concluded that a lump-sum amount received in settlement of a patent infringement action could be treated "as a payment in lieu of a reasonable royalty," rather than damages for lost profits. *See* I.R.S. F.S.A. 200139022 (June 29, 2001).

168. Rev. Rul. 68-443, 1968-2 C.B. 304.

169. I.R.S. F.S.A. 200222011 (February 26, 2001).

170. *Id.*

171. *Id.*

172. *Id.* It must be noted, however, that the IRS also concluded that even if the intellectual property was not used in the U.S., the income should have been sourced in the U.S. based on the fact that no reasonable method was provided for in the contract to apportion the income between U.S. and foreign sources. *See id.*

173. *Id.*

174. Blessing, *supra* note 80, A-49.

175. *Id.* at A-48.

176. *Id.* at A-49.

based on a reasonable relationship between the factual apportionment and the royalties from the license, the royalty income will be considered U.S. source.¹⁷⁷ The apportionment rule has been applied fairly consistently in the jurisprudence.¹⁷⁸

In *Rohmer*, the Tax Court determined that the income derived from a license for the publication of copyrighted works in two different countries was U.S. source.¹⁷⁹ Although the intangible property was actually used in the U.S. and Canada, the Court refused to apportion a lump sum payment between these countries because there was no apportionment provided for in the contract.¹⁸⁰ In *Molnar*, the Tax Court determined that royalty payments received from a license of worldwide motion picture rights that were never used were U.S. source income.¹⁸¹ The Court refused to consider evidence of the amount of the taxpayer's U.S. and foreign source income because it was too speculative.¹⁸² Notably, the Second Circuit in affirming both decisions on appeal suggested that the taxpayer's introduction of expert testimony might have affected the outcome of both cases.¹⁸³ As the above discussion indicates, the place of use rule is likely the most appropriate rule for determining the source of income derived from intangible property. However, it is also clear that numerous problems exist with respect to the place of use rule, the majority of which stem from the difficulty in defining and determining the place of actual use.

B. Sales for Fixed or Contingent Payments

Where the owner of a copyright or patent grants an exclusive right to another to exploit such property for the life of the copyright or patent, the IRS takes the position that the transaction shall be characterized as a sale of personal property.¹⁸⁴ However, it has been established that in the context of transactions involving patents, copyrights, trademarks and know-how, "the requirements for a complete sale – perpetual transfer, exclusive use, and the right to monopolize the transferred right – are not defeated by the transferor's retention of certain rights" including "(i) retention of legal title for the

177. *Id.*

178. *See id.*

179. *Rohmer*, 5 T.C. at 185, 188.

180. *Id.* at 188-89.

181. *Molnar*, 156 F.2d at 924-26.

182. *Id.* at 926.

183. *Id.*

184. Rev. Rul. 60-226, 1960-1 C.B. 26.

purpose of bringing an infringement suit, provided the transferee or licensee also has such power with respect to the transferred right; and (ii) right of termination of the license for breach, bankruptcy or insolvency, or failure to meet quantity or quality requirements.”¹⁸⁵

The scope of a sale of intangible property was expanded in *Myers v. Commissioner*.¹⁸⁶ In *Myers*, the Tax Court considered the issue of whether an exclusive license for the life of a patent qualified as a sale as opposed to a license.¹⁸⁷ In reaching its decision, the Tax Court determined that if an exclusive license for the life of the patent grants “rights to make, use, or sell the patented product or process within a designated territory” the transaction will qualify as a sale.¹⁸⁸ Several years after the *Myers* decision, the IRS considered a related issue with respect to a copyright, and the similarity between patents and copyrights was markedly the basis for its rationale.¹⁸⁹ In Revenue Ruling 60-226, the IRS held that income from “a grant transferring the exclusive right to exploit [a] copyrighted work in a medium of publication throughout the life of the copyright shall be treated as proceeds from a sale of property.”¹⁹⁰ Accordingly a grant of exclusive rights within a designated territory or within a particular medium of publication weighed heavily in favor of sale treatment. However, such characterization could have been used as a mechanism to circumvent license/royalty treatment. Taking advantage of this pronouncement by the IRS may have been as simple as including certain provisions in a contract. As discussed below, any potential abuse that resulted from the characterization problem presented in *Myers* was alleviated because the source rules applicable to such transactions were altered.

