What Lies Beneath Section 956(c)(1)(D): Does an Intangible Property Right Constitute an Investment in U.S. Property?

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Abstract

Controlled foreign corporations with U.S. shareholders often engage in business activities within the United States, which includes the establishment of intangible property rights in the United States. In so doing, the controlled foreign corporation’s U.S. shareholders may be subject to immediate taxation in the United States on some or all of such corporation’s earnings under section 956 of the Internal Revenue Code if the establishment of intangible property rights by the controlled foreign corporation in the United States is considered an investment in U.S. property. Making this determination depends on proper interpretation and application of section 956(c)(1)(D), for which little guidance has been issued by the Internal Revenue Service, and for which no court rulings have specifically been issued.

This article, therefore, evaluates whether the establishment of intangible property rights by controlled foreign corporations in the United States ought to be considered investments in U.S. property. More specifically, this article will analyze the scope of section 956(c)(1)(D) in terms of the intangible property rights covered by the statute and examine when such property rights are considered “used” in the United States, as well as the meaning of “acquired or developed by the controlled foreign corporation for use in the United States.” Prior to discussing these items, this article will provide some general background information on the U.S. anti-deferral regime, including the subpart F provisions (sections 951-964) which constitute a major component of the regime.

I. INTRODUCTION

In 1962, Congress enacted the U.S. anti-deferral regime. Under this regime, a controlled foreign corporation that has the “right to the use in the United States” of certain kinds of intangible property rights may be considered to hold an investment in U.S. property. In particular, certain intangible property rights are considered to be an investment in U.S. property if the controlled foreign corporation has the right to the use in
the United States of such property rights, and the right to the use of such property rights were acquired or developed by the controlled foreign corporation for use in the United States.\(^2\) Once it is established that the intangible property rights constitute an investment in U.S. property, the U.S. shareholders of the controlled foreign corporation are subject to immediate U.S. taxation on their pro-rata share of such corporation’s increase in investment of earnings in such U.S. property.\(^3\)

Because the United States may represent a major market for many controlled foreign corporations, it is prudent for such corporations to seek the protection of U.S. intellectual property law to protect their intangible property rights from any potential infringing activities in the United States. In doing so, the U.S. shareholders of these controlled foreign corporations could be subject to immediate U.S. taxation on some or all of such corporations’ earnings to the extent of the intangible properties’ adjusted bases.\(^4\)

This issue is equally applicable to U.S. corporations or their controlled foreign corporations that acquired stock in a foreign corporation and made an election under section 338\(^5\) – i.e., the deemed new controlled foreign corporation could be treated as investing in U.S. property to the extent of the fair market value of any intangible property deemed acquired if there is a right to the use of such property in the United States. In other words, as a result of the section 338 election, the deemed new controlled foreign corporation would step-up its asset basis, including its intangible property, with reference to the amount the U.S. corporation or its controlled foreign corporation paid for the stock in the deemed new controlled foreign corporation. Therefore, the deemed new controlled foreign corporation now has an adjusted basis in the acquired foreign corporation’s internally developed intangible property; hence, the U.S. shareholders of the deemed new controlled foreign corporation could be subject to immediate U.S. taxation on some or all of such corporations’ earnings.

So, one important question becomes: Does a controlled foreign corporation’s right to sell a patented product manufactured outside the United States into the U.S. market constitute an investment in U.S. property? Suffice it to say, the answer to this question is of critical importance to certain U.S. shareholders of controlled foreign

\(^2\) Id.
\(^3\) I.R.C. § 956(a) (West 2007).
\(^4\) Id.
\(^5\) 26 C.F.R. § 1.338-1 (2009). ("Deemed transaction. Elections are available under section 338 when a purchasing corporation acquires stock of another corporation (the target) in a qualified stock purchase...Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist...Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities...and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of those liabilities." (Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale tax consequences.))
corporations. Unfortunately, little guidance has been issued by the Internal Revenue Service (IRS), and no court rulings have specifically dealt with this topic.

This article will evaluate whether intangible property rights held by a controlled foreign corporation in the United States constitute an investment in U.S. property. More specifically, this article will analyze the scope of section 956(c)(1)(D) in terms of the intangible property rights covered by the statute and examine when such property rights are considered “used” in the United States, as well as the meaning of “acquired or developed by the controlled foreign corporation for use in the United States.” Prior to discussing these items, this paper will provide background information on the U.S. anti-deferral regime, including the subpart F provisions (sections 951-964) which constitute a major component of the regime.

II. U.S. ANTI-DEFERRAL REGIME – GENERAL BACKGROUND

As a general rule, foreign-source income earned by a foreign corporation, controlled or uncontrolled, is not subject to U.S. taxation until such earnings are repatriated as a dividend to its U.S. shareholders, at which point the shareholders are taxed on the foreign-source income. In 1961, the Kennedy Administration advocated to end avoidance of U.S. taxation on foreign-source income by U.S. persons with control of foreign corporations.6 With the exception of income from investment in under-developed, non-tax haven countries, the Kennedy Administration recommended the adoption of new legislation to subject U.S. corporations (and U.S. individual shareholders of closely-held foreign corporations) to immediate U.S. taxation on their pro-rata share of each foreign subsidiary’s current undistributed profits.

The following is an excerpt from President Kennedy’s “Message from the President of the United States Relative to Our Federal Income Tax System,” dated April 20, 1961, to Congress, wherein he expressed the Administration’s position on the tax treatment of foreign-source income:

Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to United States tax only when they are returned to the parent company in the form of dividends. In some cases, this tax deferral has made possible indefinite postponement of the United States tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S.

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6 Section 7701(a)(30) defines “U.S. person” to include all citizens and residents of the United States as well as United States entities such as corporations and partnerships, and certain estates and trusts not classified as foreign. Section 7701(b) determines whether a non-U.S. citizen is a resident of the United States. I.R.C. § 7701(a)(30) (West 2010).
tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States.

The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

To the extent that these tax havens and other tax deferral privileges result in U.S. firm investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States.

The Kennedy Administration’s proposal was countered by the argument that an end to deferral would prevent U.S. multinational corporations from effectively competing in the global marketplace. As a compromise, Congress enacted the subpart F rules, as part of the U.S. anti-deferral regime, in 1962. These rules only apply to U.S. shareholders who own, in aggregate, more than fifty percent of a foreign corporation’s stock, by vote or value, which would define the foreign corporation as a controlled foreign corporation (CFC).

