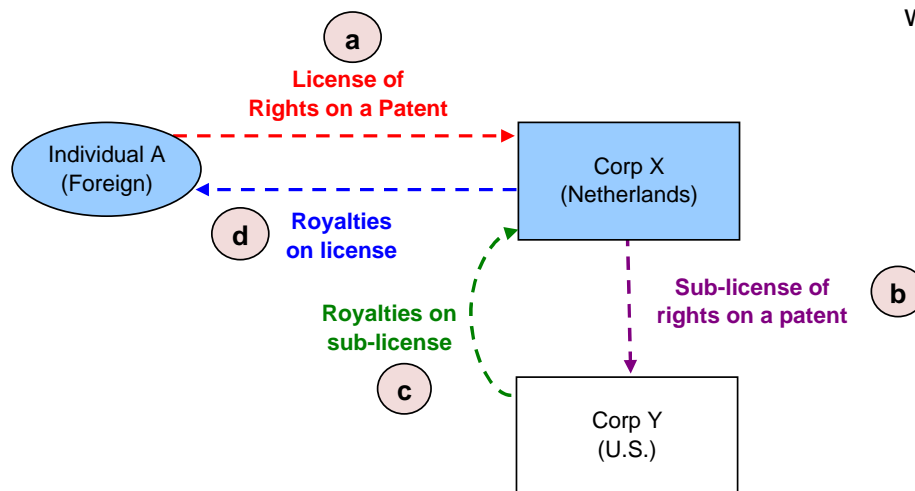


**Cascading Royalties**



A, a citizen and resident of a country other than the United States or the Netherlands, licenses the United States rights on a patent to X, a Netherlands corporation. X is a bona fide corporation unrelated to A. X agrees to pay A a fixed royalty each year in return for the patent license. X relicenses the patent to Y, a United States corporation, for use in the United States. Y agrees to pay X royalties based on the number of units produced by Y each year under the patent. X's fixed royalty to A is not contingent upon the receipt of royalties from Y. A's royalty income is not effectively connected with the conduct of a trade or business within the United States within the meaning of section 871(b). The United States-Netherlands Income Tax Treaty provides that royalties paid to a resident or corporation of the Netherlands shall be exempt from tax by the United States. There is no income tax treaty between A's country of residence and the United States.

Code § 861(a)(4) provides that royalties for the privilege of using a patent in the United States are treated as income from sources within the United States. Code § 871(a)(1)(A) imposes a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. Treas. Reg. § 1.871-7(b) provides that royalties, including royalties for the use of a patent, constitute fixed or determinable annual or periodical income to which the 30-percent tax rate imposed by Code § 871(a)(1)(A) applies.

Code § 1441(a) provides that all persons, in whatever capacity acting, having the control, receipt, custody, disposal or payment of any of the items of income specified in section 1441(b) (to the extent that any of such items constitute gross income from sources within the United States), of any nonresident individual shall deduct and withhold from such items a tax equal to 30 percent thereof. Treas. Reg. § 1.1441-2(a) provides that royalties are included in the items of income enumerated under Code § 1441(b).

The ruling held that the royalties from Y to X are exempt from United States tax under the United States-Netherlands Income Tax Treaty, but that the royalties from X to A are not exempt from taxation by the United States because there is no income tax treaty between A's country of residence and the United States providing for such an exemption. The ruling held that the royalties from X to A are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United States under Code § 861(a)(4) and are subject to United States income taxation under Code § 871(a)(1)(A). The holding of this ruling was rejected by the Tax Court in SDI Netherlands B.V. v. Commissioner, 107 T.C. 161 (1996).