It is important to note that in contrast to characterizing other intangible property transactions as sales, transactions

185. Blessing, *supra* note 80, at A-60 (citing *Coplan v. Comm’r*, 28 T.C. 1189, 1190 (1957); *Myers v. Comm’r*, 6 T.C. 258, 260 (1946)).

186. *Myers v. Comm’r*, 6 T.C. 258, 264 (1946)

187. *Id.* at 262.

188. Blessing, *supra* note 80, at A-59 (citing *Myers*, 6 T.C. at 258). This transaction would qualify as a sale even if the payment consisted of royalties contingent on the product’s sales. *Id.* (citing *Myers*, 6 T.C. at 258).

189. Rev. Rul. 60-226, 1960-1 C.B. 26.

190. Blessing, *supra* note 80, at A-59 (quoting Rev. Rul. 60-226, 1960-1 C.B. 26). This transaction would be characterized as a sale “regardless of whether the consideration received is measured by a percentage of the receipt from the sale, performance, exhibition or publication of the copyrighted work, or is measured by the number of copies sold, performance given, or exhibition made of the copyrighted work, or whether such receipts are payable over a period generally co-terminous with the grantee’s use of the copyrighted work.” *Id.* (quoting Rev. Rul. 60-226, 1960-1 C.B. 26).

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involving trademarks and know-how “must be [a transfer] in perpetuity or until legal protection is lost, and must be exclusive as to the territory or field in which the license is granted.”¹⁹¹ Furthermore, the IRS has specified that trademarks and know-how “must be legally protected in the country of transfer in order to qualify as ‘property,’ and the transferor must transfer the right to enjoin others from use or disclosure of the technology in the territory or field of transfer.”¹⁹²

As stated above, due to the complex nature of classifying a transaction as a license or a sale, additional source rules were enacted to tax income differently depending on whether a sale of intangible property is for a fixed price or for a price “contingent on the productivity, use or disposition of the intangible.”¹⁹³ These provisions require that gains from sales of intangible property for a fixed price be sourced according to the residence of the seller.¹⁹⁴ It is important to note that application of this rule is limited to non-inventory property.¹⁹⁵ Therefore, if a U.S. individual or corporation sells intangible property, generally the income will be deemed U.S. source income irrespective of where the intangible property is used or of the location of the purchaser.¹⁹⁶ On the other hand, if a foreign individual sells a business in the U.S., any gain derived from the sale that is attributable to intellectual property (i.e. patents, franchises) will be foreign source.¹⁹⁷ Typically, U.S. individuals and corporations prefer to generate foreign source income in order to increase their foreign tax credits, while foreign individuals and corporations can avoid U.S. taxes altogether by deriving income from foreign sources that is not effectively connected to a U.S. trade or business.¹⁹⁸

Notwithstanding classification as a sale, in situations where payments are “contingent on the productivity, use, or disposition of the intangible,” the source rule for royalties applies, thus

191. Blessing, *supra* note 80, A-60 (citing Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 64-56, 1964-1 C.B. 133).

192. *Id.* (citing Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Rul. 68-443, 1968-2 C.B. 304; Rev. Proc. 69-19, 1969-2 C.B. 301).

193. I.R.C. § 865(a), (d) (2000). In the case of amortizable intangible property, such as a patent, gain derived to the extent of the amortization will be sourced according to the depreciable personal property rules, and the remaining gain will be sourced based on the fixed or contingent payment rules. POSTLEWAITE, *supra* note 2, at ¶ 14.02[8][b].

194. I.R.C. § 865(a), (d).

195. *Id.* § 865(b).

196. 1 INTERNATIONAL TAXATION 15:1, ¶ 15.8, *available at* <http://www.lexisnexis.com/>.

197. *Id.* It should be noted that income from sales attributable to a foreign person’s U.S. office or other fixed place of business will be U.S. source income. I.R.C. § 865(e)(2).