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8 Section 951(b) defines a “U.S. shareholder” as a U.S. person (including a U.S. corporation) who owns (directly, indirectly or constructively under the ownership rule of section 958) “10 percent or more of the total combined voting power of all classes of stock entitled to vote” of a foreign corporation. As mentioned above, section 957(c) defines a U.S. person to include all citizens and residents of the United States as well as United States entities such as corporations and partnerships, and certain estates and trusts not classified as foreign. Section 7701(b) determines whether a non-U.S. citizen is a resident of the United States. I.R.C. § 951 (West 2007).
9 Section 957(a) defines a “controlled foreign corporation” as “any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation that is held by all other holders of such foreign corporation taken as a group does not exceed 5 percent of the total combined voting power of all classes of stock of such foreign corporation.”
With respect to a U.S. shareholder of a CFC, the subpart F rules require current taxation of both subpart F income and earnings invested in certain U.S. property. In particular, these rules target certain types of income earned by a CFC, such as passive income and income earned through a CFC located in a tax haven (subpart F income), and subjects its U.S. shareholders to immediate U.S. taxation on their pro rata share of the CFC’s subpart F income. These rules also subject U.S. shareholders of a CFC to immediate U.S. taxation on their pro-rata share of any increase in a CFC’s investment of earnings in U.S. property as determined under section 956.

IV. SECTION 956 – INVESTMENT IN U.S. PROPERTY

Section 956 was targeted at U.S. shareholders who were repatriating foreign earnings and profits from CFCs disguised as various non-taxable transactions such as loans from the CFCs to their U.S. shareholders or as investments by the CFCs in their U.S. shareholders’ stock. Congress was clearly concerned with U.S. shareholders who were acquiring the use of their CFCs’ earnings and profits in the United States while avoiding U.S. taxation. To prevent this perceived abuse, Congress wrote section 956 in such a way that an amount invested in U.S. property is treated as a constructive dividend paid by a CFC to its U.S. shareholders, who are thereby taxed on their allocable share of the CFC’s investment in U.S. property.

More specifically, a U.S. shareholder of a CFC is subject to immediate U.S. taxation for any taxable year on the lesser of (1) the U.S. shareholder’s pro-rata share of the average of the “amount of U.S. property” held (directly or indirectly) by the CFC as of the close of each quarter of the taxable year, less the amount of undistributed earnings and profits included in the U.S. shareholder’s income under section 956 in prior years (or would have been included in the U.S. shareholder’s income under section 956 if such earnings and profits had not been entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.”

I.R.C. § 957 (West 2007).

10 Section 951(a)(1)(A)(i) provides that “[i]f a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder...of such corporation and who owns...stock of such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends the sum of his pro rate share...of the corporation’s subpart F income for such year.” I.R.C. § 951 (West 2007).

11 Section 951(a)(1)(B) provides that “[i]f a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder...of such corporation and who owns...stock of such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends...the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).” Id.
previously taxed as Subpart F income), or (2) the U.S. shareholder’s prorata share of the CFC’s “applicable earnings.”\textsuperscript{12} The amount taken into account with respect to the U.S. property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.\textsuperscript{13} The term “applicable earnings” means the CFC’s earnings and profits (current and accumulated in prior years) reduced by the sum of (1) current year distributions, and (2) accumulated earnings and profits included in the U.S. shareholder’s income under section 956 in prior years (or would have been included in the U.S. shareholder’s income under section 956 if such earnings and profits had not been previously taxed as Subpart F income).\textsuperscript{14}

The term “United States property” is defined in section 956(c)(1), which reads as follows:

(1)\textbf{ IN GENERAL.}—For purposes of subsection (a), the term “United States property” means any property acquired after December 31, 1962, which is

\begin{itemize}
  \item[(A)] tangible property located in the United States;
  \item[(B)] stock of a U.S. corporation;
  \item[(C)] an obligation of a U.S. person; or
  \item[(D)] any right to the use in the United States of any of
    \begin{itemize}
      \item[(i)] a patent or copyright,
      \item[(ii)] an invention, model, or design (whether or not patented),
      \item[(iii)] a secret formula or process, or
      \item[(iv)] any other similar right, which is acquired or developed by the controlled foreign corporation for use in the United States \textsuperscript{emphasis added}.\textsuperscript{15}
    \end{itemize}
\end{itemize}

With that said, there are certain exceptions to the definition of “United States property,” such as government obligations, bank deposits, property purchased for export, and certain trade or business obligations.\textsuperscript{16}

If a CFC also has previously taxed subpart F income, any amounts invested in U.S. property under section 956 shall be excluded from the U.S. shareholders’ gross income to the extent attributable to previously taxed subpart F income, and taxation will, therefore, only occur under section 956 when the amounts invested in U.S. property exceed previously taxed subpart F income.\textsuperscript{17}

\textsuperscript{12} I.R.C. § 956(a) (West 2007).
\textsuperscript{13} Id.
\textsuperscript{14} I.R.C. § 956(b)(1) (West 2007).
\textsuperscript{15} I.R.C. § 956(c)(1) (West 2007).
\textsuperscript{16} I.R.C. § 956(c)(2) (West 2007).
\textsuperscript{17} I.R.C. § 959(a) (West 2007).
V. SECTION 956(C)(1)(D) – SCOPE OF INTANGIBLE PROPERTY RIGHTS

A literal reading of section 956(c)(1)(D) appears to limit intangible property rights to production intangible property rights: the specifically listed intangibles (i.e., patents, copyrights, inventions, models, designs, secret formulas or processes) all relate to intangible property rights that are used to produce or manufacture a product or products (production intangible property rights). There is no mention in section 956(c)(1)(D) of any intangibles that relate to intangible property rights that are used to market and sell a product or products (marketing intangible property rights), such as trademarks, trade names and brand names, or general intangible property rights, such as goodwill and going concern values. Therefore, the phrase “any other similar property right” in section 956(c)(1)(iv) should be interpreted as “any other similar production intangible property right.”

In an article written by Ken Brewer and Bruce Reynolds, the authors made the following observation:

In subparagraph (1) [Section 956(c)(1)], Congress addressed tangible property within the reach of section 956 by the phrase “any property…which is tangible property located in the United States.” If, in addition to all types of tangible property, Congress had also intended to capture all types of intangibles, a similar phraseology would have been called for. The language actually chosen gives no indication of such an intention. The subparagraph specifically mentioned types of production intangibles, and is silent on trademarks, brand names, or any other kinds of marketing intangibles. It would seem curious that Congress would attempt to achieve broad coverage of all intangible property rights by explicitly listing only a few examples of one fairly narrow category of intangibles (i.e., production intangibles), but not make any attempt to describe the broader category.

