CHAPTER 18

CURRENT ISSUES IN INTERNATIONAL TAX PLANNING FOR MOTION PICTURE PRODUCTION AND DISTRIBUTION

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¶ 1800 INTRODUCTION

A motion picture industry analyst commented recently that "[t]he film industry is a complex adaptive system poised between order and chaos."[1] While the comment was addressed to the fundamental business dynamics of producing motion picture films, and not to the taxation of the income generated thereby, the U.S. federal income taxation of international transactions can be described similarly as a complex adaptive system. And despite the appearance of being chaotic, in most instances there is an underlying order to be discovered.

This article is intended to summarize the most significant U.S. international tax laws applicable to motion picture producers and distributors in the hope of providing greater order to what otherwise may be a potentially chaotic tax planning arena. As the motion picture industry has been adapting to ongoing changes in the economic environment and the international tax provisions of the U.S. Internal Revenue Code (the "Code"), the tax planning opportunities these changes provide have taken on increased importance.

¶ 1800.1 Industry Dynamics

There are a number of emerging trends in motion picture production and distribution that individuals who are responsible for managing the tax exposure of the industry participants need to be cognizant of in order to provide their clients with fully reasoned tax planning advice. First, the current engine of growth in the industry appears to be the foreign (non-U.S.) markets. The industry-wide rates of growth in foreign box office, foreign video sales, and other foreign media presently outpace the corresponding domestic growth rates.[2]

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[1] John Cassidy, *Chaos in Hollywood*, The New Yorker, March 31, 1997, at 36, 36 (quoting Art De Vany, PhD economist at University of California, Irvine).

[2] Paul Kagan Associates, Inc., Media Trends at 107 (1995).

The second emerging trend, not wholly unrelated to the first, is that the percentage of the total box office receipts (*i.e.,* the market share) in the major foreign territories garnered by American motion pictures has been increasing substantially. One estimate is that American films are now earning in excess of ninety percent of the box office receipts in every major foreign territory.[3] Third, there appears to be a new spirit of entrepreneurship within the motion picture industry. With increasing frequency, major Hollywood talents, in effect, are becoming business partners with the studios, opting to own proprietary interests in their own movies (and, thus, their sequels), rather than simply working as studio employees with the more traditional profit participations.[4] Finally, the studios themselves have been searching actively for new sources of finance and opportunities to spread the economic risks associated with continually escalating film production budgets,[5] and this, in turn, has resulted in greater use of co-production agreements.

¶ 1800.2 Planning Implications

While the emergence of each industry trend just enumerated has been driven by the invisible hand of the marketplace, each trend has significant implications for what many taxpayers view as the all too visible hand of the federal tax collector. Consequently, as foreign markets, foreign revenues, and foreign financing sources have taken on added commercial importance, international tax planning strategies have focused on opportunities to avoid or defer U.S. taxation of offshore revenues. Such strategies and opportunities are not new, but as foreign source revenue grows in both absolute dollar amount and as a percentage of total revenue, failure to take advantage of legitimate international tax planning strategies becomes increasingly costly. Such strategies are relevant not only to the major studios, but to the top

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[3] *See* Claudia Eller, *It's Deal Ho! For Pioneering Attorneys,* Los Angeles Times, September 6, 1996, at D1, D4.

[4] *Id.*

[5] *See, e.g.*, Dan Cox, *Foreign Co-Financing Now a Universal Plan,* Daily Variety, May 8, 1997, at 1, 1 and 58 (reporting that Universal Pictures is actively seeking more foreign co-financing and split rights deals, which "reflects the current trend among Hollywood studios to help defray costs on big-budget projects").

Hollywood talent with sufficient leverage to obtain an ownership interest in the films on which they work.

It deserves emphasis that while the general international tax planning strategies discussed herein are not new, the rules under which they are implemented continue to evolve. As a result, it is vitally important that tax professionals serving the motion picture industry stay abreast of changes in the rules for the taxation of international transactions in order to ensure that their clients continue to obtain all of the tax benefits to which they are entitled.

For instance, the relatively recent emergence of more restrictive limitation on benefits articles in bilateral U.S. tax treaties,[6] together with the promulgation of regulations addressing conduit financing arrangements,[7] have significantly reduced the opportunities to avoid U.S. withholding taxes on income derived from domestic markets. Thus, it is now quite difficult for a non-U.S. person resident in a country with which the United States does not have an income tax treaty, and who owns the U.S. rights to a motion picture, to avoid U.S. withholding tax on income ultimately derived from the exhibition of the film in the U.S. by licensing the film "through" a country with which the United States does have an income tax treaty that provides for a zero rate of withholding tax.

With proper planning and in appropriate circumstances, however, the ownership and exploitation of the non-U.S. rights to American motion pictures may be structured in a manner that avoids (or defers) U.S. taxation. Successful implementation of such tax planning, which requires careful attention to the direct and indirect tax regimes discussed below, has been facilitated to a considerable extent by the recent promulgation of final cost sharing regulations,[8] which afford far greater certainty with respect to a number of important federal income tax consequences of the various co-production and split-rights agreements commonly used in today's marketplace.

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[6] *See, e.g.,* Art. 22 of Treasury Department's Model Income Tax Convention of September 20, 1996, (the "1996 Model Treaty").

[7] *E.g.,* Treas. Reg. § 1.7701(l)-1(b).

[8] Treas. Reg. § 1.482-7 (T.D. 8670, May 9, 1996).

¶ 1800.3 Trailer

This article starts by reviewing the federal income tax rules that determine whether the ownership and exploitation of the U.S. and non-U.S. rights to a motion picture will be subject to immediate, direct federal income taxation. It then considers the three indirect tax regimes that are of primary importance when non-U.S. rights ultimately are owned in whole or in part by domestic taxpayers. The article concludes by examining briefly the important role that the new cost sharing regulations play in structuring the types of co-production arrangements that allow for maximum U.S. tax efficiencies. Key unresolved legal issues are discussed in detail where appropriate. Depending on the particular situation, full awareness of these unresolved issues may enable taxpayers to structure their operations so as to minimize the risk of U.S. income tax on certain income or assist them in understanding the level of U.S. income tax risk to which they may be subject.

¶ 1801 DIRECT TAXATION

¶ 1801.1 Overview

While U.S. citizens, U.S. residents, and domestic corporations (collectively, "U.S. persons") are subject to U.S. federal income tax based on their worldwide income, non-U.S. persons generally are subject to U.S. federal income tax only on income that is either from U.S. sources or connected with the conduct of a trade or business within the United States. As a result, it is often desirable to structure motion picture production and distribution operations so that the income from the exploitation of non-U.S. rights is derived by non-U.S. persons. Opportunities for non-U.S. persons to avoid U.S. taxation on income derived from the domestic exploitation of film rights also exist but are more limited.

Non-U.S. persons that are "engaged in trade or business within the United States" are subject to the same graduated income tax rates applicable to U.S. persons with respect to net taxable income that is "effectively connected with the conduct of a trade or business within the United States."[9]

[9] *See* I.R.C. §§ 871(b), 882(a) (all section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated); Treas. Regs. §§ 1.871-8(b)(2),

Such income is commonly referred to simply as "effectively connected income," or "ECI."

Non-U.S. persons generally are subject to a flat 30 percent U.S. withholding tax on the gross amount of their "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") from sources within the United States that is not ECI.[10] FDAP income includes, *inter alia,* rents and royalties.

Non-U.S. persons are not subject to U.S. federal income tax on income that is neither ECI nor U.S. source FDAP. For example, capital gains on the sale of stock of a foreign corporation earned by a non-U.S. person that does not have an office or other fixed place of business in the United States is never subject to direct U.S. federal income tax.

¶ 1801.2 Effectively Connected Income

A. United States Trade or Business

In order to have ECI that is subject to the regular graduated rates of U.S. federal income taxation, a non-U.S. Person generally must be engaged in the conduct of a trade or business within the United States. Whether a non-U.S. person is engaged in trade or business in the United States is determined by examining all of the facts and circumstances associated with the activities of such person and such person's agents. In this regard, foreign film makers and cast need to be aware that the performance of personal services within the United States at any time during the taxable year constitutes a trade or business within the United States.[11] As a result, if during a given taxable year a foreign film maker with no other connection with the United States shoots a single film for one of the major U.S. studios in part within the United

1.882-1(b)(2). In the case of foreign corporations, additional branch profits taxes generally apply. *See* I.R.C. § 884; Treas. Regs. §§ 1.884-0 to -5.

[10] *See* I.R.C. §§ 871(a), 881(a); Treas. Regs. §§ 1.871-7(b), 1.871-8(b)(1), 1.882-1(b)(1).

[11] I.R.C. § 864(b); Treas. Reg. § 1.864-2. As relevant to the motion picture industry, there is a narrow exception to this rule for nonresident alien individuals temporarily present in the United States for no more than 90 days during the taxable year whose compensation for personal services rendered for certain foreign persons or foreign offices maintained by U.S. persons does not exceed, in the aggregate, $3000. I.R.C. § 864(b)(1); Treas. Reg. § 1.864-2(a)-(b).

States and in part without the United States, the film maker will be deemed to be engaged in a U.S. trade or business and, in connection with the U.S. federal income tax return that it will be required to file, it will be necessary to allocate a portion of the service income it derives from its work on the film to U.S. sources.

Equally important as the rule for personal services performed within the United States is the look-through rule for partnerships. A non-U.S. person that is a partner in a domestic or foreign partnership that is engaged in a U.S. trade or business is deemed to be engaged in a U.S. trade or business.[12] Moreover, a partnership engaged in a U.S. trade or business ordinarily is required to withhold tax, at the highest personal or corporate tax rate, whichever is applicable, on a non-U.S. partner's allocable share of ECI.[13]

B. Nexus Rules

If it is determined that a non-U.S. person is engaged in a trade or business in the United States, the income that is deemed to have a sufficient nexus with that United States trade or business is treated as ECI and is subject to the regular graduated U.S. federal income tax rates. The specific circumstances under which U.S. and foreign source income can be taxed as ECI are discussed immediately below. However, before proceeding with that discussion it should be pointed out that the geographic source of rental and royalty income, which are the two most important items of FDAP income in the context of motion picture production and distribution activities, is determined by the location where the underlying property in question is used by the lessee or licensee.[14] Knowledge of the correct geographic source of rental and royalty income is important because the applicable rules for determining whether income is ECI vary depending on whether such income is of U.S. or foreign source.

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[12] I.R.C. § 875(1); Treas. Reg. § 1.875-1. A non-U.S. person that is a beneficiary of an estate or trust which is engaged in a trade or business within the United States similarly is deemed to be engaged in such trade or business. I.R.C. § 875(2).

[13] I.R.C. § 1446.

[14] I.R.C. §§ 861(a)(4), 862(a)(4); Treas. Regs. §§ 1.861-5, 1.862-1(a)(1)(iv).

1. U.S. Source Income

U.S. source FDAP income and gains from the sale or exchange of capital assets are treated as ECI only if there is some factual connection between such income and the non-U.S. person's U.S. trade or business. A sufficient nexus exists if either the asset use test or the business activities test is satisfied.[15] Under the asset use test, the income or gain in question is treated as ECI if it is derived from assets used in or held for use in the conduct of a U.S. trade or business. Under the business activities test, the income or gain in question is treated as ECI if the activities of the U.S. trade or business are a material factor in its realization. Thus, for example, U.S. source royalty income received by a non-U.S. person actively engaged in licensing motion pictures will be treated as ECI if the non-U.S. person is engaged in such licensing efforts in the United States.

All U.S. source income other than that which is subject to the asset use and business activities tests described above is treated as ECI regardless of whether the income is in fact connected with the non-U.S. person's U.S. trade or business.[16] This is commonly known as the limited force of attraction rule.

