FOREIGN AUTHORS, INVENTORS, AND
THE INCOME TAX

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FEW provisions in the Internal Revenue Code are the object of more polemics and pulpsteering than those governing taxation of foreign income. Yet the profusion of studies, tracts, books and bills on foreign taxation seldom actually concern foreign taxpayers¹—except to the extent that an American owned corporation is a “foreign” taxpayer because it has a foreign charter, does business abroad, and is taxed as a “foreign corporation” under the Code. The “legitimate” foreign corporation gets only peripheral attention in current dialogues; the nonresident alien is virtually ignored.² Recent experience with balance of payments deficits and a lagging growth rate, however, emphasizes the importance of the foreigner in our economy—apart from his traditional role as customer.³ The United States no longer has a monopoly on exportable wealth, science, or mass media artistic products. The United States can use more investment from abroad and will increasingly need the art and technology of other countries as they continue to advance.

The swiftly accelerating interactions among nations and the revolutions in transportation and communication have both created and made possible the fulfillment of demands crossing national and continental boundaries. Products produced in Pakistan are daily consumed in France; movies made in Japan are viewed in Norway; communication satellites promise enormous developments in worldwide dispersion of technology, art, and ideas. The creator of a

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1. For a bibliography see OWENS, *THE FOREIGN TAX CREDIT* xxvii (1961). The “tax haven” provisions of the Revenue Act of 1962 (INT. REV. CODE OF 1954, §§ 951-64, as amended by Revenue Act of 1962 [hereinafter cited as I.R.C.]) concern primarily “controlled foreign corporations,” defined as a foreign corporation more than 50 per cent of the voting stock of which is owned by United States shareholders. I.R.C. § 957(a).

2. Among the most recent works on aliens are PHILLIPS, *UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS* (1952); Allan & Coggan, *Aliens and the Federal Income Tax*, 5 TAX L. REV. 253 (1950); Weyher & Kelley, *The Income Taxation of Aliens—Some Riddles and Paradoxes*, 9 TAX L. REV. 371 (1954).

3. On the relationship of the taxation of foreign income to the gold flow, see Anthoine & Bloch, *Tax Policy and the Gold Problem: An Agenda for Inquiry*, 61 COLUM. L. REV. 322 (1961).

book, an invention, or an idea may have a worldwide market for his wares, and he may have a wide choice of places and methods by which to exploit them.

Tax burdens can significantly influence the owner of a patent, copyright, or similar property in his choice of methods of exploitation, and in deciding whether to exploit his foreign rights abroad or to produce the products covered by the rights domestically for export. In the recent hearings on the Revenue Act of 1962, some attention was paid to the possible impact of the tax structure on the exodus of United States-produced patents and processes, and the effect of this migration on domestic investment and economic growth.⁴ The corollary of this problem also deserves inclusion in current studies of tax reform. If the tax burden on local exploitation of foreign owned patents and copyrights can significantly affect the foreigner's choice of licensing his rights for foreign production and export to the United States or licensing them for domestic production, the tax burdens on the foreign-owned patents and copyrights⁵ may have an impact on the United States economy far out of proportion to the revenue raised by the tax.

Taxation of the non-national has taken a posterior position in current discussions partly because of the spreading network of tax treaties between the United States and the countries which produce most of our imports. The treaties commonly grant relief from taxation of royalties and other income earned here by specified residents and corporations of treaty countries. But they have only limited application and are merely mitigative; they do not im-

4. See, e.g., *Hearings on H.R. 10650 Before the Senate Committee on Finance*, 87th Cong., 2d Sess., pt. 6, at 2703-08; pt. 8, at 3683-91; pt. 11, at 4565-67. See generally, the President's Tax Message, urging critical examination of "certain features of our tax system which, in conjunction with the tax systems of other countries, consistently favor U.S. private investment abroad compared with investment in our own economy." *Message from the President of the United States Relative to Our Federal Tax System*, H.R. Doc. No. 140, 87th Cong., 1st Sess. (1961).

5. The terms "patent" and "copyright" are used in this article in a very loose and imprecise sense. When used together, the words are meant as a shorthand expression for the legal rights to prevent unauthorized use and/or reproduction of inventions, writings, designs, processes, formulas, artistic expressions and ideas, whenever the idea or expression has reached such form, concreteness, or development that the tax law regards it as "property," which should be treated as a patent or copyright is treated. The subject matter thus extends far beyond the contours of the statutory monopolies on patents and copyrights and includes trade secrets, unpatentable secret processes and formulae, and industrial "know-how" acquiring the status of "property" for tax purposes. All personal property, tangible or intangible, is ultimately the product in part of someone's personal efforts. Determining the point at which personal efforts have culminated in intangible "property" has been a problem plaguing lawyers and metaphysicians for years. Few incursions into that interesting and fundamental thicket will be made here. See generally, on the tax aspects of the definitional problem, Creed & Bangs, *"Know-How" Licensing and Capital Gains*, 4 *PATENT, TRADEMARK, AND COPYRIGHT J. OF RES. & ED.* 93 (1960); Duffy, *Doing Business Abroad: Use of American Know-How*, N.Y.U. 20TH INST. ON FED. TAX. 1269 (1962).

Where the statutes, treaties or decisions draw distinctions between various kinds of artistic and intellectual property, "copyright" and "patent" will refer herein to more specific concepts but will not, unless the context requires, refer exclusively to the rights granted under titles 17 U.S.C. (copyrights) and 35 U.S.C. (patents).

pose tax or close fissures in local law. Where they are applicable their scope is uncertain as the terms are inadequately defined and to some extent take their meaning from domestic law.

The tax treaty program is invaluable, but only if it rests upon a consistent, clarified statutory scheme for taxing foreigners. This we do not have. Moreover, so long as countries which remain outside the treaty network have substantial economic intercourse with the United States, reappraisal of our present statutory scheme should not be postponed.

THE BASIC SCHEME

The United States income tax is imposed upon the worldwide income of all individuals who are either citizens or residents⁶ of the United States and upon corporations created or organized under federal or state law.⁷ Relief from "double taxation" resulting from income taxes imposed by other nations upon foreign source income is provided by a tax credit⁸ or a deduction from gross income,⁹ at the option of the taxpayer.

Nonresident aliens and foreign corporations are taxed by the United States only upon income derived from sources within the United States.¹⁰ These taxpayers are divided into two basic classes: those engaged in business in the United States and those not so engaged. Those engaged in business here are taxed at regular corporate or individual rates on all income from United States sources.¹¹ Foreign corporations not engaged in United States business, referred to as "nonresident foreign corporations,"¹² are taxed at a flat 30 per cent rate on "fixed or determinable annual or periodical" income and upon certain gains from timber and coal.¹³ Nonresident aliens who are not engaged in business here are taxed only on "fixed or determinable annual or periodical" income and other specified gains.¹⁴ Those individuals having income of the kinds covered which is \$15,400 or less are taxed at a flat 30 per cent rate¹⁵

6. I.R.C. § 1 imposes a tax on "every individual" and § 61 defines gross income to include income "from whatever source derived." The scope of these provisions is limited, however, by the special provisions for nonresident aliens in § 871.

7. I.R.C. § 11 imposes a tax on the income of "every corporation." The distinction between foreign and domestic corporations is created by the definitions of foreign and domestic corporations in § 7701(a) (2), (3) and the special provisions for taxing foreign corporations in §§ 881, 882.

8. I.R.C. §§ 901-05.

9. I.R.C. § 164.

10. I.R.C. §§ 872, 882(b). Definitions of income from sources within and without the United States are contained in §§ 861-64.

11. Individuals in this class are taxed at the same rates as citizens and residents, I.R.C. § 871(c), and corporations pay the same rates as domestic corporations, I.R.C. § 882(a).

12. Treas. Reg. § 1.881-1. Foreign corporations engaged in business in the United States are "resident foreign corporations," I.R.C. § 882.

13. I.R.C. § 881(a).

14. I.R.C. §§ 871(a), (b).

15. I.R.C. § 871(a) (1).

without deductions or personal exemptions.¹⁶ Those with more than \$15,400 taxable income are taxed at progressive rates after personal exemptions¹⁷ and deductions attributable to domestic source income,¹⁸ or at the flat 30 per cent rate—whichever method produces the greater tax.¹⁹

DEVELOPMENT OF THE PRESENT FRAMEWORK

Revenue Act of 1936

The dichotomy of nonresident aliens and foreign corporations engaged in business here and those not so engaged entered the Code in the Revenue Act of 1936.²⁰ Under the earlier Acts, the entire net income from United States sources, including capital gains, was subject to tax.²¹ However, except for foreign taxpayers whose income was withheld or who had property here subject to distraint, little revenue was collected since the Treasury relied on the "honesty" and "willing cooperation" of aliens against whom it had been unable to enforce the tax.²² The 1936 Act separated aliens and foreign corporations who were engaged in a trade or business or had an office or place of business²³ in the United States, and continued to tax them on their entire domestic source income. Other nonresident aliens and foreign corporations were taxed only on "fixed or determinable annual or periodical" income, a concept borrowed from the withholding provisions where it had been used since 1913.²⁴ The withholding rate and the taxing rate were equalized, and both

16. Treas. Reg. § 1.873.1(b). See note 25 *infra*.

17. Only one exemption is permitted an alien who does not reside in Canada or Mexico. I.R.C. § 873(d).

18. I.R.C. § 871(b). Deductions for charitable contributions or gifts provided by § 170 are limited to contributions or gifts to domestic corporations, funds or foundations created in the United States § 873(c).

19. I.R.C. § 871(b).

20. 49 Stat. 1648 (1936).

21. See Revenue Act of 1934, ch. 277, 48 Stat. 680, §§ 11, 12(b), 13(a), 212(a), 213, 231(a).

22. Statement of Arthur Kent, Acting Chief Counsel, Bureau of Internal Revenue, *Confidential Hearings on H.R. 12395 Before the Senate Finance Committee*, 74th Cong., 2d Sess., pt. 2, at 90 (1936). See also H.R. REP. No. 2475, 74th Cong., 2d Sess. at 9-10 (1936); S. REP. No. 2156, 74th Cong., 2d Sess. at 23 (1936).

23. Section 160 of the Revenue Act of 1942, 56 Stat. 861, deleted the reference to office or place of business, leaving as the sole criterion engaging in trade or business here. When present, the office or place of business phrase caused difficulties of interpretation and invited foreign taxpayers to establish offices primarily for purposes of getting favorable tax treatment. Cf. *Aktiebolaget Separator*, 45 B.T.A. 243 (1941).

24. Revenue Act of 1913, ch. 16, § II, 38 Stat. 168. The 1936 Act, however, added dividends to the specified items constituting "fixed or determinable annual or periodical" income, both for purposes of withholding (Revenue Act of 1936 [hereafter referred to as 1936 Act], 49 Stat. 1648, §§ 143(b), 144(a)) and for purposes of taxation (§§ 211(a), 231(a) 1936 Act).

were computed without deductions or exemptions.²⁵ Thus the tax, with minor exceptions,²⁶ was only upon income which was subject to withholding. Filing a return in most cases was not required,²⁷ as the tax withheld would ordinarily equal the tax due. The decision to exempt most income not subject to withholding reflected both the impracticality of enforcing the more comprehensive tax and the desire to encourage investment from abroad, since capital gains were exempt.²⁸

Rate Increases on New Class of Aliens

Soon after the 1936 Act went into effect, Congress discovered that a wealthy nonresident alien might pay less tax at the flat rate than a citizen who was

25. The 1936 Act did not deny deductions and personal exemptions as clearly as it might have, although the Finance Committee's Report indicated that deductions and personal exemptions were not to be allowed. See S. REP. NO. 2156, *supra* note 22, at 21. Denial of deductions and exemptions is implied by the statutory language: "... there is hereby imposed for each taxable year, in lieu of the tax imposed by section 1, on the amount received ... as interest ... dividends [etc.] ... or other fixed or determinable annual or periodical gains ... a tax of 30 percent of such amount." I.R.C. § 871(a)(1). See also I.R.C. § 881(a).

The Regulations take the position that neither deductions nor personal exemptions are allowed under I.R.C. § 871(a)(1) [Treas. Reg. § 1.873-1(b)].

26. The basic statutory definitions of income subject to withholding (§ 143(b), 1936 Act) and income subject to tax (§ 211(a), 1936 Act) were identical; and this is still the case. I.R.C. §§ 871(a)(1), 1441(b). But the 1936 Act exempted certain dividends from withholding, although still subjecting them to tax, and gave the Commissioner authority to exempt other taxable items from withholding. Section 143(b), 1936 Act. The disparity between withholdable and taxable income was further widened when Congress in 1950 imposed a tax on certain capital gains which are not subject to withholding. See I.R.C. §§ 871(a)(2), 1441(a).

27. See statement of Mr. Beaman, *Hearings on H.R. 12395 Before the Senate Finance Committee, supra* note 22, at 87. Section 217(b) of the 1936 Act and § 6012(a) of the present Code, gave the Commissioner authority to exempt nonresident aliens taxable under I.R.C. § 871 and nonresident foreign corporations taxable under I.R.C. § 881 from the duty to file returns. Treas. Reg. §§ 1.6012-1(b)(1) and 1.6012-2(g)(1), provide that such taxpayers need not file returns if their tax liability is satisfied at source, although a return is a prerequisite to allowance of deductions, if any, to which a nonresident alien is entitled. I.R.C. § 874(b).

28. The Committee Reports on the 1936 Act stressed the difficulty of enforcement, although mentioning that nonresident aliens not engaged in business here and nonresident foreign corporations would "not be subject to the tax on capital gains, including gains from hedging transactions," and opining that the exemption "will result in additional revenue from the transfer taxes and from the income tax in the case of persons carrying on the brokerage business." H.R. REP. NO. 2475, *supra* note 22, at 9. The Finance Committee, however, suggested that the principal increase in revenue would result from withholding of dividends, theretofore not required. S. REP. NO. 2156, *supra* note 22, at 21.

The impact on foreign investment was considered in the *Hearings on the Revenue Act of 1936 Before the Committee on Ways and Means*, 74th Cong., 2d Sess. 161-74, 369-83 (1936), and the decision to exempt capital gains is hard to explain unless this policy was behind it. See Angell, *The Nonresident Alien: A Problem in Federal Taxation of Income*, 36 COLUM. L. REV. 908 (1936).

taxed at progressive rates.²⁹ This was remedied in the 1937 Act³⁰ by dividing nonresident aliens not engaged in business here into two classes. In one class were those whose "fixed or determinable"³¹ income was \$21,600 or less. This class continued to be taxed at the flat rate. In the second class were those aliens whose income exceeded \$21,600. This group was allowed deductions attributable to United States income and personal exemptions and was taxed at ordinary rates applicable to citizens. This method of computing the tax, however, was to apply only if the tax so computed exceeded the flat rate before deductions and exemptions. The \$21,600 figure selected as the break-off point was the amount at which the tax calculated at ordinary rates would approximately equal the tax due under the flat rate. Thus, when tax rates were substantially increased in the 1942 Act,³² the break-off point was reduced to \$15,400, its present figure, where the effective rate on citizens and residents was approximately equal to the new flat rate of 30 per cent. Under this scheme a nonresident alien not engaged in business here can pay more tax than an alien with the same amount of income who is engaged in business, since the latter, though taxable on his entire income from domestic sources, is allowed deductions. The nonresident alien not engaged in business here can pay less tax than one engaged in business only if he has income from United States sources, such as capital gains, which is not included in his tax base.