It is equally difficult to reconcile the notion that subparagraph (D) [Section 956(c)(1)(D)] encompasses all intangible property with the fact that section 956 specifically deals with two other types of intangible property; that is, corporate stock and financial obligations, in subparagraphs (B) and (C) [Sections 956(c)(1)(B) and 956(c)(1)(C)]. If subparagraph (D) was

18 Ken Brewer and Bruce Reynolds, Some Intangibles May be Untouched by US Internal Revenue Code Section 956, 21 Tax Notes Int’l 1791 (Oct. 16, 2000) [hereinafter Brewer and Reynolds].
intended to cover all types of intangibles, subparagraphs (B) and (C) are superfluous.\textsuperscript{19}

In other words, if the intent of Congress was to pull all intangible property rights within the scope of section 956, they could have simply drafted section 956(c)(1) to read as follows:

(1) IN GENERAL.—For purposes of subsection (a), the term “United States property” means any property acquired after December 31, 1962, which is
(A) tangible property located in the United States; or
(B) any right to the use in the United States of intangible property which is acquired or developed by the CFC for use in the United States.

Furthermore, after reviewing the legislative history surrounding the enactment of section 956, Brewer and Reynolds concluded that Congress intended to limit the scope of section 956 to intangible property rights that are used in producing or manufacturing a product or products — i.e., production intangible property rights. In particular, Brewer and Reynolds noted that the list of intangibles under section 956(c)(1)(D) and section 1249 are virtually identical to each other.\textsuperscript{20} More importantly, both code sections originated from the same 1962 House bill addressing income derived from patents, copyrights, and exclusive formulas and processes which were developed, created or produced in the United States, or, alternatively, acquired directly or indirectly from related U.S. persons.\textsuperscript{21}

\textsuperscript{19} Id. at 1792.
\textsuperscript{20} Id. at 1793-95.
\textsuperscript{21} Section 13 of the original House bill proposed that:
(c) Income from United States patents, copyrights, and exclusive formulas and processes. — Paragraph (1) defines the term “income from United States patents, copyrights, and exclusive formulas and processes” as used in section 952(a)(1)(B). Such term means the amount of gross rentals, royalties, or other income derived from the license, sublicense, sale, exchange, use, or other means of exploitation of patents, copyrights, and exclusive formulas and processes which are —
(1) either substantially developed, created, or produced in the United States, or
(2) acquired from (A) a United States person which, directly or indirectly, owns or controls the controlled foreign corporation, (B) a United States person owned or controlled, directly or indirectly, by the controlled foreign corporation, or (C) a United States person which is, directly or indirectly, under common ownership or control with the controlled foreign corporation.

The amount described in the preceding sentence is reduced by the cost and expense allowance defined in section 952(c)(2). Under this definition, if a domestic corporation develops in the United States an exclusive process to be used in the production of a certain product, and a right (whether exclusive or nonexclusive) to use this process is granted to a controlled foreign corporation, the income derived from the use of such process by such controlled foreign corporation would be treated as income derived from a United States exclusive process. \textit{H.R. Rep. 1447}, pt. 2, (1962).

Section 16 of the Senate bill deleted section 13 of the original House bill and substituted a new section 1249 relating to the transfer of the intangible property rights contained in the original House bill to a controlled foreign corporation, which provided that:

[G]ain from the sale or exchange after December 31, 1962, of certain intangible property rights to a controlled foreign corporation by a U.S. shareholder is to be treated as ordinary income rather

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Therefore, it would be reasonable to conclude that the scope of these two code sections would be virtually identical as well. Although the Treasury Regulations under section 956(c)(1)(D) do not expand on the phrase “any other similar property right,” the Treasury Regulations under section 1249 provide as follows:

[If gain is recognized from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right (not including property such as goodwill, a trademark, or a trade brand) to any foreign corporation by any United States person...which controls such foreign corporation, and if such gain would (but for the provisions of section 1249) be gain from the sale or exchange of a capital asset or of property described in section 1231, then such gain shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 [emphasis added].22

The fact that the Treasury Regulations under section 1249 specifically excludes marketing intangible property rights further supports the conclusion that the scope of intangible property rights contained in section 956(c)(1)(D) should also be so limited. Additional support for...
this conclusion is also found in other code sections that deal with intangible property rights.23

For example, section 936, which deals with the possessions tax credit, includes a list of intangible property rights that are subject to its provisions. The term “intangible property income” means the gross income of a corporation attributable to any intangible property.24 The term “intangible property” is defined to include any of the following:

(i) patent, invention, formula, process, design, pattern, or knowhow;
(ii) copyright, literary, musical, or artistic composition;
(iii) trademark, trade name, or brand name;
(iv) franchise, license, or contract;
(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
(vi) any item similar, which has substantial value independent of the services of an individual.25

Clearly, Congress intended that this list of intangibles encompass both production and marketing intangibles. Furthermore, Congress included a catchall provision in category (vi) – i.e., “any item similar,” which expressed its intent to also encompass any intangible that is similar to the production or marketing intangibles described in categories (i) through (v). Although Congress used a similar catchall provision in section 956(c)(1)(D)(iv) – i.e. “any other similar property right,” the list of intangibles in section 956(c)(1)(D) only encompassed production intangibles. Therefore, the catchall provision of category (vi) above could be distinguished with the catchall provision used in section 956(c)(1)(D)(iv) by claiming that Congress intended to only encompass intangible property rights similar to the production intangible property rights described in sections 956(c)(1)(D)(i)-(iii).

Also, section 197, which deals with special amortization rules, includes a list of “section 197 intangibles” that are subject to its provisions. Essentially, an amortization deduction is allowed with respect to any amortizable “section 197 intangible” that is acquired after August 10, 1993, and held in connection with a trade or business or in an activity engaged in for the production of income, equal to such intangible’s adjusted basis amortized ratably over a 15-year period beginning with the

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23 See Brewer and Reynolds, supra note 18, at 1795-96.
24 I.R.C. § 936(h)(3)(A) (West 2007). This section does not apply to intangible property which has been licensed to a corporation since prior to 1948 and is in use by such corporation on the date of the enactment of this subparagraph.
month in which such intangible was acquired.\textsuperscript{26} The term “section 197 intangible” is defined to include any of the following:

(A) goodwill,
(B) going concern value,
(C) any of the following intangible items:
(i) workforce in place, including its composition and terms and conditions (contractual or otherwise) of its employment,
(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
(iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item,
(iv) any customer-based intangible,
(v) any supplier-based intangible, and
(vi) any other similar item,
(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or a substantial portion thereof, and
(F) any franchise, trademark, or trade name.\textsuperscript{27}

Obviously, this list of intangibles is more expansive than the list of intangibles provided in section 936, and it is significantly more expansive than the list of intangibles provided in sections 956(c)(1)(D) and 1249. Once again, Congress clearly intended that this list of intangibles be comprehensive and encompass a broad range of intangibles, including production, marketing and general intangibles. Interestingly, the list of intangibles in category (iii) above is substantively identical to the list provided in section 956(c)(1)(D), including the catchall provision. Therefore, a strong argument could be made that the remainder of the “section 197 intangibles” listed above are outside the scope of intangible property rights under section 956(c)(1)(D).