Although income earned by a non-U.S. person from the sale of personal property normally is treated as foreign source income,[17] there is a rule, which is sometimes overlooked, for the sale of copyrights and other intangibles that is of particular importance to film producers and distributors. To the extent that payments received in consideration of the sale of an intangible are not ECI but are contingent on the productivity, use, or disposition of the intangible, such payments are sourced in the same manner as if they were royalties (*i.e.*, according to where the intangible is used).[18] As a result, if the U.S. rights to a particular film are sold by a non-U.S. person that is not engaged in a trade or business in the United States, and some or all of the consideration received in

[15] *See* I.R.C. § 864(c)(2); Treas. Reg. § 1.864-4(c)(2)-(3).

[16] I.R.C. § 864(c)(3); Treas. Reg. § 1.864-4(b).

[17] *See* I.R.C. § 865(a)(2).

[18] I.R.C. § 865(d)(1)(B).

exchange for those rights is contingent on the revenues or profits generated by the film, any gain attributable to such contingent consideration will be subject to a 30 percent U.S. tax.[19]

2. *Foreign Source Income*

Foreign source income generally is *not* treated as ECI. There are, however, exceptions to this general rule that are especially relevant to the motion picture industry. Specifically, certain statutorily prescribed types of foreign source income (discussed below) earned by a non-U.S. person are treated as ECI if that person has an office or other fixed place of business within the United States and the income is properly attributable to that office.[20]

The initial inquiry, therefore, is whether the non-U.S. person has a U.S. office. In determining whether a non-U.S. person has an office or other fixed place of business within the United States for purposes of the foreign source income nexus test, the statute and regulations provide that an office or fixed place of business of a general commission agent, broker, or other agent of *independent* status acting in the ordinary course of that independent agent's business is not imputed to the non-U.S. person.[21] Moreover, the office or fixed place of business of a *dependent* agent is similarly disregarded unless the agent has the authority to enter into contracts in the name of the non-U.S. principal and regularly exercises such authority.[22]

It is also important to note that in order for income or gain to be considered attributable to an office or other fixed place of business within the United States, such office or fixed place of business must be a material factor in the production of such income *and* such office or fixed place of business must

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[19] I.R.C. §§ 871(a)(1)(D), 881(a)(4); Treas. Reg. § 1.871-11.

[20] I.R.C. § 864(c)(4)(B). *See also* Treas. Reg. § 1.864-5(a).

[21] I.R.C. § 864(c)(5)(A); Treas. Reg. § 1.864-7(d)(2)-(3).

[22] I.R.C. § 864(c)(5)(A); Treas. Reg. § 1.864-7(d)(1). The office or fixed place of business of a dependent agent also can be imputed to the agent's non-U.S. principal if the agent has a stock of merchandise from which it regularly fills orders on behalf of such principal. *See id.*

regularly carry on activities of the type from which such income, gain or loss is derived.[23]

Foreign source income earned by a non-U.S. person that is attributable to an office or other fixed place of business within the United States in accordance with these rules is treated as ECI only if it is one of several statutorily prescribed types of income. As pertinent to the motion picture industry, the types of foreign source income or gain that are treated as ECI if attributable to an office or other fixed place of business within the United States include rents or royalties for the use of, or for the privilege of using, intangible property located outside the United States which is derived in the active conduct of a U.S. trade or business,[24] as well as income derived from the sale or exchange (outside the United States) through the U.S. office or fixed place of business of personal property described in section 1221(1) of the Code (*i.e.*, inventory property or property held by the taxpayer primarily for the sale to customers in the ordinary course of the taxpayer's trade or business) *unless* the property is sold or exchanged for use, consumption or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.[25]

One issue that arises for motion picture production and distribution companies is whether amounts received in exchange for the right to distribute and exhibit films in foreign territories is properly treated for purposes of these rules as rents or royalties for the use of or for the privilege of using *intangible* property located outside the United States or, alternatively, is properly treated as amounts received in consideration for the use of *tangible* property. If such amounts do not constitute rents or royalties for the use of or for the privilege of using *intangible* property, then such income earned by a non-U.S. person *cannot* be treated as ECI. While

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[23] I.R.C. § 864(c)(5)(B); Treas. Reg. § 1.864-6(b).

[24] I.R.C. §§ 864(c)(4)(B)(i), 862(a)(4); Treas. Reg. § 1.864-5(b)(1). Prior to amendment in 1988, section 864(c)(4)(B)(i) provided that gains on the sale or exchange of such intangible personal property could also be ECI. *See* P.L. 100-647, § 1012(d)(10)(A)-(B) (1988). The Treasury Regulations have not yet been updated to reflect the statutory change. *See* Treas. Reg. § 1.864-5(b)(1)(ii).

[25] I.R.C. § 864(c)(4)(B)(iii); Treas. Regs. §§ 1.864-5(b)(3), -6(b)(3).

the better view, as described below, may be that such income can be ECI, this issue remains open.

Section 864(c)(4)(B)(i) provides that foreign source income can be ECI if it "consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) derived in the active conduct of [a trade or business in the United States]." Section 862(a)(4), which describes certain items of gross income which are treated as income from sources without the United States, refers to "rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, . . . trademarks, . . . and other like properties." Consequently, it is clear that rents or royalties received for the use of or for the privilege of using without the United States a film copyright (intangible property described in section 862(a)(4)) can be ECI. However, it is somewhat less clear that the rents or royalties received from the licensing of a motion picture film are properly viewed as being for the use of or for the privilege of using the copyright in the film as contrasted to the film as an item of tangible property. In light of the statutory provisions and judicial precedents discussed below, the argument could be made that such rents or royalties should be viewed as being for the use of or for the privilege of using the actual tangible film. In other words, it is possible to argue that the copyrights are not talismanic and that films should be treated as tangible property for purposes of applying the section 864 nexus rule for foreign source income.

Neither the Code nor the regulations expressly set forth the status of theatrical motion pictures as tangible or intangible property for purposes of applying the foreign source income nexus rule of section 864. Looking to other Code provisions, one finds that section 263A expressly provides that for purposes of the capitalization rules, a film, sound recording, video tape, book, or similar property is treated as tangible personal property.[26] In addition, there is a long line of judicial

[26] I.R.C. § 263A(b).

precedents which hold that motion picture films are tangible property for purposes of the investment tax credit rules.[27]

Of course, the fact that motion picture films are tangible personal property for purposes of the capitalization rules and the investment tax credit provisions does not necessarily mean that such films should be treated as tangible property for purposes of the nexus rule for foreign source income. In fact, it can be argued that if Congress intended motion picture films to be treated as tangible property for purposes of the foreign source income nexus rule it would have explicitly so provided in the statute as it did for purposes of the capitalization rules. Furthermore, a closer examination of the investment tax credit cases relating to motion picture films reveals that what the courts held to be tangible property were the master negatives (which were not copyrighted) that were used to create exhibition prints (which were copyrighted) for rental or sale. For example, the Ninth Circuit Court of Appeals stated as follows:

> [W]e agree with *Disney I* that master negatives are tangible property within the meaning of [section] 48(a)(1) (1970) and that the investment tax credit

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[27] *Walt Disney Prods. v. Commissioner*, 549 F.2d 576 (9th Cir. 1976) [*Disney II*]; *Walt Disney Prods. v. United States*, 480 F.2d 66 (9th Cir. 1973) [*Disney I*], *cert. denied*, 415 U.S. 934 (1974); *Bing Crosby Prods. v. United States*, 588 F.2d 1293 (9th Cir. 1979). *Cf. Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir. 1994) (computer program's master source code embodied in magnetic tapes and disk, which was used by the taxpayer to produce executable code software for distribution to its customers, constitutes tangible personal property for purposes of the investment tax credit); *Texas Instruments, Inc. v. United States*, 551 F.2d 599 (5th Cir. 1977) (seismic data tapes and films from which pictures depicting the contours of the earth's different strata were produced, which pictures were sold to customers for use in exploring for oil and gas, held to be tangible personal property eligible for the investment tax credit and the double-declining balance method of depreciation); *EMI N. Am. Holdings, Inc. v. United States*, 675 F.2d 1068 (9th Cir. 1982) (master sound tapes are functionally equivalent to master prints of movies and therefore, based on long-established precedent, qualify for the investment tax credit); *Norwest Corp. v. Commissioner*, 108 T.C. No. 18 (1997) (software acquired by taxpayer without any copyright rights treated as tangible personal property eligible for the investment tax credit); *Sprint Corp. v. Commissioner*, 108 T.C. No. 18 (1997) (same). *But cf., e.g., Ronnen v. Commissioner*, 90 T.C. 74 (1988) (computer software acquired by taxpayer with right to exploit in a particular territory found to constitute intangible personal property that is not eligible for the investment tax credit); *Bank of Vermont v. United States*, 88-1 U.S.T.C. ¶ 9169 (D. Vt. 1988) (computer software purchased by taxpayer for its exclusive use treated as intangible property that is not eligible for the investment tax credit — cases dealing with motion picture films distinguished).

> can be claimed for the production costs of such property.
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> The master negatives for each film title are used by Disney as a capital asset to create exhibition prints for rental or sale. Most of the value of the exhibition prints rests on the right of exclusive exploitation protected by copyright, but that fact does not render the capital asset (the master negatives) an intangible.[28]

As evident from the language quoted above, even though the court found the noncopyrighted master negatives to be tangible property, it clearly recognized that the economic value of the exhibition prints was derived principally from the copyrights thereon. In the case of the nexus rule for foreign source income, presumably the focus should be on the underlying economic value that gives rise to the rents or royalties that are derived from motion picture films, without regard to whether such films physically are exhibition prints or master negatives. Consequently, the investment tax credit cases dealing with motion picture films can be interpreted consistently with the view that such films should be treated as intangible property for purposes of the foreign source income nexus rule. Moreover, even if the cases had gone as far as to acknowledge that exhibition prints also are tangible property that could be treated as such for purposes of the investment tax credit provisions, it would not necessarily follow that exhibition prints should be treated similarly for purposes of the foreign source income nexus rule. In the case of the investment tax credit, there is legislative history that provides strong evidence that Congress intended motion picture films to qualify for the credit:

> As previously indicated the investment tax credit is generally available for depreciable tangible personal property. Questions have arisen, however, whether motion picture and television films are tangible (as distinct from intangible) personal property eligible for the credit. A court case decided the question in favor of the taxpayer. The committee agrees with the

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[28] *Disney II*, at 580-81.

> court that motion picture and TV films are tangible personal property eligible for the investment credit.[29]

There is no similar legislative history indicating whether motion picture films are tangible or intangible property for purposes of the foreign source income nexus rule.

Moreover, Congress modified the investment tax credit rules in 1976 to provide explicitly that certain motion pictures and television films are to be treated as tangible personal property eligible for the credit.[30] In doing so, however, Congress made clear that the credit was not available for all films, and it enacted rules for application of the credit that emphasized the intangible nature of such property.[31] For example, the useful life of an investment in a qualifying film was determined by the period during which the film was exhibited, not by the length of time a particular negative or tape was used, or was being held for future use, in the print making process.[32]

Throughout the litigation concerning the availability of the investment tax credit in connection with the creation of motion picture films, the Service maintained the view that motion picture films are intangible property. That position was explicitly set forth in the investment tax credit regulations as follows:

> Intangible property, such as patents, copyrights, and subscription lists, does not qualify [for the investment tax credit]. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or

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[29] S. Rep. No. 437, 92d Cong., 1st Sess. 34 (1971), reprinted in 1971 U.S.C.C.A.N. 1942.

[30] Tax Reform Act of 1976, Pub. L. No. 94-455, § 804, 1976-3 (Vol. 1) C.B. 67; *See also*, H.R. Rep. No. 658, 94th Cong., 1st Sess. 188 (1975), 1976-3 (Vol. 2) C.B. 695, 880.