Capital gains of aliens present in the United States

Prompted by the presence of wealthy wartime and postwar immigrants who retained legal residences elsewhere and thus were not taxed on stock and commodity transactions,³³ Congress in 1950 partially retreated from the 1936 exemption of capital gains. Nonresident aliens not engaged in business but present here 90 days or more during the taxable year were subjected to tax on all net capital gains realized during the year from United States sources.³⁴ The tax base of those nonresident aliens not engaged in business who were here less than ninety days was broadened to include net capital gains "effected" during the alien's presence here.³⁵ No distinction was made between long and short term gains; both were taxable in full at 30 per cent.³⁶ Capital losses were permitted only to offset capital gains, not as deductions from other income, and

29. See H.R. REP. No. 1546, 75th Cong., 1st Sess. 30 (1937).

30. Revenue Act of 1937, § 501, 50 Stat. 830.

31. In the interest of brevity, "fixed or determinable" will hereafter often be used as shorthand for "fixed or determinable annual or periodical."

32. Revenue Act of 1942, ch. 619, §§ 103, 106, 56 Stat. 802, 807.

33. See Zareh Nubar, 13 T.C. 566 (1949); H.R. REP. No. 2319, 81st Cong., 2d Sess. 57 (1950).

34. Revenue Act of 1950, § 213, 64 Stat. 936, now I.R.C. § 871(a)(2)(B).

35. I.R.C. § 871(a)(2)(A).

36. I.R.C. §§ 871(a)(2)(A), (B). The alternative tax imposed by § 871(b) upon aliens with taxable income exceeding \$15,400 is, however, computed at regular rates. Thus the 25 per cent maximum rate and the alternative 50 per cent deduction of net long term capital gains (§§ 1201, 1202) would apply to such aliens, together with progressive rates on other taxable income, if such method produced a greater tax than the 30 per cent flat rate.

no carryovers were permitted.³⁷ Capital gains effected by an alien not present in the United States at any time during the taxable year remained exempt,³⁸ as did all capital gains of nonresident foreign corporations.

Base broadening in the 1954 Code

The 1954 Code added a third category of income taxable to nonresident aliens.³⁹ It consists of certain items "considered to be gains from the sale or exchange of capital assets" and subject to the 30 per cent rate regardless of the alien's presence in the United States.⁴⁰ The items are: certain distributions from exempt pension trusts,⁴¹ employee annuities,⁴² certain gains from timber and coal,⁴³ and, the only one that concerns us here, gains from patent transfers described in section 1235.⁴⁴ Only gains from sales of timber and coal were added to the tax base of nonresident foreign corporations.⁴⁵

Thus, unless a treaty provides otherwise,⁴⁶ a nonresident alien or foreign corporation engaged in business here is taxable on net income from patent or copyright assignments if the income is from United States sources. Nonresident foreign corporations and nonresident aliens not engaged in business here are taxed on such receipts from patents or copyrights as is "fixed or determinable annual or periodical" income from United States sources; the alien is also taxed on transfers constituting a "sale or exchange of a capital asset" if the alien is present here as provided in section 871(a)(2). Under some conditions, moreover, the income from a patent may be taxable whether or not it is "fixed or determinable" and regardless of the alien's presence.⁴⁷

The statutory developments since 1936 have thus created a two-layered definition of taxable income of foreign taxpayers not engaged in business in this country. The income of these taxpayers must satisfy two definitions before it is taxable by the United States. It must be both (1) "fixed or determinable annual or periodical" or one of the specified capital gains, and, (2) derived

37. Moreover, as to aliens present less than 90 days and taxed only on gains effected while present, only capital losses effected while present here may be deducted in computing the net capital gains subject to tax. I.R.C. § 871(a)(2)(A).

38. See H.R. REP. NO. 2319, *supra* note 33, at 100. Also the gains of aliens present here less than 90 days which are effected when the alien is outside the United States are not taxed under the 1950 amendment.

39. I.R.C. § 871(a)(1).

40. The alternative tax applied to aliens with taxable income in excess of \$15,400 [I.R.C. § 871(b)] also requires application of capital gain rates to these items in determining whether the 30 per cent flat rate or ordinary rates are applicable. See note 36 *supra*.

41. As described in I.R.C. § 402(a)(2).

42. As described in I.R.C. § 403(a)(2).

43. As described in I.R.C. § 631(b) and (c).

44. I.R.C. § 871(a)(1).

45. I.R.C. § 881(a).

46. I.R.C. § 894 provides: "Income of any kind, to the extent required by any treaty obligation of the United States, . . . shall be exempt from taxation. . . ." Substantial exemptions are granted by treaty on the income from patent and copyright proceeds in many cases, as is discussed *infra* at text accompanying notes 185-215.

47. If it is an "amount described in . . . Section 1235." I.R.C. § 871(a)(1).

from sources within the United States. To the extent income is from foreign sources it is not taxable even though it is "fixed or determinable" or is otherwise within the "tax-imposing" provisions.

Part I of this article deals with the "tax-imposing" provisions, sections 871 and 881, which must be applicable before the question of source of income arises. Thus, it concerns only nonresident aliens and foreign corporations not engaged in a United States business. The more basic problem of source of income, a factor in the tax base of all non-nationals, is treated in Part II.

I. THE TAX-IMPOSING PROVISIONS

Proceeds of patent and copyright assignments as "fixed or determinable annual or periodical" income

The meaning of the four adjectives, "fixed or determinable annual or periodical" is a middle-aged mystery. The Code specifies several types of income, such as dividends, interest, and salaries, which are considered to be "fixed or determinable annual or periodical," then adds a catchall, "or other fixed or determinable annual or periodical" income.⁴⁸ "Royalties" from patents and copyrights are not listed specifically but were subject to withholding before the 1936 Act, and the Regulations have consistently stated that royalties are "fixed or determinable annual or periodical."⁴⁹ Income from the "sale of personal property," however, has always been considered outside the "fixed or determinable" concept.⁵⁰ Thus, the cases and rulings have usually centered on the characterization of the transaction as an exempt "sale" or a taxable "license."

The Rationale of the Sale Exemption—Distinguishing Net Income from Returns of Capital

Most of the items upon which withholding had been required prior to 1936 were ordinary income items, such as interest and salaries, upon which there was no cost to be deducted before arriving at taxable income and upon which expenses attributable to the income were minimal or non-existent.⁵¹ It appar-

48. The tax is imposed upon "the amount received . . . as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income. . . ." I.R.C. §§ 871(a), 881(a).

49. Treas. Reg. § 1.1441-2. See *Commissioner v. Wodehouse*, 337 U.S. 369, 382 (1949).

50. "Income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income." Treas. Reg. § 1.1441-2 (a) (3). Similar language has appeared in the Regulations since 1924. *Commissioner v. Wodehouse*, *supra* note 49 at 382.

51. Withholding was not required on insurance premiums as "It was not the intent of Congress to require withholding of gross income where . . . little income (and sometimes even a loss) is derived therefrom. . . . The intent was to include only such kinds of gross income as have a very high content, so to speak, of net income." I.T. 1359, I-1 CUM. BULL. 292, 294 (1922). See also I.T. 2836, XIII-2 CUM. BULL. 81, 82 (1934): "The use of the words 'fixed or determinable' income in connection with the withholding provision . . . evi-

ently seemed practical and fair to Congress in 1936 to withhold a fixed percentage of such receipts and to impose a tax equal to the amount withheld.

However, when an alien sold property the Treasury before 1936 had not required the purchaser to withhold any of the purchase price.⁵² Apparently it was thought that to require the purchaser to withhold a fixed percentage of the entire proceeds would be vexatious and harmful to foreign investment, since the amount withheld would frequently bear no relation to the net income then subject to tax. Compelling the purchaser to withhold an amount determinable only by reference to the seller's basis was seemingly thought impractical.⁵³ Congress in 1936 pretty clearly intended to continue to exempt such items from withholding and from taxation.

A system of flat-rate taxation is not easily adapted to gross proceeds constituting, in part at least, a return of capital. In fixing the flat rate on aliens approximately equal to the effective rate on income of domestic taxpayers,⁵⁴ Congress implied that only items consisting substantially of net income were ordinarily to be taxed.⁵⁵ In exempting sales of personal property, Congress apparently recognized the impracticality of fitting within the scheme of flat rate taxation and withholding proceeds which might consist entirely of a return of

dences an intent that the tax shall be deducted at the source from those payments which are definitely known to constitute income as distinguished from gross proceeds."

52. See, *e.g.*, I.T. 1679, II-1 CUM. BULL. 140 (1923); *cf.* I.T. 1232, I-1 CUM. BULL. 207 (1922) ("sale" of patent).

53. An article contemporaneous with the Revenue Act of 1936 explained the proposed changes as follows:

No withholding at the source is possible, for in the majority of instances the American agent who accomplishes the sale has no record of the cost, and without the cost taxable gain cannot be computed. It would be futile for Congress to undertake to exact a contribution out of the sales price as an alternative. In the first place, such a statute presumably would be unconstitutional as a capital levy. In the second place, in the absence of a cost figure, the transaction might result in a loss and not a gain and so work gross inequality. Finally, the rule would so harass foreign investors that foreign funds inevitably would be driven elsewhere. . . .

Angell, *The Nonresident Alien: A Problem in Federal Taxation of Income*, 36 COLUM. L. REV. 908, 911-12 (1936).

54. See text accompanying note 32 *supra*.

55. The inclusion of "rents" in I.R.C. §§ 871(a)(1), 881(a) as "fixed or determinable" income probably deserves to be called an exception, for rental proceeds will often bear little relationship to net income. Another possible qualification exists in the case of "annuities," also expressly listed as "fixed or determinable" income. If the gross proceeds on an annuity contract were subject to withholding before 1936, and to tax after 1936, then an alien purchaser of an annuity would ordinarily be taxed on returns of capital. In I.T. 2183, IV-2 CUM. BULL. 66 (1925), the Treasury ruled that a nonresident alien receiving annual payments on an annuity contract was "subject to Federal income tax" on "the entire amount of the annuity payments" and the payments were "subject to withholding at the rate of 6 per cent." The annuity contract, however, was purchased for the alien by her former employer. It is possible—but not revealed in the ruling—that the annuity was compensation for services rendered in the United States and was therefore taxable in full on that ground.

Before 1934 a domestic annuitant was not taxed on annuity payments until he recovered his cost. See *Egtvedt v. United States*, 112 Ct. Cl. 80 (1948). The Revenue Act of 1934,

capital, or might even represent a loss.⁵⁶ Yet if this is the rationale underlying the "sale" exemption, it should be recognized that the "sale" concept is inadequate for distinguishing items consisting of income and those constituting returns of capital. The method of disposition sheds no light on the cost of acquisition or production. A copyright or patent owner, for example, may be realizing a loss whether he "sells" all his rights for a lump sum or "licenses" partial rights for periodic payments.⁵⁷ The policy of excluding items constituting in substantial part a return of capital arguably should have resulted either in taxing all patent and copyright transfers or none—or, at least, should have resulted in a different scheme for taxing income from such property. Nonetheless, "sales" were exempted while "rentals" and "royalties" were taxed in full. The legacy of the courts, then, has been to distinguish between "sales" and "licenses" where one of the main purposes of the distinction cannot be given effect. If the taxpayer disposes of rights for an amount which barely covers his cost or expense in acquiring or disposing of the item, it would seem at once inconsistent with congressional policy to impose a tax of 30 per cent on the entire proceeds. Yet there is no statutory warrant for an *ad hoc* investigation into the expenditures of each foreign taxpayer before deciding whether his receipts shall be taxed or exempt. So long, however, as a "sale" is exempt, the foreign taxpayer who is potentially subject to a capital levy on "license" proceeds has an alternative to a confiscatory tax. Hence, the need for a distinction remains until the system of flat-rate taxation is eliminated.⁵⁸

§ 22(b)(2), 48 Stat. 687, included in income the portion of each annuity payment which did not exceed 3 per cent of the total cost of the annuity. Under § 72(b) of the 1954 Code, a portion of each annuity payment is excluded from gross income equal to the ratio the investment in the contract bears to the expected return under the contract. All these provisions were presumably intended to apply to the nonresident alien. Thus "annuities" under I.R.C. §§ 871(a)(1), 881(a) and their predecessors probably refers to that portion of an annuity payment which is "gross income" under §§ 61, 72. Cf. Treas. Reg. § 1.871-7(d).

56. In 1954, however, when Congress added to the tax base of nonresident aliens certain items "considered to be gains from the sale or exchange of capital assets," I.R.C. § 871(a)(1), the practical problems of withholding did not seem insoluble. Congress made these items subject to withholding too. I.R.C. § 1441(a), (b). The Regulations permit the withholding agent to rely upon the written statement of the taxpayer as to the amount of gain he has, and to withhold no more than this amount. Treas. Reg. § 1.1441-3(d)(2).

57. In *Commissioner v. Wodehouse*, 337 U.S. 369 (1949), the Court recognized the purpose of the "sale" exemption, but failed to recognize its inadequacy:

Those words [annual or periodical] are merely generally descriptive of the character of the gains . . . which arise out of such relationships as those which produce readily withholdable interest, rents, royalties and salaries *consisting wholly of income*, especially in contrast to gains, profits and income in the nature of capital gains from profitable sales of real and personal property. [Emphasis added.]

337 U.S. at 393-94. Similar statements appear in the Brief for Petitioner at 13, 57.

58. Suppose nonresident alien X "purchases" a patent from nonresident alien Y, the "price" being 80 per cent of the proceeds X gets from exploiting the patent. X "licenses" the patent in the United States, receives "royalties" of \$100,000, \$80,000 of which he owes Y. Could X have \$100,000 "fixed or determinable" income, taxable at 30 per cent? If so, he

The doctrine of indivisibility

Lacking a clear functional basis for defining "sale," the courts and the Commissioner have looked to other guides—one of which has been the distinction between a "sale" and a "license" developed in patent and copyright litigation.

The distinction between a "sale" and a "license" is an old one in patent and copyright law, designed to describe the proper parties to an infringement action. Unless a plaintiff was the assignee of all rights in the copyright or patent possessed by his assignor, it was held that he had no standing to sue for infringement without joining the assignor who retained "title."⁵⁹ The procedural justification for this result rested on the fear that an infringer might be held liable twice for the same wrong. A transfer of all rights under the patent or copyright was called a "sale"; assignment of anything less than all rights was a "license."

After some earlier rulings indicating transfers of partial rights were "sales,"⁶⁰ the Commissioner in 1933 discovered and adopted the indivisibility doctrine

would be \$10,000 in the red (not counting expenses). If the transaction between X and Y is considered a "license," the \$80,000 Y gets from X might also be "fixed or determinable." Does the United States take 30 per cent of this too, even though Y may have paid \$100,000 for the patent?

The Regulations state that "amounts received," as used in § 871(a)(1) means "gross income," Treas. Reg. § 1.871-7(b); but they also say that the tax is imposed upon "the gross amount received from sources within the United States." Treas. Reg. § 1.882-3(a). "Gross income" is not really defined in the Code. (See I.R.C. § 61.) The Commissioner has ruled that statutory exclusions from "gross income," e.g., §§ 104, 105, 106, are applicable to non-resident aliens, Rev. Rul. 56-514, 1956-2 CUM. BULL. 499; but whether gross receipts may otherwise be reduced before the flat tax rate is applied seems doubtful. Treas. Reg. § 1.61-6(a) provides that "gross income" from the sale or exchange of property means the excess of the amount realized over the unrecovered cost; but that the term ordinarily includes gross receipts in the form of rentals and royalties. Depreciation is a "deduction" under § 167 and aliens taxed under § 871(a)(1) are denied deductions, as noted *supra* note 25.