198. 1 INTERNATIONAL TAXATION, *supra* note 196, ¶ 15.8.

payments will be sourced according to the place of use.¹⁹⁹ Congress introduced the “deemed royalty source rule” for contingent payments²⁰⁰ to prevent foreign corporations from escaping U.S. taxation “on income economically analogous to royalties by transferring the property in the form of a sale.”²⁰¹ Absent the deemed royalty source rule, transactions classified as sales by foreign individuals and corporations could have avoided U.S. tax liability if the gains were not effectively connected to a U.S. trade or business, or classified as foreign source income under the residence of the seller rule.²⁰² In accordance with this rule, the portion of gain that will be taxed as a royalty does not include any recovery of basis or imputed interest, and special rules will apply to the allocation of such payments.²⁰³ Furthermore, a 30 percent withholding tax will apply to U.S. source contingent payments assuming that the income is not effectively connected to a U.S. trade or business or subject to a reduced rate of tax under a treaty.²⁰⁴ Due to the fact that income from sales of intangible property that is contingent on the productivity, use or disposition of the intangible is sourced according to the place of use, all issues associated with the place of use rule, as previously discussed with respect to licenses, are pertinent to such sales transactions.²⁰⁵

C. *Manufacture and Sale of Goods Using Intellectual Property*

In some instances, intellectual property is embodied in other products that are manufactured for sale. If the source of income derived from sales of such products is determined by the place where the intellectual property is used, then how does one determine where it is used? Is the intellectual property used where the product is manufactured, where the product is sold, or at the place of consumption of the product?²⁰⁶ There is no bright-line answer to this question, and the case law continues to apply the existing rules somewhat arbitrarily.²⁰⁷ Historically, the “title passage” rule governed all sales of personal property including

199. I.R.C. § 865(d)(1).

200. See id. § 367(d)(2).

201. Blessing, *supra* note 80, at A-58(4).

202. *Id.*

203. See Treas. Reg. § 1.871-11(d) (2005).

204. I.R.C. § 871(a)(1).

205. See Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 195 (1991).

206. Lokken, *supra* note 3, at 238.

207. *Id.*

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inventory and non-inventory.²⁰⁸ However, in 1986, new rules were promulgated in response to potential manipulation of the title passage rule.²⁰⁹ The title passage rule was retained for transactions involving inventory property under which income from the sale is sourced to the country where title to the property passes.²¹⁰ With respect to non-inventory property, the fixed or contingent payment rules for sales transactions apply.²¹¹

Because intangible property itself is seldom classified as inventory, the title passage/inventory rule is usually inapplicable.²¹² In fact, “daily operational income” derived from intangible property is most often classified as royalty or services income.²¹³ Furthermore, the non-inventory source rules are generally applicable to transactions involving “dispositions of intellectual property.”²¹⁴ However, when intangible property is used to manufacture products for later sale, the inventory source rules are applicable to income derived from such transactions.²¹⁵

In 1996, the IRS finalized regulations that apply to income derived from the manufacture of inventory in one country and sale in another.²¹⁶ In accordance with the regulations, gross income is allocated between the locations of production activity and sales activity.²¹⁷ Moreover, the regulations provide three different methods that a taxpayer may elect for the allocation of such income.²¹⁸ Under the 50-50 method, one-half of the income is allocated to the place of manufacture, and the other half is allocated to the place of sale.²¹⁹

Alternatively, a taxpayer may elect to allocate gross income using the independent factory price (IFP) method if the independent factory price can be established.²²⁰ A taxpayer who makes regular sales to independent distributors will typically use this method. In this scenario, the income earned from the production activity can be reasonably determined.²²¹ In

208. POSTLEWAITE, *supra* note 2, at ¶ 14.02[6].

209. *Id.*

210. I.R.C. § 861(a)(6); Treas. Reg. § 1.861-7 (2005).

211. I.R.C. § 865(a), (d).

212. POSTLEWAITE, *supra* note 2, at ¶ 14.02[6].

213. *Id.*

214. *Id.*

215. *Id.*

216. Source of Income from Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another, 60 Fed. Reg. 60540 (Nov. 29, 1996).