[31] *Id.*; *See also* Rev. Rul. 82-79, 1982-1 C.B. 8 (investment tax credit not available for master video tapes used for training on critical care medicine topics because not created primarily for use as public entertainment or for educational purposes within the meaning of the statute).

[32] *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 804, 1976-3 (Vol. 1) C.B. 67.

> television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape.[33]

The Court of Appeals for the Ninth Circuit held the investment tax credit regulations invalid to the extent that they denied an investment credit with respect to master film negatives.[34] However, the Service has subsequently indicated its belief that the 1976 amendments to the investment tax credit provisions negated the Ninth Circuit's decision.[35]

Finally, it should be noted that motion picture films, video tapes and sound recordings are specifically excluded, by statute, from eligibility for the accelerated depreciation which is available for certain tangible property.[36] Unfortunately, the statutory provision is ambiguous for purposes of the current analysis, since there is no express indication whether such property is viewed as tangible or intangible property. Of course, if films, video tapes and sound recordings irrefutably were intangible property, there would be no need to have a specific provision making the accelerated depreciation provisions inapplicable to such property, since only tangible property is eligible for the tax benefits provided by those provisions. Yet, reasoning by negative inference is at best a risky proposition, and there is no direct authority as to whether motion picture films are properly treated as tangible or intangible property for purposes of the foreign source income nexus rule of section 864.

However, in light of the Service's position with respect to the characterization of motion picture master negatives for purposes of the investment tax credit provisions, taxpayers should expect the Service to take the position that motion picture films are intangibles for purposes of the foreign source income nexus rule. While the investment tax credit caselaw indicates that master negatives are tangible property, it also

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[33] Treas. Reg. § 1.48-1(f).

[34] *Disney I*, 480 F.2d at 67-69.

[35] *See* Priv. Ltr. Rul. 84-08-049 (Nov. 23, 1983) (video game master tapes treated as intangible property that is not eligible for the investment tax credit).

[36] I.R.C. § 168(f)(3)-(4).

acknowledges that the value of exhibition prints derives from the right of exclusive exploitation protected by intangible copyrights. Thus, that caselaw may not be of great assistance to taxpayers for purposes of section 864.

C. Bilateral Tax Treaties

Bilateral tax treaties may supersede the effectively connected income rules described above. Income tax treaties that the United States has entered into typically provide that a resident of the foreign country that is a party to the treaty is not subject to U.S. income tax on "business profits" unless that person carries on business in the United States through a "permanent establishment," *i.e.*, a fixed place of business through which the business of an enterprise is wholly or partly carried on.[37] It is entirely possible for a resident of a treaty country to be engaged in a trade or business in the United States but not have a permanent establishment. In such a situation, the treaty prevents income that what would otherwise be ECI from being taxed by the United States.

Some examples of U.S. presence that would constitute permanent establishments under typical bilateral income tax treaties are: (i) a place of management; (ii) a branch, office, factory or workshop; or (iii) a building site or construction or installation project, but only if it lasts for more than twelve months.[38] On the other hand, the following types of U.S. presence expressly do not constitute permanent establishments under typical bilateral tax treaties: (i) use of a facility solely for storage, display, or delivery of goods; (ii) maintenance of a stock of goods or merchandise belonging to the foreign person solely for storage, display or delivery, or solely for processing by another party; or (iii) maintenance of a fixed place of business solely for (a) purchasing goods or merchandise, or collecting information for the foreign person, (b) carrying on any other activity of a preparatory or auxiliary character, or (c) any combination of activities mentioned in (a) and (b).[39]

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[37] *See, e.g.*, Art. 5(1) of the 1996 Model Treaty.

[38] *See, e.g.*, Art. 5(2) of the 1996 Model Treaty.

[39] *See, e.g.*, Art. 5(4) of the 1996 Model Treaty.

The mere existence of a company in the United States that is controlled by or controls a foreign corporation does not constitute a permanent establishment in and of itself.[40] Therefore, if a foreign corporation that is a resident of a treaty country has a wholly owned subsidiary that is engaged in business within the United States, the foreign corporation would not automatically be deemed to have a permanent establishment in the United States.[41] A non-U.S. person can have a permanent establishment in the United States, however, if such person has employees or other dependent agents in the United States who act on its behalf and who have, and habitually exercise in the United States, the authority to enter into contracts in the name of the non-U.S. person.[42] Conversely, no broker, general commission agent, or any other "independent" agent acting in the ordinary course of such agent's business will constitute a permanent establishment irrespective of the agent's authority to bind the non-U.S. principal or the agent's maintenance of an office in the United States.[43]

In a relatively recent case involving the interpretation of the income tax treaty between the United States and Japan, the Tax Court held that to be "independent" from a non-U.S. person, a U.S. agent had to be both legally and economically independent.[44] In its decision, the Tax Court determined that the agent was legally independent from the foreign taxpayer based on, among others, the following facts: (i) the agent had complete discretion over the details of its work; (ii) the non-U.S. person did not control the agent's corporate affairs; and (iii) the agent worked for several principals. The Tax Court determined that the agent was economically independent from the foreign taxpayer based on the following facts: (i) the agent was neither guaranteed revenues nor protected from loss; (ii) the clients could terminate the agency on six months notice; and (iii) the agent earned substantial profits that would not have been paid to a subservient entity.

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[40] *See, e.g.*, Art. 5(7) of the 1996 Model Treaty.

[41] *Id.*

[42] *See, e.g.*, Art. 5(5) of the 1996 Model Treaty.

[43] *See, e.g.*, Art. 5(6) of the 1996 Model Treaty.

[44] *Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995). *See also* Treas. Reg. § 1.864-7(d)(3).

A foreign partner will be deemed to have a permanent establishment in the United States if the partnership has a permanent establishment in the United States.[45] As a result, a foreign partner may be deemed to have a permanent establishment in the United States if the partnership and the general partner are located in the United States due to the general partner's ability to bind all partners with respect to the partnership business. Business profits that are attributable to (*i.e.*, derived from the assets or activities of) a permanent establishment in the United States are taxable by the United States.

Business profits generally are defined as trade or business income. Under several older U.S. tax treaties, business profits may include income derived from the rental of tangible personal property and the rental or licensing of cinematographic films or films or tape used for radio or television broadcasting.[46] On the other hand, our more modern treaties treat consideration received for the right to use cinematographic films as royalties.[47]

¶ 1801.3 Income Subject to Withholding

U.S. source FDAP income earned by a non-U.S. person that is not subject to U.S. income tax as either ECI or income attributable to a permanent establishment generally is subject to a flat 30 percent tax that is satisfied by withholding at the source.[48] However, if the recipient of the U.S. source FDAP income is a resident of a country with which the United States has an income tax treaty, a lower treaty tax rate may apply, and in the case of many U.S. treaties, the U.S. withholding tax on interest and royalty income is eliminated entirely.[49] In all cases, the tax potentially applies to the gross amount of FDAP income received (*i.e.*, the recipient of the income is not permitted any deductions). Thus, in the absence

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[45] *See Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Commissioner*, 58 T.C.M. (CCH) 1157 (1990); Rev. Rul. 85-60, 1985-1 C.B. 187.

[46] *See, e.g.*, Art. 7 of the Treasury Department's Model Income Tax Treaty of June 16, 1981, which was withdrawn in 1992.

[47] *See, e.g.*, Art. 12(2)(a) of the 1996 Model Treaty.

[48] *See* I.R.C. §§ 871(a), 881(a), 1441, 1442. It should be noted that there are certain statutory exceptions to the 30 percent withholding tax on FDAP income.

[49] *See, e.g.*, Arts. 11-12 of U.S.-U.K. income tax treaty signed Dec. 31, 1975.

of an applicable treaty, non-U.S. persons that own the U.S. rights to a motion picture generally will be subject to a 30 percent withholding tax on the royalties received from the licensing of the U.S. rights to U.S. film distributors. Naturally, non-U.S. persons would prefer to have the 30 percent withholding tax on U.S. source royalties reduced or eliminated.

Under certain circumstances it may be possible for a non-U.S. person that is not a resident of a country with which the United States has an income tax treaty to avoid or reduce U.S. withholding tax on royalty payments ultimately derived from sources within the United States if such royalties are paid in the first instance to a non-U.S. person that is a resident of a country with which the United States does have an income tax treaty and then are paid subsequently to the non-U.S. person that is not a resident of a treaty country. Royalty streams that flow from one payor, through an intermediate licensee-sublicensor and ultimately to an originating licensor are sometimes referred to as "cascading royalties." As described below, a recent decision of the United States Tax Court has created some uncertainty regarding the applicable U.S. tax treatment of cascading U.S. royalties.

The Service's long-standing position has been that when a foreign taxpayer that is a resident of a treaty country receives U.S. source royalty payments with respect to certain property and subsequently makes royalty payments with respect to the same property to a resident of a third country, the payments to the resident of the third country retain their character as U.S. source royalty income even if the intermediate treaty country recipient of the royalty is unrelated to the ultimate recipient.[50] As a result, the royalty payments from the intermediate recipient to the ultimate recipient would remain potentially subject to the 30 percent U.S. withholding tax, unless there is a treaty in effect between the United States and the ultimate recipient's country of residence that provides for a lower rate. Pursuant to the Service's view of the

[50] Rev. Rul. 80-362, 1980-2 C.B. 208.

transaction, the intermediate recipient is jointly and severally liable for the tax and is the withholding agent therefor.[51]

The validity of the Service's position on back-to-back licensing arrangements was recently thrown into question by the United States Tax Court's decision in *SDI Netherlands B.V. v. Commissioner.*[52] In *SDI Netherlands*, the Tax Court ruled that royalties paid by a Dutch company to its Bermuda affiliate were not U.S. source income subject to the 30 percent U.S. withholding tax even though, on average for the four years in controversy, approximately 55 percent of the income derived by the Dutch company (i) consisted of treaty protected U.S. source royalties received from the Dutch company's U.S. subsidiary, and (ii) was required to be remitted, together with the royalties received from other affiliated licensees of the Dutch intermediary, to the Bermuda affiliate within 28 days of its receipt from the U.S. subsidiary. The Tax court found, based on the facts of the case, that the two licenses involved had separate and distinct terms and that the Dutch company had an independent role as the licensee of the worldwide rights from the Bermuda corporation and the licensor of the other entities, including but not limited to its U.S. subsidiary. The court further found that the Dutch company earned between a 5 percent and 6 percent spread through its licensing arrangements. As a result, the character of the royalty income received by the Bermuda corporation from the Dutch corporation was determined independent of the character of the royalty income received by the Dutch corporation from its U.S. subsidiary.

The Service has appealed the Tax Court's decision to the Court of Appeals for the Federal Circuit;[53] so it is not yet known if the decision will ultimately survive. *SDI Netherlands* may, however, have opened up opportunities for non-U.S. distributors of motion picture films to employ back-to-back licensing to avoid or reduce U.S. withholding tax in certain limited circumstances. Although the U.S.-Netherlands

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[51] *Id. See also* Treas. Regs. §§ 1.7701(l)-1, 1.1441-7(d)(2)(ii), Ex. 3 (the "conduit financing" regulations that were finalized in Aug. 1995 by T.D. 8611, 1995-37 I.R.B. 20).

[52] 107 T.C. No. 10 (1996), *appeal docketed*, No. 97-1089 (D.C. Cir. Feb. 13, 1997).

[53] *See id.*

income tax treaty was amended subsequent to the years at issue in *SDI Netherlands* in a manner that today would appear to preclude a foreign taxpayer from avoiding U.S. withholding tax under the structure analyzed in the case, in many cases U.S. withholding tax relief may be available notwithstanding an applicable limitation on benefits article. On the other hand, *SDI Netherlands* was decided under the law as it existed prior to the promulgation of final legislative regulations under section 7701(l) of the Code. These regulations, commonly referred to as the conduit financing regulations, are designed to prevent taxpayers from avoiding U.S. withholding tax through back-to-back financing arrangements not unlike those at issue in *SDI Netherlands*. The conduit financing regulations need to be considered carefully in connection with any back-to-back licensing structure designed to reduce or eliminate withholding tax on royalty income derived from the exploitation of films in the United States.

