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INSIGHTS

ECONOMIC NEXUS THROUGH OWNERSHIP AND USE OF INTELLECTUAL PROPERTY

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EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **Economic Nexus Through Ownership and Use of Intellectual Property**. For many tax advisers outside the U.S., state corporate income tax is viewed simply as an add-on to the Federal tax. This relatively simplistic view ignores the requirements of U.S. Federal and Constitutional law that an activity must have a connection – called a nexus – to a state before tax can be imposed on profits allocated to the state. Alvan L. Bobrow of Akerman LLP in New York explains the concept of "economic nexus," a way by which digital activity within a state may trigger exposure to state tax. Companies that license marketing intangibles should be particularly wary.

- **Foreign Tax Credits: General Principles and Audit Risks**. In April, the Large Business & International Division ("LB&I") of the I.R.S. published an International Practice Unit directed to the foreign tax credit claimed by individuals. Tax advisers to Americans living abroad or having global investment portfolios may find that the Practice Unit indicates topics of interest for the I.R.S. Fanny Karaman and Galia Antebi explain the concepts covered, including persons eligible to claim the credit, foreign taxes that qualify for credit, whether to deduct or credit a foreign income taxes, foreign tax credit limitations, and means of ameliorating the effect of unused credits in a particular year.

- **I.R.S. Information Exchanges & the Coordinated Tax Raids on Credit Suisse**. In April, coordinated tax raids targeted three separate offices Credit Suisse involved in tax fraud examinations by the Netherlands, France, Germany, the U.K., and Australia. Was it merely a coincidence that these are countries with which the U.S. regularly cooperates in the exchange of tax information? Rusudan Shervashidze and Stanley C. Ruchelman discuss the many avenues through which the I.R.S. furnishes and receives information. One thing is clear: The I.R.S. had the means to transfer information to the relevant tax authorities.

- **Foreign Tax Credit May Not Be Available for Gains Derived Outside the U.S.** Merely because a foreign country imposes an income tax and the tax is creditable does not mean that effective relief from double taxation is available. The U.S. retains the first right to tax income and gains that are domestic in character, and the income or gain on which the foreign tax is imposed must be categorized as foreign for relief to be provided. Kenneth Lobo and Galia Antebi focus on this issue and advise that advance planning will be required.

- **Tax 101: Taxation of Intellectual Property – The Basics**. This month, Tax 101 presents an overview of the basic U.S. Federal tax considerations of transactions that occur over the life cycle of intellectual property ("I.P.") – from its creation to its acquisition, exploitation, and ultimate sale in a liquidity event. The article address several important questions: Should expenditures be capitalized or deducted? If capitalized, over what period is the expenditure amortized? How are acquisitions of I.P. reported to the I.R.S. when an entire business is acquired? What is the character of gain on sale? When is a sale treated as a license? And when is a license treated as a sale? Elizabeth V. Zanet and Stanley C. Ruchelman explain.

- **Net Operating Losses: A Valuable Asset Worth Preserving**. Troubled companies that incur significant net operating losses ("N.O.L.'s") can carry back those losses for up to two years in order to obtain refunds of tax. In addition, the losses can be carried forward for up to 20 years to reduce future taxable income. However, the losses cannot be monetized through transfers to others. Code §§382 and 269 and separate return limitation year ("S.R.L.Y.") provisions under the consolidated tax return regulations are designed to prevent taxpayers from selling the benefit of the N.O.L. directly or indirectly. Philip R. Hirschfeld explains how the loss limitation rules are applied when (i) a change occurs in the ownership of the loss corporation, (ii) a reshuffle of profitable and unprofitable businesses occurs to benefit from a "mixing bowl" effect, or (iii) companies with existing losses enter an affiliated group filing a consolidated Federal income tax return.

- **Amazon Makes the C.U.T. – An Important Taxpayer Win, A Reminder to Consider Transactional Evidence**. Last month, *Insights* reported on the Tax Court decision in *Amazon v. Commr.*, involving the "buy-in" payment made as compensation for the right to use pre-existing I.P. in a related-party cost sharing arrangement ("C.S.A."). This month, Michael Peggs comments on the lessons learned from the taxpayer victory in that case regarding (i) the transfer pricing method used, (ii) the assumptions made and analyses used to value the buy-in payment, and (iii) the correct treatment of intangible development costs within the term of the C.S.A.

- **Corporate Matters: Five Steps for Leveraging Your Start-Up's Emerging Intellectual Property**. For an emerging business, I.P. can be the business's most important asset and the difference between its success and failure. That is why steps must be taken early on to protect those "jewels." Barry Lewin of Gottlieb, Rackman & Reisman, P.C. in New York explains five important actions designed to protect and enhance value.

- **Updates and Tidbits**. This month, Astrid Champion and Nina Krauthamer look briefly at several timely issues, including (i) a novel claim of treaty residence in Ireland by a nonresident Irish domiciled individual subject to the domicile levy under Irish law and (ii) the introduction of a beneficial ownership register regime in the Cayman Islands regarding certain Cayman Islands corporations.

We hope you enjoy this issue.

- The Editors

ECONOMIC NEXUS THROUGH OWNERSHIP AND USE OF INTELLECTUAL PROPERTY

Author
Alvan L. Bobrow

Tags
Intangible Assets
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State and Local Tax

INTRODUCTION

The key issue in determining whether a corporation is subject to income tax in a particular state is whether nexus exists to that state. It is often prudent for a corporation to be proactive and diligent in in this analysis because each mistake with regard to a state in which some form of activity or connection exists could prove costly. If a corporation is found by state tax authorities to have the requisite nexus to that state and it has failed to file a tax return, the corporation will be exposed to additional taxes and penalties for noncompliance. That is why corporations that are subject to disclosure of high risk tax positions in their financial statements under ASC 740 -10 (the codification to FIN 48 in the accounting world) find that issues of possible nexus are closely monitored by the financial statement auditors.

However, managing nexus as part of annual or quarterly tax planning can also serve as a state and local tax saving opportunity. Under certain circumstances, a corporation may be able to use nexus statutes to shift profits from a high-tax state to a low-tax state.

DOING BUSINESS

An out-of-state corporation is subject to tax in a particular state only if the corporation engages in business in the state and the business activities are sufficient to establish nexus. The definition of "doing business" varies from state to state, but typically includes buying or selling services or property, executing contracts, enforcing contract rights, maintaining a place of business, and hiring employees in the state. However, nexus can also arise from less obvious transactions.

Public Law 86-272 limited the rights of states to tax out-of-state corporations with respect to the solicitation of sales within the state. Its application is limited to sales of tangible personal property. This limitation benefits out-of-state retailers of hard goods but provides little benefit to companies selling a digital product that is delivered over the internet.

Under Public Law 86-272, if an out-of-state corporation merely solicits orders in a state, and nothing more, the corporation does not have nexus with the state for tax purposes. Solicitation includes actual requests for purchases and ancillary activities that have no independent business purpose apart from the solicitation of orders. Examples of solicitations and ancillary activities that do not give rise to nexus include minor or incidental advertising, the display of free samples of a product, or the training or meeting of sales representatives on a periodic basis.

Nonetheless, the scope of nexus is broad, and some states and courts have expanded the definition of nexus to include "economic nexus," including nexus arising

Alvan Bobrow is a partner with Akerman LLP, New York. He provides counsel on state and local, Federal, and international taxation to clients in the financial services, manufacturing, e-commerce, entertainment, and media sectors. Alvan's extensive experience includes New York City and New York State, multistate, civil, and criminal tax matters.

from the ownership and use of intellectual property ("I.P.") within a state.[1]

WHAT IS ECONOMIC NEXUS?

States have increasingly extended the definition of nexus to include an out-of-state corporation's ownership and use of I.P. within the state. I.P. typically includes copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how that are used within a state.

> *"A foreign corporation could be subject to tax in a particular state despite being exempt from income tax on the Federal level due to reliance on a tax treaty."*

Thus, a corporation can have economic nexus with a state solely by executing a licensing agreement that earns the corporation royalties from that state, even if the corporation itself has no presence in the state. This greatly expands the concept of nexus for state tax purposes, and can be a trap for out-of-state corporations that are unaware of such provisions. It is important that any corporation leasing I.P. outside of its home state becomes familiar with the nexus laws of any state in which it enters into a licensing agreement.

This is particularly important for non-U.S. corporations (frequently referred to by state law as "alien corporations") that do not otherwise engage in business in the U.S. As with their domestic counterparts, alien corporations can be swept up in a state's broad nexus provisions. Because tax treaties between the U.S. and foreign countries are not necessarily binding on states, a foreign corporation could be subject to tax in a particular state despite being exempt from income tax on the Federal level due to reliance on a tax treaty.

From the viewpoint of a state tax administration, a corporation formed and headquartered in another state is considered to be a "foreign corporation" but not an "alien corporation." Alien corporations and foreign corporations are afforded similar treatment. Hence, income tax treaties are often ignored for state income tax purposes.

For example, the Massachusetts Department of Revenue issued a directive in 1996[2] (the "Directive") advising that a foreign corporation's I.P. used within the state subjects that corporation to income tax if (i) the I.P. generates or is otherwise a source of gross receipts within Massachusetts for the corporation, including through a license or franchise; (ii) the activity is purposeful (such as through a contract with a company in the state); and (iii) the corporation's presence in Massachusetts is more than *de minimis*.

The Directive provided several examples of I.P. giving rise to nexus in Massachusetts:

- A dress shop in Wisconsin licenses its name to a Massachusetts company for use in connection with the sale of the Massachusetts company's clothing line in the state, pursuant to which the dress shop receives royalties from the Massachusetts company's sales in the state.
- A Delaware company located in Alabama develops and patents technology

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1 Revenue earned from the performance of services is not protected by P.L. 86-272 and may form the basis for nexus. This article, however, is limited to a discussion of I.P. that does not have a physical presence within the state.

2 D.O.R. Directive No. 96-2.

for a motor scooter, then licenses the patent to a Massachusetts company for use in its manufacture and sale of scooters in Massachusetts, pursuant to which the Alabama company receives an upfront fee for the right to use the patented technology and a royalty on the sale of scooters.

- A Delaware fast food franchiser located in New Jersey franchises the rights to one of its restaurants to a New Hampshire resident for a location in Massachusetts, and the terms of the franchise agreement require the franchisee to use various items of I.P. owned by the franchiser, pay a monthly franchise fee, and pay a royalty charge based on sales proceeds.

These examples illustrate that nexus exists in Massachusetts whenever an out-of-state corporation enters an agreement to license certain I.P. and receives a royalty payment based on in-state sales of the licensee. Even a Japanese corporation licensing trade secrets and know-how on automobile radar devices would have a corporate income tax liability in Massachusetts.

In 2011, New Jersey issued Technical Advisory Memorandum 2011-6, which provided that taxpayers performing services and domiciled outside the state who solicit business within the state or derive receipts from sources within the state may have corporate nexus with the state.

While taxpayers have attempted to claim that economic nexus violates the due process clause and the commerce clause, courts have largely rejected these arguments and have found economic nexus properly exists based on the use of intangibles in the state.

"Unlike nexus for sales and use tax, which requires physical presence, courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P."

ECONOMIC NEXUS REPLACES PHYSICAL PRESENCE

Unlike nexus for sales and use tax, which requires physical presence,[3] courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P. Courts have emphasized that physical presence is not required if the corporation has an economic connection to the state.

For example, in *Geoffrey, Inc. v. Commr. of Revenue*,[4] the Massachusetts Supreme Judicial Court rejected the taxpayer's claim that it lacked nexus with Massachusetts because it did not have physical presence in the state. The court upheld the state's authority to tax out-of-state corporations due to their ownership and use of I.P. in the state because Geoffrey made "purposeful efforts to reap economic benefits" from Massachusetts' retail marketplace. The court held that collecting royalties based on net sales pursuant to a licensing agreement gave rise to "substantial nexus" in the state and that the imposition of tax upon a foreign corporation without a physical presence in Massachusetts did not violate the commerce clause.

In the case, Geoffrey was engaged in the business of licensing trademarks for the Toys "R" Us logo that were used in retail stores throughout the U.S. It had no employees and owned no tangible property in Massachusetts, and its sole activity in

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[3] See *National Bellas Hess v. Department of Revenue of I.L.*, 386 U.S. 753 (1967).

[4] *Geoffrey, Inc. v. Commr. of Revenue*, 899 N.E. 2d 87 (M.A. Sup. Jud. Ct. 2009).

the state was its licensing of trademarks to stores in the state in exchange for royalty payments on net sales. Nonetheless, the court emphasized the fact that the agreements afforded Geoffrey the continued right to regulate use of the trademarks and access to courts in Massachusetts to protect its I.P. rights. Interestingly, Geoffrey did not exercise the latter privilege.

The Massachusetts court's decision closely resembled the holdings of courts in several other jurisdictions, including South Carolina, which had also determined that Geoffrey's receipt of royalties in the state gave rise to economic nexus.[5] The Supreme Court of South Carolina held that since Geoffrey was engaged in the business of owning and licensing I.P., its decision to license trademarks for use in many states evidenced a purposeful intent to seek the benefit of economic contact with those states. The court also noted that Geoffrey could have prohibited the use of its intangibles in the state, and it did not elect to do so.

In both cases, Geoffrey relied on the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*,[6] which held that personal presence was required to subject a company to sales tax in a state. However, both courts limited the holding of *Quill* to sales and use tax and held it inapplicable to corporate income tax.

In yet another case brought by Geoffrey,[7] a court in Oklahoma upheld the existence of economic nexus. Geoffrey received income that was derived from Oklahoma customers. Consequently, a sufficient economic connection to Oklahoma was established.

Likewise, in *Lanco, Inc. v. Division of Taxation*,[8] the New Jersey Supreme Court, reversing the decision of the New Jersey Tax Court, held that the license of I.P. to a New Jersey company gave rise to royalty income that was taxable in New Jersey, based on the Division of Taxation's argument that the royalty income was from New Jersey sources. The court, like those in the *Geoffrey* cases, distinguished the bright-line nexus rule set forth in *Quill*, holding that the physical presence requirement for nexus applies only in the sales and use tax context. Subsequent New Jersey decisions have confirmed this treatment, permitting the state to tax income generated by I.P. even if the corporate recipient lacks physical presence in the state.[9]

PURPOSEFUL INTENT IS REQUIRED

The precise facts that give rise to economic nexus in a given state are not always clear. While taxpayers have argued that the commerce clause and the due process clause of the U.S. Constitution prevent a state from imposing tax in the absence of physical presence, state courts have largely rejected these claims.