The cases on "deductions" under § 871(a)(1) are not illuminating. In *Rohmer v. Commissioner*, 153 F.2d 61, 65 (2d Cir. 1946), the author's agent collected the \$10,000 lump sum "royalty" and withheld 10 per cent as his commission. Rohmer was taxed on the full amount: "Since the tax is on the gross income from United States sources, such an expense item could not properly be deducted." See also *Evelyn M. L. Neill*, 46 B.T.A. 197 (1942) (gross rentals on land taxable in full); *Dupre v. United States*, 45 A.F.T.R. 1141 (S.D.N.Y. 1953) (alimony taxable in full without deduction of attorney's fees spent in getting judgment); but cf. *Otto H. Wittschen*, 5 T.C. 10 (1945) (alien trust beneficiary taxable only on net income of trust).

The likelihood of a confiscatory tax would be considerably lessened if § 871(b) were amended to permit aliens with incomes over \$15,400 to pay ordinary rates after deductions even if the tax so computed is less than the flat rate before deductions. (See discussion of this provision at text accompanying notes 30-32 *supra*.)

59. See, e.g., *New Fiction Publishing Co. v. Star Co.*, 220 Fed. 994 (S.D.N.Y. 1915); *Fulda, Copyright Assignments and the Capital Gains Tax*, 58 YALE L.J. 245, 247-49 (1949).

60. O.D. 988, 5 CUM. BULL. 117 (1921); I.T. 1231, I-1 CUM. BULL. 206 (1922); I.T. 2169, IV-1 CUM. BULL. 13 (1925).

for determining if there was a "sale" of a copyright for tax purposes.⁶¹ The doctrine asserted that a copyright was indivisible and could not be partially assigned, either as to time, place, or particular rights or privileges and that a grant of limited rights was therefore not an assignment or sale of an interest but a mere "license." Accordingly, the Commissioner ruled against a "sale" of serial, movie, and dramatic rights in books, on the ground that the proceeds were "royalties" from a "license" even though paid in a lump sum.⁶²

Promptly accepted by the Tax Court, the doctrine was soon swallowed by the Second Circuit. In *Rohmer v. Commissioner*,⁶³ an author who was a citizen and resident of England assigned the American and Canadian serial rights in his novel to an American magazine publisher, retaining movie, stage, and book rights. The publisher paid Rohmer's American agent a lump sum of \$10,000 for the rights. The Commissioner assessed the flat rate tax under the predecessor of section 871(a)(1) on the entire \$10,000. Rohmer sued for a refund, contending the proceeds were not "fixed or determinable annual or periodical" because the transaction was a "sale of personal property" and also because the consideration, having been paid in a lump sum, was not "annual or periodical." The court rejected both the taxpayer's arguments:

Where a copyright owner transfers . . . substantially less than the entire "bundle of rights" conferred by the copyright, then payment therefor, whether in one sum or in several payments, constitutes royalties within the meaning of section 211(a)(1)(A). [Now section 871(a)(1)]. For such a transfer is the grant of a license. Payment for the grant of such a license . . . is no less a royalty paid for such use when disbursed in a single amount It is like interest paid for several years in one sum or rent paid in advance for the use of a building for a period of years."⁶⁴

A few years later, P. G. Wodehouse repeated Rohmer's arguments to the Fourth Circuit.⁶⁵ Wodehouse, in 1938 and 1941, had assigned for lump-sum payments the North American, and in some instances also the South American serial rights to three novels and an article; he also assigned the book rights in one of the novels to a different publisher for a lump sum. Disagreeing with the Second Circuit, the Fourth Circuit criticized the *Rohmer* decision for relying on cases concerned only with copyright law and questions of an assignee's

61. I.T. 2735, XII-2 CUM. BULL. 131 (1933). This ruling concerned source of income but its reasoning was later applied in other questions involving assignments of patents and copyrights.

62. *Ibid.*

63. 153 F.2d 61 (2d Cir. 1946). In *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938), involving source of income, the court had even earlier applied the indivisibility doctrine to find there was no "sale."

64. 153 F.2d at 63. Revenue Act of 1940, § 211(a)(1)(A) was the predecessor of I.R.C. § 871(a)(1). It did not mention royalties. The court inferred that Congress, in borrowing the "fixed or determinable" concept from the withholding provisions, approved the interpretations placed on the latter in the Regulations. And as noted *supra*, note 49, the Regulations stated that "royalties" were subject to withholding.

65. *Wodehouse v. Commissioner*, 166 F.2d 986 (4th Cir. 1948), *rev'd*, 337 U.S. 369 (1949).

standing to sue for infringement.⁶⁶ Such decisions, the court said, were concerned with procedural matters and "did not undertake to controvert the undeniable fact that serial rights, book rights, dramatic production rights and motion picture rights of a literary production are property rights which may be and are separately and effectively bought and sold in the literary market."⁶⁷ Holding the payments exempt as "proceeds of the sales of personal property," the court said, "We cannot suppose that Congress intended to exempt the proceeds of a single sale of all the rights in a literary production to one person, but to tax the proceeds of separate sales of parts of the whole."⁶⁸ The court added that the "plain meaning of the statutory terms"⁶⁹ required the holding that payment in a lump sum for serial rights is not "annual or periodical" income even if the transaction is a "license" rather than a "sale."

The Supreme Court resolved the conflict by reversing the *Wodehouse* case and holding the payments taxable.⁷⁰ In doing so, it contributed little but confusion. The majority opinion, written by Mr. Justice Burton, is mainly devoted to pointing out that "royalties," in the abstract, were subject to withholding prior to the 1936 Act and were income from United States sources. In its preoccupation with demonstrating that royalties were taxable, the Court came close to begging the real question—whether the payments were "royalties" or sales proceeds. Apparently agreeing with the Commissioner's surprising position that "fine questions of title, or of sales or copyright law"⁷¹ were not involved in the case, the majority did not rely on the doctrine of indivisibility.⁷² The Court said there was no suggestion in the history of the 1936 Act "that lump sum advance payments of rentals or royalties should be exempted from taxation while at the same time smaller repeated payments of rentals or royalties would be taxed and collected at the source."⁷³ To have exempted non-resident aliens from such readily collectible taxes, reasoned the Court, "would have discriminated in their favor against resident citizens of the United States who would be required to pay their regular income tax on such income. . . ."⁷⁴ In short, the Court was unwilling to construe the statute to permit aliens to

66. 166 F.2d at 989. *E.g.*, *Goldwyn Pictures Corp. v. Howells Sales Co.*, 282 Fed. 9 (2d Cir. 1922) ; *New Fiction Publishing Co. v. Star Co.*, 220 Fed. 994 (S.D.N.Y. 1915).

67. 166 F.2d at 989.

68. *Id.* at 990.

69. *Id.* at 991.

70. *Commissioner v. Wodehouse*, 337 U.S. 369 (1949).

71. *Id.* at 376. The Commissioner's eschewing of fine questions of copyright law is surprising because it was on such grounds that he had prevailed in *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946), which in turn was based on the doctrine of indivisibility dating back to *I.T. 2735*, *supra* note 61, which had relied on such authorities on copyright law as *Corpus Juris* and *Goldwyn Pictures Corp. v. Howell Sales Co.*, 282 Fed. 9 (2d Cir. 1922).

72. 337 U.S. at 376.

73. *Id.* at 391.

74. *Ibid.*

go untaxed on United States source income which was readily withholdable.⁷⁵ As a result, the content of the exemption of sales of personal property was left obscure. The Court apparently conceded that the "sale" of a copyright was exempt⁷⁶ but seemed to leave no room for a "sale" of "limited rights."⁷⁷ Thus, while appearing to reject the doctrine of indivisibility the Court seems also to have embraced it.

The opinion abounds with question-begging equivocations, exposed both by the dissent of Mr. Justice Frankfurter⁷⁸ and by the commentators.⁷⁹ But however feeble the attempt, the Court sought to avoid formalistic distinctions and to ground its decision in policy. Apparently, however, the only policy considered was the need for revenue. Congress, unlike the Court, chose to forego tax on some sources of withholdable revenue from nonresident aliens. There is force, therefore, in Mr. Justice Frankfurter's dissenting charge that the Court's decision was guided by fiscal considerations which Congress chose not to write into law.⁸⁰

Mr. Justice Frankfurter, describing the legislation as "precise," excoriated the majority for relying on "long prior practice," which in his view was either irrelevant or ill-conceived.⁸¹ Rejecting the notion of indivisibility, he agreed with the Fourth Circuit that the doctrine arose in a procedural context and had no bearing on the tax question. In his view, if there is an exclusive transfer of any one of the rights granted by the Copyright Act "under terms of payment which do not depend on future use by the transferee, . . . [tax law] should reflect business practice in recognizing that the proceeds are from 'the sale of personal property' . . ."⁸² He could not see why a lump sum transfer of exclusive but partial rights should be taxed when Congress clearly chose to foregoe taxation of a single disposition of all the rights.⁸³

75. "One advance payment to cover the entire 28-year period of a copyright comes within the reason and reach of the Revenue Acts as well as, or even better than, two or more partial payments of the same sum." *Id.* at 394.

76. *Id.* at 384, 388, 393-94.

77. See *id.* at 392.

78. *Id.* at 401. Joined by Justices Murphy and Jackson.

79. See, e.g., Fincke, *An Analysis of the Income Aspects of Patents, Copyrights, and Their Analogues*, 5 TAX L. REV. 361, 365-71 (1950).

80. 337 U.S. at 409.

81. *Id.* at 404. The majority, for example, relied on decisions such as *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938), and I.T. 2735, XII-2 CUM. BULL. 131 (1933), which adopted the indivisibility doctrine and held that proceeds from transfer of partial rights were taxable as royalties. Justice Frankfurter said these decisions were ill-founded because based on "a metaphysical view of copyright law" and were irrelevant—or nearly so—as they did not involve the "fixed or determinable" concept; they merely held that the proceeds were income from United States sources, an issue not in the *Woodhouse* case. It is problematical whether the majority understood the difference in issues. See, e.g., 337 U.S. at 371, where the Court said the case turned on "the meaning of 'gross income from sources within the United States.'" However, the majority may have felt that a "royalty" under the source rules was so clearly a "royalty" under the taxing provisions as not to merit comment.

82. 337 U.S. at 424.

83. *Id.* at 424-25.

The Method of Payment as a Criterion of "Sale"

Though suggesting in his *Wodehouse* dissent that taxation might turn on whether the transferor retained a participating interest producing recurring receipts, Mr. Justice Frankfurter may merely have been adhering to his frequently preached principle of deciding only the case before the Court. It is not clear that he would have taxed *Wodehouse* had the consideration been a typical royalty arrangement, for this, too, might have been a "sale." Certainly, "business practice" commonly included such an arrangement.

There was, however, some support for the view that "annual or periodical" refers to the method of payment and that a casual, non-recurring payment was not subject to withholding before the 1936 Act. Early rulings under the withholding provisions excluded from withholding requirements racetrack winnings,⁸⁴ prizes won in an art contest,⁸⁵ and a selling commission on a single transaction.⁸⁶ Periodicity seemed to be required in these early rulings with the only likely justification that it would be unduly burdensome to require withholding where there was merely a temporary relationship between the payor and payee.⁸⁷

The periodicity question, however, was apparently not decided by any court before 1936.⁸⁸ There is no evidence that the Treasury's position on periodicity

84. S. 957, 1-CUM. BULL. 184 (1919).

85. G.C.M. 21575, 1939-2 CUM. BULL. 172.

86. O.D. 907, 4 CUM. BULL. 232 (1921). See also Bulletin B. Treasury Department (1920), *Income Subject to Withholding*, p. 11:

This phrase [Fixed or determinable, annual or periodical income] refers, generally, to gross income subject to taxation, which is . . . *paid from time to time*. A salesman who works by the month for a commission on sales, and is paid monthly, receives income of this character. On the other hand, *earnings of lawyers and doctors are not usually within . . . this provision of the law (unless paid on a regular retainer)*. [Emphasis added.]

87. There were no reasons given in the rulings for the conclusions reached. (They were revoked recently in reliance on *Wodehouse*, Rev. Rul. 58-479, 1958-2 CUM. BULL. 60.) It is possible, though improbable, that the Treasury may briefly have had adherents to the now quaint notion that *income* includes only recurring receipts. The theory is propounded in Plehn, *The Concept of Income, as Recurrent, Consumable Receipts*, 14 AM. ECON. REV. 1 (1924), and is apparently law in much of South America. See Froomkin, *Some Problems of Tax Policy in Latin America*, 10 NAT'L TAX J. 370, 372 (1957).

88. Some courts after 1936, but before *Wodehouse*, had rejected the notion that periodical payment was a necessary element of "fixed or determinable annual or periodical" income. See *Commissioner v. Raphael*, 133 F.2d 442 (9th Cir. 1943), which held that interest paid in lump sum was taxable. "Because the interest gain is not *payable* periodically makes it nonetheless interest income when paid." *Id.* at 445; *De Nobili Cigar Co. v. Commissioner*, 143 F.2d 436 (2d Cir. 1944). *But cf.* *General Aniline & Film Corp. v. Commissioner*, 139 F.2d 759 (2d Cir. 1944), holding that down payments on patent rights were not taxable, even if they were "royalties." The Second Circuit in *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946), tortuously construed its *General Aniline* opinion to have held there was a "sale."

was known or approved of by Congress.⁸⁹ Moreover, the statute, in specifying that "interest," "rents," "annuities," etc. "and *other* fixed or determinable annual or periodical gains, profits, and income" were subject to withholding—and to taxation after 1936⁹⁰—tends to confirm the *Wodehouse* majority's conclusion that the words "annual or periodical" were "merely generally descriptive of the character" of the income subject to tax.⁹¹ In specifying that "interest" was taxable, Congress is not likely to have meant only interest paid periodically. The items of income specified are items ordinarily paid periodically, but the statute suggests a purpose to tax them regardless of how they are paid. Thus, a "royalty," if it is income of the general character covered in the statute, is taxable even if paid in a lump sum. Conversely, a "sale," even if the price is paid annually or periodically, is not taxable as it is not the kind of transaction covered. Yet even after this is decided, the fact that the transferor's compensation is a lump sum, rather than paid in installments or geared to exploitation of the property, might be relevant in determining whether there was a "sale." The Court in *Wodehouse*, however, did not appear to think so.

The *Wodehouse* decision was at least clear that payment in a lump sum would not convert what otherwise would be a taxable royalty into an exempt "sale." But *Wodehouse* did not render the method of payment immaterial.

In *Bloch v. United States*,⁹² a nonresident alien who granted to a domestic corporation an exclusive "license" to "make, use, exercise and vend" products covered by his patent throughout the United States and its territories for the life of the patent, was held taxable on receipts which were measured by sales of the patented product because the payments were not part of a fixed, specified sum. Only the taxability of sums received in the 1940's was in issue, but the court ventured that a \$40,000 lump sum paid Bloch in 1935 upon execution of the contract "was not subject to withholding when made and not taxable as a royalty." The consideration based on sales of the product was held to be taxable "royalties" because Bloch had retained "an interest in the profitable exploitation of the patented articles." The Second Circuit thought the method of payment crucial, apparently classifying the transaction as a "sale" to the extent of the lump sum and as a "license" to the extent of the participating payments. Thus, payment for all the United States rights may be "purchase price"

89. However, the Regulations since 1918 have provided: "The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals." This statement is now contradicted by the one which follows it: "The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being fixed or determinable annual or periodical income." Treas. Reg. § 1.1441-2(a)(2). This "qualification" was not present in earlier regulations. See, *e.g.*, Treas. Reg. 101, Art. 119-5, Revenue Act of 1938.