¶ 1802 INDIRECT TAXATION

In addition to potentially being subject to the system of direct U.S. income taxation described above, motion picture income earned by a foreign corporation may be subject to a separate labyrinth of indirect U.S. income taxation that applies where a foreign corporation ultimately is owned in whole or in part by U.S. persons.

¶ 1802.1 Overview

Under certain circumstances, U.S. income tax can be imposed on a U.S. shareholder of a foreign corporation with respect to all or a portion of the foreign corporation's income if such corporation earns specified types of income or owns certain types of assets. In many situations the tax is imposed in the same year that the corporation earns the income regardless of whether the U.S. shareholder actually receives a distribution from the corporation during that year. Although ECI of a foreign corporation generally is not taxed a second time under the indirect U.S. income tax system, U.S. source FDAP income may be subject to such an indirect second tax.

Before delving into the substantive provisions of the Code that can result in the indirect taxation of income earned by certain foreign corporations, it would be wise to quickly review the reason for the existence of such provisions. The story is relatively easy to understand.

The foreign source income of a foreign corporation is not subject to direct U.S. income tax except in the very limited circumstances previously described. In contrast, the foreign source income of a domestic corporation generally is subject to direct U.S. income tax. As a result, without special provisions to prevent potential U.S. tax deferral, U.S. persons would be able to conduct activities producing foreign source income through a foreign corporation and not pay U.S. income tax until they either received a dividend from the foreign corporation or sold their stock in the corporation at a gain.

The United States has put in place certain indirect tax mechanisms for the principal purpose of preventing U.S. persons from achieving what is viewed as the inappropriate deferral of U.S. income tax on foreign source income through the use of foreign corporations. This indirect tax system is a patchwork of several independent anti-U.S. tax deferral regimes, each targeted at a particular perceived evil, that have been developed over time and stitched together in a complicated, sometimes overlapping pattern, rather than being the product of a single comprehensive plan.

The three principal anti-deferral regimes that are of importance to current international tax planning efforts in the motion picture industry are subpart F, the foreign personal holding company provisions, and the passive foreign investment company provisions.[54] A general overview of each of the three anti-deferral regimes of primary importance, as well as a brief mention of the anti-deferral regimes of lesser significance, is provided below. That overview is followed by a more detailed look at the principal provisions of the three anti-deferral regimes of primary importance to motion picture producers and distributors.

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[54] There are additional anti-deferral regimes that should not be overlooked but which will only be mentioned briefly herein.

Subpart F is an anti-avoidance regime designed to prevent tax deferral of certain types of foreign source income earned by a foreign corporation that is controlled by one or more U.S. person shareholders each of which owns at least 10 percent of the of the voting power of such corporation. The targeted income is taxed in a manner that is intended to resemble the tax treatment that would have applied if the income had been distributed to the shareholders as a dividend. Theoretically, the tax liability created by subpart F does not cause a liquidity problem for the controlling U.S. shareholders because they could force the corporation to make a dividend distribution that would cover their liability.

The foreign personal holding company provisions are designed to tax U.S. persons that are shareholders, at any percentage level of ownership, of certain closely held foreign corporations that have primarily passive income and gains. A U.S. shareholder of a foreign personal holding company is taxed as if such corporation had distributed all of its net income to its shareholders in the form of a dividend.

The passive foreign investment company provisions are intended to preclude the benefits of deferring tax from inuring to U.S. persons that are shareholders, at any percentage level of ownership, of certain foreign corporations that have principally passive income or passive assets, through special rules that apply to any gain from the direct or indirect sale or exchange of, and certain direct or indirect distributions in respect of, their stock in such foreign corporations. The special rules are designed to result in a tax imposed at the maximum applicable ordinary income tax rate together with an interest charge designed to eliminate any potential deferral benefit. Alternatively, the rules permit a U.S. shareholder to elect to be taxed currently on its pro-rata share of the passive foreign investment company's income.

In addition to the three anti-deferral regimes of primary concern, there are several other sets of anti-deferral provisions that U.S. shareholders of foreign corporations must be aware of. These additional sets of provisions that may apply in certain situations are the accumulated earnings tax provisions (I.R.C. §§ 531-537), the personal holding company

provisions (I.R.C. §§ 541-547) and the foreign investment company provisions (I.R.C. §§ 1246-1247).

¶ 1802.2 Subpart F

A. In General

Subpart F (I.R.C. §§ 951-964) contains the rules for taxing "United States shareholders"[55] of controlled foreign corporations ("CFCs") on, principally, "subpart F income" and tax deferred earnings that are invested in U.S. property. In general, if a foreign corporation is a CFC, as defined below, for an uninterrupted period of 30 days or more during any taxable year, every person who is a "United States shareholder" of such corporation on the last day, in such year, on which such corporation is a CFC must include in such shareholder's gross income, for the taxable year in which or with which such taxable year of the corporation ends, such shareholder's pro rata share of, principally, (i) the CFC's "subpart F income" for such year, and (ii) the CFC's increase in earnings invested in U.S. property for such year.[56] A CFC is any foreign corporation more than 50 percent of (i) the total combined voting power of all classes of stock entitled to vote *or* (ii) the total value of the stock of which is owned directly, indirectly or constructively by "United States shareholders" on any day during the taxable year of such foreign corporation.[57]

For purposes of subpart F the term "United States shareholder" is defined as a United States person who owns directly, indirectly or constructively (applying specified stock ownership attribution rules)[58] 10 percent or more of the total combined *voting power* of all classes of stock entitled to vote of such foreign corporation.

Certain items of income that could otherwise be Subpart F income are specifically excluded from that taxpayer unfavorable category. For example, Subpart F income does not

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[55] As will be explained, "United States shareholder" has a special definition for purposes of subpart F. To prevent any confusion, that phrase will appear in quotes herein whenever intended, and only when intended, in its technical subpart F sense.

[56] *See* I.R.C. §§ 951(a), 956; Treas. Reg. § 1.951-1.

[57] *See* I.R.C. § 957(a).

[58] *See* I.R.C. § 958 for the rules for determining stock ownership. *See also* Treas. Regs. §§ 1.958-1, -2.

include ECI that is not exempt from U.S. tax, or subject to a reduced rate of tax, pursuant to a U.S. income tax treaty.[59] Income otherwise taxable under subpart F also does not include any item of income that is subject to an effective rate of foreign tax greater than 90 percent of the maximum U.S. corporate tax rate.[60] Given that the maximum corporate tax rate currently is 35 percent, an item of income must be subject to an effective rate of income tax imposed by a foreign country that is greater than 31.5 percent in order to be excluded from Subpart F income under this high-taxed income exception.

In addition to the exclusion of certain types of income from Subpart F income, a foreign corporation's Subpart F income for any taxable year cannot exceed the amount of the CFC's earnings and profits for the year.[61] However, if the current year earnings and profits limitation causes subpart F income to be less than it otherwise would have been in a given year, then any excess earnings and profits of the CFC for any subsequent year over the subpart F income for such year is recharacterized as subpart F income.[62] On the other hand, prior year deficits in earnings and profits generally are not taken into account in determining includible subpart F income. There is an exception to this rule for "qualified deficits" in earnings and profits which can be applied to reduce subpart F income attributable to a "qualified activity."[63] As may be relevant to motion picture production and distribution entities, "qualified activity" is defined to include any activity giving rise to foreign base company sales income or foreign base company services income.[64] In order to be a "qualified deficit," a deficit in earnings and profits must be attributable to the same qualified activity that gave rise to the income that the deficit is going to offset.

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[59] I.R.C. § 952(b).

[60] I.R.C. § 954(b)(4); Treas. Reg. § 1.954-1(d).

[61] I.R.C. § 952(c)(1)(A).

[62] I.R.C. § 952(c)(2).

[63] I.R.C. § 952(c)(1)(B).

[64] *See infra* notes 80-87 and accompanying text for a discussion of foreign base company sales income and foreign base company services income.

B. Foreign Base Company Income

The primary types of subpart F income that are relevant to producers and distributors of motion pictures fall within a subcategory of subpart F income known as foreign base company income. The three types of foreign base company income that are of greatest concern to the motion picture industry are foreign personal holding company income ("subpart F FPHCI"),[65] foreign base company sales income, and foreign base company services income.[66] Each of these three important types of foreign base company income is described in more detail below.

Subpart F FPHCI includes interest and dividends[67] except where such items of income (a) are received from a related corporation that is organized under the laws of the same foreign country as the CFC receiving the income and that has a substantial part of its trade or business assets located in the same country,[68] or (b) were previously subject to tax under subpart F when they were earned by the distributing CFC.[69]

In general, rents and royalties are treated as subpart F income.[70] There are, however, several exceptions to the general rule that are of particular importance in the context of motion picture production and distribution. Under an active trade or business exception, subpart F FPHCI does not include rents or royalties that are derived in the active conduct

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[65] The term "subpart F FPHCI" will be used to distinguish income that may be subject to tax under subpart F from certain "foreign personal holding company income" that may be subject to tax under the separate foreign personal holding company provisions which are discussed later in this article. *See* discussion *infra* ¶ 1802.3. Although the term "foreign personal holding company income" is used in both the subpart F tax regime and the foreign personal holding company tax regime, there are significant differences in the types of income that qualify as foreign personal holding company income for purposes of each regime. *Compare* I.R.C. § 954(c) (referred to herein as "subpart F FPHCI") *with* I.R.C. § 553 (referred to herein as "foreign personal holding company income" or "FPHCI").

[66] Foreign base company income also includes "foreign base company shipping income" and "foreign base company oil related income," *see* I.R.C. §§ 954(a)(4)-(5), neither of which is relevant to producers and distributors of motion pictures.

[67] I.R.C. § 954(c)(1)(A).

[68] I.R.C. §§ 954(c)(1)(A), (3)(A); Treas. Reg. § 1.954-2(b)(4).

[69] *See* Treas. Reg. § 1.954-2(b)(1).

[70] I.R.C. § 954(c)(1)(A).

of a trade or business and are received from unrelated persons.[71] The regulations contain separate, yet substantially similar and parallel, rules for rents versus royalties with respect to qualifying such items of income for the active trade or business exception to subpart F FPHCI treatment. Consequently, for purposes of qualifying for such exception, it generally is not critical to determine whether the income from the licensing of film rights is classified as rental income or royalty income. In contrast, as will be discussed below, the classification of the income received from licensing motion picture film rights as either rents or royalties is crucial for purposes of determining whether the foreign personal holding company provisions apply.

Pursuant to the applicable regulations, in order for rent or royalty income from the leasing or licensing of rights in motion pictures to qualify for the active trade or business exception, one of two tests must be satisfied. Both are limited to amounts received from unrelated parties.[72] Under the first test, the CFC must be regularly engaged in developing, creating or producing, (or acquiring and adding substantial value to) the property of the kind that is leased or licensed.[73] The performance of marketing functions is not considered to "add substantial value" to property.[74]

As relevant to the motion picture industry, one issue that arises under the first active trade or business exception is whether a CFC that regularly hires an independent production company to produce films, which the CFC owns and subsequently licenses, is engaged in the development, creation or production of such films within the meaning of the regulations. Although the use of such independent production

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[71] I.R.C. § 954(c)(2)(A); Treas. Reg. §1.954-2(b)(6).

[72] Related persons for subpart F purposes are defined under the criteria of I.R.C. § 954(d)(3), which, in general terms, require greater than 50 percent common control.