217. Treas. Reg. § 1.863-3(a) (2005).

218. *See id.* § 1.863-3(b).

219. *Id.* § 1.863-3(b)(1)(i).

220. *Id.* § 1.863-3(b)(2)(i).

221. *Id.*

accordance with this method, the amount of the income equal to the IFP will be allocated to production activity, and the excess income over the IFP will be allocated to the sales activity.²²²

Finally, a taxpayer may seek permission from the District Director to determine the amounts of income allocable to production and sales activity based on its books of account.²²³ This method requires the taxpayer to regularly account for receipts and expenditures from production and sales, and thus, should clearly reflect the taxpayer's income allocated to each activity.²²⁴

Under each of these three methods, once the allocations have been made, income derived from the sale is sourced in accordance with the title passage rule²²⁵ while income from the production activity is sourced according to the location of the production assets.²²⁶ In cases where production is conducted in multiple jurisdictions, i.e. manufacturing commences in one country and is completed in another, the income from manufacturing will be divided between the countries "based on the relative values of the production assets located in each jurisdiction, as measured by the average adjusted bases of the production assets used in the production process."²²⁷ Production assets are defined to include intangible assets "directly used" to manufacture the inventory property (i.e. patents), and do not include "marketing intangibles, including trademarks and customer lists."²²⁸ Moreover, intangible assets are considered to be located where the tangible production assets to which they relate are located.²²⁹ To illustrate, if a foreign company manufactured goods using a patented process with machinery located in a foreign country and thereafter shipped the goods to a U.S. factory for completion, the patent will be deemed to be located in the foreign country.²³⁰ Prior to the 1996 regulations,

222. *Id.* § 1.863-3(b)(2)(ii). If a taxpayer elects this method, however, the IFP must be applied to all inventory sales under section 863 "that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP." *Id.*

223. Treas. Reg. § 1.863-3(b)(3). The District Director may revoke permission to use this method if the taxpayer's books of account are not kept in accordance with certain conditions set forth in the regulations. *Id.*

224. *Id.*

225. POSTLEWAITE, *supra* note, at 2 ¶ 14.02[6].

226. *Id.*

227. *Id.* (citing Treas. Regs. §§ 1.863-3(c)(1)(i)(A); 1.863-3(c)(1)(ii)(A); 1.863(c)(1)(ii)(B)).

228. Treas. Reg. § 1.863-3(c)(1)(B).

229. *Id.*

230. See generally, POSTLEWAITE, *supra* note 2, at ¶ 14.02(6) for a similar

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certain scholars had suggested that “the role of intellectual property in the production of income realized on sales of goods is not . . . explicitly recognized in the application of the source rules.”²³¹ Specifically, these scholars had argued that methods for allocating income between the manufacturing and sales functions were “without regard to whether either of these locations is in any realistic sense a place of economic origin of the portion of the income attributable to the use of intellectual property.”²³² It remains to be determined whether the 1996 regulations have fully addressed these scholars’ concerns.

D. Services

As evidenced throughout this article, many difficulties arise with respect to the classification of transactions and sourcing of income derived from intangible property. Another area for consideration involves transactions in which income is derived from some type of service. Problems in this area typically arise in distinguishing services income from royalties for licenses, and also distinguishing services income from gains from sales of intangible property.²³³

The first type of services income that must be distinguished from other classifications is income derived from a taxpayer’s performance of services that results in the creation of intangible property, such as a copyright, patent, or secret process.²³⁴ If a taxpayer grants the right to use the property to another person or entity, difficulties arise with respect to determining whether the payments received must be classified as royalties for the *use* of the intangible property, or as *compensation* for personal services.²³⁵ Additionally, it is often difficult to distinguish between contracts for personal services and the sale of an intangible property right. The critical factors relied on in the identification of income as compensation for personal services are “whether the creator is obligated under contract to create such property and, on its creation, whether the property rights thereto

illustration.