\textsuperscript{26} I.R.C. § 197(a), (c) (West 2007).
\textsuperscript{27} I.R.C. § 197(d)(1) (West 2007).
VI. SECTION 956(C)(1)(D) – USE OF INTANGIBLE PROPERTY RIGHTS

If we accept the premise that the scope of “intangible property rights” under section 956(c)(1)(D) is limited to production intangibles property rights, the next step in the analysis is to determine whether there is a “right to the use” of the production intangible property rights in the United States. Although this step applies a fairly objective standard, the final step in the analysis requires a subjective inquiry into the intent of the CFC in acquiring or creating the production intangible property rights. More specifically, did the CFC acquire or develop the production intangible property rights “for use in the United States?” Unfortunately, a limited amount of authority exists regarding the meaning of the phrase “acquired or developed by the controlled foreign corporation for use in the United States.”

Under section 956, the Treasury Regulations provide that:

> Whether a right described in this subdivision [an intangible property right] has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use [emphasis added].

Therefore, even if the production intangible property was acquired or developed outside of the United States, there is a presumption that the production intangible property rights were acquired or developed for use in the United States if such property rights were put to actual use principally in the United States. This presumption, however, may be rebutted with affirmative evidence showing that the production intangible property rights were not so acquired or developed for use principally in the United States. Alternatively stated, the Treasury Regulations provide that the production intangible property rights will not constitute “United States property” if the taxpayer can show that such property rights either: 1) were not actually used principally by the CFC in the United States and the IRS is unable to present affirmative evidence showing that such property rights were acquired or developed by the CFC with the intent to use principally in the United States, or 2) were not acquired or developed by the CFC with the intent to use principally in the United States. So, what is meant by the words “used principally” in the United States?

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If a CFC is manufacturing products in the United States or has assigned its right to manufacture products in the United States to another party, related or unrelated, that is manufacturing products within the United States, in exchange for royalty payments, any production intangible property rights affirmatively used and actively exploited in the manufacturing process should be treated as “used” in the United States. The only issue is whether the CFC’s or the licensee’s “use” of these production intangible property rights is “principally” in the United States. However, this argument loses its strength if a CFC merely sells a patented product in the U.S. market, which was manufactured outside the United States. In other words, should the mere sale of a patented product by a CFC in the U.S. market, which was manufactured outside the United States, constitute a “use” of production intangible property rights “principally” in the United States?

As a legal matter, Title 35 U.S.C. 154(a)(1) provides as follows:

Every patent shall contain a short title of the invention and a grant to the patentee [an inventor], his heirs or assigns, of the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States, and, if the invention is a process, of the right to exclude others from using, offering for sale or selling throughout the United States, or importing into the United States, products made by that process, referring to the specification for the particular thereof.

In other words, once an inventor legally-protects its “right to the use” of an invention in the United States, U.S. patent law provides them with the exclusive rights to use such invention in the United States. Under section 956, a literal reading of the Treasury Regulations recited above, in contrast, seems to place the emphasis on the “actual use” of production intangible property rights “principally” in the United States, or the “intent to use” production intangibles property rights “principally” in the United States, rather than whether the “right to the use” production intangible property rights is one protected by U.S. intellectual property law.

So, the questions becomes: If a CFC manufactures its patented products outside the United States, does the exclusive right to sell its patented products in the U.S. market and exclude others from infringing on its patent rights in the United States constitute a “use” of production intangible property rights in the United States? More importantly, if an argument is successfully made that the exclusive rights mentioned above constitute a “use” by the CFC of its production intangible property rights

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29 Id.
in the United States, were such property rights acquired or developed by the CFC with the intent to use principally in the United States? As discussed below, the answer is, arguably, no.

In an article written by Gary Sprague and Lothar Determann, the authors recalled the nature and function of intellectual property rights:

> Intellectual property laws are intended to incentivize and reward innovation by providing creators with a right to exclude others from reaping the fruits of the creator’s intellectual labor. Such a right to exclude can be commercialized in two ways. First, the intellectual property owner can earn money by selling copies or other embodiments of the innovation. In this scenario, the intellectual property owner is not actually invoking its exclusion rights, but presumably it can extract a higher market price by being able to potentially exclude other suppliers from the particular market. Alternatively, the intellectual property owner can charge others for the permission (i.e., license) to sell copies or other embodiments of the innovation.  

For example, assume a CFC opts to commercialize its production intangible property rights (i.e., patents, copyrights, inventions, models, designs, secret formulas and processes, and other similar property rights) by manufacturing its products in Country Z and selling a substantial portion of its production output in the United States. Due to the volume of sales in the U.S. market, the CFC seeks the protection of U.S. intellectual property law to protect its production intangible property rights from any potential infringing activities in the United States, thereby establishing legally protected production intangible property rights in the United States. Country Z was selected as the best manufacturing location based on a number of economic factors, including, but not limited to, access to capital, key management personnel, costs of production, logistics, skilled labor, regulatory environment, and access to raw materials. Also, the CFC possessed the requisite infrastructure and manufacturing know-how to affirmatively use and actively exploit its production intangible property rights in its physical production facilities located in Country Z.

Suffice it to say, the CFC has no physical presence in the United States. The CFC is not affirmatively using or actively exploiting its production intangible property rights by producing products in the United States. Furthermore, the CFC has not assigned its production intangible property rights to others to affirmatively use and actively exploit them.

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exploit such property rights through production activities in the United States. Last, but not least, the CFC is not excluding others from affirmatively using and actively exploiting its production intangible property rights in the United States (“negative and dormant production intangible property right”). By selling its products in the United States, the only right the CFC is affirmatively using and actively exploiting is the right to sell products produced with its production intangibles in country Z in the U.S. market.

