SDI Netherlands B.V. licensed from SDI Bermuda (pursuant to the Bermuda license agreement), the worldwide rights to certain commercial systems software for use on IBM mainframe computers. SDI Netherlands sub-licensed the software to various related and unrelated parties, including SDI USA. The royalty payments received by SDI Netherlands from SDI USA constituted U.S. source income. However, royalties paid by SDI USA to SDI Netherlands were exempt from taxation by virtue of section 894 and the United States-Netherlands Income Tax Convention. There is no comparable U.S. treaty exemption that would apply to royalty payments from SDI USA to SDI Bermuda.

The issue in the case was whether the royalties paid by SDI Netherlands to SDI Bermuda (step d above) constitute income "received from sources within the United States by" SDI Bermuda and are thus subject to withholding under section 1441(a). The Tax court rejected Rev. Rul. 80-362, stating that "revenue rulings are not entitled to any special deference." The IRS did not argue that SDI Netherlands was a mere conduit or agent of SDI USA in paying royalties to SDI Bermuda or that SDI Bermuda was the beneficial owner of the royalties SDI Netherlands received from SDI USA so that the U.S.-Netherlands treaty exemption should not apply.

The two license agreements had separate and distinct terms and that SDI Netherlands had an independent role as the licensee from SDI Bermuda and the licensor of the other entities, including but not limited to SDI USA. The schedules of royalty payments provided for a spread, not unlike the spread involved in Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341, 350 (1995), which compensated SDI Netherlands for its efforts. Like the finance subsidiary in Northern Indiana, SDI Netherlands engaged in licensing activities from which it realized substantial earnings. In fact, on a percentage basis, it earned between 5 and 6 percent, compared to the 1 percent earned by that finance subsidiary in Northern Indiana. The Tax Court held that these arrangements should be accorded separate status with the result that, although the royalties paid by SDI Netherlands to SDI Bermuda were derived from the royalties received by SDI Netherlands from SDI USA, they were separate payments. The payments were not "received from sources within the United States by" SDI Bermuda under sections 881(a), 1441(a), and 1442(a).

HUNDREDS of additional charts at www.andrewmitchel.com