90. I.R.C. §§ 871(a)(1), 881(a).

91. 337 U.S. 369, at 393 (1949). See also *Rohmer v. Commissioner*, 153 F.2d 61, 63 (2d Cir. 1946): "The phrase . . . is descriptive of the nature or type of income, regardless of the actual manner of payment."

92. 200 F.2d 63 (2d Cir. 1952).

to the extent paid in a lump sum and substitution of participating royalty payments for a lump sum may therefore convert what would otherwise be exempt "purchase price" *pro tanto* into taxable "royalties." Many courts would quail at the conceptual difficulty of such a part "sale," part "license" approach⁹³ and no subsequent court has taken it up. The Commissioner's position is unclear.

In a ruling involving facts similar to those in *Bloch*, the Commissioner seemed to reach a contrary result.⁹⁴ There a nonresident foreign corporation granted to a domestic corporation "the exclusive right and license" to manufacture, use and sell patented devices in the United States and Canada during the lives of the patents. A lump sum characterized by the parties as an "advance on royalties" was paid in 1929. The contract provided for subsequent annual payments based on each device manufactured but subject to a specified minimum annual sum. The issue was the taxability of payments received in 1953. Without mentioning whether the payments in question consisted of the guaranteed minimum or were measured by the units manufactured, the Commissioner ruled that the transaction, being "a grant of all the patentee possessed under the patent," was a "sale" and thus not "fixed or determinable annual or periodical." *Wodehouse* was read as not overturning the "well-settled rule that the exclusive grant of all the rights under a copyright or patent was a sale . . . with the tax consequences attendant upon the sale of any personal property by a nonresident alien." The Commissioner also read *Wodehouse* as holding that a transfer of less than all the rights in a patent or copyright would be taxable "whether it be called a sale or a license." *Bloch* was distinguished as follows:

[I]t can hardly be said that an economic interest . . . has been retained where there is a total consideration to be paid not dependent in any way upon the volume of sales or production. As no economic interest is retained, the instant transaction is a sale with periodic payment of the purchase price, in the nature of an installment sale.⁹⁵

One difficulty with this reasoning is that it does not seem to apply to the facts. The taxpayer clearly retained an "economic interest" dependent upon production. If merely specifying a minimum annual payment in a contract otherwise calling for payments measured by the products manufactured will convert a taxable license into an exempt sale, then all rationality in this area seems to be gone. The Commissioner's ruling may imply that if all rights are granted and a royalty arrangement is buttressed by a guaranteed annual payment, then the royalties, even if they exceed the guaranteed minimum, will be "sales proceeds." Or the ruling may mean that whether the proceeds are from a "sale" or a "license" will vary from year to year, being "sales price" when the guaranteed minimum is paid, and "royalties" when the minimum is ex-

93. As was suggested by Judge Clark in his concurring opinion, 200 F.2d at 66-67.

94. Rev. Rul. 57-317, 1957-2 CUM. BULL. 909.

95. *Id.* at 912.

ceeded. Either approach seems ludicrous. More likely, the Commissioner disagreed with *Bloch* and was willing to treat as a sale any transaction wherein all United States rights are granted, whether or not the transferor retains a participating economic interest.⁹⁶

The capital gains context: the demise of indivisibility for domestic taxpayers

A "sale" is a chameleon, capable of as many meanings as there are jobs for it to perform. It is pressed into service many times for many purposes, within and without the Internal Revenue Code. Besides serving as a criterion for carving out a category of income which is not "fixed or determinable" under sections 871(a)(1) and 881(a), a "sale" is also a condition of capital gains treatment under section 1222. Thus, domestic taxpayers pursuing capital gains on the income from patent and copyright assignments have often sought "sale" classification for their transactions.⁹⁷

For more than two decades, the Commissioner's principal weapon against the allowance of capital gains on copyrights and patents was the indivisibility doctrine.⁹⁸ The application of the doctrine to a domestic taxpayer received its first judicial test in *Goldsmith v. Commissioner*,⁹⁹ where the Second Circuit ruled on capital gains treatment of income from an exclusive grant of motion picture rights by an American playwright. Judge Learned Hand, joined by Judge Swan, said that where the grant is exclusive, perpetual, and in a particular medium, the author is required to protect the licensee against other infringement; the right of the assignee to exclude others is "property" within the capital gains provisions and its grant is a "sale." Judges Hand and Swan, how-

96. See also, *Eterpen Financiera Sociedad v. United States*, 108 F. Supp. 100 (Ct. Cl. 1952). There, payments for an exclusive "license" to "make, use and vend" patented products throughout the United States were based on a percentage of net sales. The court held the payments were "fixed or determinable," not because the consideration was indeterminate but because the court thought a contemporaneous option agreement belied the stated intention in the "license" agreement to grant all rights in the United States.

97. I.R.C. §§ 1201, 1202 provide for special treatment of "capital gain," defined under § 1222 to mean the "sale or exchange" of a capital asset. Although "sale" has been differentiated from "exchange," *Gruver v. Commissioner*, 142 F.2d 363, 366 (4th Cir. 1944), a "sale" probably includes an "exchange." It is so defined in § 864, which deals with source of income. At any rate, there seldom is reason for making a distinction.

As discussed more fully, *infra*, amendments of the Code in 1950 eliminated copyrights created by the taxpayer from capital asset status, and § 1235 of the 1954 Code specifically grants capital gains treatment to certain transfers of patents by inventors even though on a royalty basis. Thus, since 1954, there has been little interest in the "sale"- "license" distinction among domestic authors and inventors.

98. In its first pronouncement on copyright transfers, the Treasury ruled that an author's assignment of movie rights in his play was a sale of property for capital gains purposes. I.T. 2169, IV-1 CUM. BULL. 13 (1925). But after its 1933 ruling adopting the indivisibility doctrine, I.T. 2735, XII-2 CUM. BULL. 131 (1933), the Service contended that copyrights and patents were incapable of being sold piecemeal.

99. 143 F.2d 466 (2d Cir. 1944).

ever, concluded the property was held for sale in the ordinary course of business, and thus was within one of the statutory exclusions from capital assets.¹⁰⁰

Goldsmith got little comfort from Judge Hand's dictum but later courts eventually accepted it. In *Herwig v. United States*,¹⁰¹ the Court of Claims allowed capital gains treatment of an assignment by Kathleen Winsor of exclusive motion picture rights in her novel, "Forever Amber." The court said, "the exclusive and perpetual grant of any one of the 'bundle of rights' which go to make up a copyright [is] a 'sale' of personal property rather than a mere 'license.'" ¹⁰²

After the government's loss in *Herwig*, it capitulated on the divisibility question, modified its 1933 ruling, and announced that "a copyright proprietor's grant of the exclusive right to exploit a copyrighted work in a particular medium effects a transfer of property," but "a grant of less confers only a license."¹⁰³ The ruling added, however, that such a grant would only be a "sale" if the consideration is not measured by use or profitability of the copyrighted work and is not payable periodically over a period generally coterminous with the grantee's use of the copyright. The latter contention—that interests in copyrights could be "sold" for capital gains purposes only if the consideration was a fixed sum—had earlier been rejected by the Tax Court where all rights had been parted with.¹⁰⁴ But later in *Cory v. Commissioner*,¹⁰⁵ a percentage of the sales price of books sold was held not to be the proceeds of a "sale" of the book rights by both the Tax Court and the Second Circuit. The combination of a partial assignment plus retention of a participating interest was too much for either court to take.¹⁰⁶

The Commissioner had also announced a similar requirement of a fixed sum for "sale" treatment of patent assignments in a 1950 ruling¹⁰⁷ and he re-

100. Revenue Act of 1938, § 117(a) (1), 52 Stat. 500, now I.R.C. § 1221(1). Judge Chase, in a separate opinion announcing the court's result, accepted the doctrine of indivisibility. 143 F.2d at 467.

101. 105 F. Supp. 384 (Ct. Cl. 1952).

102. *Id.* at 389. The court even suggested that a grant of reproduction rights limited to certain cities or to specified languages might be a "sale." 105 F. Supp. at 388. It is not clear from the opinion whether the taxpayer's entire consideration was a fixed sum or whether part of it was determined on a royalty basis. See *id.* at 385.

103. Rev. Rul. 54-409, 1954-2 CUM. BULL. 174. The Commissioner stressed the fact, relied upon by the Fourth Circuit in *Wodehouse v. Commissioner*, 166 F.2d 936 (4th Cir. 1948), *rev'd on other grounds*, 337 U.S. 369 (1949), that various rights in copyrighted works are "purchased and sold" in the literary market. He also conceded that whether a grantee has sufficient rights to sue for infringement "has nothing to do with the question of what rights in a literary work do or do not constitute property."

104. *Richard W. Te Linde*, 18 T.C. 91 (1952).

105. 230 F.2d 941 (2d Cir. 1956), *affirming* 23 T.C. 775 (1955).

106. Judge Frank said that even though a transfer of part of the bundle of rights for a fixed sum or of all the rights for an indeterminate sum might be a "sale" of property for capital gains purposes, where the transfer is "both (1) a transfer of part of the cluster of rights and (2) for an amount wholly indeterminable at the time of the transfer, no such sale occurs." 230 F.2d at 944.

107. Mim. 6490, 1950-1 CUM. BULL. 9.

affirmed this position in 1955,¹⁰⁸ although he had frequently been trounced in court.¹⁰⁹ In 1958, however, the Commissioner acquiesced in the judicial onslaught¹¹⁰ and ruled that measuring consideration by production, sale or use of patents would not prevent a sale for capital gains purposes.¹¹¹ A caveat was added, however: retention of other rights in addition to "interests resembling royalties" might preclude a "sale."¹¹²

The latest word from the Treasury is Revenue Ruling 60-226,¹¹³ where the Commissioner interpreted his 1958 patent ruling as permitting consideration received by the owner of patent "for the assignment of the patent, *or the granting of an exclusive license to such patent*," to be "treated as the proceeds of a sale of property, for Federal income tax purposes, even though the consideration . . . is measured by production, use, or sale of the patented article."¹¹⁴ Concluding that patent and copyright transfers should be treated alike, the Commissioner retreated from his earlier position¹¹⁵ and said that consideration for a grant of exclusive rights in a medium of publication for the life of a copyright would be treated as proceeds from a sale of property even if measured by the copies sold, performances given, or exhibitions made.

Thus, the Commissioner has conceded not only that an exclusive grant of partial rights in a patent or copyright or a grant of all the rights subject to a retained royalty interest may be a sale, but, contrary to *Cory v. Commis-*

108. Rev. Rul. 55-58, 1955-1 CUM. BULL. 97.

109. See Edward C. Myers, 6 T.C. 258 (1946); Carl G. Dreyman, 11 T.C. 153 (1948); cf. *Allen v. Werner*, 190 F.2d 840 (5th Cir. 1951).

110. See also Roy J. Champayne, 26 T.C. 634 (1956); Leonard Coplan, 28 T.C. 1189 (1957).

111. Rev. Rul. 58-353, 1958-2 CUM. BULL. 408, *revoking* Mim. 6490, *supra* note 107; Rev. Rul. 55-58, *supra* note 108.

112. *Ibid.*

113. Rev. Rul. 60-226, 1960-1 CUM. BULL. 26.

114. *Id.* at 22, emphasis added. This seems a charitable interpretation of Rev. Rul. 58-353, *supra* note 111, since all the Commissioner conceded in that ruling was that a grant of all rights, subject to a participating royalty interest and a right of termination for security purposes, was a "sale." He seemed to withhold approval of sale treatment for partial but exclusive grants subject to a royalty interest such as was involved in *Cory v. Commissioner*, 230 F.2d 941 (2d Cir. 1956), *affirming* 23 T.C. 775 (1955). It is not yet clear, however, what the Commissioner means by an "exclusive license." Presumably, assignment of an undivided interest in all rights under the patent is an "exclusive license." Less clear, however, is whether an assignment of rights limited to a particular industry or geographical area would qualify; or whether assignment of the right to use the invention, but not to assign it; the right to manufacture and sell, but not to use the patented products, etc., is, in the Commissioner's view, an "exclusive license." Since the Commissioner in Rev. Rul. 60-226 said "property rights of patents and copyrights are similar in substance" and said his new position on copyrights was the same "position . . . taken in the case of patents," it seems likely that all or some of the aforementioned slices of patent rights may be "exclusive licenses," hence, "sales."

115. See Rev. Rul. 54-409, note 103 *supra*.

sioner,¹¹⁶ an exclusive assignment of partial rights with periodic payments based upon exploitation may be a sale "for Federal income tax purposes."¹¹⁷

Relationship of a capital gains "sale" to the fixed or determinable concept

In his 1954 ruling renouncing the indivisibility doctrine, the Commissioner cautioned that the taxability of assignments by a nonresident alien was a separate and distinct question from the qualification of a citizen for capital gains treatment.¹¹⁸ Thus a "sale of property" under section 1222 is not necessarily a sale of property under sections 871 or 881. The courts have often "put to one side" cases involving aliens as irrelevant for decision under section 1222,¹¹⁹ and vice versa.¹²⁰ Frequently, however, they seem to consider the cases interchangeable and the inquiry identical.¹²¹

The Committee Reports on the 1936 Act explicitly stated that "capital gains" are exempt.¹²² Moreover, the Revenue Act of 1950 which added section 871 (a) (2), imposing a tax on net gains "from sales or exchanges of capital assets" by aliens present here implies that such gains by aliens not present are exempt, *i.e.*, not "fixed or determinable" income.¹²³ Arguably, therefore, the capital gains concept of "sale" is also applicable to carve out a category of income which is not "fixed or determinable" under sections 871(a)(1) and 881(a). If so, *Commissioner v. Wodehouse* retains little force.¹²⁴ The assignment in that case (serial rights) would clearly qualify as a "sale" under the

116. See notes 105 and 114 *supra*.

117. Rev. Rul. 60-226, *supra* note 113.

118. Rev. Rul. 54-409, *supra* note 103. Rev. Rul. 60-226, *supra* note 113, contains no such caveat.

119. See, *e.g.*, *Herwig v. United States*, 105 F. Supp. 384 (Ct. Cl. 1952).

120. See, *e.g.*, *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946).

121. See, *e.g.*, *Carl G. Dreyman*, 11 T.C. 153 (1948); *Eterpen Financiera Sociedad v. United States*, 108 F. Supp. 100 (Ct. Cl. 1952); *Broderick v. Neale*, 201 F.2d 621 (10th Cir. 1953). Several commentators argue, or assume, there should be no difference. See, *e.g.*, *Fulda, Copyright Assignments and the Capital Gains Tax*, 58 YALE L.J. 244, 261 (1949); 3B MERTENS, LAW OF FEDERAL INCOME TAXATION 579 (1957).

122. See note 28 *supra*.

123. The House Report on the 1950 Act states:

A nonresident alien [who has not been present in the United States at any time during the taxable year] . . . is not affected by this . . . bill, insofar as his capital gains derived in, or his capital losses allocable to, the United States are concerned. Gains derived in the United States on sales or exchanges of capital assets effected by such an individual during the taxable year are not subject to tax in the United States.

H.R. REP. NO. 2319, 81st Cong., 2d Sess. 100 (1950).