231. Lokken, *supra* note 3, at 294.

232. *Id.*

233. POSTLEWAITE, *supra* note 2, at ¶ 14.02[3].

234. *Id.*

235. *Id.* In certain instances, compensation earned by nonresident aliens will not be U.S. source. I.R.C. § 861(a)(3) (2000). This limited exception to the compensation for services source rule applies to nonresident aliens who are present in the U.S. for periods not in excess of 90 days during the tax year, the compensation is not in excess of \$3,000, and if the services are performed on behalf of a foreign office or branch of a U.S. entity or for a foreign entity not engaged in a U.S. trade or business. *Id.*

(beneficial ownership, not merely legal title) belong to another.”²³⁶ Therefore, if the creator of the intellectual property is under contract to create such property and surrender the rights thereafter, payments made to the creator will be compensation for personal services.²³⁷

In Revenue Ruling 74-555, a nonresident alien author entered into a contract with a domestic corporation that granted to the corporation the first American serial rights in the taxpayer’s exclusive output of stories.²³⁸ The domestic corporation was to pay the author a fixed amount for each story.²³⁹ The contract terms also provided that the domestic corporation would be granted the right to publish the stories in the U.S. at “royalty rates mutually agreeable to the contracting parties.”²⁴⁰ Absent from the contractual terms was any stipulated time frame or manner in which the author was to write the stories.²⁴¹ The issue was whether the payments received by the author constituted compensation for personal services or royalties for the privilege of using copyrights in the U.S.²⁴² Because the contract did not commit the author to write anything in any specific manner or time frame, the IRS ruled that the contract was “neither a contract of employment nor a contract for the rendition of personal services.”²⁴³ As a result, the rights contracted for were “licenses for the use of or for the privilege of using copyrights in the United States,” and the payments were taxable as U.S. source income.²⁴⁴

Similarly, in *Boulez v. Commissioner*, the taxpayer was a resident of Germany who entered into a contract with CBS Records to render services as a producer/performer of musical compositions for the purpose of making phonograph records in the U.S.²⁴⁵ The issue before the court was whether certain payments received by the taxpayer were “royalties” within the meaning of a tax treaty between Germany and the U.S., and therefore exempt from tax by the U.S., or whether the payments were compensation for personal services and taxable by the

236. POSTLEWATE, *supra* note 2, at ¶ 14.02[3].

237. *Id.*

238. Rev. Rul. 74-555, 1974-2 C.B. 202.

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. Rev. Rul. 74-555, 1974-2 C.B. 202.

245. *Boulez v. Comm’r*, 83 T.C. 584, 585 (1984).

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U.S.²⁴⁶ After examining the terms of the contract, the Tax Court explained that “the labels which the parties affix to a transaction are not necessarily determinative of their true nature, and the fact that a party’s remuneration under the contract is based on a percentage of future sales of the product created does not prove that a licensing or sale of property was intended, rather than compensation for services.”²⁴⁷ Thereafter, the Court concluded that a contract for personal services was intended as opposed to a contract for the sale or license of any future property rights of the taxpayer.²⁴⁸ In its reasoning the Court emphasized that the existence of “an ownership interest in the property whose licensing or sales gives rise to the income” is fundamental for the purpose of determining whether royalty income exists. The Court held that no ownership interest existed in the recordings created by the taxpayer because he had entered into a contract for the performance of personal services.²⁴⁹ Consequently, the payments received were taxable as U.S. source income.²⁵⁰

Under the general rule, compensation received for services is sourced according to the location where the services are performed.²⁵¹ As a result, compensation earned for labor or services performed in the U.S. will be U.S. source income, and compensation for services performed outside the U.S. will be foreign source.²⁵² While application of this rule appears simplistic, it is important to note that the rule does not take into account the place where the contract for services was made, the residence of the payor, or the place or time of payment.²⁵³

Another difficulty that arises in the context of services transactions is determining the “source of service income attributable to the attendant servicing or operational instruction regarding an intangible asset.”²⁵⁴ To illustrate, if a license is granted for the use of patented property and additionally the licensee contracts for the right to have the licensor service the patented property (for example, performing installation and maintenance services for a patented manufacturing process),²⁵⁵ the royalties derived from the license will be sourced according

246. *Id.* at 584.

