X, a resident foreign corporation, owns a trademark for certain products in many foreign countries. X corporation entered into a license agreement with Y, a domestic corporation, pursuant to which Y was given the right to place the foreign trademark owned by X on Y's products and sell the trademarked products. The United States trademark for these products is owned by Z, an unrelated party. The license agreement between X and Y is a conventional trademark license agreement for a limited period of time and includes customary provisions to identify and protect the licensor's proprietorship of this mark. Under the terms of the license, Y corporation pays X corporation a royalty measured by a percentage of the initial sales price of the trademarked products. Y manufactures the trademarked products in the United States and sells them to foreign buyers in the United States for resale and consumption in foreign countries; all rights, title, and interest of Y in the products pass to the foreign buyers within the United States. Thus, the initial sale of the trademarked products is regarded as having taken place in the United States.

The question presented was whether, by reason of the initial sale of the products to the foreign buyers in the United States, Y corporation has "used" the foreign trademark in the United States and the royalties paid by Y to X are income from sources within the United States. Section 861(a)(4) states, in part, that royalties for the use of or for the privilege of using in the United States trademarks and other like property shall be treated as income from sources within the United States. Section 862(a)(4) states, in part, that royalties for the use of or for the privilege of using without the United States trademarks and other like properties shall be treated as income from sources without the United States.

The gist of a trademark is its association in the public mind with the product, it being the identifying mark of the trade. The function of a trademark is to designate the goods as the product of a particular trader and to protect his goodwill against the sale of another's product as his. In the instant case the character of X corporation's income is royalty income measured by a percentage of the sales of the foreign trademarked products. The initial sale of the trademarked products to foreign shippers is a means of placing the products in the avenues of commerce with a view towards their ultimate consumption outside the United States. Although the amount of the royalty income is measured by the sales of the trademarked products, the place of sale does not necessarily determine the source of such royalty income. The royalties paid by Y to X are paid for the use of the trademarks in the foreign countries. The place of initial sale of the trademarked products is not the controlling factor in the determination of the source of income. Accordingly, in the instant case, where products are ultimately used in the foreign country where their trademark is protected, a royalty, received by X for the use of the foreign trademark, is income from sources outside the United States despite the fact that the initial sale of the trademarked articles took place in the United States.