124. The taxpayer in the *Wodehouse* case argued that what constitutes a "sale" for capital gains purposes also constitutes a "sale" for purposes of taxing nonresident aliens, relying on the Committee Reports, note 28 *supra*. Brief for Respondent, *Commissioner v. Wodehouse*, 337 U.S. 369, p. 10. Justice Frankfurter, in dissent, accepted the argument. 337 U.S. at 423. However, the only decision in the capital gains field supporting the lower court's concept of a "sale" was *Goldsmith v. Commissioner*, 143 F.2d 466 (2d Cir. 1944); hence little was made of the issue. The *Wodehouse* majority was not even stirred to mention it.

criteria of Revenue Ruling 60-226;¹²⁵ so would the transactions in many other cases lost by aliens and foreign corporations.¹²⁶ The proceeds of most assignments by aliens, formerly taxable, may now be exempt without any change in the legislation directly affecting these taxpayers and notwithstanding the consistent opposition of the courts and the Commissioner to such an expansive definition of the sale concept under sections 871(a)(1) and 881(a).

A literal approach may be possible, however. Even if the "sale" of a capital asset is exempt unless the alien is present in this country as provided in section 871(a)(2), the same result is not literally required when the "sale" is of a non-capital asset. The "sale" criteria of Revenue Ruling 60-226 can be applied to decide if income from a patent or copyright which is a capital asset is "fixed or determinable" under sections 871(a)(1) or 881(a), and more stringent requirements conceivably could be applied to assignments of non-capital assets. The indivisibility doctrine and the fixed sum requirement might be dusted off and put back to work. Thus, if a nonresident alien—not present in the United States—assigned serial rights in a book, the income would not be "fixed or determinable" if the copyright was a capital asset and would therefore be exempt; but if the copyright was not a capital asset—because held primarily for sale in the ordinary course of business¹²⁷ or because held by a taxpayer whose personal efforts produced the property¹²⁸—the income would be "fixed or determinable" and would be taxable under *Wodehouse*.¹²⁹

The result of this approach would be that in many cases aliens and foreign corporations which produced a copyright themselves would be taxed on the proceeds of a partial assignment, while a purchaser of a copyright could dispose of his rights piecemeal, free of tax, provided he did so while not present in the United States. The policies that could support such distinctions are not apparent.

Admittedly, taxing partial assignments of an alien who created a copyright by his personal efforts while exempting assignments by one who purchased the property is remotely relevant to the purpose in the 1936 Act to tax nonresident aliens only on proceeds consisting substantially of net income.¹³⁰ The typical alien author may have spent less money in producing his work than the typical alien who purchased a copyright has paid for the property, and the author would not normally be permitted to treat all of his expenses as investments, anyway. Hence, the proceeds of an assignment by the alien author may carry a higher proportion of profit than those of his counterpart who bought the copyright. Yet such a dichotomy is a crude criterion for distinguishing net income

125. *Supra* note 113.

126. *E.g.*, *Estate of Marton*, 47 B.T.A. 184 (1942); *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946); *Bloch v. United States*, 200 F.2d 63 (2d Cir. 1952).

127. I.R.C. § 1221(1).

128. Or by a person who holds the property with the author's basis. I.R.C. § 1221(3)(B).

129. *Commissioner v. Wodehouse*, 337 U.S. 369 (1949).

130. See text at note 55 *supra*.

from returns of capital. Surely there are enough exceptions to make it unrealistic and inequitable.

The distinction would not apply to patents. In 1950, copyrights produced by the personal efforts of the taxpayer were eliminated from the "capital asset" category, but patents created by the personal efforts of the taxpayer were not.¹³¹ Hence, the amateur alien inventor may be able to qualify his patent as a "capital asset" and his gain as capital gain.¹³² The proceeds from the "sale" would not be "fixed or determinable" even though the proceeds of the "sale" of partial rights by his author counterpart would be. Of course, the inventor might avoid classification of his income as "fixed or determinable" only to have it taxed, if it is an "amount described" in section 1235. But as will be discussed in detail later,¹³³ it is quite possible that he can avoid section 1235 and hence avoid tax altogether if he is not present in the United States.

Moreover, the distinction between purchasers and producers of copyrights would not apply to assignments of partial rights by an alien who purchased a copyright but holds it for sale in the ordinary course of business, for his property would not be a capital asset,¹³⁴ and his income might therefore be "fixed or determinable." On the other hand, if he used the property in a trade or business but did not hold it primarily for sale, the property, although not a capital asset, would be a section 1231 asset. His gains might therefore be "considered" capital gains and thus not "fixed or determinable."¹³⁵

Another possible interpretation is that income from transactions in capital assets meeting the criteria of "sale" established for capital gains are not exempt if they otherwise would fall within the vague criteria of the "fixed or determinable" concept. Thus, if all rights must be assigned for the transfer to be a "sale" which does not produce "fixed or determinable" income, a transfer of partial rights could be taxed under sections 871(a)(1) or 881(a) even if the gain were capital gain and the transferor was never present in the United States.¹³⁶ But this interpretation would not only seem to require taking substantial liberties with legislative history;¹³⁷ it would also produce paradoxes of its own. For ex-

131. See text at note 153 *infra*.

132. See text at note 155 *infra*.

133. See text at notes 175-79 *infra*.

134. I.R.C. § 1221(1).

135. Depreciable property used in a trade or business is also excluded from the definition of "capital assets." I.R.C. § 1221(2). But § 1231 permits net gains from such property in most cases to be "considered as gains . . . from sales or exchanges of capital assets." Patents and copyrights are depreciable. Treas. Reg. § 1.167(a)-3. Gains from such property may therefore be capital gains, hence, not "fixed or determinable" income. The conclusion that § 1231 gains are to be treated as capital gains for purposes of §§ 871, 881 is, of course, far from inexorable.

136. Provided, of course, the alien who "sells" the property here is present less than 90 days during the year and "effects" the "sales" while he is not present, so as not to come within I.R.C. § 871(a)(2).

137. See notes 28, 123 *supra*. It should be noted, however, that while the Committee Reports refer to exempt "capital gains" and "sales or exchanges of capital assets," there is no evidence that Congress, either in 1936 or in 1950, actually had in mind anything but stock

ample, a nonresident alien who assigned serial rights in a book which was a capital asset would be subject to tax under *Rohmer* on his entire proceeds and no losses on other transactions would be allowed.¹³⁸ Yet if the alien "effects" the assignment while present here, the specific provisions of section 871(a)(2) would be applicable since he has "sold" a capital asset. Only his *gains* would then be taxed at 30 per cent, and only to the extent they exceed capital losses effected while present here. It would therefore be possible for the alien's presence in the United States to result in a considerable tax reduction, an outcome antithetic to the apparent purpose of Congress in enacting section 871(a)(2), which was to impose a greater tax burden on aliens present here than on those never, or only temporarily, accepting our hospitality.¹³⁹

Whether income is "fixed or determinable" should not depend on whether the rights assigned are technically capital assets. If sales of capital assets do not produce "fixed or determinable" income—and it seems clear they do not—sales of other patent and copyright interests, using the same criteria of "sale," should also produce income which is not "fixed or determinable."

It is remotely possible that this is the Commissioner's present position. In his latest ruling that an exclusive license for the life of a patent or copyright is a "sale" for "Federal income tax purposes," even if the rights assigned are limited and the consideration is paid on a royalty basis,¹⁴⁰ the Commissioner may have intended to exempt such transfers made by aliens and foreign corporations taxed under the "fixed or determinable" concept. A bit more bombast is to be expected, however, in a ruling reversing a quarter-century's judicial development. The Commissioner's ruling acquiesced in a steady stream of losses to domestic taxpayers,¹⁴¹ not to aliens against whom the Commissioner's indivisibility doctrine had proved an effective weapon.¹⁴² It is unlike the Commissioner to concede so quietly. When the question arises, therefore, the Commissioner may attempt to extricate himself and revert to narrower concepts of "sale" in taxing aliens. The *cul-de-sac* in which the Commissioner will find himself, however, is largely attributable to Congress and the courts, for the most reasonable interpretation of the statute is that a "sale" under sections 871(a)(1) and 881(a) and under section 1222 is the same thing, whatever that thing may be, and the courts have told us what it is.¹⁴³

CAPITAL GAINS TAXABLE UNDER THE 1950 AMENDMENTS

We have noted that every fluctuation in case law interpretation of "sale" for capital gains purposes may also affect the alien under the "fixed or deter-

and commodity transactions. The "liberties" would be taken with what the Committees said, rather than what they probably meant to say.

138. See note 58 *supra*.

139. See text accompanying note 33 *supra*.

140. Rev. Rul. 60-226, *supra* note 113.

141. See cases cited in notes 104, 109, 110 *supra*.

142. See, e.g., cases cited in note 126 *supra*.

143. However, as suggested at text accompanying note 233 *infra*, the Commissioner may have conceded a little too much in Rev. Rul. 60-226, *supra* note 113.

minable" concept: what helps the domestic taxpayer also helps the alien. But in imposing a tax under section 871(a)(2) on "sales or exchanges of capital assets" by an alien present in the United States, Congress created another tax base which oscillates with every modification—legislative or judicial—of the definition of "capital assets." In this instance, however, Congress has put the alien on one side of a see-saw and the domestic taxpayer on the other side. When Congress takes away a tax preference from domestic taxpayers by restricting the definition of "capital asset," it creates an exemption for aliens by creating a class of income from a "sale" which is not taxable as a capital gain under section 871(a)(2). When it confers a tax privilege on domestic taxpayers by enlarging the capital gains device, it imposes a new tax on aliens. The most interesting ingredient in this quaint formula for foreign taxation is that Congress seldom seems to notice what is happening on the alien's side of the see-saw. An illustration may be taken from the Revenue Act of 1950, the same Act in which the capital gains tax on aliens present here was first imposed.

Prior to 1950 there was no tax on "sales" of copyrights by nonresident aliens not engaged in business here since the "sale" of property is not "fixed or determinable." The 1950 Act, however, by imposing a tax on "sales or exchanges of capital assets" by aliens present here 90 days or who effect the gains while here, made some copyright sales by nonresident aliens taxable. The professional alien author, since his property is held for sale in the ordinary course of business and is not a "capital asset,"¹⁴⁴ was apparently not affected. Only the amateur or one who purchased the copyright for investment would have been subjected to the tax under section 871(a)(2).

But in the same Act, Congress enacted the so-called "Eisenhower Amendment," sections 1221(3) and 1231(b)(1)(C), designed to close a "loophole"¹⁴⁵ through which amateur authors like former President Eisenhower¹⁴⁶ received capital gains rates on the products of their personal efforts.¹⁴⁷ Section 1221(3) provides that a "capital asset" does not include "a copyright, a literary, musical, or artistic composition, or similar property, held by . . . a taxpayer whose personal efforts created such property," or a taxpayer whose basis is determined by reference to the author's basis.¹⁴⁸ Section 1231(b)(1)(C) contains a similar

144. I.R.C. § 1221(1).

145. This description is the Senate Finance Committee's. See S. REP. NO. 2375, 81st Cong., 2d Sess. 43 (1950).

146. Mr. Eisenhower received a rumored million dollars or so at capital gains rates for "Crusade in Europe." See N.Y. Times, June 2, 1948, p. 31, col. 5.

147. See generally Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code*, 64 YALE L.J. 1, 8-11 (1954); Krage & Barton, *The Tax Dilemma of the Entertainer*, 31 SO. CAL. L. REV. 390, 401 (1958).

148. The author's donee and a corporation receiving the property as a contribution to capital in certain instances (see I.R.C. § 362) are thus denied capital gains treatment. A purchaser or a legatee is not affected by the amendment. Moreover, the Service has ruled that I.R.C. § 1221(3) does not apply to motion pictures created by a corporation because of the multiplicity of skills and persons involved, and the use of substantial amounts of capital. Rev. Rul. 55-706, 1955-2 CUM. BULL. 300.

exclusion from the definition of property used in a trade or business, which is entitled to quasi-capital gains treatment.¹⁴⁹ Thus, the amateur alien author's copyright is no longer a capital asset or a section 1231 asset; his gain is no longer gain from "the sale or exchange of capital assets" under section 871(a)(2) and any income from the "sale" of this non-capital asset is tax free since it is not "fixed or determinable" income.

Without the "Eisenhower Amendment," section 871(a)(2) would have resulted in taxation of sales of copyrights by amateur alien authors satisfying the requirements of presence in this country. Professionals would have remained exempt. The amendment therefore had the laudable effect of preventing unwarranted distinctions between amateur and professional alien authors. But few would suppose Congress had this in mind. By depriving domestic amateur authors of capital gains treatment, Congress seems inadvertently to have allowed nonresident alien amateur authors to sell copyrights tax free even though present here 90 days or more.

About the only alien copyright owner potentially subject to tax under section 871(a)(2) is the alien who purchased the property.¹⁵⁰ His copyright may still be a capital asset. But if before selling his copyright, he first holds it primarily for sale in the ordinary course of business, he may thereby take the property out of the "capital asset" category,¹⁵¹ its sale outside the terms of section 871(a)(2), and its proceeds out of the clutches of the Commissioner.¹⁵²

PATENT ASSIGNMENTS AND SECTION 1235

Employment of capital gains criteria to measure the nonresident alien's tax base reaches its *reductio ad absurdum* in the 1954 Amendment of section 871(a)(1). Under this amendment, the nonresident alien is taxable on income from specified patent assignments whether or not the proceeds are "fixed or determinable" and regardless of the alien's presence in the United States. The patent income which is so taxable is that which constitute "amounts described in . . . section 1235." Section 1235 was conceived and created for the purpose of conferring a succulent tax preference on domestic inventors. Why the provision was also used to define the alien's tax base is a puzzle; the apparent effects of such use are preposterous.

149. Net gains from sales or exchanges of depreciable property used in the trade or business, together with certain other gains and losses, are usually "considered as gains . . . from sales or exchanges of capital assets held for more than 6 months." I.R.C. § 1231(a).

150. However, Rev. Rul. 55-706, *supra* note 148, indicates that many copyrights which are the result of institutionalized creative efforts may still be capital assets or § 1231 assets.

151. I.R.C. § 1221(1).

152. Of course, if he was this determined to avoid tax he would merely stay out of the United States, making I.R.C. § 871(a)(2) inapplicable to his "capital gain."

Since there was no amendment of the capital asset definition in 1950 which excluded patents transferred by the amateur inventor, he, along with the alien who purchases a patent for investment, may be subject to the tax under I.R.C. § 871(a)(2) if present in the United States. He, too, may apparently avoid the tax under that section, either by staying out of the United States while he effects the "sale," or by converting the patent to a noncapital

Section 1235

The 1950 revenue bill, as it passed the House, denied capital gains treatment to inventors as well as authors.¹⁵³ But the Senate deleted the references to inventors because "the desirability of fostering the work of . . . [amateur] inventors outweighs the small amount of additional revenue which might be obtained under the House bill. . . ."¹⁵⁴ Thus, from 1950 to 1954 all domestic authors and professional inventors paid ordinary rates while amateur inventors could qualify for capital gains.¹⁵⁵ Section 1235 of the 1954 Code eliminated the distinction between amateur and professional inventors and permitted both to get long term capital gains. The avowed purpose of the new provision was to "obviate the uncertainty" caused by the Commissioner's 1950 ruling that indeterminate payments precluded a sale¹⁵⁶ and "to provide an incentive to inventors to contribute to the welfare of the Nation. . . ."¹⁵⁷

Section 1235(a) grants long term capital gains treatment for a transfer "of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights" even though the compensation is periodical and measured by use, productivity, or sales of the patented product. It applies, however, only to transfers by a "holder," defined as the individual inventor or one who purchases the invention before it is reduced to practice.¹⁵⁸ A corporation, the inventor's employer, a relative,¹⁵⁹ or a purchaser after reduction to practice is not a "holder." Moreover, section 1235 does not apply to transfers by a "holder" to a relative or a corporation in which the "holder" owns, directly or indirectly, 25 per cent of the stock.¹⁶⁰

The section did not substantially liberalize the requirements for a "sale."¹⁶¹ In eliminating the six-month holding requirement for long term gains and including professional inventors, however, the provision had the purpose and effect of granting a substantial tax reduction to a significant group of taxpayers.¹⁶²

asset before disposing of it. Since 1954, however, he must get clear of I.R.C. § 1235 before these problems arise. By then his imagination and his spirit may have been exhausted.