247. *Id.* at 591 (citing *Karrer v. United States*, 152 F.Supp. 66 (Ct. Cl. 1957)).

248. *Id.* at 589.

249. *Id.* at 593-95.

250. *Id.* at 596.

251. I.R.C. §§ 861(a)(3) and 862(a)(3) (2000).

252. I.R.C. § 861(a)(3).

253. Treas. Reg. § 1.861-4(a)(1) (2005).

254. POSTLEWAITE, *supra* note 2, at ¶ 14.02[3].

255. *Id.*

the place of use rule,²⁵⁶ and the services income will be sourced to the place of performance²⁵⁷ of the services.²⁵⁸ If the services are minimal in proportion to the licensing, however, the IRS takes the position that the total income received will be sourced as royalties.²⁵⁹

Allocation of services income between U.S. and foreign sources can present additional difficulties as well.²⁶⁰ When labor or services are performed partly within and partly outside the U.S., there are no definite rules that provide for apportioning income received. The regulations indicate that apportionment may be made on whatever basis “most correctly reflects the proper source of income,” and that “in many cases . . . apportionment on the time basis will be acceptable.”²⁶¹ Furthermore, a facts and circumstances analysis may be used to establish an alternative method of apportionment if apportionment on the time basis is not appropriate.²⁶²

E. *Space and Ocean Activities*

In January 2001, the IRS issued proposed regulations to address the taxation, and specifically, the sourcing of income derived from space and ocean activities.²⁶³ Although only issued in proposed form, the regulations evidence IRS initiative to provide guidance in other developing areas that involve transfers of intangible property.²⁶⁴ In accordance with the proposed regulations, space activities include “any activity conducted in space” including the “licensing of technology or other intangibles for use in space.”²⁶⁵ Ocean activities include those performed “on or under the water outside the jurisdiction of the U.S. or any

256. I.R.C. § 861(a)(4).

257. I.R.C. § 861(a)(3).

258. POSTLEWAITE, *supra* note 2, at ¶ 14.02[3].

259. *Cf.* Rev. Rul. 64-56, 1964-1C.B. 133, *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.

260. Treas. Reg. § 1.861-4(b)(1)(i) (2005).

261. *Id.* Apportionment on the time basis requires including in gross income an “amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.” *Id.* § 1.861-4(b)(2).

262. *Id.* § 1.861-4(b)(1)(i).

263. Source of Income from Certain Space and Ocean Activities, 66 Fed. Reg. 3903, 3903 (proposed January 17, 2001). Proposed regulations, unlike final regulations, do not have the effect of law. *See* 18 Stand. Fed. Tax Rep. (CCH) ¶ 43,282.0213, at 72,895 (2000).

264. 66 Fed. Reg. 3903, 3904 (proposed January 17, 2001).

265. *Id.* at 3906.

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other country (as recognized by U.S. law), including the licensing of technology or other intangible assets for use in international waters.”²⁶⁶ It is important to note, however, that space and ocean activities do not encompass any “activities giving rise to transportation income or international communications income, or any activity with respect to mines, oil and gas wells, or other natural deposits if located in the United States or another country.”²⁶⁷ The source rules under the proposed regulations provide that income from space and ocean activities is sourced according to the residence of the taxpayer.²⁶⁸ Therefore, income earned by a U.S. person from such activities will be considered U.S. source, and income earned by a foreign entity will accordingly be foreign source.²⁶⁹

IV. EXAMINATION OF PROPOSED SOLUTIONS

Modern day e-commerce as well as the widespread use of digitized products presents clear evidence of how the global use of intellectual property has “threaten[ed] the continued viability of certain traditional tax concepts.”²⁷⁰ Historically, source-based taxation was wholly dependent on the identification of the precise economic situs of certain activities.²⁷¹ However, application of the existing source rules has become increasingly difficult due to the fact that the physical location of intangible property is impossible to identify.²⁷² Scholars have proposed the development of new international tax laws as well as modification of the existing regime²⁷³ in an effort to adapt the source rules that once applied in a mostly tangible world to a new age high-tech atmosphere.