Nonetheless, it seems clear that purposeful intent is required so that the use of I.P. in a state alone is not sufficient to give rise to nexus if the taxpayer does not have a purposeful intent to engage in activity in the state. For example, intangible income

5 *Geoffrey, Inc. v. S.C. Tax Commission*, 437 S.E.2d 13 (1993).

6 *Id.*

7 *Geoffrey Inc. v. O.K. Tax Commission*, No. 99,938 (O.K. Civ. App. 2005).

8 *Lanco, Inc. v. Division of Taxation*, 188 N.J. 380 (N.J. S. Ct. 2006).

9 See *Praxair Tech., Inc. v. Division of Taxation*, 988 A.2d 92 (N.J. S. Ct. 2009).

from transactions taking place outside New Jersey will not give rise to nexus in New Jersey.[10]

Further, in *Griffith v. ConAgra Brands, Inc.*,[11] the Supreme Court of West Virginia refused to find economic nexus on the receipt of royalties from trademarks used in the state, holding that the taxpayer did not meet the "purposeful direction" test under the due process clause or the "significant economic presence" test under the commerce clause. The holding in that case was contingent upon the fact that the taxpayer did not provide services to licensees in West Virginia and did not dictate in any way how the licensees distributed products using the trademarks.

In *J.C. Penney Natl. Bank v. Johnson*,[12] the Tennessee Court of Appeals refused to uphold economic nexus where the taxpayer extended credit card lending services to residents in the state but did not issue credit cards in its Tennessee stores.

THE ROLE OF PASSIVE INVESTMENT COMPANIES

One common factor in many of the cases finding the presence of economic nexus, such as the *Geoffrey* cases and *Lanco*, was the existence of a passive investment company (also referred to as a Delaware holding company). In many cases, the taxpayer was a passive investment company formed by its parent company, and the parent company itself had physical nexus with the state in question. Thus, when the parent company transferred the intangible assets to the passive investment company, which then licensed it for use in the state, application of the economic nexus concept to the passive investment company allowed the state to maintain its tax base. Application of the physical presence test would have allowed a unitary group to shift income from the state by using a passive entity with no physical presence in the state to received deductible license fees.[13]

However, where the sole issue is the taxpayer's use of a passive investment company, rather than invoking economic nexus, states have instead sought to enact statutes prohibiting the parent companies from deducting royalties and licensing fees where the income of the passive investment company was not taxable in the state. This achieves the same revenue protection goal but does so in a less contentious way.

ADVANCED PLANNING IS NECESSARY

Ideally, a corporation should evaluate any potential state nexus issues prior to

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10 *Whirlpool Properties, Inc. v. Division of Taxation*, N.J. Tax Ct. No. 66-2007 (2013).

11 *Griffith v. ConAgra Brands, Inc.*, 2012 W.V. LEXIS 282 (W.V. May 24, 2012).

12 *J.C. Penney Natl. Bank v. Johnson*, 19 S.W.3d 831 (T.N. Ct. App. 1999).

13 To the same effect, see *Kmart Props. Inc. v. Tax and Rev. Dept. of N.M.*, No. 21, 140 (N.M. Ct. App. 2001) (upholding economic nexus based on use of intangibles in N.M.); *L.A. Dept. of Rev. v. Gap (Apparel) Inc.*, 886 So. 2d 459 (L.A. Ct. App. 2004) (upholding economic nexus based on use of intangibles in L.A.); and *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004) (upholding economic nexus based on use of intangibles in N.C.). In each of these cases, the taxpayer was an out-of-state passive investment company whose parent company had physical presence in the state.

entering into a licensing or other agreement governing the use of I.P. with any in-state corporation. If the corporation engages in advanced planning, there are tax planning opportunities that can give rise to savings for the corporation, given the differences in tax rates between states.[14] Thus, if a corporation's home state is a high-tax state, the corporation may benefit from having economic nexus in a lower-tax jurisdiction.

"It is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis."

If a corporation is unsure whether its activities are sufficient to give rise to nexus in a particular state, it should seek to determine its level of exposure prior to engaging in activities in the state. Some states permit ruling requests so a taxpayer may identify whether the state considers it to have nexus based on its activities in the state.[15]

REMEDYING PAST MISTAKES

If the corporation discovers that it has economic nexus in a state after entering into an agreement and after having failed to file a tax return in the state, but prior to being contacted by that state in connection with asserted noncompliance, the corporation may benefit from entering the state's voluntary disclosure program, if one is available. Typically, doing so would enable the corporation to avoid penalties on the failure to file a return and pay tax, and it may limit the number of years for which a filing is required. Many states have initiated voluntary disclosure programs as an easy revenue fix.

These states rely on disclosures of uncertain tax positions in the published financial statements of corporations having publicly traded shares. However, the states act at their own pace. As a result, it may be possible to enter a program even if the financial statement disclosure is publicly available.

If a voluntary disclosure program is not available, the corporation should still consider coming forward voluntarily, as penalties for late filing and payment may be abatable for reasonable cause. If the corporation waits for the state to assess taxes, the corporation's argument for abatement of penalties is substantially weaker.

Thus, it is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis. Keeping up-to-date with changing laws in different states is the best way to avoid what could be a costly mistake.

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[14] See, *e.g.*, O.H. Rev. Code Ann. §5733.042.

[15] See, *e.g.*, 830 Code M.A. Regs. §63.39.1(9), outlining the procedures for requesting nexus determination from the Department.

FOREIGN TAX CREDITS: GENERAL PRINCIPLES AND AUDIT RISKS

Authors
Fanny Karaman
Galia Antebi

Tags
Foreign Tax Credits
Foreign Tax Credit Limitations
LB&I
International Practice Units

The foreign tax credit ("F.T.C.") is a keystone of U.S. outbound tax legislation. Its purpose is to alleviate the burden of double taxation in the presence of income subject to both U.S. tax and foreign tax. The main provisions of the Internal Revenue Code of 1986 as currently in effect (the "Code") addressing F.T.C. are found in Code §§901 to 909.

The I.R.S. Large Business and International Division ("LB&I") has published several International Practice Units that serve as training aids for examiners.[1] In doing so, LB&I has provided taxpayers with a good sense of the areas on which the I.R.S. will focus during an examination. Nevertheless, these materials cannot be used or cited as precedent by taxpayers.[2]

A recent practice unit, "F.T.C. General Principles," was published by LB&I on April 11, 2017. It deals with the general principles of F.T.C. applicable to individuals (the "Practice Unit"), and discusses the limitations under Code §904. More specifically, it addresses the following:[3]

- Basic concepts of the F.T.C.
- Identification of taxpayers eligible to claim the F.T.C.
- Foreign taxes that qualify for the F.T.C.
- F.T.C. versus foreign tax deduction
- Carryback and carryover of unused F.T.C.

OVERVIEW OF F.T.C.'S UNDER CODE §901

General

As a general rule, and upon election, eligible taxpayers can offset the U.S. taxes due on their non-U.S. sourced income by the creditable foreign tax paid or accrued on such income.[4]

Eligible Taxpayers

For purposes of claiming the F.T.C., eligible taxpayers, although to different extents,

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1 See our articles relating to other International Practice Units here.

2 "Practice Units," I.R.S., April 24, 2017.

3 "LB&I Concept Unit: Knowledge Base - International," I.R.S., February 28, 2017.

4 Code §901(a); absent an election, foreign taxes are generally allowed as a deduction under Code §§164(a)(1) and 275(a)(4).

are the following:

- U.S. citizens and U.S. corporations[5]
- Residents[6] of the U.S. or Puerto Rico[7]
- Alien residents[8] of the U.S. or Puerto Rico[9]
- Certain nonresident individuals of the U.S. and certain non-U.S. corporations[10]
- Certain U.S. beneficiaries of estates or trusts, certain U.S. partners, and certain U.S. settlors of grantor trusts[11]

This article is limited to the F.T.C. as applicable to U.S. individuals. For this purpose, a U.S. individual is any of the following:

- A U.S. citizen
- A U.S. green card holder[12]
- A U.S. resident individual as defined for purposes of the substantial presence test of Code Section 7701(b)(3)

"The amount of tax actually withheld by a foreign country isn't necessarily 100% creditable."

Creditable Taxes

The creditable taxes are defined as any "income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States."[13]

Treasury Regulations provide extensive rules as to what constitutes a creditable tax.[14] Those rules are summarized in the Practice Unit as payments that meet the following four requirements:

- The tax must be the legal and actual foreign tax liability.
- The tax must be an income tax (or a tax in lieu of an income tax).
- The tax must be imposed on the taxpayer.
- The taxpayer must have paid or accrued the tax.

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5 Code §901(b)(1).

6 *I.e.*, U.S. green card holders.

7 Code §901(b)(2).

8 *I.e.*, individuals meeting the substantial presence test of Code §7701(b)(3).

9 Code §901(b)(3).

10 Code §901(b)(4); but only with respect to foreign source income that is treated as effectively connected with a U.S. trade or business.

11 Code §901(b)(5).

12 Code §7701(b)(1)(A)(i).

13 Code §901(b)(1).

14 Treas. Reg. §1.901-2.

Thus, the amount of tax actually withheld by a foreign country isn't necessarily 100% creditable. For example, if Country X withholds $25 from a payment made to a U.S. individual, but under the income tax treaty between the U.S. and Country X, only $15 can be withheld under the circumstances, only $15 will be eligible for the F.T.C.

Credit or Deduction

For individual taxpayers, the F.T.C. is generally claimed on Form 1116, *Foreign Tax Credit*.[15] Limited exceptions apply to allow individuals to make the election on their U.S. tax return. If no election to claim the F.T.C. was made, individuals who choose to itemize their deductions may do so on Schedule A, *Itemized Deductions*, of their U.S. tax return.[16]

Whether an F.T.C. is claimed or a deduction is taken, the same treatment must apply to all foreign taxes paid or accrued in that given year.[17] Exceptions apply in certain circumstances, for example, when credit is disallowed with respect to foreign source dividends because the minimum holding period required was not met,[18] and when credit is disallowed because of the boycott rules.

Refunds or credits for overpayment of taxes attributable to foreign taxes paid or accrued can be claimed within 10 years from the filing date of the return for the year in which the taxes were actually paid or accrued.[19] This is an extended period compared to the general three-year rule applicable to other refund claims.

During this same 10-year period, the taxpayer can change its election to claim an F.T.C. and instead deduct the foreign tax, and vice versa.[20] However, note that a refund claim relating to a deduction of foreign tax doesn't benefit from the extended period that a refund claim relating to the F.T.C. benefits from.

While the I.R.S. generally has three years as of the filing date to assess additional taxes,[21] the I.R.S. has an unlimited statute of limitations to assess U.S. taxes that become due as a result of a redetermination of a foreign tax claimed as a credit. For that purpose, taxpayers who receive a refund of foreign taxes that were claimed as an F.T.C. must notify the I.R.S. of the refund.[22]

F.T.C. LIMITATIONS UNDER CODE §904

General Limitation

Since the purpose of an F.T.C. is to avoid double taxation, but not to reduce U.S. income tax on other income, the F.T.C. claimed is generally limited to the lesser of

[15] Treas. Reg. §1.905-2(a).

[16] Code §§164(a)(1); 275(a)(4).

[17] Treas. Reg. §1.901-1(c).

[18] The required holding period is at least 16 days within the 31-day period that begins 15 days before the ex-dividend date.

[19] Code §6511(d)(3).

[20] Treas. Reg. §1.901-1(d).

[21] Code §6501(a).

[22] Code §§6501(c)(5); 905(c)(3).

(i) the foreign tax paid or (ii) the U.S. tax that is due on the foreign taxable income.[23]

The Practice Unit provides the following example to its agents:

> Assume country Y's tax rate is 46% and the U.S. tax rate is 35%. Taxpayer B pays $46 of foreign tax on $100 of income earned in country Y. Taxpayer B earned no other foreign source income, but earns $50 of U.S. source income. If the foreign tax were fully creditable, the after-credit U.S. tax on the $100 country Y income would be a negative $11 ($35 of pre-credit U.S. tax less $46 of credit). The credit would not only reduce U.S. tax on the country Y income, but also reduce U.S. tax on U.S. source income by $11. The latter effect is not necessary to alleviate double taxation.
>
> […] In the above example, IRC 904(a) will limit the FTC to $35, the lesser of the foreign tax paid or the U.S. tax on the foreign source income.

The F.T.C. limitations must generally be computed separately for passive-type income and for general income ("income baskets").[24] Additional baskets include, *inter alia*, certain income resourced by treaty and foreign income paid from certain countries with which the U.S. has no diplomatic relations or that the U.S. has designated as repeatedly providing support for acts of international terrorism. These limitations are beyond the scope of this article.

Carryforward and Carryback

An F.T.C. in excess of the limitations ("excess credit") can be carried back one year and then carried forward 10 years.[25] This carryback and carryforward must be done separately for every basket.[26] It enables a taxpayer to use its excess credit in a year in which the taxpayer's limitation amount exceeded the taxpayer's creditable taxes ("excess limit").

The Practice Unit provides the following example:

> Assume all foreign income is general category income for 2014 and 2015. The limit on the credit and the qualified foreign taxes paid on the income are as follows:

Tax Year	Limit on F.T.C.	Tax Paid	Unused Foreign Tax (+) or Excess Limit (-)
2014	$200.00	$100.00	($100.00)
2015	$300.00	$500.00	$200.00

23 Code §904(a).

24 This section applies for post-2006 income. Prior to 2007, there were eight separate categories that were eliminated by the American Jobs Creation Act of 2004.

25 Code §904(c).

26 Code §904(d)(1).

In 2015, the taxpayer has unused foreign tax of $200 to carry to other years. The taxpayer is considered to have paid this unused foreign tax first in 2014 (the first preceding tax year) up to the excess limit in that year of $100. The taxpayer can then carryover the remaining $100 of unused tax.