153. H.R. 8920, 81st Cong., 2d Sess., § 209(a) (1950).

154. S. REP. No. 2375, *supra* note 145, at 44.

155. See Note, *A Comparison of the Tax Treatment of Authors and Inventors*, 70 HARV. L. REV. 1419, 1427 (1957).

156. Mim. 6490, 1950-1 CUM. BULL. 9.

157. S. REP. No. 1622, 83d Cong., 2d Sess. 439 (1954).

158. I.R.C. § 1235(b).

159. A related person, for purposes of I.R.C. § 1235(b), includes a spouse, ancestors, and lineal descendants, but does not include brothers and sisters. I.R.C. § 1235(d).

160. *Ibid.*

161. I.R.C. § 1235 clearly rejected the Commissioner's position in Mim. 6490, *supra* note 107, that indeterminate consideration would preclude a sale. But this was superrrogatory in view of the decisions. See, e.g., *Commissioner v. Hopkins*, 126 F.2d 406 (2d Cir. 1942); *Edward C. Myers*, 6 T.C. 258 (1946).

162. Few provisions in the Code have kindled more fire from the commentators than the statutory distinctions between authors and inventors. See, e.g., Cary, *Pressure Groups and the Increasing Erosion of the Revenue Laws*, FEDERAL TAX POLICY FOR ECONOMIC

Effect on nonresident aliens

The nonresident alien neither engaged in business nor present here paid no tax before 1954 on gain from transfers of patent rights satisfying the vague requirements of a "sale."¹⁶³ Only if here 90 days or more or when the "sale" was effected, and only if the patent was a capital asset, would he be taxed under section 871(a)(2). A professional inventor, having no "capital gains,"¹⁶⁴ even though present 90 days or more, was probably not subject to tax on a "sale" of his rights, whereas the amateur inventor might be taxed if present in the United States.¹⁶⁵

The 1954 amendment of section 871(a)(1) to include in the tax base of all nonresident aliens, *inter alia*, "amounts described in . . . section 1235, which are considered to be gains from the sale or exchange of capital assets," eliminated the dubious discrimination between amateur and professional alien inventors and removed the presence requirements, making the alien taxable, even though never present here, on patent assignments falling within section 1235. It also compounded confusion.¹⁶⁶

A tax on gross receipts or on gain?

An alien is permitted no "deductions" from his "fixed or determinable" income before computing his tax at the flat 30 per cent rate. As earlier noted, the decisions indicate that the flat rate on "royalty" income which is "fixed or determinable" is on gross receipts. The alien is not permitted to deduct or offset against his royalties any expenses for producing, or costs for purchasing, the

GROWTH AND STABILITY, JOINT COMMITTEE ON THE ECONOMIC REPORT, 84th Cong., 1st Sess. 260, 263; Pilpel, *Developments in Tax Law Affecting Copyrights in 1954*, 33 TAXES 271 (1955).

163. See *Kimble Glass Co.*, 9 T.C. 183 (1947); *Commissioner v. Celanese Corp.*, 140 F.2d 339 (D.C. Cir. 1944).

164. His patents would be held for sale to customers in the ordinary course of business and thus would be excluded from the definition of "capital assets" by I.R.C. § 1221(1).

165. As noted at text accompanying notes 149, 150 *supra*, a similar distinction between amateur and professional alien authors was accidentally precluded by the "Eisenhower Amendment."

166. The Committee Reports disclose little on the purpose of this change in I.R.C. § 871(a)(1). The House bill broadened the tax base of both nonresident aliens and nonresident foreign corporations to include income "considered gains from the sale or exchange of capital assets" but no reason was given. See H.R. REP. NO. 1337, 83d Cong., 2d Sess., A245 (1954). The purpose may merely have been to make clear that several provisions in the 1954 Act (*e.g.*, I.R.C. §§ 402(a)(2), 631) which conferred capital gains treatment on ordinary income items, were not intended to benefit aliens and foreign corporations by broadening the exemption of capital gains of aliens not present here. Thus, preserving existing law may have been the only motive. There is even opinion that existing law as to nonresident alien patent owners was not changed by this amendment. See Mann, *Capital Gains Treatment of Patent Transfers*, 44 J. PAT. OFF. SOC'Y 97, 110-11 (1962).

The Senate Finance Committee gave I.R.C. §§ 871(a) and 881(a) their present forms, broadening the tax base only as to *specific* items "considered to be gains" etc. Presumably, it was thought superfluous to tax foreign corporations on § 1235 transactions since a corporation cannot qualify as a "holder" under § 1235. See S. REP. NO. 1622, *supra* note 157 at 416.

patent or copyright.¹⁶⁷ If "fixed or determinable" income does not include receipts from exclusive assignments of partial rights on a royalty basis, this harsh result will not affect most aliens as their proceeds will not be "fixed or determinable." But a similar trap may lie within section 871(a)(1)'s tax on "amounts described in . . . section 1235"—for it is not clear whether "amounts" refers to gross receipts or gain.

Section 1235 does not in terms describe any "amounts"; it describes a "transfer."¹⁶⁸ In defining the transfer, it specifies that although the "payments in consideration of such transfer" are periodical or contingent, the transfer shall still be treated as a sale.¹⁶⁹ It is therefore conceivable that "amounts" in section 871(a)(1) refers to *payments* received for the transfer, and such payments are taxed at 30 per cent without reduction for the holder's costs. To the extent that proceeds from patent assignments under section 1235 would otherwise be taxable as "fixed or determinable" income, reading "amounts" in section 871(a)(1) as equivalent to payments received would be consistent with the decisions indicating gross royalties are "fixed or determinable" and therefore taxable at 30 per cent. But many patent assignments may be within section 1235 which would be "sales"—even under the indivisibility doctrine—and the proceeds therefore would not be "fixed or determinable." Proceeds from a transfer of all rights under a United States patent, even on a "royalty" basis, were probably not "fixed or determinable" income before 1954,¹⁷⁰ but such a transaction may now come within section 1235, making the entire "amount" taxable at 30 per cent. And if, as suggested earlier, the criteria of "sale" for capital gains purposes are applied to treat partial assignments as "sales" and therefore not taxable at the flat rate as "fixed or determinable" income, the effect of the amendment of section 871(a)(1) is even more drastic. If interpreted to levy a flat tax on the proceeds received in a section 1235 transaction, it would adversely effect many transfers of partial rights in patents which would otherwise be exempt.

There is evidence, however, that "amounts described in . . . section 1235" refers to *gains* from patents therein described, rather than proceeds.¹⁷¹ And the

167. See note 58 *supra*.

168. A transfer . . . of all substantial rights to a patent . . . by any holder shall be considered the sale or exchange of a capital asset held for more than six months, regardless of whether or not payments in consideration for such transfer are (1) payable periodically . . . or (2) contingent on the productivity, use, or disposition of the property transferred.

I.R.C. § 1235(a).

169. *Ibid.*

170. See text accompanying notes 94-96 *supra*. Of course, an alien present here might be taxable on net capital gains under I.R.C. § 871(a)(2), but he would be permitted to deduct his basis under that section. As to the possibility of avoiding United States tax by executing the sale abroad, even where § 1235 is applicable, see part 11 *infra*.

171. In the case of amounts described in . . . Section 1235 . . . the amount required to be . . . withheld shall, if the amount of such *gain* is not known to the withholding agent, be such amount, not exceeding 30 per cent of the proceeds . . . as may be necessary to assure that the tax . . . withheld shall not be less than 30 per cent of such *gain*. [Emphasis added.]

description in section 871(a)(1) of such amounts as "considered to be gains from the sale or exchange of capital assets" is hardly appropriate if gross royalties was the intended meaning. Moreover, if section 871(a)(1) were construed as imposing a tax on gross receipts it would create a conflict with section 871(a)(2) which imposes a tax on capital gains of aliens present here. An alien present here 90 days or more who "sold" a patent which was a capital asset would be taxable on his gain under section 871(a)(2), but, if his transfer was also within section 1235, would be taxable under section 871(a)(1) on his proceeds. The weight of the evidence, and certainly of the equities, suggests that section 871(a)(1) should be read as taxing gain rather than receipts. Even if read as reaching only gains, the provision represents a substantial departure from existing law.

Thus, as to transactions which did not qualify as "sales" and therefore would have been taxable as "fixed or determinable" under section 871(a)(1) before 1954, and which now fit within section 1235, the 1954 amendment may have liberalized the tax treatment of nonresident aliens by permitting them to deduct their basis on the patent.¹⁷² But if the decisions and rulings involving "sales" for capital gains purposes also carve out a category of proceeds which is not "fixed or determinable" under section 871(a)(1), then the nonresident alien was exempt before 1954 on many sales which now may fall within section 1235 and produce taxable gains. Congress, without any evidence of premeditation or malice aforethought, imposed a new tax on nonresident alien inventors while reducing the tax on domestic inventors "to provide an incentive to inventors to contribute to the welfare of the nation."¹⁷³

Transfers "described in section 1235"

Section 871(a)(1) does not make all gains from patent transfers subject to tax; it expressly includes only "amounts described" in section 1235. In transactions not fitting within section 1235, income from patent assignments will still be taxable only if "fixed or determinable" or within the limited category of capital gains covered by the presence requirements of section 871(a)(2). Existing law was not affected by section 1235 as to transactions outside its scope.¹⁷⁴ Thus, all patent transfers by non-holders, or by holders to related persons including the holder's corporation, which transfers are not covered by section

I.R.C. § 1441(c)(5). The Regulations also state that the tax is on "gain recognized on certain transfers of patent rights by an individual." Treas. Reg. § 1.871-7(b)(3).

172. Some transfers not within I.R.C. § 1235 might still be taxable on the gross proceeds. Thus, a § 1235 transfer by a "holder" might sometimes receive preferential treatment. This result would at least seem consistent with the general purpose of § 1235 to favor individual inventors as opposed to institutional inventors.

173. See note 157 *supra*.

174. In enacting this section, for the specific purposes set forth in this report, your committee has no intention of affecting the operation of existing law in those areas without its scope. For example, the tax consequences of the sale of patents . . . by individuals who fail to qualify as "holders," or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted.

S. REP. NO. 1622, *supra* note 157 at 441.

1235,¹⁷⁵ may still be exempt if "sold" while the alien is not present here, or if the patent is not a capital asset. A nonresident foreign corporation may be able to exploit patents here tax free while the individual inventor cannot. The invitation to contrivance is apparent. An alien inventor wanting to avoid tax may consider the possibilities of a transfer abroad to a relative or a controlled foreign corporation for tax free exploitation here.¹⁷⁶ Or he may have his corporation employ him to invent for it, and have the corporation—as a non-holder, not subject to tax on capital gains—market the patents here tax free.

Furthermore, all transfers by the inventor himself to unrelated persons are not within section 1235. It may be possible for the inventor to convey an exclusive license in a limited geographical area which is not within section 1235 but is nevertheless a "sale," exempt unless the inventor is present in the United States. Section 1235 refers to a transfer of "all substantial rights."¹⁷⁷ Conceivably, therefore, a transfer of partial rights, which may be a "sale" and not "fixed or determinable," may not be covered by section 871(a)(1),¹⁷⁸ with the anom-

175. See Treas. Reg. § 1.1235-1(b).

176. If such a transfer is not within I.R.C. § 351 (nonrecognition of gain or loss on certain transfers of property to a controlled corporation) and is not a gift, the inventor might be taxable in theory. However, unless the foreign transferee is subject to the obligation of withholding (see I.R.C. § 1441[a]) the tax on the transfer would be difficult to collect. Moreover, since a transfer to a relative or controlled corporation is not within I.R.C. § 1235, it would not be subject to tax—if the inventor is not present here—unless it produced "fixed or determinable" income. Furthermore, as suggested *infra*, part II, the income might not be from United States sources.

177. Treas. Reg. § 1.1235-2(c), provides that a transfer of "all substantial rights" under § 1235 does not include a license limited geographically, functionally, or in time. The reference to geographical limitations is probably only to intracountry restrictions. The Regulations define "patent" under § 1235 to mean a patent granted under title 35 U.S.C. or any foreign patent granting similar rights. Treas. Reg. § 1.1235-2(a). Hence, all rights under a United States patent apparently constitute "all substantial rights" under § 1235.

178. "It is the intention of your committee that, if the mode of payment is as described in subsection (a) [of § 1235], the sale of a patent by any 'holder' must qualify under the section in order for such 'holder' to obtain capital gain treatment." S. REP. No. 1622, *supra* note 157 at 441. The "mode of payment" referred to is periodical or contingent (see note 168 *supra*). Query, therefore, whether a transfer by a nonresident alien "holder" for a *lump sum* is taxable under I.R.C. § 871(a)(1)? The thrust of the quoted provision of the Committee report seems to be that if payment is periodical or contingent, all substantial rights must be transferred by a holder for his gain to qualify. Arguably, therefore, a transfer of less than all substantial rights, whether in a lump sum or on a royalty basis, may nevertheless be a "sale" qualifying for capital gains treatment under the general provisions of §§ 1221, 1231 though not satisfying the special requirements of § 1235. Such transfers by nonresident aliens, therefore, may conceivably be exempt capital gains not taxable as "amounts described in . . . section 1235." Cf. Leonard Coplan, 28 T.C. 1189 (1957), holding that a transfer of a patent to a family owned corporation was a sale of a capital asset even though the transfer, by a "holder" to the corporation, did not satisfy § 1235. This decision, and Treas. Reg. § 1.1235-1(b) have been read as holding that § 1235 does not in any way preclude "sale" treatment under § 1222, and that geographically limited transfers may qualify under § 1222, even though made by a "holder." See SURREY & WARREN, *FEDERAL INCOME TAXATION* 757 (1960); Clark, *Tax Aspects of Operating Patents: Income from a License Agreement as Capital Gain or Ordinary Income*, PATENT LICENSING (P.L.I. 1958), 91, 111-12. But cf. Kirby v. United States, 191 F. Supp. 571 (S.D. Tex. 1960).

alous result that piecemeal dispositions may be exempt¹⁷⁹ while the transfer of the whole bundle is taxable. The law would then have made a 180 degree turn from its course of a decade before.

Summary

Whatever the wisdom or merit in the domestic tax policies reflected by the 1950 copyright amendment and the 1954 amendments relating to patents, these provisions are pregnant with infirmities where nonresident aliens are concerned. In plugging the copyright "loophole" in 1950,¹⁸⁰ Congress was apparently heedless of the relationship of the capital gains provisions to the sections governing nonresident aliens, even though in the same act the capital gains concept was used in broadening the alien's tax base. Congress in 1954 saw a relationship between capital gains and section 871, but it takes a conjurer to discover the congressional purpose in partially displacing the "fixed or determinable" concept with section 1235, a provision conceived simply and solely to confer a subsidy on domestic inventors. Perhaps Congress thought long term capital gains treatment for professional inventors was not enough and the tax burden on nonresident alien inventors should be increased to give resident inventors a competitive advantage. The prudence of such a policy is dubious if the purpose of section 1235 was to stimulate United States technological and industrial development. But even if this were the congressional design it provides little help in interpreting the statute. Moreover, whatever changes in policy regarding nonresident alien authors and inventors were intended by the 1950 and 1954 amendments, there are enough cracks and crevices in the scheme to guarantee ineffectuality.