Nevertheless, if you were to accept the position that a mere right to sell products in the U.S. market, coupled with a negative and dormant intangible property right, constitutes a “use” of production intangible property rights in the United States regardless of the production location, a literal reading of section 956(c)(1)(D)(ii) would also seem to encompass “hypothetical” production intangible property rights in the United States. In particular, this statute states: “[T]he term ‘United States property’ means…(D) any right to the use in the United States of…(ii) an invention, model, or design (whether or not patented)…which is acquired or developed by the controlled foreign corporation for use in the United States [emphasis added].”31 The “whether or not patented” language appears to encompass a “hypothetical” right to use production intangible property rights in the United States. In other words, an investment in “United States property” may exist even though the CFC does not have any formal legally-protected production intangible property rights in the United States. Therefore, the only “use” of production intangible property rights in the United States as it relates to unpatented inventions, models or designs is the “hypothetical” right to use production intangible property rights in the United States.

Assume in the above example that the CFC also opts to commercialize certain unpatented inventions, models and/or designs in its manufacturing process conducted in Country Z and sells a substantial portion of its production output in the United States. These production intangible property rights are unpatented because the CFC is unable or unwilling to protect such property rights under U.S. intellectual property laws. This leads to the question of whether or not the mere sale of the manufactured products in the United States should give rise to an investment of earnings in “United States property” even though the CFC has no formal legally-protected production intangible property rights in the United States. Alternatively stated, should the CFC still be viewed as having an investment in “United States property” under section 956(c)(1)(D)(ii) because they have a “hypothetical” right to the use of these production intangible property rights in the United States? Although it is true that this “hypothetical” right to the use exists in the United States, it also exists in a number of other countries.

One reasonable interpretation of section 956(c)(1)(D) is that Congress was concerned with the “use” of production intangible property rights through physical manufacturing activities in the United States regardless of whether such property rights are “actual” or “hypothetical.” In other words, Congress wanted to capture in the “Section 956 net” the affirmative use and active exploitation of production intangible property rights (i.e., inventions, models and/or designs - whether or not patented) by a CFC through physical manufacturing activities in the United States, as well as the assignment of the CFC’s right to manufacture products in the United States to another party, related or unrelated, that is affirmatively using and actively exploiting such production intangible property rights (i.e., inventions, models and/or designs – whether or not patented) through physical manufacturing activities in the United States. In other words, if the physical manufacturing activities occur in the United States, the production intangible property rights will be considered “used” in the United States regardless of whether such property rights are “actual” or “hypothetical.”

In addition to analyzing the language used in section 956(c)(1)(D) and related Treasury Regulations, it is also necessary to analyze any guidance issued by the IRS or contained in court rulings which have addressed this issue. Unfortunately, no court cases have specifically dealt with this issue, and the IRS has only addressed this issue on two separate, seemingly contradictory occasions.

On July 19, 2002, the IRS released Private Letter Ruling 200229030 (PLR 200229030). In PLR 200229030, various CFCs of a U.S. corporation owned software that was protected by copyright laws in the United States and several foreign countries. The CFCs produced the software in several foreign locations and sold the software (usually on disks) to customers in numerous countries, including the United States. Title to the software passed in the foreign country in which it was produced. Some purchasers of the software used the software in the United States. The CFCs did not own any inventory of the software in the United States, and the software master disks were stored at production facilities outside the United States.

Under federal copyright law and local law, to guard against the unauthorized use and distribution of the software, the software sales were structured as license agreements. Purchasers of the software, however, did not receive any of the following rights: (1) the right to make copies of the software for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending; (2) the right to prepare derivative computer programs based upon the software; (3) the right to make a public performance of the software; and (4) the right to publicly display the software. All other benefits and burdens of

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ownership of the software were transferred to the purchasers of the software.

Notwithstanding the CFC’s characterization of the software sales as “license” agreements, the IRS concluded that the transfers of the software by the CFCs “constitute transfers of tangible property, namely, copyrighted articles and not copyrighted rights.”\(^{33}\) In other words, the CFCs were engaged in transfers of tangible property (i.e., copyrighted articles) as opposed to transfers of intangible property rights (i.e., copyrighted rights). An important consideration by the IRS in rendering its decision was the fact that the purchasers of the software did not have any of the intangible property rights enumerated in Treas. Reg. \(\S\) 1.861-18(c)(2). However, if the purchasers of the software had acquired one or more of the intangible property rights enumerated in Treas. Reg. \(\S\) 1.861-18(c)(2), the transfers of the software would have been classified as a transfer of a copyrighted right as opposed to a copyrighted article.\(^{34}\)

More importantly, even though the software owned by the CFCs was protected by copyright laws in the United States, the IRS concluded that “the Software does not constitute a right to the use in the United States of a copyright, within the meaning of section 956(c)(1)(D).”\(^{35}\) In other words, the CFC’s legally-protected copyright rights in the United States, which encompassed the right to sell the software to U.S. purchasers within the United States and exclude others from reproducing the software within the United States, did not constitute an investment in a “right to the use in United States of a copyright.”\(^{36}\)

On March 12, 2004, the IRS released Private Letter Ruling 200411016 (PLR 200411016),\(^{37}\) wherein PLR 200229030 was revoked, without an explanation, effective as of September 5, 2003. At a minimum, the IRS was not yet prepared to provide guidance to taxpayers in this area.

For seven years, the IRS was silent on this issue. Then, on February 11, 2011, the IRS released Chief Counsel Advice 201106007 (CCA 201106007).\(^{38}\) In CCA 201106007, the taxpayer, a U.S. entity, was a distributor of information technology products and services. The taxpayer developed software in the United States pursuant to a cost sharing agreement (CSA) with its CFC. Pursuant to the CSA, the CFC acquired the rights to exploit copyrights in the United States, which were developed through the CSA. When the taxpayer completed development of a software product intended for sale to end-user customers, a final

\(^{33}\) Id.

\(^{34}\) Those rights are: (i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending; (ii) The right to prepare derivative computer programs based upon the copyrighted computer program; (iii) The right to make a public performance of the computer program; or (iv) The right to publicly display the computer program. 26 C.F.R. \(\S\) 1.861-18(c)(2) (1998).

\(^{35}\) PLR 200229030, supra note 32.

\(^{36}\) Id.


version of the software code was transferred to a “gold master” disk and sent to the CFC. The CFC then reproduced and sold copies of the software to end-user customers in the United States.

The Chief Counsel’s Office held that “the actual sales of the computer software copies from Sub to end-user customers in the U.S. do not in themselves give rise to an investment in U.S. property within the meaning of section 956(c)(1)(D).” Rather, as long as a production intangible property right is intended for use in the United States, “an investment in U.S. property arises upon the acquisition or development of rights to use intangible property in the U.S., not upon the actual use of that intangible property in the U.S.” In other words, if the CFC intends to use the copyright rights in the United States, the investment in U.S. property arose when the CFC developed the software pursuant to the CSA and legally-protected the rights to exploit the copyright in the United States “not in relation to whether such right is actually exercised.”