CONCLUSION

While taxpayers often believe that the concept of the F.T.C. is easy, and that no double taxation would apply as the U.S. will credit on a dollar-to-dollar basis any foreign tax paid, the actual computation of an F.T.C. is not that straight forward and tax leakage may nevertheless occur. The F.T.C. should be carefully examined as it constitutes an important element in an internationally mobile client's income structuring.

I.R.S. INFORMATION EXCHANGES & THE COORDINATED TAX RAIDS ON CREDIT SUISSE

Authors
Rusudan Shervashidze
Stanley C. Ruchelman

Tags
Exchange of Information
F.A.T.C.A.
I.R.S.

INTRODUCTION

In early April, Bloomberg News reported on coordinated tax raids on three separate offices of Credit Suisse.[1] It is believed that the bank was taken by surprise. However, in light of the global tax efforts to discover and prosecute facilitators of abusive tax planning, one wonders why the raids were not anticipated.

When the raids took place, two people were arrested and valuables such as gold bars, paintings, and jewelry were seized. The raids were part of a joint tax fraud examination by the Netherlands, France, Germany, the U.K., and Australia regarding millions of euros concealed in Swiss accounts. Information collected by one government will be subject to exchange with other governments that are trusted partners in the battle against tax evasion.

Due to the secrecy surrounding tax fraud investigations, no one knows for certain whether the I.R.S. furnished information that was relevant to the tax raids. However, there are many avenues through which the I.R.S. furnishes and receives information. It is clear that the I.R.S. had the means to transfer information to the relevant tax authorities, as will be explained in this article.

BACKGROUND

The I.R.S. website provides a laundry list of financial institutions and advisory firms that have assisted U.S. taxpayers in evading U.S. tax through the use of hidden accounts outside the U.S.[2] Of the 145 institutions listed, the second bank to appear on the list is Credit Suisse.

As of February 6, 2017, 78 Swiss banks had executed non-prosecution agreements under the Swiss Bank Program of the U.S. Department of Justice. Credit Suisse was not among these banks. Instead, on May 19, 2014, Credit Suisse pled guilty to conspiracy to aid and assist U.S. taxpayers in filing false income tax returns and agreed to pay a fine of $2.6 billion. Eight of the bank's employees were also indicted.[3]

It appears that, once the plea bargain was agreed and the fine paid, Credit Suisse believed the "fire drill" was over. In doing so, it failed to consider developments in taxpayer transparency and exchanges of taxpayer information among governments,

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1 Jan-Henrik Foerster and Joost Akkermans, "Credit Suisse Taken by Surprise in Five-Nation Tax Probe," Bloomberg.com, March 31, 2017.

2 "Foreign Financial Institutions or Facilitators," IRS.gov, January 31, 2017.

3 "Credit Suisse Pleads Guilty to Conspiracy to Aid and Assist U.S. Taxpayers in Filing False Returns," U.S. Department of Justice, May 19, 2014.

namely those that followed the advent of the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in 2010.

F.A.T.C.A. changed the landscape of the U.S. and global routine exchanges of tax information between governments. Since the legislation was introduced, the U.S. has entered into intergovernmental agreements ("I.G.A.'s") that have facilitated information exchange with over 100 counties. According to the latest numbers, the I.R.S. has collected over $10 billion through the voluntary disclosure program from 55,000 participants.[4]

Although European advisers initially expressed doubts about the participation by E.U. Member States in government-to-government programs that impose information gathering obligations on home country financial institutions, events proved the opposite. European countries instead welcomed the F.A.T.C.A. initiative, and today, the E.U. stands at the forefront of automatic exchanges of information as part of global transparency.

"Credit Suisse was naïve in believing that a firewall was successfully erected against further examination."

In recent years, the O.E.C.D. has published the B.E.P.S. Action Plan attacking perceived tax abuse in cross-border transactions and has developed the Common Reporting Standard (the "C.R.S.") for exchange of financial information. The C.R.S. requires jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. The provision was warmly received by the European Commission, which converted the C.R.S. into a directive and effected the Anti-Tax Avoidance Directive.

In this environment, Credit Suisse was naïve in believing that a firewall was successfully erected against further examination.

MEANS OF OBTAINING INFORMATION

Tax Treaties

Most U.S. tax treaties include articles relating to the exchange of information and mutual assistance in tax matters. These provisions authorize the exchange of tax related information between the treaty countries on an automatic basis and pursuant to specific requests. Information received under a treaty is treated as secret in the same manner as information obtained under the domestic laws of the state making the request.

Information can be disclosed by the requesting state only to persons or authorities that have responsibility for administering the tax collection process in all relevant phases. This includes (i) courts and administrative bodies; (ii) personnel in departments involved in the assessment, collection, or administration of the tax; (iii) personnel involved in the administrative appeals function; (iv) personnel responsible for the investigation and enforcement of the tax laws; (v) legal officers involved in the prosecution those who commit tax offenses; and (vi) persons who oversee each of the foregoing functions.

Persons who receive information can use the information only for the purposes described above. If a criminal or civil trial is pursued by the tax officials, disclosure

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4 "Offshore Voluntary Compliance Efforts Top $10 Billion; More Than 100,000 Taxpayers Come Back into Compliance." IRS.gov, October 21, 2016.

is permitted in public court proceedings or in judicial decisions.[5]

Each treaty contains unique language that sets forth the boundaries of who may receive information and how the information may be used.

Mutual Legal Assistance Treaties ("M.L.A.T.'s")

These bilateral agreements authorize the exchange of evidence and information in criminal and related matters. M.L.A.T.'s. cover criminal non-tax matters and, in some instances, criminal tax matters. M.L.A.T.'s. are negotiated by the U.S. Department of State in cooperation with the Department of Justice. They have been used to obtain banking and other financial records from the treaty partners.

To encourage foreign governments to cooperate in joint investigations related to narcotics trafficking and money laundering – for which the penalties include asset forfeiture – the U.S. has offered treaty partners the opportunity to share in forfeited assets.

Multilateral and Bilateral Agreements

The U.S. is a party to several multilateral and bilateral agreements, which authorize exchanges of information for tax purposes. Various agreements and consortia for information exchange are outlined below.

Tax Implementation or Coordination Agreements

These bilateral agreements allow for exchanges of tax-related information between the U.S. and its five territories (*i.e.*, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands). All five territories have a local tax system, but some are required to mirror the U.S. Code system and substitutes the name of the territory for the "United States." These territories are U.S. Virgin Islands, Guam, and the Northern Mariana Islands. Although American Samoa is not bound by this system, it has chosen to adopt much of the U.S. Code for its income tax purposes. Puerto Rico, in contrast, has its own income tax system.

Tax Information Exchange Agreements ("T.I.E.A.'s")

The purpose of this type of bilateral agreement is to facilitate the exchange of tax related information with partner countries. It provides for mutual assistance in civil and criminal tax investigations and proceedings. A T.I.E.A. is an executive agreement rather than a treaty. It is entered into by the Treasury without the advice and consent of the Senate and is limited in scope to the mutual exchange of information.

Joint International Tax Shelter Information Center ("J.I.T.S.I.C.")

At its inception, the agreement that formed J.I.T.S.I.C. was signed by the commissioners of the Australian, Canadian, U.K. and U.S. tax administrations, and later by the Japanese commissioner. Today J.I.T.S.I.C. represents the heads of tax administrations from 36 countries. J.I.T.S.I.C. is designed to supplement the ongoing work of tax administrations in identifying and curbing abusive tax avoidance transactions, arrangements, and schemes.

To put its task in perspective, one can look to the meeting of J.I.T.S.I.C. members

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[5] U.S. Model Tax Convention, art. 26 (2006).

in January 2017, where 30 countries gathered to exchange information helpful in coordinating collaborative tax investigations. The tax administrations that met have reportedly audited more than 1,700 taxpayers and have made more than 2,550 requests for information. The administrations have also identified a "target list" of 100 intermediaries who help wealthy individuals and companies set up and use entities in tax havens; these include lawyers, bankers, and accountants.[6]

Common Reporting Standard ("C.R.S.")

Although the U.S. is not a signatory to the C.R.S., the C.R.S. should be recognized as representing the international consensus on reciprocal automatic exchanges of financial account information for tax purposes. As of May 7, 2017, 100 jurisdictions have committed to implementing the C.R.S. Of the participating jurisdictions, half will implement initial exchanges in 2017 and the balance will implement initial exchanges in 2018.[7]

The Forum on Tax Administration ("F.T.A.")

The F.T.A. was created in 2002. It represents heads of tax administration from 50 O.E.C.D. and non-O.E.C.D. countries, including members of the G-20.[8] The purpose of the forum is to identify, discuss, and influence relevant global trends and develop new ideas to enhance tax administration around the world. To that end, it attempts to improve taxpayer services and tax compliance by helping tax administrations increase the efficiency, effectiveness, and fairness of tax administration and reduce the costs of compliance.

Inter-American Center of Tax Administration ("C.I.A.T.")

C.I.A.T. is a public, non-profit organization. The goal of C.I.A.T. is to promote mutual assistance and cooperation among the member countries. The organization was founded in 1967 and currently has 39 members in Latin America and other places, not including associate member countries. Among its activities is training tax administrations in tax policy, tax collection, information exchanges, and transfer pricing.[9]

International Tax Dialogue ("I.T.D.")

I.T.D. is a joint initiative of the European Commission, the Inter-American Development Bank, the International Monetary Fund, the O.E.C.D., the World Bank, and the Inter-American Center of Tax Administrations. The I.T.D. aims to facilitate discussion of tax matters among national tax officials, regional tax organizations, international organizations, and other key stakeholders.[10]

EXCHANGE OF INFORMATION PROCEDURES

Generally, an information request by the U.S. results from an on-going examination

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6 Will Fitzgibbon and Mar Cabra, "Tax Agencies Draw Up 'Target List' of Offshore Enablers," I.C.I.J., January 20, 2017.

7 "AEOI: Status of Commitments (100 Jurisdictions Have Committed)," (O.E.C.D. Publishing, 2017).

8 "About - Forum on Tax Administration," O.E.C.D.

9 Inter-American Center of Tax Administrations Website.

10 I.T.D. Website.

“Treaties and T.I.E.A.’s provide for the exchange information relevant for carrying out the provisions of the domestic laws concerning covered taxes of the requested party.”

of a particular tax return. The request may also arise from collection matters, criminal investigations, or other tax administrative procedures covered by the international tax information sharing agreements.

The Competent Authority or Central Authority is responsible for matters relating to the application of international tax information sharing agreements. This authority may be delegated to one or more subordinate officials. To illustrate, for tax treaties and T.I.E.A.’s, the authority to act as the U.S. Competent Authority has been delegated by the secretary of the Treasury to the deputy commissioner of the Large Business and International Division (“LB&I”). The authority to sign or act on behalf of the deputy commissioner of LB&I has been delegated to the program manager at the Exchange of Information Headquarters, who has the authority to sign or act on all exchanges of information under tax treaties and T.I.E.A.’s. All such exchanges are administered by the Exchange of Information program manager in Washington, D.C.; the revenue service representative in Plantation, Florida; tax attachés stationed at various overseas I.R.S. posts; and the J.I.T.S.I.C. program manager in Washington, D.C.[11] With respect to M.L.A.T.’s and similar law enforcement agreements, the Office of International Affairs in the Criminal Division of the Department of Justice is authorized to act as the U.S. Central Authority.

Protection of Information by the I.R.S.

Information received by the I.R.S. is treated as sensitive and is safeguarded in accordance with the disclosure and confidentiality provisions of the relevant agreement, Code §6103 (in the case of taxpayer-specific information), and Code §6105 (which governs the disclosure and confidentiality of information exchanged under international tax information sharing agreements).

Non-sensitive information may be provided to a foreign tax official without the need to exchange it under a tax information sharing agreement. However, to ensure the information is in fact considered non-sensitive for exchange purposes, no I.R.S. employee other than the employees described above may contact, provide any information to, request any information from, or exchange any information with a foreign tax official.[12]

To ensure compliance with applicable disclosure and confidentiality rules, an I.R.S. office is not allowed to respond to direct contact from a foreign tax official. Rather, it must refer the contact to Exchange of Information Headquarters. If any I.R.S. office in possession of information originally received from foreign tax officials is sought in response to court orders, subpoenas, or Freedom of Information Act requests in the U.S., that office is required to contact Exchange of Information Headquarters.[13] Furthermore, if any I.R.S. office discovers or suspects that an unauthorized disclosure of information has occurred, that office must immediately notify Exchange of Information Headquarters.

Treaty Exchanges

Treaties and T.I.E.A.’s provide for the exchange information relevant for carrying out the provisions of the domestic laws concerning covered taxes of the requested

[11] I.R.M. 4.60.1.1.2.

[12] I.R.M. 4.60.1.1.2.3.

[13] I.R.M. 4.60.1.1.2.6.

party. If the U.S. is the requesting party, the I.R.S. examiner must demonstrate the relevance of the requested information and show a connection between the taxpayer and the foreign-based information. The I.R.S. examiner must exhaust all means to access the requested information under domestic law prior to requesting information under a treaty or T.I.E.A.

Types of Exchanges

There are nine basic types of exchanges:

- Specific requests
- Spontaneous exchanges
- Automatic exchanges
- Industry-wide exchanges
- Simultaneous examination program
- Joint audits
- Simultaneous criminal investigation program
- Mutual legal assistance program
- Mutual collection assistance request program

Each has its own set of procedures. The information that can be obtained through these exchanges includes the following:

- Tax returns and return information such as filing status, income/expenses/tax liability, and citizenship/residency
- Bank and brokerage records
- Business records
- Public records such as deeds
- Birth, death, and marriage records
- Witness interviews
- Property ownership information[14]

Foreign Information Request

If a foreign country with which the U.S. has a T.I.E.A. in place forwards a specific exchange of information request to the U.S. Competent Authority, the request is assigned to an I.R.S. employee ("designated agent"). Once the request is received, and determined to be appropriate, the designated agent reviews the request to see if it is within the authorized scope of the relevant agreement and does not violate any secrecy or trade secret exceptions. One determined to be acceptable, the request will be forwarded to the appropriate I.R.S. civil group manager or the executive

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[14] I.R.M. 4.60.1.1.3.

director of Criminal Investigation: International Operations, who will then fulfil the foreign-initiated information request.