An alien who is present here, or expects to be present, and intends to dispose of a copyright, or an interest therein, can easily enough conform the transaction to the sale criteria of the Commissioner's latest ruling,¹⁸¹ and if his copyright is a capital asset he can probably convert it to a non-capital asset by first holding it for sale in the ordinary course of business. Thus, his gain will not be capital gain within section 871(a)(2). Even if capital gain, the income will not be taxable to an alien present less than 90 days who effects the "sale" while he is not present.¹⁸² Alternatively, he may be able to use a corporation to dispose of the property as a nonresident foreign corporation is not taxable on capital gains.¹⁸³

179. On the question of what kinds of assignments of partial rights may be "sales," see note 114 *supra*; Vincent A. Marco, 25 T.C. 544 (1955); *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955); *First National Bank v. United States*, 136 F. Supp. 818 (D. N.J. 1955).

180. See text accompanying note 145 *supra*.

181. Rev. Rul. 60-226, 1960-1 CUM. BULL. 26.

182. See note 38 *supra*.

183. Other than gains from timber and coal. I.R.C. § 881(a). The Commissioner, of course, is not wholly impotent to deal with some of the grosser manipulations. The corporate entity has been and can be "disregarded" under a number of principles. See generally, BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 12-17 (1959).

The nonresident alien disposing of a patent can also employ the corporate device, and several others, to avoid the tax on capital gains levied by section 871(a)(2) or the tax on patent assignments imposed by section 871(a)(1).¹⁸⁴ A tax scheme which encourages such maneuvering and lays such a penalty on those not clever enough to outflank it demands reappraisal.

THE TAX CONVENTIONS: A WAY OUT OF THE MORASS?

The tax treaties between the United States and most Commonwealth and Western European countries, and a few others,¹⁸⁵ doubtless diminish the practical importance of the statutory arcana, as most grant some relief from taxation of royalties by countries from which the royalties are remitted. But many countries not parties to the conventions still have a substantial impact on the United States economy. Moreover, even where the treaties are applicable, their terms may provide only illusory or incomplete relief. When compared with the statutory developments previously discussed, the treaty provisions also seem replete with ambiguity.

Exemption of royalties

The typical treaty exempts residents and corporations of one contracting state from taxation of specified types of income by the other provided the taxpayer is not engaged in business through a permanent establishment in the taxing state.¹⁸⁶ The broadest of exemptions regarding patents and copyrights applies to "royalties and other amounts paid as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trademarks, and other like property."¹⁸⁷ Many treaties do not go this far.¹⁸⁸ Several specifically exclude motion picture rentals from the exempt

184. See note 178 *supra* and related text.

185. Japan, Pakistan, Honduras, Union of South Africa. Conventions with India, Israel, United Arab Republic, and Luxembourg have been signed and await Senate ratification. Negotiations are in progress with several South American and African countries.

186. There is little uniformity in defining the classes of persons who are exempt. The United Kingdom treaty, for example, exempts royalties received from the United States by a United Kingdom resident (including a corporation managed and controlled in the United Kingdom) who is subject to tax on the royalties in the United Kingdom and who is "not engaged in trade or business in the United States through a permanent establishment situated therein," or if so engaged, the royalties are "not directly associated with the business carried on through the permanent establishment." Art. VIII (1). Compare the Treaty with Sweden which exempts royalties of a Swedish resident or corporation without limitation to those so engaged in business or having a permanent establishment here. Art. VI. The Regulations for the Swedish treaty, however, exclude a Swedish corporation doing business here on the ground it is a resident of the United States. There is no similar limitation on individuals. See § 25.8 T.D. 4975, 1940-2 CUM. BULL. 54.

187. Treaty with United Kingdom, July 30, 1946, Art. VIII (1). For similar, but not identical provisions see Treaty with Switzerland, October 13, 1951, Art. VIII; Treaty with France, October 18, 1946, Art. 7.

188. The Treaty with the Union of South Africa, December 13, 1946, contains no royalty relief other than for natural resources, and no exemption is provided even for natural resource royalties. Protocol, Art. III.

category.¹⁸⁹ Others merely provide for reduced rates on certain types of royalties.¹⁹⁰ And the conventions with Canada and Australia confine the exemption to royalties on literary or artistic works.¹⁹¹

Even though a nonresident alien or foreign corporation is within the class of taxpayers entitled to exemption under a treaty and his property is included in the classes of property on which royalties are exempt, he is aided by the treaty only if his income is "royalties" or "royalties and other amounts," as the treaty may provide.¹⁹² Herein lies the quagmire. The conventions customarily provide that terms not defined in the treaty shall have the meaning accorded them under the laws of the taxing country.¹⁹³ "Royalties" are not defined apart from their description in most of the treaties as payments "for the use of" or for the "right to use" the specified property. Therefore, what constitutes a "royalty" for the "right to use" a patent or copyright is, for purposes of the exemption from United States tax, presumably determined by United States law. Does the treaty exemption thus depend upon the chameleonic distinction—developed mainly in the capital gains context—between "sales" and "licenses" and their correlative bifurcates, "purchase price," and "royalties"? Which test is applicable if the criteria of a sale under the "fixed or determinable" income concept are different from those for capital gains purposes? And what of still different criteria that may be applied in determining standing to sue or other non-tax questions, the results of which are often described in terms "sales" or "licenses"?¹⁹⁴

189. *E.g.*, Treaty with Canada, June 17, 1942, Art. XIII C; Treaty with Australia, May 14, 1953, Art. X; Treaty with Finland, March 3, 1952, Art. VIII; Treaty with Greece, February 20, 1950, Art. VII.

190. *E.g.*, Treaty with Japan, April 16, 1959, Art. VII (15%); Treaty with Canada, June 17, 1942, Art. XI (limiting tax on all income not exempt to 15%).

191. Treaty with Canada, June 17, 1942, Art. XIII C; Treaty with Australia, May 14, 1953, Art. X.

192. Some of the treaties exempt "royalties" for the "right to use" specified property (see *e.g.*, Treaty with France, October 18, 1946, Art. 7; Treaty with Greece, February 20, 1953, Art. VII) while others exempt "royalties and other amounts" for the right to use specified property (*e.g.*, Treaty with Denmark, December 8, 1948, Art. VIII; Treaty with Norway, June 13, 1949, Art. VII; Treaty with Switzerland, October 13, 1951, Art. VIII). Whether the difference is significant is problematical. It has been suggested that a "royalty" applies only to intangible property and does not include "rentals." PHILLIPS, UNITED STATES TAXATION OF NON-RESIDENT ALIENS AND FOREIGN CORPORATIONS 290 (1952). Several conventions or protocols, however, have defined "royalties" to include motion picture rentals. See Treaty with Belgium, October 28, 1948, Art. IX (2); Treaty with France, October 1, 1946, Art. 7(b).

193. See, *e.g.*, Treaty with Belgium, October 28, 1948, Art. II (2); Treaty with Denmark, December 8, 1948, Art. II (2); Treaty with Greece, February 20, 1953, Art. II (2); Treaty with United Kingdom, July 30, 1946, Art. II (2).

194. See text accompanying note 59 *supra*. Another possibility is that "royalties" as used in the treaties refers not to what is a "royalty" for purposes of taxation under the "fixed or determinable" concept [I.R.C. §§ 871(a), 881(a)] but under the rules for determining source of income. I.R.C. §§ 861(a) (4), 862(a) (4), specify the geographical origin of "royalties," whereas I.R.C. §§ 861(a) (6), 862(a) (6) specify the origin of income from

It is not clear why consideration for a "license" should always be a "royalty," or why consideration for a "sale" is necessarily not a "royalty." A transaction may be a "sale" for several purposes yet the consideration may conceivably be for the "right to use" the property. Indeed consideration for all sales could be so described, though the term ordinarily refers to consideration for a transfer of something less than complete ownership. If all consideration for patent and copyright assignments was intended to be exempt under the treaties, different language would have been appropriate. But if countries were willing reciprocally to exempt royalties received by nonresident aliens, it is not evident why they would have wished to draw the line at purchase price.¹⁹⁵

If the nonresident alien inventor assigns his patent rights in a limited geographical area to a United States manufacturer for periodic, contingent compensation, why should the fact that our courts and Commissioner decide such a transaction is a "sale"¹⁹⁶ prevent treaty exemption where the basic policy behind such a characterization is the granting of preferential rates to domestic taxpayers and stimulation of patent and copyright assignments? If the Commissioner's latest ruling defining a "sale" to include assignments of limited rights on a royalty basis¹⁹⁷ correspondingly confines the scope of the royalty exemption under the treaties but does not have the same effect on the "fixed or determinable" concept,¹⁹⁸ then many taxpayers in treaty countries will find themselves subject to a United States tax, and domestic assignees, insensible of these niceties, may be liable for the tax which they should have withheld.¹⁹⁹ It seems likely, however, that a "royalty" which is "fixed or determinable" is also a "royalty" under the treaties. The likelihood that a treaty exemption will not apply to "royalties" taxable as "fixed or determinable" income seems remote.

But an alien might "sell" his patent or copyright and his gain might be taxable as a capital gain if the presence conditions of section 871(a)(2) are

a "sale" of personal property. The courts, however, seem to equate the criteria of a "royalty" for source of income purposes with the criteria of a "royalty" for purposes of defining the "fixed or determinable" concept. See text accompanying notes 264-65 *infra*.

195. This would have seemed particularly true of the United States before 1950 because "sales" were not included in the "fixed or determinable" concept and were therefore exempt by statute. Thus unless an alien or foreign corporation was engaged in business he would not have to rely on treaty exemption of "sales." And if the alien or foreign corporation was engaged in business here through a permanent establishment, most treaty exemptions would not apply to him. The 1950 amendment making capital gains of aliens present here taxable [I.R.C. § 871(a)(2)] and the 1954 amendment making patent transfers under § 1235 taxable regardless of presence [I.R.C. § 871(a)(1)] complicates the question, to say the least.

196. See notes 114, 178 *supra*.

197. Rev. Rul. 60-226, 1960-1 CUM. BULL. 26. See note 113 *supra*.

198. *I.e.*, proceeds can be received in a "sale" for treaty purposes and will not be exempt as "royalties" under the treaties, but are nevertheless "royalties" under I.R.C. §§ 871(a)(1), 881(a) and taxable as "fixed or determinable" income. As suggested at text accompanying notes 139-43 *supra*, however, what is a "sale" for capital gains purposes should also be a sale for "fixed or determinable" purposes, at least under the present statutory scheme.

199. See I.R.C. §§ 1441, 1461.

met, or the gain from a patent might be an "amount described in . . . section 1235," taxable regardless of presence and "considered the sale . . . of capital assets."²⁰⁰ If capital gains criteria of a "sale" limit the treaty exemptions of "royalties," there is a substantial gap in treaty protection,²⁰¹ whether or not the "fixed or determinable" concept is also confined by such criteria. That taxation of such transactions accords with the expectations of the signatories seems doubtful. Even more doubtful is that Congress, when enacting the 1950 amendment imposing tax on certain capital gains, and in 1954, when imposing the 30 per cent tax on "amounts described" in section 1235, gave any consideration to the possible impact of these provisions on the "royalty" exemptions under the tax conventions.

Exemption of capital gains

Taxpayers protected under Canadian, Swedish, and United Kingdom treaties may get some relief from other provisions peculiar to these conventions. Each contains a clause exempting "gains . . . from the sale or exchange of capital assets."²⁰² The use in these treaties of technical "sale or exchange of capital assets" terminology suggests a desire for precision.²⁰³ And literal interpretation of the terms would, of course, extend the exemption to gains from patents and copyrights which are from "sales of capital assets." These clauses were included and the treaties ratified before the 1950 amendment imposing tax on capital gains of aliens present here, and were therefore considered largely restatements of existing law.²⁰⁴ The Senate refused to ratify similar

200. I.R.C. § 871(a)(1).

201. I.R.C. § 894 provides that gross income does not include income exempted by treaty but this is little help in determining the effect of the 1950 and 1954 amendments on the treaty exemptions inasmuch as the definition of "royalties" under the treaties is left to domestic law.

202. Treaty with Canada, March 4, 1942, Art. VIII; Treaty with Sweden, March 23, 1939, Art. IV; Treaty with United Kingdom, April 16, 1945, Art. XIV. The French Treaty exempts gains from "the sale or exchange of stocks, securities or Commodities." Art. 11. The Treasury construes the term to include only commodities "of a kind customarily dealt in on an organized commodity exchange." Section 7.421, T.D. 5499, 1946-1 CUM. BULL. 146.

203. Literal interpretation is also suggested by the Regulations under the Canadian and United Kingdom Treaties which merely refer to the statutory definition of "capital assets" (I.R.C. § 1221) for "what constitutes capital assets" under the respective treaty. See § 7.29, T.D. 5206, 1943-2 CUM. BULL. 537 (Canada); § 7.523, T.D. 5569, 1947-2 CUM. BULL. 115 (United Kingdom). The Regulations under the Swedish Treaty do not define the scope of the exemption, other than to exclude gains from real property, held taxable under Art. V of the treaty notwithstanding the exemption of capital gains in Art. IX, by the Tax Court in *Jan Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955). But there is no evidence in available interpretive materials that anything other than stock, securities, and the like, were actually considered within the scope of the treaty exemptions. See, *e.g.*, Technical Memorandum of the Treasury Dept. on Swedish Convention, ¶ 7351 CCH Tax Treaties; First Report of the Senate Foreign Relations Committee on the Income Tax Convention with the United Kingdom, ¶ 8153 CCH Tax Treaties.

204. See Technical Memorandum on Swedish Convention and First Report of Senate Foreign Relations Committee, *supra* note 203.

provisions²⁰⁵ in later treaties, but the 1950 amendment did not impair the pre-existing treaty exemptions.²⁰⁶

An unresolved question, however, is whether the Canadian, Swedish, and United Kingdom Conventions incorporate all the niceties of United States capital gains law; whether, for example, the exemption includes gains "considered to be sales or exchanges of capital assets"²⁰⁷ under the Code even though what was sold was not a "capital asset." Patent assignments under section 1235, which are taxable under section 871(a)(1) to all nonresident aliens who are "holders," are "considered to be gains from the sale or exchange of capital assets" although under the general definition of the term "capital assets" and the decisions construing it, patents sold by a professional inventor are not capital assets.²⁰⁸ Moreover, patents or copyrights used in a trade or business are not "capital assets"²⁰⁹ but gain from them may be treated as capital gain under section 1231 and presumably taxed under section 871(a)(2) if the presence requirements are satisfied.²¹⁰ Is it possible that these items may be taxable under the Code but not within the treaty exemptions of "sales or exchanges of capital assets"? Statutory modifications which confer capital gains treatment on gain, such as that of a professional inventor, which is not literally gain from the "sale or exchange of a capital asset," may confer exemption under the treaties. One writer has expressed this view,²¹¹ but the treaties and available interpretive materials are silent on the question.²¹² The reason, of course, is that the treaties were executed before Congress began using the capital gains device to subsidize personal efforts, as in the case of the professional inventor under section 1235.

Construing the treaty exemptions of capital gains as also exempting items "considered to be" capital gains under the Code seems sound when applied to

205. Treaty with Denmark, December 8, 1948, Art. XII; Treaty with Ireland, September 13, 1949, Art. XIV; Treaty with the Netherlands, April 29, 1948, Art. XI.