International tax scholars have suggested that Congress adopt a source rule based solely on the place of use of intellectual property regardless of whether the transaction involves a license, sale, or other transfer, and without respect to the type of income derived from such transactions.²⁷⁴ The primary justification for their suggestion is that a “place of use rule rightly sources intellectual property income in the country providing the legal

266. POSTLEWATE, *supra* note 2, at ¶ 14.02[10] (citing I.R.C. § 863(d)(2)(A); 66 Fed. Reg. at 3911).

267. *Id.* (citing I.R.C. § 863(d)(2)(B); 66 Fed. Reg. at 3906).

268. *Id.* (citing I.R.C. § 863(d)(1); 66 Fed. Reg. at 3910).

269. *Id.* (citing I.R.C. § 863(d)(1); 66 Fed. Reg. at 3910).

270. Sweet, *supra* note 60, at 1991.

271. *Id.* at 1991-92.

272. *Id.* at 1992.

273. *Id.*

274. Lokken, *supra* note 3, at 244; Cross, *supra* note 44, at 585.

protections under which the owner is exploiting commercially the value of the intellectual property.”²⁷⁵ In addition, scholars have advocated that uniform application of source rules based on the place of use of intellectual property would minimize the difficulties associated with characterization of such transactions, and would also eliminate problems linked to allocations of income from different types of transactions.²⁷⁶ One aspect of this proposal includes making an evaluation of the “predominant nature” of the transaction, and using it as the controlling factor to determine the place of use of the intellectual property for purposes of applying the source rules.²⁷⁷ Notably, determining the place of use of intellectual property based on the predominant nature of the transaction is very similar to the concept of determining the place of use based on the location that contributes most significantly to the production of the licensee’s income.²⁷⁸ Therefore, this would effectively broaden the place of use rule, which is preferred as a mechanism to more accurately reflect the economic origins of income derived from intellectual property.²⁷⁹

Another component of this proposal is to limit application of the source rules that apply to compensation for personal services derived from transactions involving intellectual property to those that clearly evidence an employment arrangement.²⁸⁰ Moreover, income received as compensation for personal services should only be characterized as such in instances where the creator of the intellectual property transfers his entire ownership interest.²⁸¹

Adopting the place of use rule for all transactions would minimize any adverse affects arising from incorrect characterization. For example, under the current regulations, classifying a transaction as a service as opposed to a license could trigger the imposition of different source rules which, in turn, may deprive a particular country of taxing jurisdiction. Under the proposal, the place of use source rule would be applicable to both licenses and services transactions, thus ensuring the taxing jurisdiction of the country where the intellectual property is used.²⁸² It must be noted, however, that in such cases, the

275. Cross, *supra* note 44, at 587.

276. *Id.*

277. *Id.* at 585-86.

278. Lokken, *supra* note 3, at 277-78.

279. *Id.* at 250.

280. Cross, *supra* note 44, at 586.

281. *Id.*

282. *Id.* at 585, 587.

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proposal would not resolve the problem of applying the incorrect rate of tax, which is determined by the characterization of the transaction.

Universal application of the place of use rule envisions that the predominant activity will determine the source of income derived from intellectual property. However, this does not ensure that in other countries where other activities, although not predominant in nature, are performed that contribute to the income generated from intellectual property would forego the taxation of income based on those activities. This would undoubtedly lead to double taxation unless the place of use source rule is uniformly accepted or unless the issue is addressed in a significant number of new bilateral tax treaties. Furthermore, this proposition would require establishing a uniform methodology for determining what is the predominant activity, which is similar to the issue of determining the *actual* place of use in the licensing area.

Additionally, under the proposal, any “ancillary and incidental” services would be disregarded in determining the predominant nature of a transaction.²⁸³ However, this may pose a number of problems. For example, if a foreign individual grants a license to a U.S. corporation to use a patent in the U.S. and also contracts to service the intellectual property, currently the IRS would apply two different source rules to the royalties derived from the license and the income earned from the performance of services.²⁸⁴ Only in the case where a portion of the income earned is considered de minimis will the transaction be sourced as *either* a royalty *or* as compensation for personal services.²⁸⁵ Applying the predominant nature test to determine the place of use of intellectual property, however, would effectively remove any potential for bifurcation of income derived from such intellectual property transactions even when two separate functions (i.e. use and services) may be performed equally in two separate locations.