The I.R.S. Manual governs the manner in which the request is processed by field offices. This includes timelines for each step in the process. If the requested documents are not already in the possession of the field office, an Information Document Request ("I.D.R.") may be issued or a summons may be served. In those cases, the examining agent will provide guidance on how to proceed.

An information request under the exchange of information agreement does not require the existence or initiation of an I.R.S. examination and does not constitute an I.R.S. examination. As previously stated, the field office personnel assisting with a foreign request may not directly contact any foreign tax official regarding the request or any other matter.

All T.I.E.A.'s limit the exchange of trade secrets when disclosure may cause substantial harm to the taxpayer's competitive position. However, information related to transfer pricing is not necessarily protected from disclosure.

Improper disclosure of returns and return information may result in civil or criminal penalties under Code §§7431 and 7213.[15] To ensure compliance with applicable disclosure and confidentiality rules, only I.R.S. employees described above and those having transfer pricing responsibility may contact, provide information to, request any information from, or exchange information with a foreign tax official.[16]

I.R.S.-Initiated Requests

When examiners seek information from a treaty partner, the basic Code and regulatory rules, along with case law, will apply. Under Code §7602, the I.R.S. may examine books, papers, records, or other data that may be relevant to "ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue or collecting any such liability." This was addressed in an article that appeared in the April 2017 edition of *Insights*.[17]

CONCLUSION

In light of the U.S. investigations and the broad network of U.S. tax treaties, executive agreements in the form of I.G.A.'s or T.I.E.A.'s, and multilateral agreements covering intergovernmental cooperation and exchange information to prevent tax fraud, it is hard to image the I.R.S. did not exchange information developed in the Credit Suisse prosecution with its counterparts the Netherlands, France, Germany, the U.K., and Australia. Indeed, financial institutions should be wary of further examinations. It seems to be only a matter of time before the I.R.S. exchanges information about all facilitators of tax fraud encountered in its prosecution of foreign banks and obtained in the offshore voluntary disclosure programs.

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15 Code §6103(b).

16 IRM 11.3.25.1.

17 Galia Antebi and Stanley C. Ruchelman, "LB&I Audit Insights: Using a Code §6038a Summons When a U.S. Corporation is 25% Foreign Owned," *Insights* 4 (2017), p. 51.

FOREIGN TAX CREDIT MAY NOT BE AVAILABLE FOR GAINS DERIVED OUTSIDE THE U.S.

Authors
Galia Antebi
Kenneth Lobo

Tags
Capital Gains
Foreign Tax Credit
Foreign Office
Source Rules

INTRODUCTION

The U.S. applies a worldwide tax system imposed on residents and citizens alike. Therefore, U.S. citizens and persons treated as U.S. residents for U.S. tax purposes are subject to U.S. tax on income and gains derived from their investments outside the U.S.

Under U.S. tax law, a foreign tax credit is available for foreign-source income and gains that were taxed in the foreign jurisdiction. The general U.S. source rule provides that subject to certain exceptions, the source of capital gains from the sale of a personal property is determined based on the residency of the person selling the asset.[1] Thus, for an individual who is treated as a U.S. person (for purposes of the source rule), gain from the sale of property outside the U.S. would be treated as U.S.-source gain.

This creates a problem whereby any tax paid outside the U.S. on such a sale will not be eligible for a foreign tax credit.[2] Fortunately, a tax treaty may provide relief by allowing re-sourcing of income or gains to the foreign country. In the absence of treaty relief, this problem may be alleviated if gains can be attributed to a foreign office maintained by the taxpayer outside the U.S.

GENERAL SOURCE RULE FOR INCOME AND GAINS FROM A SALE OF PERSONAL PROPERTY

As mentioned above, income from the sale of personal property by a U.S. resident is generally U.S.-source income no matter where in the world the sale takes place.[3] For these purposes, "U.S. resident" is

- any individual who
    - is a U.S. citizen or a resident alien and does not have a tax home in a foreign country, or
    - is a nonresident and has a tax home in the U.S.; and

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1 Code §865(a)(1).

2 Code §§901, 904. See "Foreign Tax Credits: General Principles and LB&I" in this issue of *Insights*.

3 Code §865. This general rule does not apply to sales of: (i) inventory property; (ii) depreciable personal property; (iii) intangibles (*e.g.*, patents, copyrights, trademarks) under certain circumstances, and goodwill; and (iv) stock of certain affiliated companies.

- any corporation, trust, or estate that is a U.S. person under the general rule for residence.[4]

For the purpose of determining an individual's "tax home" one must look to the individual's home for purpose of the travel expense deduction.[5] The regulations provide that an individual's tax home is located where his or her regular or principal place of business is located.

However, if the individual has no regular or principal place of business then his or her tax home is located at the individual's regular place of abode (in a real and substantial sense).[6] Under this rule, an individual will not be treated as having a tax home in a foreign country for any period for which his or her abode is within the U.S.[7] Nevertheless, temporary presence in the U.S. does not necessarily mean that the individual's abode is in the U.S., and maintaining a dwelling in the U.S. (whether or not that dwelling is used by the individual's spouse and dependents) does not necessarily mean that the individual's abode is in the U.S.[8]

Therefore, under certain circumstances, when an individual has more than one abode available (*i.e.*, one in the U.S. and one in a foreign country), claiming a foreign tax home may not be simple. This challenge not only extends to a U.S. citizens and residents but also to individuals who are otherwise treated as nonresidents. In these circumstances, case law provides that whether a taxpayer has a U.S. abode is determined by comparing the taxpayer's domestic ties (*i.e.*, familial, economic, and personal ties) to the U.S. with ties to the foreign country that is claimed as a tax home.[9]

In sum, when a U.S. citizen or resident maintains a home in the U.S. and has strong ties to the U.S., he or she may not be able to prove the existence of a tax home outside the U.S., even if that person spends a large amount of time outside the U.S. during the tax year. It must also be noted that showing that a U.S. citizen or resident's tax home is not in the U.S. is not sufficient grounds for the individual to be treated as a nonresident for purposes of the source rule unless a tax of 10% or more is imposed on the transaction by a foreign jurisdiction.[10]

RE-SOURCING INCOME UNDER A TAX TREATY

As mentioned above, for U.S. citizens and residents, gains from sales of property outside the U.S. will be sourced to the U.S. Consequently, the foreign tax credit limitation will restrict taxpayers from claiming a credit for foreign taxes paid. This result undermines the allocation of taxing rights as agreed between the U.S. and its treaty partners. To avoid this undesirable effect, certain U.S. income tax treaties provide a re-sourcing rule, which allows an individual who is eligible for treaty benefits to treat

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4 Code §865(g)(1)(A). The general rule for residence is found in Code §§7701(a)(30) and (31).

5 Code §865(g)(1)(A) defines "tax home" with reference to Code §911(d)(3).

6 Treas. Reg. §911-2(b).

7 Code §911(d)(3).

8 Treas. Reg. §911-2(b).

9 See, *e.g.*, *Harrington v. C.I.R.*, 93 T.C. 297, 307-308 (1989).

10 Code §865(g)(2).

certain income and gains as arising from foreign sources.

For example, absent a re-sourcing rule, if a U.S. individual sold shares in a Canadian corporation holding Canadian real property, the U.S. would tax the transaction and treat it as U.S.-source income. At the same time, Canada would tax the gain because, under the U.S.-Canada Income Tax Treaty, gain attributable to real property may be taxed in the country where the real property is located.[11] Thus, if no treaty relief was available, double taxation would occur. However, Article XXIV (Elimination of Double Taxation) of the U.S.-Canada Treaty provides that gains that may be taxed in Canada under the U.S.-Canada Treaty will be deemed to arise in Canada. Paragraph 3(a) provides that:

> Profits, income or gains (other than gains to which paragraph 5 of Article XIII (Gains) applies) of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules)) shall be deemed to arise in that other State.[12]

Therefore, the gain from the transaction in the above example would be re-sourced for U.S. tax purposes and treated as foreign-source gain, creditable against the U.S. tax liability arising from the transaction. Note that in order to claim treaty benefits the taxpayer must file Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

However, not all countries have a treaty with the U.S., and not all treaties allow such re-sourcing in these circumstances. For example, under the U.S.-India Income Tax Treaty, the determination of the source of income for purposes of foreign tax credits is made under the domestic source rules of the two countries for all matters except for royalties and fees for included services.[13]

GAIN ATTRIBUTED TO A NON-U.S. OFFICE

Notwithstanding the general source rule mentioned above, if a U.S. citizen or resident maintains an office or other fixed place of business in a foreign country, income from a sale of personal property that is attributable to such office is sourced outside the U.S., provided that it is subject to a foreign tax of at least 10%.[14]

Which Offices Can the Gain be Attributed to?

An office or other fixed place of business is generally defined as any fixed facility

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[11] Convention with Respect to Taxes on Income and Capital, U.S.-Can., art. xiii, para. 1 and 3, September 26, 1980. T.I.A.S. 11087; 1469 U.N.T.S. 189. Real property is defined to include stock of a domestic corporation of which value is derived principally from real property situated in that jurisdiction.

[12] See also Convention with Respect to Taxes on Income and Capital, U.S.-Can., art. xiii, para. 5, and art. xxix, para. 2, with regard to expatriates.

[13] See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Ind., art. 25, para. 3, September 12, 1989.

[14] Code §865(e). Note that the same limitations applicable to the general rule, relating to inventory, depreciable property, intangibles, and stocks of affiliated company, apply here.

through which a taxpayer engages in a trade or business. This definition includes facilities that are not regularly thought of as "offices," such as stores or other sales outlets, factories, workshops, and mines.

> *"Materiality will be satisfied if the non-U.S. office makes a significant contribution to the transaction by being an essential economic element in the realization of the gain."*

The use of another person's office or fixed place of business, including that of a related person, is attributed to the taxpayer only if the taxpayer's trade or business is conducted in that office or fixed place of business and such activities are not "sporadic or infrequent." The office or fixed place of business of a dependent agent will be attributed to the taxpayer if one of the following requirements is met:

- The agent has the authority to negotiate and conclude contracts in the name of the taxpayer and regularly exercises that authority over a continuous period of time.
- The agent has a stock of merchandise belonging to the taxpayer from which the agent regularly fills orders on behalf of the taxpayer over a continuous period of time.

If the agent's authority to negotiate and conclude contracts is limited only to unusual cases or if such authority must be separately secured by the agent prior to each transaction, the above requirement will not be considered as met.

In contrast, an office or other fixed place of business of an independent agent is generally not treated as the taxpayer's office or fixed trade or business. The determination whether an agent is of independent nature depends on facts and circumstances.

When is Gain Attributed to a Foreign Office?

For gain to be attributed to a non-U.S. office two conditions must be met:

- The office must constitute a "material factor" in realizing the gain.
- The office must regularly carry out, in the ordinary course of its trade or business, activities of the type from which such income or gain is derived.[15]

Materiality will be satisfied if the non-U.S. office makes a significant contribution to the transaction by being an essential economic element in the realization of the gain.[16] For example, for an office to be treated as materially participating in the sale of stock, the office must actively solicit, negotiate, or perform certain other activities required to arrange the sale. An office will not be treated as materially participating merely because the office collects the gain from the sale, exercises general supervision over the activities or the persons directly responsible for the sale, performs clerical functions incident to the sale, or exercises final approval over the execution of the sale.

For the second requirement to be met, one must first determine that the office is engaged in a trade or business outside the U.S. and thereafter determine that the activity related to the transaction at issue takes place in the ordinary course of such trade or business.

"Trade or business" in not defined for purposes of the source rules. Thus, we refer

[15] Code §864(c)(5)(B) and Treas. Reg. §1.864-6(b)(1).

[16] Treas. Reg. §1.864-6(b)(1).

to the definition of a "U.S. trade or business" under Code §864. Under these rules, a non-U.S. person trading in securities through a resident broker or other independent agent is not considered to have a U.S. trade or business unless the taxpayer maintains an office or a fixed place of business in the U.S., through which the transactions were effected. This may be interpreted to mean that a U.S. person who sells stock through a foreign office or fixed place of business is engaged in a trade or business outside the U.S.

Thus, in order to have the foreign office attributed to the taxpayer, it may be advisable to conclude an agency agreement between the non-U.S. company whose office is deemed to be attributed and the taxpayer. Under such agreement, the non-U.S. company should be appointed as the taxpayer's agent and be granted the authority to negotiate and conclude contracts on behalf of the taxpayer on a regular basis and without the need for a prior authorization. Furthermore, the agent should be authorized to hold property as the taxpayer's agent, seek potential buyers, act as the principal point of contact in the negotiations to sell the property, sign the contract of sale, deliver the property to the buyer, and receive the proceeds from the sale as the taxpayer's agent.

CONCLUSION

In sum, if a U.S. taxpayer owns foreign property, the sale may be treated as producing U.S.-source income or gains and the taxpayer may be denied a foreign tax credit. If a treaty is not be available to re-source such gains, the taxpayer may still find relief from double taxation if such gain is subject to non-U.S. tax of at least 10% and the taxpayer has an office outside the U.S. that is regularly engaged, as the taxpayer's dependant agent, in buying and selling property of the type in issue. If that office negotiates and concludes the contract for the sale of said property, the gains derived from the sale should be attributable to such non-U.S. office and be treated as foreign-source gains.

TAX 101:
TAXATION OF INTELLECTUAL PROPERTY – THE BASICS

Authors
Elizabeth V. Zanet
Stanley C. Ruchelman

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Intangible Assets
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INTRODUCTION

Change driven by development of intellectual property ("I.P.") is now a constant. Whether the I.P. user is a tax adviser accessing a digital library, an auto mechanic interfacing with an engine, or a shopper looking for a specific brand of product, I.P. in all its varied forms serves as an important tool in daily life.

For purposes of U.S. tax law, I.P. can take many forms. As embodied in the Internal Revenue Code ("Code"),[1] I.R.S. regulations, and case law, it includes patents, trademarks, copyrights, trade secrets, know-how, and computer software.[2]

This article presents an overview of the basic U.S. Federal tax considerations of transactions that occur over the life cycle of I.P, from its creation, to its acquisition, its exploitation, and its ultimate sale in a liquidity event.

TAX CONSIDERATIONS OF SELF-CREATED I.P.