[73] Treas. Reg. § 1.954-2(d)(1)(i). The regulation provisions that deal specifically with royalty income require the licensor to be regularly engaged in the "*development, creation* or production of, or in the acquisition of and addition of substantial value to" property of the kind that is licensed. *Id.* (emphasis added). The regulation provisions that deal specifically with rental income are slightly different. The rental income provisions require the lessor to be regularly engaged in the "*manufacture* or production of, or in the acquisition and addition of substantial value to" property of the kind that is leased. Treas. Reg. § 1.954-2(c)(1)(i) (emphasis added).

[74] Treas. Regs. §§ 1.954-2(c)(2)(i), -2(d)(2)(i).

companies is a common industry practice that is followed for reasons unrelated to international tax planning, the regulations could be read to require the CFC to use its own employees to produce the films. An example in the regulations, in which a CFC "finances" independent persons to develop patented items in exchange for an ownership interest in such items from which the CFC derives a percentage of subsequently generated royalty income, concludes that the royalties received by the CFC are not derived in the active conduct of a trade or business.[75] The alternative reading of the regulations is that a CFC can use an independent production company to produce its films and be deemed to be actively engaged in a trade or business through the activities of the production company, provided that the CFC is the "owner" of the film (*i.e.*, bears the risk of loss) rather than, as may be inferred from the example, a party that "finances" and thereafter acquires an ownership interest in the film from the production company.

The second, alternative test that a CFC can satisfy to qualify for the active trade or business exception requires the CFC to maintain and operate an "organization" in a foreign country (i) through which the CFC is regularly engaged in the business of marketing the property through its own officers or staff of employees located in such foreign country and (ii) which is "substantial" in relation to the amount of rentals or royalties derived from the property.[76] Whether an organization is substantial is generally determined through a facts and circumstances analysis, although a safe harbor exists for an organization that has "active leasing/licensing expenses," of at least 25 percent of the "adjusted leasing/licensing profit."[77] Amounts paid to agents or independent contractors generally are excluded from "active leasing/licensing expenses" and are subtracted from gross income in calculating "adjusted leasing/licensing profit."[78]

Rents or royalties also can be excluded from subpart F income under what may be referred to as the related person

[75] Treas. Reg. § 1.954-2(d)(3), Ex. 5.

[76] Treas. Regs. §§ 1.954-2(c)(1)(iv) (rents), -2(d)(1)(ii) (royalties).

[77] Treas. Regs. §§ 1.954-2(c)(2)(ii)-(iv) (rents), -2(d)(2)(ii)-(iv) (royalties).

[78] Treas. Regs. §§ 1.954-2(c)(2)(iii)(D), (iv)(C) (rents), -2(d)(2)(iii)(D), (iv)(C) (royalties).

— same country exception. Under this exception, subpart F FPHCI does not include rents or royalties received from a corporation which is a related person for the use of, or the privilege of using, property in the CFC's country of incorporation, unless the related person is a CFC and the payment either reduces its subpart F income or creates (or increases) a deficit which under section 952(c) may reduce the subpart F income of itself or another CFC.[79] As a practical matter, the related person — same country exception affords taxpayers a much more limited opportunity, as compared to the active trade or business exceptions, for shielding rents or royalties from subpart F categorization.

Foreign base company income also includes "foreign base company services income" and "foreign base company sales income." Both types of income are derived only from transactions in which a related person is involved.

Subject to a number of limited exceptions,[80] foreign base company *services* income is income derived in connection with the performance of services which are (i) performed for or on behalf of any related person, and (ii) performed outside the CFC's country of incorporation.[81] The regulations provide that services will be considered to be performed for or on behalf of a related person if "substantial assistance contributing to the performance of such services has been furnished by a related person or persons."[82] "Assistance" is defined to include direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, materials, or supplies.[83] However, assistance in the form of direction, supervision, services or know-how is not considered substantial unless either (i) the assistance provides the CFC with skills which are a principal element in producing the income from the performance of the services by the CFC, or (ii) the cost to the CFC of the assistance equals 50 percent or more of the total cost (after any section 482

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[79] I.R.C. § 954(c)(3).

[80] *See* I.R.C. § 954(e)(2); Treas. Reg. § 1.954-4(d).

[81] I.R.C. § 954(e)(1); Treas. Regs. §§ 1.954-4(a)(1)-(2).

[82] Treas. Reg. § 1.954-4(b)(1)(iv).

[83] Treas. Reg. § 1.954-4(b)(2)(ii)(a).

adjustments) to the CFC of performing the services.[84] In at least one instance, the Internal Revenue Service has applied these regulations to recharacterize what a CFC desired to treat as income from the sale of a motion picture film to an unrelated U.S. film studio as foreign base company services income.[85] The Service determined that the U.S. studio, not the CFC, was the owner of the film because the U.S. studio had the benefits and burdens of ownership at the time of the supposed "sale." The income received by the CFC was treated as consideration for production services performed by the CFC. The income was treated as foreign base company service income because the indirect sole shareholder of the CFC provided "substantial assistance" (the shareholder was a producer and director) to the CFC in producing the film for the U.S. studio.

Foreign base company *sales* income is income derived in connection with the purchase and subsequent sale of tangible or intangible personal property if the property is (i) purchased from, or sold to, a related person, (ii) manufactured, produced, grown or extracted outside the CFC's country of incorporation, and (iii) sold or purchased for use, consumption, or disposition outside the CFC's country of incorporation.[86] If the use of a branch of the CFC outside the CFC's country of incorporation has substantially the same tax effect as if such branch were a wholly owned subsidiary of the CFC, such branch can be treated as if it were in fact a wholly owned subsidiary of the CFC, and thus as a related party for purposes of determining whether the CFC has foreign base company sales income.[87]

C. Investments in U.S. Property

Even if all of the income earned by a CFC is non-subpart F income, a "United States shareholder" may still have a current income inclusion if the CFC invests its funds in "United States property."[88] The "United States shareholder"

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[84] Treas. Reg. § 1.954-4(b)(2)(ii)(b).

[85] *See* Priv. Ltr. Rul. 95-27-010 (April 7, 1995).

[86] I.R.C. § 954(d); Treas. Reg. § 1.954-3(a).

[87] *See* I.R.C. § 954(d)(2); Treas. Reg. § 1.954-3(b).

[88] *See* I.R.C. §§ 951(a)(1)(B), 956; Treas. Reg. § 1.956-1(a).

[91] *See* Treas. Reg. § 1.956-2(a)(1).

in the United States (or is otherwise acquired or developed for use in the United States within the meaning of the statute) presumably should be determined by comparing the relative amounts of domestic and international revenues, though there is no explicit authority to that effect.

An obligation of a U.S. person generally is treated as "United States property." There are exceptions to this rule for (i) an obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both parties to the transaction had the transaction been made between unrelated persons, and (ii) obligations of a domestic corporation which is neither a "United States shareholder" of the CFC, nor a domestic corporation, 25 percent or more of the total combined voting power of which is owned, or is considered as owned by "United States shareholders." The exceptions do not apply, however, if the obligation is a trade or service receivable (i) with a U.S. person obligor and (ii) that is acquired from a U.S. person that is related to the CFC.

Lastly, "United States property" classification even extends to an obligation of a U.S. person with respect to which a CFC is a pledgor or guarantor (*i.e.*, an obligation with respect to which the assets of the CFC serve at any time as security).[92]

¶ 1802.3 FPHC Provisions

A. In General

The foreign personal holding company provisions (I.R.C. §§ 551-558) provide a series of rules, overlapping the Subpart F provisions,[93] that may result in the taxation of certain U.S. persons who own stock of a foreign personal holding company (FPHC). In general, if a corporation qualifies as an FPHC,

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[92] I.R.C. § 956(d); Treas. Reg. § 1.956-2(c). A pledge of two-thirds or more of the CFC's stock is treated as an indirect pledge of the CFC's assets if the pledge is accompanied by one or more negative covenants or restrictions on the shareholder effectively limiting the CFC's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business.

[93] *See infra* ¶ 1802.3, Section C, for a discussion of the manner in which the Subpart F provisions and the FPHC provisions are coordinated.

each U.S. shareholder[94] who is a shareholder on the day in the taxable year of the company which is the last day on which a "United States group" exists with respect to the company must include such shareholder's statutorily defined share of the corporation's undistributed income in such shareholder's gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends.[95] If a U.S. person has an amount included in gross income pursuant to the FPHC rules, that amount is determined based on such person's share of the FPHC's total undistributed taxable income (with certain adjustments) from all sources and of any character.[96] This is to be contrasted with the inclusion under the subpart F provisions, which ordinarily is based only on certain "tainted" income and investments (*e.g.*, subpart F FPHCI, foreign base company services/sales income).[97] An FPHC is defined as a foreign corporation that meets two statutory requirements, one concerning the ownership of its stock and the other concerning the character of its gross income.[98] A foreign corporation satisfies the stock ownership requirement if more than 50 percent of either (i) the total combined voting power of all classes of stock entitled to vote, or (ii) the total value of the stock of the corporation, is owned, at any time during the corporation's taxable year, directly or indirectly (applying certain stock ownership attribution rules), by or for five or fewer individuals who are citizens or residents of the United States (the "United States group").[99] It should be pointed out that the FPHC stock ownership attribution rules are considerably broader than

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[94] For purposes of the FPHC provisions, a U.S. shareholder is any U.S. person who owns any amount of stock in an FPHC. A shareholder does not have to own 10 percent or more of the voting stock to qualify as a U.S. shareholder, as is the case for subpart F purposes.

[95] *See* I.R.C. §§ 551(a)-(b); Treas. Regs. §§ 1.551-1, -2.

[96] *See* I.R.C. §§ 551(a)-(b), 556; Treas. Regs. §§ 1.556-1, -2, -3.

[97] *But See* I.R.C. § 954(b)(3)(B) (the so called "full inclusion rule" which generally treats all gross income of a CFC as "tainted" if more than 70 percent of the CFC's gross income for the taxable year is in fact "tainted"); Treas. Reg. § 1.954-1(b)(1)(ii).

[98] I.R.C. § 552(a); Treas. Reg. § 1.552-1. Certain foreign banking corporations and corporations that satisfy all of the tests for federal tax exemption applicable to domestic corporations seeking tax exempt status are specifically excluded from the definition of FPHC. I.R.C. § 552(b); Treas. Regs. § 1.552-1, -4.

[99] I.R.C. § 552(a)(2); Treas. Reg. § 1.552-3.

those that apply for subpart F purposes.[100] For example, stock is attributed between siblings for FPHC purposes but not for subpart F purposes.[101] Initially, in order to satisfy the gross income requirement, at least 60 percent of the foreign corporation's gross income for its taxable year must be foreign personal holding company income (FPHCI). For subsequent years, only 50 percent of the foreign corporation's income need be FPHCI. The lesser threshold applies until either the stock ownership requirement is not met for an entire taxable year or the expiration of three consecutive taxable years in which FPHCI is less than 50 percent of gross income.[102]

B. Foreign Personal Holding Company Income

1. In General

In order to determine if a foreign corporation satisfies the gross income requirement it is necessary to determine the total of its FPHCI for the taxable year. FPHCI generally includes, *inter alia*, dividends, interest and royalties.[103] Similar to the subpart F FPHCI rules, in the case of interest and dividends there is an exception for such items of income that are received from a related person that is a corporation organized under the laws of the same foreign country as the foreign corporation receiving the income and that has a substantial part of its trade or business assets located in the same country. However, the exception only applies if the payor is not an FPHC, and then only to the extent the interest or dividends received are not attributable to income of the payor that would be FPHCI.[104]

Of particular relevance to motion picture producers and distributors, FPHCI includes rents unless they constitute 50 percent or more of the corporation's gross income. "Rents" generally are defined as "compensation, however designated, for the use of, or the right to use, property."[105] As explained

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[100] *Compare* I.R.C. § 554 *with* I.R.C. § 958.