Another proposed modification to the sourcing regime is to eliminate the U.S. withholding tax on royalty payments altogether.²⁸⁶ As one commentator noted, because royalties are paid for the right to exploit or use rights owned by others, the

283. *Id.* at 585-86.

284. Don R. Spellmann, *United States Tax Rules for Nonresident Authors, Artists, Musicians and Other Creative Professionals*, 27 Vand. J. Transnat'l L. 219, 229 (1994) (citing I.R.C. § 861(a)(3)-(4)).

285. I.R.C. § 861(a)(3).

286. Brauner, *supra* note 45, at 282.

country in which the rights are used or exploited generally has priority over other countries to tax the royalties.²⁸⁷ However, “many countries mutually refrain from imposing withholding taxes on royalties under their current bilateral tax treaties,”²⁸⁸ and due to the enhanced use of intellectual property in today’s business environment, it can be rather difficult to determine where such property is used or exploited.²⁸⁹ Therefore, elimination of the withholding tax would effectively change the source rule to a residence-based rule, and potentially remove the complexities attendant in distinguishing between a sale and a license.²⁹⁰

Taking into consideration the nature of intellectual property rights, it is unlikely that the second proposed modification will find wide acceptance. As previously discussed, the right to use intellectual property is the most important aspect in the bundle of rights. Therefore, the majority of transfers involving intellectual property rights are affected through licensing transactions. Consequently, absent income tax treaties, elimination of the U.S. withholding tax would deprive the U.S. of its taxing jurisdiction on a significant number of transactions involving intellectual property. This would be particularly detrimental to the U.S. because its current application of the withholding tax is in part for the legal protection the U.S. provides. In addition to this detriment, elimination of the U.S. withholding tax would place U.S. companies at a competitive disadvantage as a result of lowering foreign entities’ bottom-line cost by permitting them to escape U.S. tax liability, while the bottom-line cost for U.S. companies remains unaltered.

V. CONCLUSION

The use of intellectual property in commercial business transactions has become increasingly important in our global economy. Specifically, intangible property is making a significantly larger contribution to the value of companies, and certain forms of intellectual property “have become separable marketable items.”²⁹¹ However, because intangible assets are highly mobile,²⁹² it has become more of a challenge to characterize a transaction involving intellectual property as a sale, a license,

287. *Id.*

288. *Id.*

289. *Id.*

290. *Id.*

291. Neubig & Poddar, *supra* note 7, at 1206.

292. *Id.* at 1207.

or as a services contract for purposes of applying the appropriate sourcing rules. Apart from problems posed by the characterization issues, the sourcing rules applicable to such transactions have presented additional challenges. Designed primarily for application in a tangible world, the sourcing rules have not been adequately adapted to apply to transfers of *invisible* property. While the physical location of where property is used was once the controlling factor in determining the source of income, identifying the place of use of intellectual property is often not obvious.

There appears to be some consensus among international tax scholars regarding the need to modify the current characterization and sourcing regimes to achieve simplification within the international tax rules. Pursuant to one of the proposed modifications, the place of use source rule would be applied to income derived from all transactions involving intangible property, irrespective of characterization as a sale, license, or other transfer.²⁹³ It is likely that implementation of such a rule would require further development, particularly with respect to establishing a uniform definition of predominant use. Whether or not this particular modification would be effective in achieving simplification and the streamlining of sourcing rules applicable to intellectual property transactions, it is clear that any modification of the rules must ensure that the fiscal interests of the U.S. are not jeopardized by permitting the use of U.S. resources and by providing legal protection to those entities who, through creative tax planning, seek to avoid the corresponding tax liability. On the other hand, it is equally important that these rules do not unduly burden foreign entities that transact business in the U.S. by imposing a taxing mechanism that will subject them to double taxation or any other unfair tax treatment.

293. Cross, *supra* note 44, at 585.