Basis

Deduction v. Capitalization

A taxpayer that creates and utilizes I.P. as part of a profitable ongoing trade or business likely will prefer deducting the costs attributable to creating the I.P. This treatment allows the taxpayer to obtain a current tax benefit for the tax year during which the research and development ("R&D") costs were paid or incurred. The Code permits a current deduction under Code §162 for all the ordinary and necessary expenses paid or incurred during the tax year in any trade or business. To be deductible under Code §162, a business expense must not be subject to a provision of the Code that requires capitalization, such as Code §263 or Code §263A.

If the Code requires that the costs incurred by a taxpayer in the creation of I.P. must be capitalized, the capitalized costs will form the taxpayer's basis in the I.P. However, if the costs may be deducted under the Code when and as incurred, the accelerated tax benefit prevents the expenditure from being part of the taxpayer's basis in the I.P. Consequently, a taxpayer may have zero basis in self-created I.P. if all the costs incurred in creating the asset were deducted.

Case law and Code §263 require the capitalization of a business expense if that

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1 All references to the Code refer to the Internal Revenue Code of 1986, as amended since that date.

2 Under the Code, I.P. is described as part of the broader category of "intangible assets."

expense will create or enhance a separate and distinct intangible asset, or create or enhance a future benefit beyond the tax year in which the expense is incurred.

The Regulations under Code §263 generally require that amounts paid to create or acquire an intangible asset must be capitalized.[3] Amounts paid to facilitate the creation or acquisition of an intangible asset also must be capitalized.[4] The regulations list some of the costs related to self-created intangible assets that must be capitalized. The most significant in the context of I.P. are (i) costs incurred to obtain rights from a governmental agency, such as costs to obtain, renew, renegotiate, or upgrade rights under a trademark, trade name, or copyright and (ii) costs to defend or perfect title to an intangible asset, such as the cost to settle a patent infringement lawsuit.[5]

Code §263A requires the capitalization of a variety of costs attributable to property produced by a taxpayer or acquired for resale in a trade or business or an activity conducted for profit. For the purposes of Code §263A, "property" is defined to include tangible property, which would seem to exclude I.P. However, tangible property under Code §263A includes films, sound recordings, videotapes, books, and similar property that is intended to be produced on a tangible medium and mass distributed in a form that is not substantially altered. Thus, for example, the cost of writing a book, including the cost of producing a manuscript and obtaining a copyright or license for the project, must be capitalized pursuant to Code §263A.

Research Expenses

Code §174 provides a current deduction for certain types of research and experimental ("R&E") expenses. Under this section, a taxpayer may elect to (i) currently deduct all R&E expenses made in connection with the taxpayer's trade or business or (ii) amortize the expenditures over a period of not less than 60 months beginning with the month in which the taxpayer first realizes benefits from the expenditures. For taxpayers operating at a loss, the deferral of the 60-month amortization period may provide a more valuable tax benefit. If neither election is made, the expenditures are merely capitalized into the basis of the I.P., eliminating any tax benefit until the I.P. is sold.

Code §174 actually applies more broadly than Code §162 because it is available to taxpayers who are not yet engaged in a trade or business. R&E expenses must be R&D costs in the experimental or laboratory sense – that is, activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Thus, for example, the cost of creating a patentable pharmaceutical product may be currently deducted under Code §174.

Startup Expenses

Many I.P. companies are "startups," working on developing and testing a new I.P. asset, with the hope that it will soon attract investors and customers. Expenses related to starting a new business generally are not deductible under Code §162 because the taxpayer is not yet engaged in carrying on a trade or business. Code §195 allows taxpayers to elect to defer deducting certain expenses incurred before

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3 Code §1.263(a)-4(b)(1).

4 Code §1.263(a)-4(b)(1)(v).

5 Code §§1.263(a)-4(d)(5), (9).

the business becomes active and to deduct such expenses over a 15-year period beginning with the month in which the active business begins. Startup expenses are limited to costs that would be deductible if the business was already an active trade or business.

Amortization

Self-created I.P. used in a trade or business or held for the production of income may qualify for an amortization deduction under Code §167. The amount subject to the amortization deduction is the taxpayer's basis in the property. As discussed above, a taxpayer may not have a basis in self-created I.P. because the costs incurred to create the asset were currently deductible. The amortization deduction for self-created I.P. is available in cases in which a taxpayer was required to amortize the costs incurred in creating the I.P.

Code §167

The regulations state that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, which can be estimated with reasonable accuracy, the intangible asset may be amortizable under Code §167. The regulations specifically state that patents and copyrights have a useful life that can be reasonably estimated.[6] In contrast, trade secrets and know-how generally have been held to not have limited useful lives because they remain valuable as long as they remain confidential.

"Self-created I.P. used in a trade or business or held for the production of income may qualify for an amortization deduction under Code §167."

The issues of (i) whether certain intangible assets have useful lives and (ii) the lengths of the useful lives of certain intangible assets have been the subjects of controversy. The regulations under Code §167 created some certainty by providing a safe harbor for certain intangible assets.

Under the safe harbor, a taxpayer may treat an intangible asset as having a useful life of 15 years, unless (i) another useful life is specifically prescribed or prohibited under the tax law, (ii) the intangible asset is acquired from another person or is a financial interest, (iii) the intangible asset has a useful life that can be reasonably estimated, or (iv) the intangible asset relates to certain benefits arising from real property.[7] The basis of an intangible asset subject to the safe harbor must be amortized ratably over the 15-year period.[8]

Code §197

Code §197 generally applies to acquired intangible assets, typically in connection with the acquisition of a business as part of an asset purchase transaction. However, it also applies to a limited class of self-created intangible assets that are not part of an acquisition of a business. The class of self-created assets includes trademarks and trade names.[9] Thus, to the extent that costs incurred to create such

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6 Code §1.167(a)-3.

7 Code §1.167(a)-3(b)(1).

8 Code §1.167(a)-3(b)(3).

9 Code §197(c)(2) and (d)(1)(F). Other self-created intangible assets that may be amortized under Code §197 include (i) licenses, permits, and other rights granted by a governmental unit and (ii) any covenant not to compete entered into in connection with the acquisition of a trade or business. See generally Code §§197(c)(2) and (d)(1)(D), and (E).

assets must be capitalized under general tax principles, Code §197 will apply to determine the period over which the capitalized costs will be amortized for income tax purposes.

TAX CONSIDERATIONS OF ACQUIRED I.P.

Basis

In General

Generally, a taxpayer's basis in an acquired asset, including an intangible asset, will be the amount paid for the asset. In an arm's length transaction, the amount paid should be the acquired asset's fair market value as determined in an independent transaction. If a taxpayer acquires a single asset, the basis of that asset will be the purchase price. If the taxpayer acquires multiple assets from a seller or a trade or business, the acquirer and the seller might not have made an asset-by-asset allocation of the purchase price but simply agreed on an aggregate purchase price for the entire group of assets. In such a case, the acquirer must determine the fair market value of each asset through appraisals.

Direct Acquisition of the Intangible Assets of a Trade or Business

A trade or business may be acquired either directly through an asset acquisition or indirectly through the acquisition of the stock of a corporation. An asset acquisition offers the benefit of receiving a stepped-up cost basis in the assets, equal to the amount of the consideration paid. This maximizes future deductions for amortization and basis offset for assets that are subsequently sold. The drawback of an asset acquisition is that the legal documents typically are more complicated than in an acquisition of stock.[10] Further, as discussed below, under a special election procedure, the taxpayer may achieve the basis step-up of a direct acquisition in a stock acquisition.

When a taxpayer acquires an intangible asset as part of the direct acquisition of assets comprising a trade or business, the bases of the acquired assets are determined under the rules of Code §1060 and the regulations issued by the I.R.S. under that provision. Code §1060 applies to an "applicable asset acquisition," which is defined as any direct or indirect transfer of a group of assets that constitutes a trade or business in the hands of either the acquirer or the seller, and the acquirer's basis in the assets is determined wholly by reference to the consideration paid.

The acquired assets are divided into seven classes, typically referred to under the regulations as Class I through Class VII. Intangible assets, such as I.P., typically would fall into Class VI. The basis is allocated among the assets under a method by which the consideration is first reduced by the amount of Class I assets, and any remaining consideration is then allocated among the assets by ascending class number in an amount generally not in excess of fair market value of the assets within each class. Thus, after the allocation of the purchase price to Class I assets is completed, the purchase price is allocated to Class II assets to the extent of their respective fair market values, and so forth until the balance of the purchase price is allocated to Class VII assets.

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10 Stock transactions have their own complexities in connection with good legal title to assets owned and the exposure to hidden liabilities and claims.

The application of the basis allocation rules of Code §1060 imposes significant reporting requirements on both transferor and transferee, particularly with respect to Code §197 intangible assets, because the I.R.S. is interested in identifying situations in which the transferor and transferee report inconsistent allocations in order to maximize their respective tax benefits.

Acquisition of a Trade or Business Through a Stock Acquisition

In an acquisition of stock, the acquirer generally will have a cost basis in the acquired corporation's stock equal to the consideration paid for the stock. The consideration paid by the acquiring taxpayer will not be reflected through an increase or decrease in the basis of the acquired corporation's assets. Thus, for example, if the consideration paid by a taxpayer to acquire all of the stock a corporation exceeds the aggregate basis of the corporation's assets, neither the taxpayer nor the acquired corporation will be entitled to increase the basis in the corporation's assets.

Code §338 permits a taxpayer to make an election to treat certain stock acquisitions as asset acquisitions for the purposes of obtaining basis step-up in the underlying assets of the acquired corporation. The basis is allocated among the assets of the acquired corporation under rules similar to the rules described above, in which basis is first allocated to one class of assets and will continue to be allocated among the assets by ascending class number.

Acquisition Costs

The regulations under Code §263 state that a taxpayer must capitalize amounts paid to another party to acquire any intangible asset in a purchase or similar transaction, and specifically list certain intangible assets as falling under that rule. Examples are (i) a patent or copyright; (ii) a franchise, trademark, or trade name; and (iii) computer software.[11]

Amortization

In General

The amortization of acquired intangible assets is largely governed by Code §197, which permits a taxpayer to amortize any "amortizable Code §197 intangible" ratably over a 15-year period starting with the month in which the intangible asset is acquired. The 15-year amortization period applies regardless of the taxpayer's ability to establish the asset's limited useful life.

An amortizable Code §197 intangible is any "Code §197 intangible" held in connection with the conduct of trade or business or the production of income. A Code §197 intangible is defined to specifically include any and all of the following items:

- Patents
- Copyrights
- Formulas

[11] Treas. Reg. §§1.263(a)-4(c)(vii), (viii), and (xiv). The full list overlaps with intangible assets covered under Code §197, as explained later in the text under amortization.

> *“Acquired I.P. will be either an amortizable Code §197 intangible asset or an intangible asset excluded from Code §197 but possibly amortizable under Code §167.”*

- Processes
- Designs
- Patterns
- Know-how
- Formats or other similar items
- Franchises, trademarks, or trade names

In addition, a license, contract, or other arrangement for the use of a Code §197 intangible is itself a Code §197 intangible (unless the underlying asset is otherwise excluded from Code §197).

Special Rules for Licenses of Code §197 Intangibles

If the rights to use a Code §197 intangible are acquired in a *bona fide* license that is part of the acquisition of a trade or business, payments made pursuant to the license must be capitalized and amortized under Code §197. In contrast, if the rights to use a Code §197 intangible are acquired in a *bona fide* license that is not part of the acquisition of a trade or business, payments made pursuant to the license may be deducted rather than capitalized. As discussed in detail below, under certain circumstances, the I.R.S. may challenge a purported license as a sale of an intangible asset.

I.P. Excluded from the Application of Code §197

Two categories of assets are specifically excluded from the application of Code §197:

- Assets excluded regardless of the means by which the assets are acquired
- “Separately acquired assets” (defined below)

In the I.P. context, assets in the first category include certain computer software, sometimes referred to as “off-the-shelf” computer software. This is software that meets the following criteria:

- Readily available for purchase by the general public
- Subject to a nonexclusive license
- Has not been substantially modified

Examples include word processing software used by a law firm or general office of a company. Such computer software typically has a limited useful life that is much less than 15 years and may be amortized under Code §167 over a period of 36 months.

Separately acquired assets are intangible assets acquired in a transaction or a series of related transactions that do not involve the acquisition of the assets constituting a trade or business or a substantial portion of a trade or business. Typically, the fact pattern includes the expansion of an existing business, rather than the acquisition of an entirely new business. These assets may include patents, copyrights, computer software, and any interest in a film, sound recording, video tape, book, or similar property. Such separately acquired assets will typically be amortized under Code §167.

Nonrecognition Transactions

If a Code §197 intangible is acquired in a nonrecognition transaction, such as the contribution of property to a corporation that is free of immediate tax for the transferor under Code §351, or a comparable transfer of property to a partnership that is free of immediate tax for the transferor under Code §721, the transferee generally will step into the shoes of transferor with respect to the Code §197 intangible. To the extent basis is increased in the transaction because of the nature of a portion of the consideration received by the transferor, the transferee is treated as receiving two assets. The first asset has a basis equal to the basis of the Code §197 intangible in the hands of the transferor, while the second asset has an increased basis resulting from the gain partially recognized by the transfer. The former asset will be amortized over the remaining amortization period, and the latter asset will be amortized over a newly started 15-year amortization period.

TAX CONSIDERATIONS OF SALES OF I.P.

Character of Gain or Loss

In General

Under general tax principles, a taxpayer will realize gain on the sale of property to the extent that the amount realized on the sale exceeds the taxpayer's adjusted basis in the property. The taxpayer will realize loss to the extent that the adjusted basis in the property exceeds the amount realized on the sale. In certain instances, a nonrecognition rule of the Code may defer immediate recognition of gain or loss.

As discussed in detail below, the characterization of the gain or loss – that is, whether it is capital gain or loss, or ordinary gain or loss – will depend on three factors:

- The type of asset involved (*e.g.*, depreciable v. not depreciable)
- The purpose for which it was held by the taxpayer (*e.g.*, for investment v. for sale to customers)
- The nature of the parties involved in the transaction (*e.g.*, related v. unrelated)

Recapture as Ordinary Income

Depreciable or amortizable property generally will be subject to a recapture provision, such as Code §1245, which will require the taxpayer to characterize some or all of the gain (but not the loss) as ordinary gain. The recapture rules of Code §1245 apply to tangible and intangible assets that may be amortized under Code §167. Since many self-created and acquired intangible assets are amortizable under Code §167 and all Code §197 intangible assets are treated as subject to Code §167, Code §1245 will impact the characterization of gain on the sales of many types of intangible assets. Under Code §1245, any gain attributable to previously taken amortization deductions must be characterized as ordinary income.