The IRS’s ruling in CCA 201106007 appears to downplay the significance of the Treasury Regulations in interpreting section 956(c)(1)(D). As recited above, under section 956, the Treasury Regulations provide that:

Whether a right described in this subdivision [an intangible property right] has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use [emphasis added].

Alternatively stated, a right not actually used principally in the United States will not be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was so acquired or developed for such use. Therefore, the conclusion reached in CCA 201106007 is only supportable in two circumstances: (1) the copyright rights were actually used principally by the CFC in the United States and the CFC is unable to present affirmative evidence showing that such property rights were not acquired or developed with the intent to use principally in the United States, or (2) the copyright rights were not actually used principally by

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39 Id.
40 Id.
41 Id.
the CFC in the United States but the IRS is able to present affirmative evidence showing that such property rights were acquired or developed by the CFC with the intent to *use principally* in the United States.

Although it is true that the *actual use principally* of the copyright rights by the CFC in the United States is irrelevant upon a showing of affirmative evidence that the CFC acquired or developed such property rights with the intent to *use principally* in the United States, the CCA ruling does not apply the appropriate standard in its definition of “U.S. property.” In particular, the ruling states:

>[B]oth the statute and regulations define U.S. property in relation to whether a CFC develops intangible property *intended for use* in the U.S. or acquires the right to use intangible property in the U.S. — not in relation to whether such right is actually exercised [emphasis added].33

The key issue is not whether a CFC acquires or develops intangible property *intended for use* in the United States, but rather whether the CFC acquires or develops intangible property intended for use *principally* in the United States. Although the CFC may have acquired or developed the copyright rights with the *intent to use* such property rights in the United States by transferring its software to U.S. purchasers and excluding others from reproducing its software, the critical issue is whether the CFC acquired or developed the copyright rights with the *intent to use principally* such property rights in the United States.

In general, as the term suggests, “production intangible property rights” are acquired or developed with the *intent to use principally* in the production process. That is, without the affirmative use and active exploitation of the production intangible property rights (e.g., patents, inventions, models, designs, secret formulas and processes) in the production process, there would be no products to sell; hence, no need to legally-protect the right to sell such products in a foreign jurisdiction or exclude others from actively exploiting such property rights in a foreign jurisdiction. That is, these production intangible property rights are acquired or developed with the *intent to use principally* in the production process and, arguably, secondarily used in the jurisdiction of consumption — i.e., sell products and exclude others from actively exploiting such property rights in the jurisdiction of consumption.

Brewer and Reynolds made the following observation:

*[W]hen a distributor merely sells a product in the United States that is produced under patent by an unrelated manufacturer, it’s highly unusual for the

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33 GCM 201106007, *supra* note 38.
distributor to require a license to use the patent for the product. By way of contrast, the distributor may well demand a license to use a trademark or trade name for the product. Thus, as a matter of custom and usage, it would not seem that the mere sale of a product in the United States should be construed as the “use” of a patent for the product within the meaning of section 956.

...

It seems more likely that Congress intended the word “use” to mean, narrowly, to produce a product in the United States, using a patent, copyright, invention, secret formula or process, etc., or to license a production intangible to someone else that will produce the product in the United States. Under this view, production intangibles, such as patents, secret formulas, and secret processes, would not be treated as having been acquired for use in the United States, and hence would fall outside the ambit of section 956, if the plan for acquiring the intangibles was for the products involved to be produced outside the United States.44

In other words, the phrase “use in the United States” in section 956(c)(1)(D) should be narrowly construed to mean those production intangible property rights that are used in actual production activities in the United States, and not in situations where the production intangible property rights are used to produce such products outside of the United States for sale in the United States.

So, if we accept this construction of section 956(c)(1)(D), how do we reconcile it with CCA 201106007? One conceivable explanation would be to focus on the jurisdictions in which the right to use the production intangible property rights are being affirmatively used and actively exploited. Once known, a determination would need to be made as to whether the right to the use of the production intangible property rights in the United States makes the greatest economic contribution to profits relative to the other jurisdictions. If the right to the use of the production intangible property rights in the United States makes the greatest economic contribution to profits relative to the other jurisdictions, such property rights should be considered to have been acquired or developed by the CFC with the intent to use principally in the United States absent affirmation evidence showing that such property rights were not acquired or developed with the intent to use principally in the United States. Therefore, depending on the specific facts and circumstances, it is

44 Brewer and Reynolds, supra note 18, at 1796-97.
possible that the location of the production activities may not make the
greatest economic contribution to profits.

For instance, if the specific production location provides insignificant
economic advantages, such as merely copying a software code, a strong
argument could be made that the copyright rights were acquired or
developed with the intent to use principally in the jurisdiction where the
software is sold and such property rights are legally protected under
intellectual property law. Of these jurisdictions, if the United States
represents the largest market for software sales, the right to use in the
United States of the copyright rights should be considered to have been
acquired or developed by the CFC with the intent to use principally in
the United States absent affirmation evidence showing that such property
rights were not acquired or developed with the intent to use principally in
the United States. However, if the specific production location provides
significant economic advantages, such as access to capital, key
management personnel, costs of production, logistics, skilled labor,
regulatory environment, and access to raw materials, a strong argument
could be made that the production intangible property rights (e.g.,
patents, copyrights, inventions, models, designs, secret formulas,
processes) were acquired or developed by the CFC with the intent to use
principally in the jurisdiction where the production activities occur.45

Applying this logic to CCA 201106007, one could reasonably
interpret the ruling to stand for the proposition that the legally-protected
right to exploit the copyright rights in the United States provided the
greatest economic contribution to profits relative to the reproduction
of the software outside the United States. Therefore, the copyright rights
should be considered to have been acquired or developed by the CFC
with the intent to use principally in the United States. Likewise, one
could reasonably conclude in our original example that the CFC’s
decision to commercialize its production intangible property rights (i.e.,
patents, copyrights, inventions, models, designs, secret formulas and
processes, and other similar property rights) by manufacturing its
products in Country Z provided the greatest economic contribution to
profits versus the “use” of such property rights in the United States – i.e.,
mere right to sell products in U.S. market coupled with a negative and
dormant production intangible property right. Therefore, these
production intangible property rights should be considered to have been
acquired or developed by the CFC with the intent to use principally in
country Z as opposed to the United States.