[101] *Compare* I.R.C. § 554(a)(2) *with* I.R.C. §§ 958(b), 318(a)(1).

[102] I.R.C. § 552(a)(1); Treas. Reg. § 1.552-2.

[103] I.R.C. § 553(a)(1).

[104] *See* I.R.C. § 552(c).

[105] I.R.C. § 553(a)(7).

in detail below, foreign corporations that earn their income from the exploitation of motion picture rights potentially may avoid FPHC status by treating such income as rents that are excluded from FPHCI under the 50 percent of gross income exception.

FPHCI also includes income attributable to services performed by an individual who owns, directly or indirectly, 25 percent or more of the foreign corporation if a person other than the foreign corporation has the right to designate the individual who is to perform the services or such individual is designated in the contract.[106] Income from the sale or disposition of such a contract is FPHCI as well.[107]

2. Rents vs. Royalties

Unlike for purposes of subpart F, whether income received in exchange for the right to use cinematographic films is classified as rent or as royalty income is highly relevant for purposes of the FPHC provisions. If such income is classified as royalty income, it automatically is treated as FPHCI, as there are no FPHC provisions available to motion picture producers and distributors that correspond to the active trade or business exceptions under subpart F. Conversely, if such income is classified as rental income, that income will not be FPHCI if it constitutes 50 percent or more of the foreign corporation's total gross income for the taxable year.

The proper classification of income received in exchange for the right to use cinematographic films is not entirely clear, although, at least for purposes of the FPHC provisions, it would appear that historical practice seems to favor treating such income as rent.

Section 553(a)(1) of the Code provides that "[d]ividends, interest, *royalties*, and annuities" are FPHCI.[108] The same

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[106] I.R.C. § 553(a)(5).

[107] *Id.*

[108] I.R.C. § 553(a)(1) (emphasis added). While the regulations under section 553 are not wholly irrelevant, they have never been updated to reflect the amendments made to the FPHC provisions in 1964. We will rely, consequently, on the Code provision as the relevant authority and simply note that the regulations expressly provide that copyright royalties are treated as FPHCI. Treas. Reg. § 1.553-1(b)(1). Since the Code provides that "royalties" (with the single exception of active business computer software royalties) are FPHCI, there is no reason to doubt that "copyright royalties" are FPHCI even without considering the regulation.

section of the Code expressly excludes "active business computer software royalties" from FPHCI status. Unlike royalties, rents, which, as previously mentioned, generally are defined for purposes of the FPHC provisions as "compensation, however designated, for the use of, or the right to use property," are not FPHCI if they constitute at least 50 percent of the foreign corporation's gross income.[109] Although rents are defined as compensation for the use of, or the right to use property, that definition would seem to apply equally to royalties. So how does one determine whether the consideration received in exchange for the use of, or the right to use property constitutes rent or a royalty?

For tax purposes, a royalty generally is thought to refer to a payment for the use of valuable *intangible* property rights,[110] but such a definition of "royalty" does not explain provisions of the Code that apply to "rents or royalties for the use of or for the privilege of using . . . patents, copyrights, secret processes and formulas, good will, trade-marks, trade

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[109] I.R.C. § 553(a)(7).

[110] *See Disabled Am. Veterans v. Commissioner*, 94 T.C. 60, 70 (1990) (holding that the payments received by a tax exempt organization in exchange for the use of names on its donor list were royalties (and not "rentals" as designated in the relevant contractual agreements) and thus not taxable as unrelated business taxable income), *rev'd on other grounds*, 942 F.2d 309 (6th Cir. 1991); *Sierra Club v. Commissioner*, 65 T.C.M. (CCH) 2582 (1993) (similar). In its decision in *Disabled Am. Veterans*, the Tax court cited as authority for its definition of "royalty" Rev. Rul. 81-178, 1981-2 C.B. 135 (an unrelated business taxable income ruling) and the cases cited therein. The issue in most of the cases cited in the revenue ruling and *Disabled Am. Veterans* was whether the payments received by the taxpayer were proceeds from the sale of property rights or, instead, "rentals or royalties for the use of or the privilege of using in the United States, . . . copyrights, . . . and other like property." In each such case, the court characterized the payments as royalties. However, because of the relevant statutory language, it was immaterial whether such payments were characterized as royalties or rents; in either case, the outcome was the same. Consequently, the decisions in these cases made no attempt to distinguish the royalties received by the taxpayers from "rent" and therefore are not directly on point. *See Commissioner v. Wodehouse*, 337 U.S. 369 (1949); *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946); *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938). In one case cited in Rev. Rul 81-178 and *Disabled Am. Veterans*, the court's characterization of the payments received by the taxpayer as royalties as opposed to rents was determinative for purposes of finding the taxpayer to be a personal holding company. Nevertheless, the court made no attempt to distinguish the payments received by the taxpayer from rents even though the relevant regulation provided that rents received by an operating company were not royalties. *See Commissioner v. Affiliated Enters.*, 123 F.2d 665 (10th Cir. 1941), *cert. denied*, 315 U.S. 812 (1942).

brands, franchises, and other like property."[111] All of the types of property enumerated in those sections of the Code are intangibles, yet the language used clearly implies that "rents" can be received in exchange for the use of such property.[112] Nevertheless, once it is accepted that a royalty is a payment received in exchange for the use of, or the right to use intangible property rights, the relevant inquiry would appear to be whether payments received in exchange for the right to exhibit or distribute motion picture films are payments for the use of the intangible copyrights on such films. This is an issue that has already been examined in connection with the nexus rule for foreign source income under section 864(c)(4)(B). As discussed previously, one could conclude that payments for the right to exhibit or distribute copyrighted films are payments for the use of the intangible copyrights.[113]

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[111] I.R.C. §§ 861(a)(4), 862(a)(4). *See also* I.R.C. § 864(c)(4)(B)(i) (referring to "rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4)").

[112] One possible explanation for these provisions of the Code is that, at least for some purposes, the difference between rents and royalties has been stated as:

> the commonly accepted one that rent is a compensation for the right to use property which is fixed and certain in amount and payable periodically over a fixed period regardless of the extent of the use of the property, while royalty is a compensation for the use of property which is based as to amount entirely upon the use actually made of the property.

Logan Coal & Timber Assn. v. Commissioner, 122 F.2d 848, 850 (3rd Cir. 1940) (footnotes omitted) (addressing payments for use of property for extraction of minerals in the context of the personal holding company provisions); *see also Johnson Inv. & Rental Co. v. Commissioner*, 70 T.C. 895 (1978) (same); *Western Union Tel. Co. v. Am. Bell Tel. Co.*, 125 F. 342 (1st Cir. 1903) (stating that "[r]entals in their ordinary signification are not limited as royalties in their ordinary signification; that is, to something proportionate to the use of the patented device. The word 'ordinarily' means specific sums paid annually, or at other stated periods, for the right to use a patented device, whether it is used much or little or not at all"). The statutory provisions addressing the source of income may have been enacted with such "commonly accepted" distinction in mind, and may have been drafted to indicate that the source of and taxability of income received by a non-U.S. person in exchange for the use of or the right to use an intangible is in no way dependent on whether payment is received in a fixed and certain amount or is instead tied to the actual use made of the property. *But see Commissioner v. Wodehouse*, 337 U.S. 369 (1949); *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946); *Commissioner v. Affiliated Enters.*, 123 F.2d 665 (10th Cir. 1941), *cert. denied*, 315 U.S. 812 (1942); *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938) (each case finding fixed and certain payments received in exchange for the use of intangible property rights to be royalties).

[113] *See supra* ¶ 1801.2, section B.2.

As stated by the Court of Appeals for the Ninth Circuit, "[m]ost of the value of the exhibition prints rests on the right of exclusive exploitation protected by copyright."[114] Such reasoning would lead to the conclusion that income received in exchange for the right to exhibit or distribute motion pictures should be treated as royalty income for purposes of the FPHC provisions. On the other hand, "[o]n this point a page of history [may be] worth a volume of logic."[115]

The fact of the matter is that there is not a clean slate on which to analyze the FPHC provisions. As early as 1954, the Service expressly treated income from the theatrical exhibition of films as rent for purposes of the FPHC rules then in effect.[116] This was so even though the gross income derived from the exhibition of the films was based on a stated percentage of the gross receipts.[117] Apparently the Service's conclusion was based on three factors: (i) common usage — since the origin of motion picture films, compensation for the right to exhibit films had been regarded as "rentals" by those involved in the industry, as well as by Internal Revenue Service agents throughout the country; (ii) prior legislation with respect to the taxation of the motion picture industry — the Revenue Act of 1919 imposed an excise tax on those involved in the business of leasing or licensing motion picture films based on the total "rentals" earned; and (iii) legislative intent — it was determined that Congress did not intend to have the personal holding company provisions apply to active operating companies.[118]

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[114] *Disney II*, 549 F.2d at 581.

[115] *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

[116] *See* Rev. Rul. 54-284, 1954-2 C.B. 275; *see also* Gen. Couns. Mem. 24697 (June 14, 1945) (providing the reasoning that presumably underlies the succinct one paragraph conclusion of Rev. Rul. 54-284).

[117] *See* Rev. Rul. 54-284, 1954-2 C.B. 275.

[118] *See* Gen. Couns. Mem. 24697 (June 14, 1945). Gen. Couns. Mem. 24697 specifically addresses the rent versus royalty issue for purposes of the personal holding company provisions, but the analysis is equally applicable for purposes of the FPHC provisions which, prior to 1964, defined FPHCI by reference to the definition of personal holding income. This is confirmed by Rev. Rul. 54-284 which held explicitly that the compensation received by the taxpayer from the distribution and exhibition of its motion pictures was rent for purposes of both the personal holding company provisions and the FPHCI provisions. It also should be noted that while the General Counsel Memorandum specifically addressed income earned by a "producer" of motion pictures, Rev. Rul. 54-284 indicates that even when a taxpayer "acquires" the rights to motion pictures and subsequently earns income from their distribution and exhibition, such income constitutes rent.

In 1960 the personal holding company provisions were amended to provide that "copyright royalties" would be treated as rents unless such income constituted 50 percent or more of the corporation's gross income and certain other conditions were met.[119] That amendment was a liberalization of the personal holding company provisions which, prior to 1960, had treated all royalties (with the exception of mineral, oil and gas royalties constituting at least 50 percent of adjusted ordinary gross income, and provided certain other conditions were met) as personal holding company income. As amended in 1960, the personal holding company statute also provided that compensation that constituted rent for purposes of the personal holding company provisions (whether or not constituting 50 percent or more of gross income) was not to be treated as copyright royalties.[120] The legislative history makes clear that the specific exemption of rent from treatment as copyright royalties was intended to ensure that "amounts which have long been interpreted as being rents, such as motion-picture films or television films (including those electronically recorded on tape)" continued to be treated as such.[121] Although the FPHC provisions generally defined FPHCI by reference to the definition of personal holding company income, the FPHC provisions also were amended in 1960 so that all royalties, whether or not copyright royalties, continued to be treated as FPHCI.[122] In other words, the FPHC provisions were not liberalized. Nevertheless, the change in the FPHC provisions had no effect on the classification of income received from the use of, or right to use motion picture films, which continued to be treated as rent for FPHC purposes.

Both the personal holding company provisions and the FPHC provisions were amended again in 1964. For purposes of the personal holding company rules, the term "copyright

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[119] Pub. L. No. 86-435, § 1(a), 74 Stat. 77 (1960).

[120] *Id.*

[121] S. Rep. No. 1041, 86th Cong., 2d Sess., 1960-1 C.B. 817, 819; *see also id.* at 818 ("Your committee has also added a sentence to make it clear that this new [copyright royalty provision] is not to apply to compensation such as that for the use of motion picture films, etc., which has by the Treasury Department been classified as rents rather than royalties.")