After applying the recapture rules of Code §1245, any remaining gain recognized on the sale – or the loss, if the property is sold for less than the amortized basis immediately prior to the transaction – must be analyzed under the rules of Code §§1221 and 1231 to determine its character (ordinary or capital) and, consequently, how it will be taxed. For a taxpayer that is an individual, ordinary income is taxed at rates up to 39.6% under current law. The capital gains of an individual taxpayer are taxed at preferential rates, typically 20%. In contrast, ordinary income and capital gains of a corporation are taxed at the same rate; the highest tax rate currently is 35%. Moreover, capital losses generally are available to reduce only capital gains, subject to a minor amount that can be applied to reduce ordinary income when the taxpayer is an individual. Therefore, the characterization of gain and loss is important.

"Losses and gains from sales or exchanges of property described in Code §1231 are subject to complicated netting rules."

Capital Asset Defined

Broadly speaking, if the property is a capital asset in the hands of the taxpayer, the remaining gain – or the total loss – on a sale or exchange will be characterized as capital gain or loss. Code §1221 provides the definition of a capital asset and contains exclusions that are important in the context of I.P. For example, (i) inventory or (ii) property that is used in a trade or business and subject to depreciation under Code §167 is not a capital asset under Code §1221. Also, certain property, including a copyright or a literary, musical, or artistic composition, held by an individual taxpayer whose personal efforts created the property (or a person in whose hands the basis of the property is determined, in whole or in part, by reference to the basis of the property in the hands of the person who created it) is not a capital asset. This exclusion prevents creators that are not engaged in a trade or business from receiving capital gains treatment when the same type of person engaged in a trade or business would not receive such treatment.

Code §1231 Special Treatment

Code §1231 generally applies to property used in a trade or business, subject to the allowance for depreciation under Code §167, and held for more than one year. However, like Code §1221, Code §1231 excludes (i) inventory, (ii) property held for sale to customers in the ordinary course of a trade or business, and (iii) certain property, including a copyright or a literary, musical, or artistic composition, held by the taxpayer whose personal efforts created the property (or a person in whose hands the basis of the property is determined, in whole or in part, by reference to the basis of the property in the hands of the person who created it) is not a capital asset.

Losses and gains from sales or exchanges of property described in Code §1231 are subject to complicated netting rules. In broad terms, if losses are netted against gains and the result is a net loss, both the losses and gains are treated as ordinary gains or losses. If instead, the result is a net gain, both the losses and gains are treated as capital gains or losses.

Self-created I.P.

As previously discussed, a taxpayer may have a zero basis in self-created I.P. if the costs incurred in creating the asset were deducted. In such a case, the taxpayer will realize gain to the full extent of the amount realized on the sale of the I.P.

Alternatively, the taxpayer may have a basis in the self-created I.P. if certain costs incurred in creating the asset were required to be capitalized. Where that occurs, the taxpayer will realize gain if the basis is less than the amount realized or loss if the basis is greater than the amount realized on the sale of the I.P.

Some self-created I.P. will be a capital asset in the hands of its creator. For example, self-created trade secrets and know-how will not be excluded from the definition of a capital asset under Code §1221 because trade secrets and know-how are not depreciable assets. Accordingly, any gain or loss from the sale will be capital gain or loss.

In contrast, self-created I.P. that is depreciable under Code §167 is specifically excluded from the definition of a capital asset under Code §1221, but it is not excluded from coverage under Code §1231. The asset will be subject to the depreciation recapture rules of Code §1245, so that any gain that is realized and is attributable to the previous amortization deductions will be characterized as ordinary gain. The remaining gain or loss may be characterized as capital gain or loss under Code §1231 if the asset was used in a trade or business, held for more than one year, and not otherwise excluded by Code §1231, as discussed above.

Illustration

In tax year 1, Taxpayer created a patent and deducted some of the R&D costs incurred in creating the patent under Code §174. The remaining costs were required to be capitalized under Code §263. As a result, Taxpayer received a basis in the self-created patent to the extent of those capitalized costs.

"Self-created I.P. that is depreciable under Code §167 is specifically excluded from the definition of a capital asset under Code §1221, but it is not excluded from coverage under Code §1231."

Taxpayer amortized the capitalized costs under Code §167, reducing its basis annually to the extent of the amortization deduction. At all times, Taxpayer used the patent in its trade or business, and the patent was not inventory or held primarily for sale to customers in the ordinary course of that trade or business. In tax year 5, Taxpayer sold the patent and realized gain. Taxpayer had no other sales during the tax year, and as a result, the realized gain was the net gain for the tax year. Under Code §1245, the gain attributable to the amortization deductions will be treated as ordinary gain. Under Code §1231, the remaining gain will be treated as capital gain.

Acquired I.P.

As discussed above, acquired I.P. will be either an amortizable Code §197 intangible asset or an intangible asset excluded from Code §197 but possibly amortizable under Code §167.

Since amortizable Code §197 intangible assets are treated as property subject to Code §167, any gain on the sale of the I.P. will be subject to depreciation recapture under Code §1245. The I.P. generally will not be a capital asset under Code §1221, but if it is used in a trade or business, held for more than one year, and otherwise not excluded from Code §1231, any gain or loss on the sale of the I.P. may be treated as capital gain or loss under Code §1231.

As discussed in detail below, certain special rules of the Code may recharacterize the gain or loss. Further, Code §197 includes certain loss disallowance rules.

In the case of assets excluded from Code §197, such as certain computer software discussed above, and not subject to depreciation under Code §197 but subject to depreciation under Code §167, any gain on a sale will be subject to Code §1245 depreciation recapture and the gain or loss may be capital under the rules of Code §1231. However, the Code §197 loss disallowance rules (discussed below) will not apply. Assets excluded from Code §197 and not depreciable would not be subject to depreciation recapture and may be capital assets under Code §1221.

Special Rules Involving Sales Between Related Parties

In a sale of I.P. between related parties, two issues are prevalent. For a sale at a loss, the issue is whether the loss is deductible, and if it is, whether the loss offsets capital gain or ordinary income. If the sale results in a gain, the issue is the character of the gain as ordinary or capital, reflecting the fact that the purchaser can reduce ordinary income through amortization of the acquisition price. Several provisions may be applicable. Regarding deductions, Code §§267 and 197 are relevant. Regarding the character of gains, Code §1239 is relevant.

Code §267 generally disallows losses on the sale or exchange of property between related parties, such as certain members of a family or corporations owned by the same shareholder. For the purposes of determining whether the purchaser and the seller are related, a taxpayer will be treated as owning property directly, indirectly, and constructively. The application of Code §267 is broad: It applies to sales or exchanges between related parties of self-created and acquired I.P.

Loss Disallowance Rules under Code §197

In addition, Code §197 contains a loss disallowance rule, which prohibits the recognition of loss on the sale or exchange of an amortizable Code §197 intangible asset if the taxpayer retains any other amortizable Code §197 intangible asset acquired in the same transaction or series of related transactions. The purpose of the loss disallowance rule is to prevent taxpayers from recovering unamortized basis faster than ratably over the 15-year amortization period available under Code §197. The disallowed loss is allocated to the retained assets as a basis increase.

Code §197 contains a special loss disallowance rule that applies to covenants not to compete. If a covenant not to compete is entered into in connection with the direct or indirect acquisition of an interest in one or more businesses, the disposition or worthlessness of the covenant will not be considered to occur until the disposition or worthlessness of all interests in those trades or businesses occurs.[12] This provision is intended to prevent a loss from being recognized in the year the covenant terminates, which typically is many years prior to the completion of the 15-year amortization period.

Regarding the character of gains, Code §1239 requires a transferor to treat any gain recognized on the sale or exchange of property as ordinary income if the property is depreciable under Code §167 in the hands of a related-partly transferee. The purpose is to prevent a tax arbitrage opportunity involving a gain taxed at preferential rates for individuals when amortization deductions offset ordinary income for the related party.

Sale or License

Intangible assets, particularly I.P., are frequently licensed, resulting in royalty income to the licensor, which is characterized as ordinary income. If the underlying intangible asset is amortizable, the licensor will continue to be able to amortize the asset notwithstanding the license agreement. On the other hand, if the transaction

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[12] Code §197(f)(1)(B); Treas. Reg. §1.197-2(g)(1)(iii).

has the economic effect of a sale but is legally characterized as a license, the seller can recover the full basis of the property right involved in the transaction.

A key question to consider in the taxation of a licensor transferring an exclusive license is whether, notwithstanding the form, the transfer should be treated as a sale of the intangible asset. Under an objective test, known as the "substantial rights test," a transfer of a license can be treated as a sale if the licensor relinquishes all substantial rights to the licensee. On the other hand, a transfer by sale can be treated as a license if it involves a transfer of a nonexclusive right to use an intangible asset, particularly for a period less than the estimated useful life of the asset. This question permeates all areas of I.P. and the conclusion may vary depending upon the type of I.P. asset that is involved.

Special Rule for Sale of a Patent

A special statutory rule applies to patents that apply to persons characterized as "holders." Under Code §1235, a holder of a patent, or an undivided interest in the patent, is any individual whose efforts created the invention and any other individual who acquired his or her interest in the property right in exchange for consideration in money or money's worth, provided the price is paid prior to the actual reduction to practice of the invention. In the latter set of circumstances, the acquirer cannot be the employer of the creator of the invention nor related to the creator within the broad meaning of Code §267(b) and certain other provisions, as adjusted by Code §1235. This provision was enacted to address an unwarranted benefit enjoyed by amateur inventors that was denied to professionals. The former class of individuals benefitted from capital gains tax rates on the sale of a patent while the latter was subject to U.S. tax at ordinary income tax rates.

"A transfer consisting of 'all substantial rights' to a patent . . . is considered to be a sale or exchange of a capital asset held for more than one year."

Under Code §1235, a transfer consisting of "all substantial rights" to a patent, or a transfer of an undivided interest in the patent, which includes a part of all the rights, is considered to be a sale or exchange of a capital asset held for more than one year. The actual holding period is irrelevant. Consequently, an individual who qualifies as a holder is entitled to compute tax on the gain from a sale of all substantial rights at favorable long-term capital gains rates. The consideration may be payable periodically with the transferee's use of the patent or contingent on the productivity, use, or sale of the patent.

All substantial rights mean all rights (whether or not then held by the grantor) that are of value at the time the rights to the patent (or an undivided interest therein) are transferred. Because the owner of a product patent owns the exclusive right to make, use, offer for sale, and sell an invention, the all substantial rights test is met when such patent owner sells the exclusive right to make, use, offer for sale, and sell an invention. In some circumstances described below, only one or another of the rights can be sold without jeopardizing application of Code §1235 for the holder.

Regulations issued by the I.R.S. establish certain hurdles that must be overcome for a transfer by license or sale to be considered a transfer of all substantial rights.[13] The regulations list grants of rights that fail to transfer all substantial rights in a patent. As a result, none of the following grants of rights under a patent satisfy the "all substantial rights test":

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[13] Treas. Reg. §1.1235-2(b).

- A transfer that is limited geographically within a country of issuance[14]
- A transfer that is limited in duration to a period less than the remaining life of the patent[15]
- A transfer that grants rights in fields of use within trades or industries that are less than all the rights covered by the patent that exist and have value at the time of the grant[16]
- A transfer that grants less than all the claims or inventions covered by the patent that exist and have value at the time of the grant[17]
- A transfer in which the transferor retains the right to terminate the transfer at will[18]

The regulations go on to provide that certain rights can be retained because they are not substantial. As a result, the following rights can be retained by a holder without violating the all substantial rights test:

- A legal title for the purpose of securing performance or payment by the transferee in a transaction involving a transfer of an exclusive license to manufacture, use, and sell for the life of the patent[19]
- Rights in the property that are not inconsistent with the passage of ownership (including a security interest such as a vendor's lien or a reservation of a right that is subject to a condition subsequent, such as a provision for forfeiture in the event of nonperformance)[20]

Because facts and circumstances control so many decisions in U.S. Federal tax law, the regulations provide that certain rights retained by the transferor may or may not be considered to be substantial rights under Code §1235 depending upon the circumstances of the whole transaction. These include the retention of an absolute right to prohibit sublicensing or sub-assignment by the transferee and the failure to convey to the transferee the right to use or to sell the patent property.[21] In the latter case, Code §1235 treatment may be jeopardized if the retained right is valuable, but it is allowed if the retained right is relatively valueless.

CONCLUSION

To understand the U.S. Federal tax considerations of I.P. it is important to first distinguish whether the asset was self-created or acquired.

If the I.P. is self-created, a taxpayer may be required to capitalize the costs incurred

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14 Treas. Reg. §1.1235-2(b)(1)(i).

15 Treas. Reg. §1.1235-2(b)(1)(ii).

16 Treas. Reg. §1.1235-2(b)(1)(iii).

17 Treas. Reg. §1.1235-2(b)(1)(iv).

18 Treas. Reg. §1.1235-2(b)(4).

19 Treas. Reg. §1.1235-2(b)(2)(i).

20 Treas. Reg. §1.1235-2(b)(2)(ii).

21 Treas. Reg. §1.1235-2(b)(3).

in creating the I.P. and amortize those costs over the asset's useful life, typically using straight line amortization over a 15-year period. Alternatively, the taxpayer may be permitted to deduct the costs of creating the I.P. on a current basis provided the cost qualify as deductible expenses.

If the I.P. is acquired from another, the taxpayer generally will have a basis in the asset equal to the amount paid to acquire the I.P. Acquired I.P. used in a trade or business or held for the production of income generally may be amortized under the rules of Code §197, which permits straight line amortization over a 15-year period. If such acquired I.P. is not amortizable under Code §197, it may nonetheless be amortizable under Code §167.

The sale of I.P. that is subject to amortization will require the taxpayer to recapture some or all of the gain as ordinary gain. Any remaining gain in excess of the recapture amount on the sale of the I.P., or loss incurred, may be characterized as capital or ordinary depending upon the type of asset involved, the purpose for which it was held by the taxpayer, and the parties involved in the transaction.