If we move outside the context of section 956(c)(1)(D) and analyze
other code sections that have dealt with the issue of where production
intangible property rights are “used,” it may provide some useful
guidance in discerning the meaning of “used principally” in the United
States. For instance, it may be helpful to consider the issue of “use” in

45 See also Sprague and Determann, supra note 30.
the context of sections 861(a)(4) and 862(a)(4), which provides rules to
determine the source of royalty income.46

In Revenue Ruling 72-232 (Rev. Rul. 72-232),47 a nonresident
individual prepared a manuscript, as an independent contractor, for
certain textbooks to be used in the public schools in Country Y, the
jurisdiction in which the nonresident individual resided. The nonresident
individual granted to M, a U.S. corporation, a license to print and
distribute these textbooks. The textbooks were printed in the United
States by M, and the textbooks were protected by copyright laws in the
United States and Country Y. The textbooks were not designed for use in
the United States and were sold exclusively in Country Y. The nonresident
individual received royalties from M for the textbooks sold
in Country Y.

In Rev. Rul. 72-232, the IRS concluded as follows:

In the instant case there is no commercial publication
of the textbooks within the United States in that the
textbooks are not sold within the United States. Without
such commercial publication M is engaged solely in
printing or manufacturing books within the United
States, which books are later sold in the foreign country.
In the vending of such books in the foreign country, the
foreign country copyrights are used and not the United
States copyright.48

Accordingly, the IRS held that the royalties paid by M to the nonresident
individual represented foreign-source income.49

Rev. Rul. 72-232 appears to ignore the fact that M is also using
the copyright rights in the United States. In other words, pursuant to the
terms of the license granted by the nonresident individual, M clearly
“used” the copyright rights in the United States when it printed the
textbooks and, possibly, when M distributed the textbooks if title to the
books passed in the United States. In an attempt to rationale this ruling,
Sprague and Determann made the following observation:

[P]erhaps the preferable approach would be to
acknowledge the U.S. copyright use, but conclude that
the location of the act of printing (at least in this case)
was not as economically significant for source-of-
income purposes as the ability to access the foreign
market. The analysis then could conclude that while both
U.S. and foreign copyright rights of distribution were

46 Id.
48 Id. at 277.
49 Id.
In other words, the copyright rights were used in both the United States and Country Y. However, the copyright rights were used principally in Country Y. If we accept this interpretation, the guidance provided by this Ruling may support the conclusion reached by the IRS in CCA 201106007. Specifically, in selling the computer software copies exclusively to end-user customers in the United States, the CFC was using principally the U.S. copyright rights as opposed to the foreign copyright rights. With that said, the IRS in CCA 201106007 did not cite any authority, including Rev. Rul. 72-232, for its conclusion.

In Sanchez v. Comm’r, the Tax Court dealt with patents rights as opposed to copyright rights and the source of royalty income flowing from such property rights under sections 861(a)(4) and 862(a)(4). In this case, Mr. Sanchez, a nonresident individual, invented a process for refining sugar which involved the use of a chemical reagent called Sucro-Blanc. He obtained U.S. and foreign patents on both the process and the chemical reagent. Mr. Sanchez then granted Sucro-Blanc, Inc., a U.S. corporation, an exclusive worldwide license to commercially exploit these patents, including the right to sublicense such patents, in exchange for royalty payments. Sucro-Blanc, Inc. decided to commercialize these patents by manufacturing the patented chemical reagent exclusively in the United States and selling it to U.S. and foreign customers, coupled with a nonexclusive sublicense to use the patented process at no charge at their sugar refineries, some of which were outside the United States. All sales of the patented chemical reagent were consummated within the United States.

Under the worldwide license agreement, the royalty payments made by Sucro-Blanc, Inc. to Mr. Sanchez were based solely on the sales of the patented chemical reagent. Mr. Sanchez claimed that a portion of the royalties received from Sucro-Blanc, Inc. should be foreign-source income to the extent the sales of the patented chemical reagent were for use outside the United States. According to the Tax Court, Mr. Sanchez’s position was as follows:

[T]he exclusive license granted by him covered not only the product, but the process, which is true; and that the sublicenses granted by Sucro-Blanc, Inc., similarly

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50 Sprague and Determann, supra note 30, at 359.
51 6 T.C. 1141 (1946), aff’d, 162 F.2d 58 (2d Cir. 1947).
52 Id. at 1141-44.
covered both process and product. From this he argues that, although no charge was allocated to the process, as distinguished from the product, either in his contract with the corporation or the corporation’s contract with its licensees, nevertheless, all the corporation’s income arising from the sale of the product, and all of petitioner’s income derived from the corporation and measured by such sales, was received for the use of both process and product, and, to the extent that the process and product were used in foreign countries, was income from without the United States.53

In other words, Sucro-Blanc, Inc. was able to extract a higher purchase price on the sale of the chemical reagent from its foreign customers by foregoing a separate charge for the use the patented process at their sugar refineries; hence, the royalty income attributable to these sales should be treated as foreign-source income derived from the use of both process and product in such foreign jurisdictions.

The Tax Court disagreed with Mr. Sanchez and held that none of the royalty income received by Mr. Sanchez from Sucro-Blanc, Inc. constituted income from sources outside the United States. In particular, the Tax Court held:

In this argument petitioner minimizes the salient fact that he himself had no relationship whatsoever with any person using the process or product in foreign countries. His contractual relationship out of which his income here in question was derived was with an American corporation, Sucro-Blanc, Inc., which disposed of the use of the process in this country and made the product necessary to the process in this country. The fact that the New York corporation received a part of these funds from sales made by the corporation to its customers doing business in foreign countries or from sublicenses which it had the right to make, granted by the corporation to persons who used the process licensed in foreign countries, cannot affect the characterization of the income derived by petitioner from the New York corporation.

Even if we were of the opinion that the source of the payments to Sucro-Blanc, Inc., would be determinative of the source of the income derived from Sucro-Blanc, Inc., by petitioner, we would still be of the opinion that

53 Id. at 1145-46.
petitioner’s income here in question would be from sources within the United States.

[I]t is sufficient to establish that the corporation chose not to charge anything for the installation and use of the patented process by its licensees, looking to the sales of the product for its remuneration. The corporate income, therefore, was, by design, derived from the sales, not the installation or use of the process, and, consequently, the source of the payments to petitioner here in question, upon the hypothesis that the source of the income of the corporation is controlling, would be the sales of Sucro-Blanc. Therefore, the place where the sales of the product were consummated would determine the source of the petitioner’s income.\(^{54}\)

Although Sucro-Blanc, Inc. exercised its rights under the U.S. patent by manufacturing and consummating the sales of the chemical reagent in the United States, it also exercised its rights under the foreign patents when it sold the chemical reagent and a nonexclusive sublicense to use the patented process, to customers in foreign jurisdictions which afforded such product and process legal protection under such jurisdictions’ intellectual property laws. Furthermore, Sucro-Blanc, Inc. possessed a negative and dormant intangible property right under the foreign patents to exclude others from affirmatively using and actively exploiting its patented product and process in such foreign jurisdictions. Despite this, the Tax Court did not address the effect of intellectual property law or the foreign market being exploited. Rather, the Tax Court ruled solely on the fact that Sucro-Blanc, Inc.’s commercial activities were located in the United States when it held that Mr. Sanchez’s royalties were U.S.-source income.