[122] *See* Pub. L. No. 86-435, § 1(e), 74 Stat. 77 (1960).

royalties" was modified to specifically include payments for the use of, or right to use, films.[123] However, a carve out was provided for "produced film rents" which were defined as "payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film."[124] This change restricts the application of the Service's 1954 ruling which otherwise did not contain any requirement with respect to when a taxpayer had to acquire rights in a motion picture in order to have the income derived therefrom treated as rent for purposes of the personal holding company provisions.

The 1964 amendments to the FPHC provisions incorporated neither the change in the personal holding company definition of "copyright royalties" (*i.e.*, to include film royalties that did not qualify as "produced film rents") nor the addition of "produced film rents" as a separate category of income. The FPHC provisions simply were rewritten, without substantive change, to eliminate all of the former references to the personal holding company provisions.[125] The legislative history states:

> Thus, under the amendment, [the section defining FPHCI] contains all of the relevant provisions which appear in [the section defining personal holding company income] and [the section defining FPHCI] of existing law . . . .
>
> Accordingly the substantive rules provided in [the section defining personal holding company income] . . . of existing law (which [is] made applicable to foreign personal holding companies by [the section defining FPHCI] . . . of existing law) [is] retained in the code, with respect to foreign personal holding companies, without change.[126]

Thus, immediately following the amendments to the FPHC provisions in 1964, income received in exchange for the use

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[123] *See* I.R.C. § 543(a)(4); Pub.L. No. 88-272, § 225(d), 78 Stat. 19 (1964).

[124] *See* I.R.C. §§ 543(a)(4)-(5); Pub. L. No. 88-272, § 225(d), 78 Stat. 19 (1964).

[125] *See* P.L. 88-272, § 225(e), 78 Stat. 19 (1964).

[126] H.R. Rep. No. 749, 88th Cong., 1st Sess., 1964-1 (Part 2) C.B. 125, 352; *see also id.* at 203, 345-46; S. Rep. No. 830, 1964-1 (Part 2) C.B. 505, 612-13.

of, or the right to use motion picture films, whether for theatrical or television exhibition, and regardless of whether the rights in those films were acquired prior to substantial completion of such films, appears to have been treated as rent for FPHC purposes. The question that remains, however, is whether anything has occurred in the past thirty-four years which would cause such income to be treated as royalties, instead of rents, for purposes of the FPHC provisions.

Since the 1964 amendments to both the personal holding company provisions and the FPHC provisions, no new regulations or rulings have been issued and no new cases have been decided that address the proper characterization, for purposes of the FPHC provisions, of income received in exchange for the use of, or the right to use, motion pictures. However, in the context of other Code and U.S. income tax treaty provisions, the Service has issued guidance as to the proper characterization of income derived from the exhibition of motion picture films via various media. Such guidance may provide some indication of the position the Service likely would take in the FPHC area.

In 1975 the Service issued a revenue ruling in which it held that income earned by a taxpayer from the distribution and exhibition of theatrical motion pictures was not rent, and therefore not passive investment income (*e.g.*, rents and royalties), for purposes of subchapter S because the taxpayer rendered significant services in connection with the payments it received.[127] The relevant statutory provision expressly excluded from the definition of "rent" payments received for the use of property where significant services were rendered in connection with such payments. The clear implications of the Service's ruling were twofold: (i) in the absence of the taxpayer's rendering of significant services, the payments it received would have been treated as rent, and (ii) the payments the taxpayer received were not royalties (if they had been, they would have been treated as passive investment income).

On the other hand, a 1978 General Counsel Memorandum (the "1978 GCM") provides that payments received by a

[127] Rev. Rul. 75-349, 1975-2 C.B. 349.

corporation for the initial broadcast rights to television specials produced by the corporation are copyright royalties, not rents, and thus passive investment income for subchapter S purposes.[128] The 1978 GCM distinguishes the 1975 revenue ruling by noting that the facts of the ruling implied that the taxpayer in question was a mere distributor, not a producer, of motion picture films, and therefore owned no copyright interest in the films.[129] Significantly, the 1978 GCM acknowledges that the same income derived by the taxpayer from the broadcast rights to its television specials would not be copyright royalties for purposes of the personal holding company provisions; the implication being that such income would be "produced film rents" for such purposes.[130] Taking the analysis one step further, given the evolution of the personal holding company and FPHC provisions described above, the 1978 GCM implies that the income received by the taxpayer for its television broadcast rights would not be royalties for purposes of the FPHC provisions; rather, such income would be treated as rent. At the same time, the 1978 GCM indicates that at least one factor that led the Service, in 1954, to take the position that income from the distribution and exhibition of motion picture films is rent for purposes of the personal holding company and FPHC provisions may not be relevant in the case of the distribution of films for television broadcast; namely, based on the Service's review of standard contracts, it appeared that the payments received in exchange for television broadcast rights were not commonly referred to as "rentals," but rather as "license fees."[131] Nevertheless, it seems that income received in exchange for television broadcast rights should be characterized as rentals for FPHC purposes since, as noted in the 1978 GCM, another factor underlying the position taken by the Service in 1954 was that the personal holding company and FPHC provisions were not intended to operate so as to tax active operating companies. A film production company is an active operating company regardless of whether it produces films for theatrical distribution or for television broadcast.

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[128] Gen. Couns. Mem. 37710 (Sept. 29, 1978).

[129] *Id.*

[130] *Id.*

[131] *Id.*

In a private letter ruling released in 1981, the Service indicated that video tape recordings are distinguishable from motion picture films for tax purposes with the result that the income received for the use of the former is not necessarily treated the same as income received for the use of the latter.[132] In particular, the Service determined that under a specific U.S. income tax treaty, U.S. source income received by a non-U.S. person for the television distribution rights to its animated video tape programs were not "rents or royalties in respect of motion picture films" and consequently were exempt from U.S. withholding tax.[133]

The Service's post-1964 guidance raises two questions. First, have motion picture industry economics and practices changed sufficiently dramatically since 1954 so as to potentially undermine the ability to rely upon Revenue Ruling 54-284? Second, is it possible that although income from the theatrical distribution of motion pictures constitutes rent for FPHC purposes, income from distribution of films via television or video tapes constitutes royalties for such purposes? Two lines of reasoning suggest that the answer to both questions should be no. First, as previously discussed, the legislative history to the 1960 and 1964 amendments to the personal holding company and FPHC provisions seems to clearly indicate a congressional purpose to treat income from motion picture films, regardless of the media through which such films are distributed, as rent for purposes of the FPHC provisions.[134] Second, the inconsistent treatment of motion picture films from one section of the Code to another suggests that rulings issued and positions taken by the Service concerning the characterization of the income received from such films for purposes of subchapter S, or for interpreting a provision of a U.S. income tax treaty, should not be accorded great weight for purposes of determining the proper characterization of such income under the FPHC provisions.

C. Subpart F Overlap

In many situations, a foreign corporation will qualify as both a CFC and an FPHC, and a U.S. person will be subject

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[132] *See* Priv. Ltr. Rul. 81-47-151 (Aug. 28, 1981).

[133] *Id.*

[134] *See* discussion *supra* notes 119-126 and accompanying text.

to tax under both subpart F and the FPHC provisions. Much of the same income that is subject to tax under the FPHC provisions may be subject to tax under subpart F. In such a situation, there is not double taxation of the same income. Rather the Code provides that if income is subject to tax under both subpart F and the FPHC provisions, it generally is taxed only under the former.[135] However, any income that escapes tax under subpart F may still be taxed under the FPHC regime.

¶ 1802.4 Passive Foreign Investment Company ("PFIC") Provisions

A. In General

If a foreign corporation qualifies as a PFIC, a U.S. shareholder generally is subject to the special tax treatment described below upon the receipt of an "excess distribution" in respect of such shareholder's stock in the PFIC or upon the sale or other disposition of such stock. Importantly, in contrast to the subpart F and FPHC indirect tax regimes, there is no stock ownership threshold of any kind for PFIC purposes; if a foreign corporation is a PFIC and has only one U.S. shareholder who owns one share of stock, such shareholder will be subject to the special PFIC system of taxation.

The purpose of the PFIC tax regime is to subject U.S. shareholders to approximately the same tax consequences as if income of the PFIC had been distributed each year. In other words, it is designed to eliminate any deferral benefit that U.S. shareholders might otherwise obtain by earning income through, and accumulating income in, a PFIC.

In fact, the special tax treatment of excess distributions potentially results in more onerous tax treatment of U.S. shareholders than if the PFIC were to distribute all of its income annually. As an alternative to being taxed in accordance with those special tax rules, a U.S. shareholder generally can elect to treat the PFIC as a qualified electing fund (QEF) and thereby be subject to tax on an annual basis on such shareholder's pro rata share of the PFIC's earnings and profits. If such an election is made, the character of the

[135] *See* I.R.C. § 951(d); Treas. Reg. § 1.951-3.

income in the hands of the U.S. shareholder will be the same as the character of the income as earned by the PFIC.

B. Income/Asset Tests

A foreign corporation qualifies as a PFIC if it satisfies either an income test or an asset test. In accordance with the income test, a foreign corporation is a PFIC if 75 percent or more of its gross income for its taxable year consists of certain specified classes of passive income.[136] Pursuant to the asset test, a foreign corporation is a PFIC if assets that produce such passive income, or which are held for the production of passive income, comprise more than 50 percent of the average value of its assets held during the taxable year.[137] The asset test is especially important for the U.S. shareholders of foreign film production companies because even if they are able to avoid the perils of the subpart F and FPHC provisions, once the production companies accumulate too much cash or other passive assets, the PFIC provisions will apply and vitiate the benefit of any further deferral of U.S. taxation.

If a foreign corporation is a PFIC and a timely QEF election is not made, then special throwback rules apply when its U.S. shareholders receive an "excess distribution" or dispose of their shares in the PFIC.[138] An excess distribution is effectively defined as a distribution for a taxable year in excess of 125 percent of the average amount of distributions received during the prior three years.[139] The excess distribution is allocated over the shareholder's holding period in the stock, and the amount allocated to each year is subject to the highest applicable income tax rate in existence for such year.[140] Any gain derived upon the disposition of PFIC stock is taxed in an identical manner.[141] In addition, in both cases, an interest charge applies to each of the throwback years, thus eliminating any tax deferral benefit the taxpayer would otherwise obtain.[142]

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136 I.R.C. § 1296(a)(1).

137 I.R.C. § 1296(a)(2).

138 I.R.C. § 1291(a)(1).

139 I.R.C. § 1291(b).

140 *See* I.R.C. §§ 1291(a)-(c).

141 I.R.C. § 1291(a)(2).

142 *Id.*

A U.S. shareholder can elect to treat a PFIC as a QEF and thereby avoid this generally undesirable tax treatment.[143] Such an election generally should be made for the first taxable year that the U.S. shareholder holds stock in a PFIC. A U.S. person that is a QEF shareholder is subject to current taxation on the QEF's income, and the character of the income as earned by the PFIC generally is preserved.[144] Upon disposition of stock in a QEF at a gain, a U.S. shareholder is treated as receiving capital gain income.[145]

C. Passive Income/Assets

In order to apply either the income test or the asset test to determine if a foreign corporation is a PFIC, it is necessary to know what constitutes passive income and assets for PFIC purposes. Borrowing from one of the other indirect tax regimes, passive income for purposes of the PFIC provisions is defined by cross-reference to subpart F FPHCI with certain modifications.[146] Assets are characterized by reference to the type of income they produce.[147] As a result, film rents and royalties are characterized as passive income unless they are excluded from subpart F FPHCI because they constitute "active" rents and royalties.