NET OPERATING LOSSES: A VALUABLE ASSET WORTH PRESERVING

Author
Philip R. Hirschfeld

Tags
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Carryforward
Code §172
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Code §269
Consolidated Tax Return
Net Operating Loss
Separate Return Limitation Year

OVERVIEW

Every cloud has a silver lining. This expression also applies to the world of tax. Troubled companies that incur significant operational and interest expenses may find that they have generated significant net operating losses ("N.O.L.'s"). Those N.O.L.'s can be carried back up to two years or carried forward for up to 20 years to reduce taxable income,[1] although an alternative minimum tax imposed at a 2% effective rate[2] plus state franchise tax and local business taxes based on methods other than income[3] may reduce the benefit somewhat. The reduction in tax attributable to the utilization of N.O.L.'s creates cash flow that is just as valuable as cash flow generated from running the business.

As a result, substantial N.O.L.'s can be valuable corporate assets that make a company an inviting target to acquire. However, U.S. Federal tax law contains three stumbling blocks that may apply when stock in a company with N.O.L.'s is sold or exchanged. In these cases, Code §§382 and 269, as well as the separate return limitation year ("S.R.L.Y.") provisions of the consolidated return regulations,[4] may limit a company's ability to benefit from the use of N.O.L.'s. To preserve N.O.L.'s, acquisitions must be carefully reviewed before stock is sold, exchanged, or issued.

CODE §382 LIMITATIONS

Code §382 limits the use of N.O.L.'s once an ownership change of a specific magnitude takes place in the company that generated the loss. In broad terms, an ownership change requires a 50-percentage point change in stock ownership of 5% shareholders[5] over a three-year testing period.[6] The focus is only on 5% shareholders to simplify the analysis.

If an ownership change occurs, the future use of an N.O.L. in any year is restricted

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[1] Code §172(b)(1)(A).

[2] Code §55(b)(1)(B) imposes a tentative alternative minimum tax on corporations at the rate of 20%. The N.O.L. is subject to a cap when applied to the A.M.T. Under Code §56(d)(1)(A)(i)(II), only 90% of the alternative minimum taxable income may be reduced by a N.O.L.

[3] New York City imposes an alternative tax based on capital if that tax is greater than the tax on income. New Jersey has an alternative minimum corporate income tax that can be as much at 0.8% of gross profits above $37.5 million.

[4] Treas. Reg. §1.1502-21(c)(1)(i).

[5] A 5% shareholder includes any person who owns 5% or more of the loss corporation. Code §382(k)(7).

[6] Code §§382(g)(1), (i).

by the Code §382 limitation.[7] This limitation is equal to the product of (i) the value of the loss corporation on the date of the ownership change multiplied by (ii) the long-term tax-exempt rate for that month (or if larger, any of the two preceding months).[8]

Ownership Change

An ownership change is defined to mean any shift in ownership with respect to one or more 5% shareholders where, after the change, the percentage of stock that the 5% shareholders own in the loss corporation is increased by more than 50 percentage points over the lowest percentage of stock owned by those 5% shareholders during the testing period.[9] The testing period is the three-year period which ends on the date of the change.[10] The computation is made on the basis of the value of the shares[11] so that the limitation applies once stock representing more than 50 percentage points in value has changed within the testing period. Value refers to the fair market value.[12]

A 5% shareholder is defined as any person holding 5% or more of the stock of the corporation at any time during the testing period.[13] Rules of attribution apply in determining whether an ownership change has occurred:[14]

- All members of a family (*viz.*, husband, wife, children, grandchildren, parents) are aggregated and treated as a single person.
- Shares owned by a corporation or partnership are considered to be owned by its shareholders or partners.
- Shares owned by a trust are considered to be owned by its beneficiaries in proportion to their actuarially determined interests in the trust.[15]

Once an ownership change triggers application of the limitation,[16] the new ownership level becomes the base against which subsequent ownership changes are evaluated. As a result, the testing period for subsequent changes cannot take into account ownership that existed on or before the day on which the limitation is triggered.

The Limitation

If the limitation applies, the amount of the N.O.L. carryover that may be claimed

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7 This limitation does not apply to certain ownership changes occurring in a bankruptcy proceeding or when the company is insolvent. Code §§382(l)(5), (6).

8 Code §382(b)(1). Also, the N.O.L. will be eliminated if the loss corporation does not continue to carry on its business.

9 Code §382(g)(1).

10 Code §382(i).

11 Code §382(k)(6)(C).

12 Code §382(k)(5).

13 Code §382(k)(7).

14 Code §382(l)(3)(A).

15 Code §318(a), except that attribution from corporations is not limited to persons who own 50% or more of the corporation.

16 Code §382(i)(2).

every year as a deduction is limited to the value of the corporation immediately prior to the change in ownership multiplied by the long-term tax-exempt rate.[17] The long-term, tax-exempt rate is an interest rate that is published periodically by the I.R.S. and is based on the average yield of tax-exempt instruments.

"There is no abuse in acquiring the shares of the corporation and utilizing the N.O.L. to shield future income to the extent the tax benefit of the N.O.L. in any year does not exceed the tax-free yield on the bonds."

The theory for this approach is that a purchaser of a corporation having an N.O.L. could have invested in municipal bonds generating tax-free income. Instead, it acquired shares of the corporation with an N.O.L. Viewed in this light, there is no abuse in acquiring the shares of the corporation and utilizing the N.O.L. to shield future income to the extent the tax benefit of the N.O.L. in any year does not exceed the tax-free yield on the bonds.

In determining the limitation, the long-term tax-exempt rate for the month in which the ownership change takes place (or if greater, the rate for either of the preceding two months) is the rate that is used during the entire carryover period. In May 2017, the rate was 2.09%.[18]

If the company has a net built-in loss in its assets on the date of an ownership change, then the Code §382 limitation also applies to the future use of the built-in losses.[19] A net built-in loss exists where a loss has economically occurred, but has not yet been realized. An example is a single asset in the company where the tax basis in the asset is $5 million but its fair market value is $1 million on the date of the ownership change. There, the net built-in loss is $4 million. A $4 million loss recognized on a later sale of that asset will be subject to the limitation. An example where a sale of an asset produces an ordinary loss would be the sale of depreciable property used in a trade or business and held for more than 12 months. When these assets are sold at a loss, they produce an ordinary loss, but when sold at a gain, the gain is given capital treatment.[20]

Lastly, if the limitation applies, the loss company must carry on the business that existed before the change in ownership for the two-year period that begins with the date of the change. If the business is not carried on for all days within that two-year period, no portion of the N.O.L. carryover may be claimed as a deduction.[21]

CODE §269 LIMITATIONS

Code §269 applies only to the extent that control of a corporation is acquired and tax avoidance is *the* principal purpose for the acquisition. Control means ownership of stock representing 50% or more of the value of all company stock or 50% or more of the vote of all company voting stock. Where either of those facts exist, Code §269 denies deductions or credits such as N.O.L. carryforwards of the acquired company.

The regulations under Code §269 provide that certain fact patterns are indicative of the presence of a tax avoidance motive. One such fact pattern is (i) the acquisition, (ii) by a profitable corporation, (iii) of control of a target corporation, (iii) having

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17 Code §382(b)(1).

18 Rev. Rul. 2017-11.

19 Code §382(h).

20 Code §1231.

21 Code §382(c)(1).

net operating losses, (v) followed by the transfer of business assets to the loss corporation, (vi) in a transaction that brings profits and losses into one entity. Where those facts exist, the burden of proof is on the taxpayer to demonstrate the existence of a business reason for the transaction which outweighs the tax reduction motive.

CONSOLIDATED RETURN REGULATIONS: S.R.L.Y.

The consolidated tax return regulations allow two or more corporations that meet certain requirements to join in the filing of a consolidated tax return.[22] As a result, the losses and credits of one company generally can be used to offset the profits or taxes of another company within the group.

The consolidated tax return regulations are legislative regulations, meaning that the I.R.S. was granted broad authority by Congress to draft the rules controlling the computation of income and tax for a group.[23]

Under that broad grant of authority, the regulations limit a group's use of loss or credit carryovers attributable to a group member that filed a separate tax return in the year when the loss or the unused credit first arose. The losses that are not available to the group are known as separate return limitation year, or S.R.L.Y., losses.[24]

"Generally, losses of a member of an affiliated group which arose in an S.R.L.Y. may not be offset against the income of other group members."

An S.R.L.Y. is any year in which a corporation either (i) filed a separate Federal income tax return or (ii) was a member of one affiliated group in the year the loss was incurred and a member of another affiliated group in the year to which the loss is carried.[25] Generally, losses of a member of an affiliated group which arose in an S.R.L.Y. may not be offset against the income of other group members. However, the S.R.L.Y. loss may continue to offset the income of the corporation that generated those losses.[26]

OVERLAP BETWEEN CODE §382 AND S.R.L.Y. RULES

The S.R.L.Y. rules do not apply if they overlap with the Code §382 limitations.[27] This occurs for an N.O.L. if a corporation becomes a consolidated group member within six months of a Code §382 ownership change with respect to the loss.[28] In practice, the overlap rule will often eliminate the need to deal with the S.R.L.Y. limitation.

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22 Treas. Reg. §1.1502-75(a).

23 Code §1502.

24 Treas. Reg. §1.1502-21.

25 Treas. Reg. §1.1502-1(f). There are exceptions such as for losses arising in S.R.L.Y.'s of the common parent corporation. Treas. Reg. §1.1502-1(f)(2).

26 Treas. Reg. §1.1502-21(c). A similar rule applies to unused credits that arise in an S.R.L.Y. and to losses that economically accrued in an S.R.L.Y. S.R.L.Y. losses and credits may be used only to reduce the income or the tax of the corporation, itself, and no other members of its group.

27 Treas. Reg. §1.1502-21(g)(1).

28 Treas. Reg. §1.1502-21(g)(2)(ii)(A). If the S.R.L.Y. event follows the §382 event, the overlap rule also applies to any "interim" N.O.L. Treas. Reg. §1.1502-21(g)(2)(ii)(B).

CONCLUSION

N.O.L.'s are valuable corporate assets that are worth preserving. However, when stock in a company that has an N.O.L. is acquired, three potential traps exist for the unwary that may limit the future use of the N.O.L.'s. The potential acquirer must consider Code §382, Code §269, and the S.R.L.Y. rules under the consolidated return regulations. With proper care, the limitations can be managed with planning prior to the stock acquisition.

AMAZON MAKES THE C.U.T. – AN IMPORTANT TAXPAYER WIN, A REMINDER TO CONSIDER TRANSACTIONAL EVIDENCE

Author
Michael Peggs

Tags
Amazon
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INTRODUCTION

In finding for the taxpayer in a recent transfer pricing decision,[1] the U.S. Tax Court followed its own determination in *Veritas*[2] in valuing a buy-in payment made as compensation for the right to use pre-existing intangible assets in a related-party cost sharing arrangement ("C.S.A."). This decision, like other major transfer pricing decisions, serves as a reminder of the fact-intensive nature of transfer pricing matters and of the importance of uncovering and properly analyzing transactional evidence from the controlled transaction in question and from uncontrolled transac-tions or dealings of the business.

This article comments on the lessons learned from this important taxpayer victory. For a full discussion of the tax treatment of intellectual property ("I.P.") at issue in the case, see "Tax Concerns on Outbound I.P. Transfers: Pitfalls & Planning in Light of I.R.S. Defeat in Amazon Case" in last month's edition of *Insights*.[3]

BACKGROUND

Amazon.com, Inc. ("Amazon") entered into a C.S.A. with Luxembourg subsidiary A.E.H.T. in 2005. The C.S.A. covered: (i) the software and other technology underlying the Amazon European domain-name websites, fulfillment centers, and related business activities; (ii) marketing intangibles, including trademarks, tradenames, and domain names used in Amazon's European business; and (iii) customer lists, customer data, and the Amazon tradename and mark. The right to use the pre-existing intangible assets in these three categories was priced at $254.5 million, payable over a seven-year period corresponding with the useful life of the intangible assets.

Using the income method and the same discounted cash flow approach rejected by the court in *Veritas*, the I.R.S. estimated the arm's length value of the buy-in payment to be $3.468 billion, effectively disregarding the C.S.A. and valuing the transfer of rights as a business that would exploit infinitely-lived intangibles in perpetuity. The I.R.S. also disputed the Amazon failure to classify certain technology and content expenses of Amazon.com as intangible development costs, thereby biasing downward the income from annual cost sharing payments received from A.E.H.T. over the term of the C.S.A.

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1 *Amazon.com, Inc. & Subsidiaries v. Commr., T.C.,* 148 T.C. No. 8 Docket No. 31197-12.

2 *Veritas Software Corp. v. Commr.*, T.C., 133 T.C. 297 (2009).

3 Philip Hirschfeld, "Tax Concerns on Outbound I.P. Transfers: Pitfalls & Planning in Light of I.R.S. Defeat in Amazon Case," *Insights* 4 (2017).

The economic substance of the A.E.H.T. Luxembourg operations hub was not critical on its own. Local language requirements, local vendor relations, and European logistics considerations and customer tastes were all factors contributing to the need to carry on a business in Luxembourg, and the change in economic position for A.E.H.T. expected to result from the C.S.A. In rejecting the I.R.S. transfer pricing method, the court made clear that "A.E.H.T. was not an empty cash box." This determination contrasts sharply with the O.E.C.D. outcomes under the B.E.P.S. Action Plan that attack hypothetical "cash boxes" that are legal owners of rights but lack the decision-making and risk management capacity needed to allocate capital to investments with uncertain returns. The dispute in *Amazon* therefore centered on (i) the transfer pricing method, (ii) the assumptions made and analyses used to value the buy-in payment, and (iii) the correct treatment of the intangible development costs within the term of the C.S.A.

"The star of the trial was a Treas. Reg. §1.482-7 transfer pricing method – the Comparable Uncontrolled Transaction method ('C.U.T.')."