In our original example, the CFC neither manufactured its products in the United States nor licensed its production intangible property rights for use in the United States. Therefore, the application of the Tax Court’s ruling in the Sanchez case, as well as the aforementioned interpretation of Rev. Rul. 72-232, to the facts in our original example would appear to support a conclusion that the CFC’s mere right to sell its products produced with its production intangible property rights in Country Z in the U.S. market, coupled with a negative and dormant production intangible property right, does not constitute a right to the use in the United States of such property rights absent affirmation evidence showing that such property rights were acquired or developed with the intent to use principally in the United States. Though not a primary source of authority, BNA 929 states that a right which is used principally

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\(^{54}\) Id. at 1146.
in the United States “would probably be in the form of either exploitation of the right in a U.S. branch operation of the CFC itself or in the form of a license of the right to another party who uses it in the United States.”

Analyses of language used in other code sections that deal with production intangibles provide additional support for this position. For instance, section 863(b)(2) and Treas. Reg. §1.863-3 dealing with the allocation of income between production and sales activities (50/50 Method). In particular, Treas. Reg. §1.863-3(c)(1)(i)(C) states that “a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.” Example 2 of Treas. Reg. §1.863-3(c)(1)(i)(iv) deals with intangible property that is employed by a corporation with production assets both within and without the United States. In this example, the patented process only applied to the production activity performed in the United States; hence, it was treated as located in the United States.

This position is also supported by section 954(c)(3)(A)(i) and Treas. Reg. §1.954-2(b)(4)(vii) dealing with foreign personal holding company income – the “Dividends and Interest Exclusion.” Pursuant to section 954(c)(3)(A)(i), the term “foreign personal holding company income” does not include “dividends and interest received from a related person which (I) is a corporation created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (II) has a substantial part of its assets used in its trade or business located in such same foreign country [emphasis added].” Although the statute simply refers to the location of “use” of the payor’s trade or business assets (tangible and intangible), the Treasury Regulations interpret that language with reference to physical operations. More specifically, for purposes of applying the substantial assets test, the Treasury Regulations define the location of intangible property as follows:

Intangible property…is considered located entirely in the payor’s country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the use or exploitation of the property in that country during that entire quarter. For this purpose, the country in which the activities connected to the use or exploitation of the property are conducted is the country in which the expenses associated with these activities are incurred. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the

\[\text{\textsuperscript{55}} \text{Id.} \]
\[\text{\textsuperscript{56}} \text{See also Sprague and Determann, supra note 30.} \]
computation...if they would be deductible under section 162 or includible in inventory costs or the cost of goods sold if the payor were a domestic corporation.57

The Treasury Regulations further provide:

If the payor conducts its activities in connection with the use or exploitation of an item of intangible property, including goodwill...during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the intangible considered located in the payor’s country of incorporation during that quarter is a percentage of the value of the item as of the close of the quarter. That percentage equals the ratio that the expenses incurred by the payor...during the entire quarter by reason of activities that are connected with the use or exploitation of the item of intangible property and are conducted in the payor’s country of incorporation bear to all expenses incurred by the payor during the entire quarter by reason of all such activities worldwide.58

The production assets test under the 50/50 method of section 863(b)(2) and the “same country” dividend and interest exclusion of section 964(c)(3)(A)(i) reflect the long-standing position that production intangibles property rights run with the production activities that affirmatively use and actively exploit such property rights as opposed to the market where the products produced with these production intangible property rights are sold.

In our original example, if the IRS were to conclude that the CFC’s right to sell its products produced in Country Z in the U.S. market, coupled with the negative and dormant production intangible property right, constitutes “United States property” pursuant to section 956(c)(1)(D), it would appear reasonable to allow the CFC the right to allocate its adjusted basis in such production intangibles between the United States and all foreign jurisdictions in which the production intangible property rights are “used.” Such allocation would include country Z where the production intangible property rights are affirmatively used and actively exploited in the physical production process. In other words, to the extent the CFC is using its production intangible property rights outside the United States via its affirmative use and actively exploitation of such property rights in its production process and its sale of products in all non-U.S. markets, the IRS should allow any

A literal reading of section 956(c)(1)(D), coupled with a review of the statute’s legislative history and a comparison of the language used in other code sections, provide strong support for the conclusion that the scope of intangible property rights under section 956(c)(1)(D) is limited to production intangible property rights.

With respect to whether production intangible property rights were acquired or developed by a CFC for use in the United States, the critical issue is whether the CFC developed or acquired such property rights with the intent to use principally in the United States. Even if it is shown that the CFC acquired or developed production intangible property rights with the intent to use such property rights in the United States (i.e., sell products and exclude other from exploiting such property rights in the U.S market), the critical issue is whether the CFC acquired or developed such property rights with the intent to use principally in the United States.

In general, production intangible property rights are considered acquired or developed with the intent to use principally in the production process. Therefore, section 956(c)(1)(D) should be narrowly construed to mean those production intangible property rights (e.g., patents,

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copyrights, inventions, models, designs, secret formulas, processes) that are used in production activities conducted in the United States. Stated differently, production intangible property rights should be considered acquired or developed with the \textit{intent to use principally} in the jurisdiction where the production activities actually occur, not necessarily in the jurisdiction where the products are eventually sold.

However, if the IRS is able to present affirmative evidence to show that the specific production location provides insignificant economic advantages, such as merely reproducing software, a strong argument could be made that the production intangible property rights were acquired or developed with the \textit{intent to use principally} in the jurisdiction where the product is sold and such property rights are legally protected under intellectual property law. In these instances, if the United States represents the largest market for the product sales, the “right to the use” in the United States of the production intangible property rights should be considered to have been acquired or developed by the CFC with the \textit{intent to use principally} in the United States absent affirmation evidence showing that such property rights were \textit{not} acquired or developed with the \textit{intent to use principally} in the United States.