Intangible assets, such as goodwill, that are associated with active income are treated as active assets. However, if the PFIC is also a CFC, the calculation of the PFIC's active and passive assets is required to be based on the adjusted basis of the assets, rather than on the fair market value of the assets.[148] This rule is detrimental to corporations that otherwise would benefit from the ability to use the fair market value of their intangible assets to avoid PFIC status. It also should be noted that there is a special rule that may apply for determining the adjusted basis of the assets of a CFC that is the licensee of intangible property which it uses in the active conduct of a trade or business.[149]

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[143] I.R.C. § 1291(d).

[144] I.R.C. § 1293(a).

[145] *See* I.R.C. §§ 1293, 1295.

[146] I.R.C. § 1296(b).

[147] *See* I.R.C. § 1296(a)(2).

[148] I.R.C. § 1296(a).

[149] *See* I.R.C. § 1297(e)(2).

For purposes of the PFIC income and assets tests, certain look-through rules apply. If a foreign corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, such foreign corporation is treated as owning its proportionate share of the assets of such other corporation, and as if it received directly its proportionate share of the income of such other corporation.[150]

D. Coordination with Subpart F

In general, relief from potential taxation of the same income under both subpart F and the PFIC provisions is provided. If a U.S. shareholder who has made a QEF election would otherwise have an amount included in gross income as subpart F income and pursuant to the PFIC rules, it is only included in income pursuant to subpart F.[151]

¶ 1803 QUALIFIED COST SHARING ARRANGEMENTS

The production of motion pictures through "qualified cost sharing arrangements" may be an extremely useful part of an overall plan to minimize U.S. income taxes associated with the exploitation of worldwide motion picture rights.

¶ 1803.1 Overview

U.S. film production companies increasingly enter into co-production agreements both with unrelated third parties and with foreign affiliates, frequently with the intention of having the U.S. corporation own the U.S. rights and the foreign parties own the foreign rights in the film produced pursuant to the agreement. If the foreign rights can be exploited without having the income earned therefrom subjected to direct or indirect U.S income taxation until distributions are made to U.S. shareholders, substantial tax savings can be achieved. However, where these arrangements involve taxpayers under common control the allocation of costs and benefits of the arrangement is potentially subject to challenge and redetermination by the Service under section 482. The

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[150] I.R.C. § 1296(c).

[151] *See* I.R.C. § 951(f).

cost of contesting the Service's determination and the potential loss of expected tax benefits could be substantial. Regulations have been issued under section 482 that set forth the specific circumstances under which the taxpayers' cost sharing agreement and allocation of rights in intangibles they produce through their joint efforts generally will be respected, and certain other important assurances will be given, for U.S. income tax purposes.[152] A cost sharing agreement that meets the requirements for this section 482 safe harbor is called a "qualified cost sharing arrangement."[153]

If a co-production or split-rights agreement is a qualified cost sharing arrangement, the Service will not make allocations with respect to the agreement except to the extent necessary to make each controlled participant's share of the costs of development of the intangible under the agreement equal to is share of reasonably anticipated benefits attributable to such development.[154] So, for example, assume a U.S. co-producer and an affiliated foreign co-producer develop a theatrical motion picture pursuant to a qualified cost sharing agreement with the U.S. co-producer acquiring the U.S. rights in the final product and the foreign co-producer acquiring the non-U.S. rights therein, with each co-producer contributing $5x of the $10x total cost of film production. Assume further that the foreign rights ultimately generate $100x in royalty income while the domestic rights generate only $50x in royalty income. The largest adjustment the Service would be able to make would be to increase the foreign co-producer's share of the costs to somewhere between $5x and $10x, the total production cost. In contrast, if there were no qualified cost sharing arrangement the Service might attempt to allocate all or a portion of the $100x derived from the foreign rights to the U.S. co-producer. When there is a qualified cost sharing arrangement, the ownership of various rights in the intangible is fixed, and only the allocation of the cost of producing the intangible is subject to adjustment.

Another benefit of having a co-production agreement that is a qualified cost sharing arrangement is that it will not be

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[152] *See* Treas. Reg. § 1.482-7.

[153] *See* Treas. Regs. §§ 1.482-7(a)-(b).

[154] Treas. Reg. § 1.482-7(a)(2).

treated as a partnership for U.S. tax purposes.[155] Consequently, the non-U.S. co-producer will not be deemed to be engaged in a trade or business in the United States through the activities of a relationship that otherwise would be subject to the risk of being classified as a partnership. This insulation from partnership classification thus provides greater opportunities to avoid direct U.S. income taxation under the regimes previously described, without regard to tax treaty considerations.

Moreover, there are a host of other significant tax issues that could arise if the co-production were to be treated as a partnership. For example, the producer may be taxed upon formation of the imputed partnership if the producer receives a capital interest in the deemed partnership in exchange for services. If the imputed partnership is not created or organized under U.S. law, whoever initially owns the film rights may be subject to a 35 percent excise tax under section 1491 upon a contribution of the film rights to the deemed partnership. Moreover, if the allocations of taxable income, losses and credits of the partnership do not have "substantial economic effect," they will be reallocated in accordance with each partner's interest in the partnership pursuant to section 704(b) of the Code. The allocations under the cost sharing arrangement may not have the requisite substantial economic effect.

There is yet another benefit to be obtained by having co-production agreements constitute qualified cost sharing arrangements. Pursuant to the pertinent regulations, if a non-U.S. person is a participant in a qualified cost sharing arrangement, such person will not be treated as engaged in a trade or business within the United States solely by reason of its participation in such arrangement.[156] Again, this protection from being deemed engaged in a trade or business within the United States facilitates the avoidance of direct U.S. income taxation.

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[155] *See* Treas. Reg. § 1.482-7(a)(1).

[156] Treas. Reg. § 1.482-7(a)(1).

¶ 1803.2 General Requirements

In order for a cost sharing arrangement (*e.g.*, co-production agreement) to be a "qualified cost sharing arrangement" and thereby qualify for the benefits described above, it must satisfy each of the following four requirements.

First, the arrangement must include "two or more participants."[157] The regulations, on their face, appear to allow a qualified cost sharing arrangement that is solely between two or more unrelated parties, since "participant" is defined to include "an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant)"[158] and there is no express requirement that there be a minimum of two controlled participants that are parties to the arrangement. Nevertheless, allowing a qualified cost sharing arrangement between two or more unrelated parties under a regulation promulgated pursuant to section 482 of the Code is peculiar, given that section 482 is specifically targeted at transactions between businesses that are controlled by the same interests.

A controlled taxpayer may be a "controlled participant," and thus a "participant," only if, among other requirements, it reasonably anticipates that it will derive benefits from the use of the intangibles covered by the cost sharing agreement.[159] This should not be a difficult requirement for motion picture co-producers to meet.

Prior to their modification in May, 1996, the regulations (which were initially finalized in December, 1995) provided that a controlled taxpayer could only be a controlled participant if it used, or reasonably expected to use, the covered intangibles in the active conduct of a trade or business.[160] The former regulations went on to provide that covered intangibles would not be considered to be used in the active conduct of a trade or business if a principal purpose for participating in the cost sharing arrangement was to obtain the intangible for transfer or license to a controlled or uncontrolled party.[161]

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[157] Treas. Reg. § 1.482-7(b)(1).

[158] Treas. Reg. § 1.482-7(c)(1).

[159] Treas. Reg. § 1.482-7(c)(1)(i).

[160] Former Treas. Reg. § 1.482-7(c)(2).

[161] Former Treas. Reg. § 1.482-7(c)(3).

Consequently, under the former regulations it was unlikely that motion picture production companies would be able to avail themselves of qualified cost sharing arrangements, since co-producers rarely distribute the films they produce.

The second requirement that must be satisfied in order to have a qualified cost sharing arrangement is that the arrangement must provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits.[162] This requirement is discussed further below.

The third requirement is that the arrangement must provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement.[163]

Finally, the arrangement must be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes certain information, including (i) the arrangement's participants and certain other beneficiaries of the arrangement, (ii) the cost/benefit methodology used to satisfy requirement number two and the cost adjustment mechanism employed to satisfy requirement number three, (iii) a description of each participant's interest in any intangible property developed as a result of the research and development undertaken pursuant to the cost sharing arrangement, and (iv) the conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination.[164]

¶ 1803.3 Costs and Benefits Methodology

As stated above, a qualified cost sharing arrangement must provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect the participant's share

[162] Treas. Reg. § 1.482-7(b)(2).

[163] Treas. Reg. § 1.482-7(b)(3).

[164] Treas. Reg. § 1.482-7(b)(4).

of anticipated benefits. The regulations go on to provide rules for choosing such a method. First, the costs of developing the covered intangible must be determined. Then the taxpayer must determine the most reliable method for measuring each participant's anticipated benefits in order to allocate the costs among the participants based on anticipated benefits.

All costs incurred in the development of the intangible must be taken into account in computing the costs to be shared by the participants.[165] On the other side of the equation, benefits are defined as additional income generated or costs saved by use of covered intangibles. A controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.[166] A controlled participant's anticipated benefits must be measured on the most reliable basis, whether direct or indirect.[167]

Anticipated benefits are measured on a direct basis by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles.[168] Anticipated benefits are measured on an indirect basis by reference to certain measurements reasonably assumed to be related to income generated or costs saved such as (i) units sold, produced or used, (ii) sales, and (iii) operating profit. Other bases may, in certain circumstances be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles.[169]

The regulations recognize that projections will need to be used to determine the reasonably anticipated benefit from the exploitation of the intangible. If there is a significant divergence over time between projected and actual benefits, the regulations assume the projections were unreliable and the Service may use actual benefits as the most reliable measure

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165 *See* Treas. Reg. § 1.482-7(d)(1).

166 Treas. Reg. § 1.482-7(e).

167 Treas. Reg. § 1.482-7(f)(3)(ii).

168 *Id.*

169 Treas. Regs. §§ 1.482-7(f)(3)(ii)-(iii).

of anticipated benefits. However, projections generally will not be considered unreliable if the divergence for every controlled participant is less than or equal to 20 percent of the participant's projected benefit share.[170]

¶ 1803.4 Buy-ins/Buy-outs

If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner equal to the arm's length charge for the use of the intangible. Similarly, if a controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of another participant, the participant relinquishing the interest must receive an arm's length consideration for its interest.[171]

¶ 1803.5 Administrative Requirements

A separate subsection of the regulations requires controlled participants to maintain certain documentation necessary to meet the documentation requirements for qualified cost sharing arrangement status, plus certain additional information. In addition, a controlled participant must satisfy certain reporting requirements. Specifically, a controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.[172]

¶ 1804 CONCLUSION

By precluding the existence of a United States trade or business, as well as a de facto partnership, for federal income

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[170] Treas. Reg. § 1.482-7(f)(3)(iv).

[171] Treas. Regs. §§ 1.482-7(g)(2)-(4).

[172] *See* Treas. Reg. § 1.482-7(j).

tax purposes, the cost sharing regulations go a long way in assisting foreign co-producers to acquire and exploit international motion picture rights without incurring direct U.S. tax costs. Following the elimination of the active trade or business requirements previously applicable to controlled participants, the current regulations make these benefits equally available to intra-group endeavors. Of at least equal significance is the ability of controlled groups to utilize the regulations for their primary purpose, the avoidance of income reallocations in connection with intangible development efforts. To the extent that the internationalization of the film business and the commercial importance of foreign markets continue to grow, co-production agreements specifically designed to constitute qualified cost sharing arrangements can be expected to become increasingly commonplace in the motion picture industry with respect to both related and third-party transactions.

The ability of U.S. persons to employ these tools when acquiring interests in the non-U.S. rights to American motion pictures does not, however, resolve the open issues or solve the planning problems that persist under the indirect tax regimes summarized above. Nor do the qualified cost sharing regulations afford any specific relief from the barriers to avoiding U.S. withholding tax that exist under the limitations on benefits articles and conduit financing regulations. Despite these challenges, opportunities are available, and international tax planning for motion picture production and distribution remains vital.