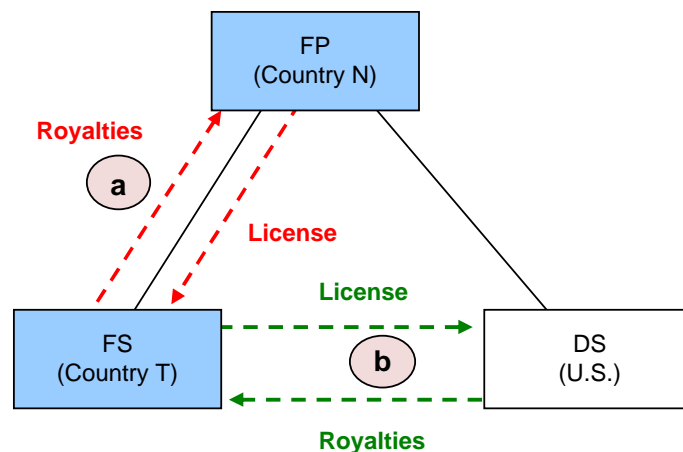


Reg. 1.881-3(e), Example 11

No Reduction in Tax, Cascading Royalties

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On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate.

Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are [according to the IRS] income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by §1.881-2(b) and subject to withholding under Reg. 1.1441-2(a). Because the rate of tax imposed on royalties paid by FS to FP is the same as the rate that would have been imposed on royalties paid by DS to FP, the participation of FS in the FP-FS-DS financing arrangement does not reduce the tax imposed by section 881 within the meaning of Reg. 1.881-3(a)(4)(i)(A) of this section. Accordingly, FS is not a conduit entity.

See also Rev. Rul. 80-362 and *SDI Netherlands BV v. Commr*, 107 T.C. 161 (1996).

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