AMAZON TRIAL

In deciding for the taxpayer, the court relied on the testimony and reports of 30 experts in computer science, marketing, economics, and transfer pricing economics. The opinions of the computer science experts on the state and viability of the Amazon software and websites served as a stable foundation upon which the transfer pricing economics experts for the taxpayer could anchor their assumptions. These assumptions were critical – as the technical constraints of the software system provided a reliable estimate of the lifespan of the software used to power the core operations of the Amazon websites and fulfillment business. The marketing experts helped the court decide on a proper method to estimate key variable values used in the marketing intangibles value calculation. They also assisted the court in determining how the intangibles allowed a team of engineers – for whom no technical challenge seemed too large – to overhaul the websites without causing them to crash during popular shopping seasons.

However, the star of the trial was a Treas. Reg. §1.482-7 transfer pricing method – the Comparable Uncontrolled Transaction method ("C.U.T."). Amazon used an unspecified transfer pricing method resembling in some respects the profit-split method to calculate the original buy-in payment, while the I.R.S. used an application of the income method. The I.R.S. income method calculated the present value of cash flows forecasted to result from A.E.H.T.'s European business, using cash flow and balance sheet forecasts as its only company data input. Both approaches neglected or devalued Amazon's outsourced web store programs, and thousands of Associates or Syndicated Stores programs that provided customer referrals to Amazon.

The website platform and referrals transactional data alone did not win the case for Amazon. Considerable expert testimony was required to establish reliable assumptions of discount rates, value decay rates, useful asset life, and trademark ownership. The company's own information, however, was a crucial element in winning the case. C.U.T.'s that involve transactions between the taxpayer and independent businesses (sometimes called internal C.U.T.'s), are highly persuasive given these fit well within the framework of the comparability requirements of Treas. Reg. §1.482(c)(1), which is critical to selecting a best method. C.U.T.'s are not abstract agreements between third parties. They must bear some resemblance to one of the controlled parties and its business.

One small levity allowed in the 207-page decision was that "one does not need a Ph.D. in economics to appreciate the essential similarity between the DCF methodology that Dr. Hatch employed in Veritas and the DCF methodology that Dr. Frisch employed here." Similarly, a Ph.D. is not required to present a well-selected and adjusted C.U.T. to the I.R.S. or a Tax Court judge. It seems unlikely in the case of Amazon's C.S.A. that the I.R.S. would have paid any attention to a C.U.T. at the examination level, given the strong motivation within the I.R.S. to re-litigate *Veritas*. Nonetheless, C.U.T.'s remain a valuable commodity to be mined and stockpiled for use in appropriate circumstances.

CONCLUSION

Not only was Amazon's transactional data important in building its case in favor of the buy-in payment value, its Code §41 credit cost detail proved useful in substantiating the company's claim that a significant class of expenses should not be classified as intangible development costs and shared with other C.S.A. participants. This is another good example of seeking the data required within the company's records before reinventing the wheel.

An open question in the case is the treatment of employee stock option costs in a C.S.A. This question will have to wait for the outcome of the I.R.S. appeal in *Altera*.[4]

Pending a successful outcome in *Altera*, two theories used by the I.R.S. to attack a technology company C.S.A. could be blunted. To the extent that I.R.S. estimates regarding the size of the tax gap rely on large income windfalls from litigating C.S.A. positions of high-tech companies, *Amazon* could prove to be an early indication that these estimates require a downward adjustment.

[4] *Altera Corp. v. Commr.*, T.C. 145 T.C. No. 3 (2015).

FIVE STEPS FOR LEVERAGING YOUR START-UP'S EMERGING INTELLECTUAL PROPERTY

Author
Barry Lewin

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Barry Lewin is partner at Gottlieb, Rackman & Reisman, P.C., in New York. Mr. Lewin focuses his practice on patent prosecution in the mechanical and electronic arts including software-based and hardware-based inventions.

Start-up companies are often created because the founders have a concept that they think will take hold. Sometimes, this concept is novel and can be protected, which may result in considerable value. For an emerging business, this intellectual property ("I.P.") can be the business' most important asset and the difference between success and failure – that is, if the business considers these five important issues.

1. **Ensure you are not reinventing something someone already invented and protected.**

   These days, new start-ups spring up all the time. Many believe that they have better ways of solving known problems, and sometimes, someone else unknown to the start-up solved the same problem in a similar way. When others protect their designs, implementations, or names first, they may own I.P. rights, and you could be infringing on those rights. It is critical to the longevity of a business to be sure that the business has freedom to operate. To do so, it is often well worth the investment to engage a professional, such as a patent attorney, and obtain a prior art and/or name search to be sure you have the freedom to operate as you would like, and to do so *before* you begin to invest heavily in a solution.

   What happens if a patent search comes back with a prior reference including your invention? You have several options. First, come up with an even better and different solution that might not already be patent-protected. It could be that a new and improved version has even more long-term value. Alternatively, you can approach the owner of the I.P. for a license. That way, the originator obtains some benefit and you can move ahead with your plans and expand the innovativeness.

2. **File for patents as early as you can.**

   Patents can become extremely valuable assets for a company, particularly early in a new company's life when it has not yet developed assets that provide value. Patents and patent applications can provide value, enhance investment opportunities, and serve as collateral for financing arrangements.

   The timing for filing for patent protection is important. New companies should understand that they must file for patent protection before they release their product in order to protect their worldwide rights. Some countries do not grant a patent if the application is made after the product is publicly disclosed.

   To save early expense, companies can file provisional patent applications in the U.S. and still preserve their worldwide rights. Provisional applications are simpler to prepare, the fees are less than for non-provisional or formal applications, and once filed, you can use the term "patent pending" right away.

The main ingredient of a provisional patent application is that the application must describe the invention in such a way that a person "of ordinary skill in the art" could replicate the invention from the description.

3. **Choose and use branding carefully.**

Name recognition is important. New companies use branding, such as names and logos, to distinguish their products and services. Importantly, the branding cannot be confusingly similar to other companies' branding. Searches can help identify whether proposed brand assets meet this requirement.

Trademark protection is based on the adage "first in time, first in right" and applies to a category of goods or services, as well as geographic use. Once selected, the name or logo can be registered with the U.S. Patent and Trademark Office. The registration effectively locks in the name nationwide for those goods or services.

4. **Keep protecting innovation as innovation continues to occur.**

In this fast-moving age of disruptive technology, innovations happen frequently and throughout the world. Numerous people and companies worldwide are often trying to solve the same problem at the same time. When multiple parties solve the same problem in the same way, only the first to file a patent application is entitled to patent protection under U.S. law.

A product may evolve during a company's start-up stage and the company may continue to introduce innovations to the product. For example, a company may introduce new features over time to improve a product. The commercial importance of one or more of these features could grow over time and become even more important than the original offering. As such, it is important for the company to file a patent application to protect a new feature. The patent application for the new feature should be filed before public disclosure of the new feature.

5. **Don't be shy about your filings.**

Once you have filed for patent protection and/or trademark registration, it is your responsibility to police your rights. As a start, it is important to let the world know that you have a pending patent on your invention by using the term "Patent Pending" when marketing the product that includes the subject of a patent application. Similarly, before obtaining a trademark registration, use the "T.M." designation next to the product identifier. Once you receive the trademark registration, use the "R" in the circle (®) to show that you have a registered trademark.

If you encounter others with similar implementations, it is important to alert them to the existence of your patent application as soon as possible. If there are potential infringements, it is beneficial to establish a notification date, which can come into play in the event you are entitled to damages. Of course, you can also license your technology to them, so this notification may result in a new revenue stream for you.

For a discussion of tax deductions available to a start-up company, particularly with respect to its I.P., see "Taxation of Intellectual Property – An Introduction to the Basic Rules" in this edition of *Insights*.

Authors
Astrid Champion
Nina Krauthamer

Tags
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Ireland
Tax Residency

WEALTH TAX BURDEN IN IRELAND DOES NOT ENTAIL RESIDENCY UNDER U.S.-IRELAND TAX TREATY

On March 3, 2017, the U.S. Court of Federal Claims (the "Court") ruled that a taxpayer's liability for the domicile levy in Ireland does not qualify him as a resident of the country under the U.S.-Ireland Income Tax Treaty (the "Treaty").[1]

Under Irish tax law, individuals are subject to income tax depending on whether they are resident, ordinarily resident, or domiciled (regardless of whether resident) in Ireland. The term "domicile" is not defined in the Irish tax code. It is a common law concept that seeks to determine the country with which an individual has the closest links and regards as its "permanent home."

A special levy applies to certain Irish-domiciled individuals, irrespective of their tax residency. This domicile levy is €200,000 payable annually by individuals (i) who are Irish domiciled, (ii) who enjoy annual "worldwide income" of over €1 million, (iii) who own Irish assets valued at over €5 million on December 31 in that year, and (iv) who have a final Irish income tax liability for that tax year of less than €200,000.

In the case before the Court, Mr. McManus, a citizen of Ireland living in Switzerland, won $17 million (€18,669,400) in a backgammon tournament that took place in the U.S. in 2012. The I.R.S. withheld $5,220,000 (€5,733,000) of the earnings. Contrary to the U.S., Ireland does not tax gambling winnings and the Treaty does not address their tax treatment.

Mr. McManus acknowledged that he was not liable to Ireland's income tax, corporation tax, or capital gains tax but only to the domicile levy, and he attempted to argue that he did not owes taxes to the U.S. since he was a resident of Ireland under the Treaty in 2012. Article 4(1)(a) of the Treaty defines a resident as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature." The Irish tax authorities provided advice regarding Mr. McManus' residency, stating that "an individual's residence status for Irish tax purposes is determined by the number of days he or she is present in Ireland during a tax year" and that "the payment of the Domicile Levy does not entitle John P. McManus to receive treaty benefits in accordance with the provisions" of the Treaty. Based on this, the I.R.S. asserted that Mr. McManus was not a resident of Ireland in 2012 and was not entitled to a refund.

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1 *McManus v. United States* (2017 BL 66227, Fed. Cl., No. 1:15-cv-00946, March 3, 2017).

The Court held that Mr. McManus's payment of Ireland's domicile levy did not make him a resident for Treaty purposes. The Court relied on O.E.C.D commentaries, which state that to be "liable to tax" under Article 4 a person must be subject to comprehensive or full taxation, such as an income tax on the full amount of the person's worldwide earnings. Given that the domicile levy is capped, this tax is not "full" and not "substantially similar" to Ireland's income tax.

Secondarily, the Court rejected the argument that the withholding on gambling earnings violated the Treaty's nondiscrimination provisions, because it was barred by the substantial variance doctrine which blocks arguments in court not raised in the refund claim.

CAYMAN ISLANDS INTRODUCE BENEFICIAL OWNERSHIP REGISTER REGIME

Cayman government's plan for a centralized register of companies' beneficial ownership information has been implemented. On April 7, 2017, the Cayman's Legislative Assembly approved the regulations requiring companies and limited liability companies ("L.L.C.'s") to create and maintain beneficial ownership registers.[2] The registry is not open to the public and is only accessible by the approved Cayman Islands authority, mainly on lawful request by U.K. law enforcement agencies.

The following companies fall within the scope of the regime ("In-Scope Entities"):

- Companies incorporated or registered by way of continuation under the Companies Law (2016 Revision), including ordinary resident and non-resident companies, special economic zone companies, and exempted companies (including exempted limited duration companies and segregated portfolio companies)
- L.L.C.'s

A number of exemptions exists (*e.g.*, publicly traded companies and registered founds). If no exemption applies, companies must take "reasonable steps" to identify

- whether any individual is a qualifying "beneficial owner" (as described below) of that In-Scope Entity, and
- whether any legal entities that are registered in the Cayman Islands (including as a "foreign company") would meet the definition of a beneficial owner in relation to that In-Scope Entity if they were an individual rather than a legal entity (a "relevant legal entity").

This obligation may require an In-Scope Entity to correspond with, and give formal notices to, persons whom it knows, or has reasonable cause to believe, are relevant legal entities or would be if registered in the Cayman Islands. Persons who receive such notice must respond within one month of receipt, as it is a criminal offence to fail to do so.

According to the regulations, a beneficial owner is an individual who meets one of

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2 The Cabinet, *The Beneficial Ownership (Limited Liability Companies) Regulations, 2017.*

the following conditions:

- The individual holds, directly or indirectly, more than 25% of the shares in company.
- The individual holds, directly or indirectly, more than 25% of the voting rights in company.
- The individual holds the right, directly or indirectly, to appoint or remove a majority of the board of directors.

“At present, no official deadline has been published, but the government had previously indicated that In-Scope Entities must establish registers no later than June 30, 2017.”

If no individual meets the foregoing conditions, an individual, trust, partnership, or other non-legal person may be classified as a beneficial owner if it has the absolute and unconditional legal right to exercise, or actually exercises, significant influence or control over the company or L.L.C. through an ownership structure or interest described above, other than solely in the capacity of a director, professional advisor, or professional manager.

Otherwise, if no individual satisfies any of the conditions above, but the trustees of a trust or the members of another legal vehicle that is not a legal person (such as a general partnership) satisfy one of the conditions set out above in relation to an In-Scope Entity in their capacity as trustees or members, then such persons will be beneficial owners for the purposes of the beneficial ownership regime if such persons have the absolute and unconditional legal right to exercise, or actually exercise, significant influence or control over the activities of that trust or other vehicle, other than solely in the capacity of a director (or manager), professional advisor, or professional manager.

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About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimer

Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Beate Erwin	erwin@ruchelaw.com	+1 212.755.3333 x 116
Philip R. Hirschfeld	hirschfeld@ruchelaw.com	+1 212.755.3333 x 112
Fanny Karaman	karaman@ruchelaw.com	+1 212.755.3333 x 127
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Jennifer Lapper	lapper@ruchelaw.com	+1 212.755.3333 x 124
Andrew P. Mitchel	mitchel@ruchelaw.com	+1 212.755.3333 x 122
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111
Rusudan Shervashidze	shervashidze@ruchelaw.com	+1 212.755.3333 x 117
Francesca York	york@ruchelaw.com	+1 212.755.3333 x 125
Elizabeth V. Zanet	zanet@ruchelaw.com	+1 212.755.3333 x 123

TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Kenneth Lobo	lobo@ruchelaw.com	+1 416.644.0432
Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232

Editorial Staff

Jennifer Lapper .... Managing Editor, Art Director
Francesca York .... Graphics Editor, Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:
Galia Antebi, Philip Hirschfeld, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.