206. Section 214 of the Revenue Act of 1950, 64 Stat. 937, preserved existing treaty obligations. See also Special Ruling, ¶ 1267 CCH Tax Treaties, to the effect that the capital gains exemption in the Canadian Treaty was not affected by 1950 Code changes.

207. The device of conferring capital gains status on certain income by "considering" it to be capital gain has become popular in recent years, not only to correct obvious definitional defects, as by I.R.C. § 1232 which considers retirement of a bond as a sale or exchange, but also to effect substantial changes in policy, as in I.R.C. § 1235 (patents), § 421 (employee stock options), §§ 402, 403 (pension fund distributions), §§ 631(b), (c) (timber and coal dispositions).

208. The patent of a professional is held for sale to customers in the ordinary course of business and is within the statutory exclusion of I.R.C. § 1221(1). See, *e.g.*, Harold Avery, 47 B.T.A. 538 (1942).

209. I.R.C. § 1221(2).

210. See note 149 *supra*.

211. PHILLIPS, UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 302 (1952).

212. See note 203 *supra*.

a treaty which exempts both "royalties" and capital gains²¹³ but creates perplexing problems under the Canadian treaty which exempts capital gains but does not exempt industrial royalties.²¹⁴ Suppose a Canadian resident disposes of a United States patent, his consideration being measured by the successful exploitation of the patent. Are his "royalties" taxable under section 871(a)(1) as "amounts described in section 1235" or are they exempt under the treaty as proceeds from "the sale or exchange of capital assets"?²¹⁵

If the exemptions in the Canadian, Swedish, and United Kingdom treaties were intended to incorporate all the minutiae of American capital gains law, it seems unlikely that the scope of the exemptions was intended to be frozen as of the effective date of the convention. The capital gains concept is notoriously fluid and it would seriously detract from the utility of a tax treaty to tie it too tightly to the past. But if the scope of a treaty provision is to expand and contract with statutory modifications, Congress should be more mindful of the foreign tax consequences of its domestically oriented legislation.

If Congress intended by section 871(a)(1) to tax patent transfers of aliens exempt by treaty on "royalties" by the expedient of calling a section 1235 transfer a "sale or exchange of a capital asset," its cleverness may have boomeranged as far as the Canadian, Swedish and United Kingdom treaties are concerned. For Congress may thereby have brought such transfers within the capital gains exemptions. Of course, the members of Congress had no such thing in mind. They had very little in mind.

The solution to the treaty problem in the future is to define in the treaty what is exempted rather than leaving the treaty terms to be defined by the conflicting and contradictory legal concepts of each contracting party. The solution to the statutory problem is to decide what the national policy is and frame a new statute to carry out that policy. Whatever the present policy, it is not served by the existing framework.

RELEVANCE OF THE CAPITAL GAINS POLICIES TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

The labyrinth created by the capital gains provisions, sections 871 and 881, and the tax treaties, seems largely the product of legislative and administrative oversight. What emerges is not a flattering picture of the legislative process. The scheme for taxing nonresident aliens and foreign corporations should either be stripped of its dependence upon capital gains concepts, or explicit study should be made of the parallels and divergencies of capital gains policies and nonresident alien exemptions.

213. On the theory that all income from assignments of personal property or the right to "use" such property was probably intended to be exempt. See notes 195, 204 *supra* and related text.

214. The exemption applies to "royalties for the right to use copyrights or in respect of the right to produce or reproduce any literary, dramatic, musical, or artistic work (but not inclusive of rents or royalties in respect of motion picture films)." Treaty with Canada, March 4, 1942, Art. XIII C.

215. Treaty with Canada, March 4, 1942, Art. VIII.

The capital gains device has been pelted with so much propaganda and sugared by so many special provisions that the basic purposes of capital gains have almost been buried. All that can be said with certainty about capital gains is that they represent something which for various reasons of policy or pressure was deemed deserving of a lower tax rate. To venture beneath this generality is a hazardous journey.²¹⁶ Before the 1954 Code, however, it was generally understood that capital gains rates were intended to apply only income realized from "investments" as opposed to the products of personal effort.²¹⁷

Income from "investments" is separated from income which contains sufficient personal service elements to make it undeserving of capital gains rates at two levels: In defining "capital assets"²¹⁸ and in defining "sale or exchange."²¹⁹ In a perfect Code the "sale" requirement would define only the requisite method of disposition and the criteria of a "sale" would not be affected by the personal effort component of the underlying asset. The "sale" criteria, being developed and articulated for property having both high and low personal effort components, are ill suited for screening out undeserving property from capital gains treatment. Congress, however, has done an inadequate job in defining "capital assets."²²⁰ The courts and Commissioner have had to fill in the gaps. Sometimes the transfer of rights has been held not "property";²²¹ at other times the courts have merely denied capital gains without spelling out which was missing, "property" or a "sale."²²² Occasionally, capital gains treatment has been denied even though the court conceded that the statutory requirements were literally met.²²³ Often, however, the task of defeating capital gains on "property" which is not within one of the statutory exclusions has fallen upon the "sale or exchange" requirement. The pressures thus put on the definition of "sale" by deficiencies in the definition of capital assets are a burden for which the concept was not built.

216. See Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956); Note, *Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are Sold*, 69 HARV. L. REV. 737 (1956); Note, *The P. G. Lake Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies*, 14 STAN. L. REV. 551 (1962).

217. See *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 53 (1955). See generally, Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code*, 64 YALE L.J. 1, 82-83 (1954).

218. I.R.C. § 1221.

219. I.R.C. § 1222.

220. A "capital asset" is defined in the Code simply as "property," subject to five specified exceptions. I.R.C. § 1221.

221. See, e.g., *Runyon v. United States*, 281 F.2d 590 (5th Cir. 1960); *Helen Miller*, 35 T.C. 631 (1961).

222. E.g., *Ehrlich v. Higgins*, 52 F. Supp. 805 (S.D.N.Y. 1943); *F. W. Jessop*, 16 T.C. 491 (1951).

223. E.g., *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1950).

Before 1950 when the patents and copyrights of amateurs were both judicially characterized as "capital assets,"²²⁴ the Commissioner could still hope to block a tax bounty on many such products of personal effort with the indivisibility doctrine.²²⁵ The notion of an inherently indivisible patent or copyright was vulnerable, however, apart from its metaphysical underpinnings, because it applied across the board to all patent and copyright assignments regardless of the investment component in the property. Thus, insofar as the doctrine was justified by the policy of curtailing capital gains for personal efforts, it was arguably too crude a criterion. Moreover, when applied to patents and copyrights in which the investment component was substantial, the doctrine seemed merely a blunt edged supplement to the "sale to customers" exclusion in section 1221(1). If property is held primarily for sale to customers in the ordinary course of business it is not a capital asset. The marketing of patents or copyrights in slices would often bring the property within the "sale to customers" exclusion if the slices were very thin.²²⁶ Thus, if a taxpayer bought a copyright in a novel, then peddled the book, serial, movie, dramatic, and television rights in separate "sales" to different "purchasers" he might be denied capital gains treatment, not because there were no "sales" but because selling his copyright was a business and a substantial part of his income was not from his investment in the copyright but from his efforts in peddling it. Used as a substitute for the "sale to customers" exception of section 1221(1), the indivisibility doctrine was arguably too inflexible.

When Congress in 1950 removed authors as claimants to capital gains²²⁷ and when it enacted section 1235 in 1954, it clarified its purposes as to the character of the property which should be treated as a "capital asset." On copyrights, Congress confirmed the Commissioner's apparent belief that capital gains for amateur authors was a "loophole."²²⁸ On patents it went in a different direction and indicated that the products of inventive effort were worthy of preferred rates.

About the only function left for the indivisibility doctrine after 1954 was to define the mode of realization that deserved encouragement. The doctrine no longer had to serve two functions and was therefore ripe for reevaluation. The only question was whether it properly described the methods of realizing income from property which warranted relief from progressive rates.²²⁹ The

224. See *Edward Myers*, 6 T.C. 258, 266 (1946); *Evans v. Kavanagh*, 86 F. Supp. 535 (E.D. Mich. 1949), *aff'd*, 188 F.2d 234 (6th Cir. 1951); *Herwig v. United States*, 105 F. Supp. 384 (Ct. Cl. 1952).

225. See text accompanying notes 59-62 *supra*.

226. Cf. *Goldsmith v. Commissioner*, 143 F.2d 466 (2d Cir. 1944); *Fields v. Commissioner*, 189 F.2d 950 (2d Cir. 1951).

227. I.R.C. §§ 1221(3), 1231(b)(1)(C).

228. See text accompanying note 145 *supra*.

229. Amateur inventors whose transfers do not qualify under I.R.C. § 1235, however, may still claim capital gains under §§ 1221, 1222. To this limited extent the problem of whether patents and copyrights created by the taxpayer's personal efforts should be "capital assets" under § 1221 is not clarified by the 1954 Code.

Commissioner might have concluded—even without prodding by the courts—that the doctrine was too restrictive. For when Congress enabled professional inventors and promoters of inventions to obtain capital gains rates even if they disposed of their property on a royalty basis, it may have seemed unreasonably harsh to deny investors in patents, who could not qualify under section 1235,²³⁰ and investors in copyrights, to “sell” their property in slices, especially since section 1221(1) would disqualify the property in marketing the slices became a business.

The Commissioner’s position against “sales” subject to a retained economic interest in exploitation²³¹ may, like the indivisibility doctrine, have been influenced by the anomaly of capital gains on personal efforts;²³² and his recalcitrance may have been buttressed by his lack of success with the indivisibility theory. This position also needed re-examination after 1954. Inasmuch as Congress specifically approved “royalty” sales on section 1235 transactions, it indicated they were not inconsistent with capital gains treatment. Congress therefore weakened the Commissioner’s support for both positions and strengthened the courts’ rejections. But Congress did not approve the use of both methods in combination. Section 1235 authorized capital gains on transfers subject to royalty rights only where the holder assigned “all substantial rights” in his patent. Thus, the Commissioner could reasonably have clung to the position taken in *Cory v. Commissioner*²³³ that a taxpayer could have a “sale” by either method—all rights subject to a royalty interest or partial rights for a fixed sum—but not both. Capitulating in Revenue Ruling 60-226,²³⁴ the Commissioner went farther than Congress or the courts required him to go. It is not unlikely, therefore, that this position may be re-examined.

Taxpayer pressures on the formulation of criteria for the “sale” concept come from two distinct sources:—to obtain favorable capital gains rates—and to secure exemptions from tax as “fixed or determinable” income. Both sources, however, have in common the desire to secure preferred treatment for transfers which for varying reasons of policy are not deemed amenable to conventional tax treatment. But further resemblance is tenuous.

Persuasive arguments can be made for minimizing deterrents to the realiza-

230. I.R.C. § 1235 applies to transfers by an individual who purchased the patent only if the purchase was made before the invention was reduced to practice. I.R.C. § 1235(b) (2).

231. See notes 103, 104, *supra*, and related text.

232. The Commissioner’s justification for his position against capital gains on “sales” by the royalty route, however, was that capital gains were intended to be granted only where income accruing over several years was telescoped into a single year—as in the case of a lump sum sale. The Commissioner’s position is stated and rejected in *Carl Dreyman*, 11 T.C. 153, 162-63 (1948). Another argument which might be made against capital gains on royalty “sales” is that the taxpayer, by retaining a substantial economic interest in the successful exploitation of the property, has not terminated his “investment,” *i.e.*, risk, in the property. Cf. Note, *Distinguishing Ordinary Income From Capital Gain Where Rights to Future Income are Sold*, 69 HARV. L. REV. 737, 742-43 (1956).

233. See note 104 *supra*.

234. 1960-1 CUM. BULL. 26, quoted at note 113 *supra*.

tion of income from patents and copyrights, whether by foreign or domestic taxpayers. There is the classic argument that net revenues will be increased by reducing tax burdens as low tax rates stimulate productive effort and realization of latent income. Reams of polemic can be mustered on the value to society of encouraging inventive and artistic effort; and few would deny that such efforts are of considerable societal value. But the factors which deter domestic exploitation by the alien are different from those affecting the domestic taxpayer. Few notions call forth less agreement than that of tax deterrents. But a judgment on the deterrent effect of taxation on socially useful activities underlies most tax preferences. The domestic owner of a patent or copyright, subject to tax on his worldwide income, does not have a feasible alternative to ordinary income rates. If he holds his property off the market and does not use it himself, it will probably lose its value in a short time. He may avoid taxation only by failing to exploit. Thus, ordinary income rates do not seem particularly oppressive. Insofar as ordinary rates may deter him from exercising his creative efforts, there are already provisions in the Code permitting him to spread income over several years and thus to mitigate the sting of progressive rates on bunched income.²³⁵

The nonresident alien or foreign corporation, however, may have attractive alternatives to avoid United States tax while exploiting the United States rights. In some cases, the author or inventor may hire out to a foreign firm to write or invent for it;²³⁶ if his property is already created, he can assign it to a foreign firm, or use it himself, and export the products produced from his patent or copyright to the United States. In many such instances, no United States tax will be due.²³⁷ The relative attractiveness of exploiting abroad and

235. I.R.C. §§ 1301, 1302.

236. If the alien's services are rendered abroad none of his compensation will be from United States sources. I.R.C. § 862(a) (3).

237. As is discussed in Part II, if "title" to tangible goods imported to the United States passes outside the United States the income from the sale of the goods is foreign source income. Thus, the alien's profit on United States patents and copyrights can be derived from United States markets free of United States tax. When the owner of a patent or copyright exploits it by publishing and selling books or building and selling patented machines, part of his income from sale of the books or machines is theoretically derived from his copyright or patent. If the patent or copyright is valuable at all, it contributes to the profitability of the sales of the product. Moreover, when the owner sells a book or a machine, he is granting an infinitesimal portion of his rights under the copyright or patent—the right to a limited use of the product. He retains, however, the more substantial rights to permit others to use or reproduce the work. Hence, he has not in any practical sense "sold" or granted a "license" of his patent or copyright. To the very limited extent that his monopoly rights are "granted" by the sale of the product, and to the extent that profit from the sale of the product is theoretically attributable to the patent or copyright monopoly rather than to his efforts and capital in producing and marketing the tangible product, it is disregarded as *de minimis*. Theoretically, the income attributable to the patent or copyright could be segregated from the income attributable to the capital and effort expended in producing and marketing the product, and this income could be allocated and taxed under different criteria. The practical difficulties, however, require that such income be treated as merged in the income from the goods and that it be taxed under the same criteria.

exploiting locally will vary from property to property,²³⁸ country to country and must take into account tariff and import restrictions, relative costs of manufacture and many other factors. But it seems undeniable that local exploitation of patents and copyrights by nonresident aliens and foreign corporations will often be deterred by taxation,²³⁹ whereas this is not so clear in case of the domestic taxpayer who is subject to United States tax on his worldwide income.

The broad policy questions involved in taxing foreign authors and inventors seem never to have been considered by Congress. And the courts and the Commissioner seem generally to feel that any patent or copyright proceeds which can be withheld ought to be taxed.²⁴⁰ Yet whether a patent or copyright is "sold" or "licensed"—however those terms are defined—has no bearing on whether a tax can be withheld on the proceeds. What determines whether a tax can be withheld is whether the purchaser or licensee is subject to the jurisdiction and effective control of the United States. Generally, this means that if a patent or copyright is assigned by a nonresident alien to a United States resident, a tax can effectively be withheld; if the assignment is made to a foreigner having little contact with the United States, detection of the transaction and enforcement of an obligation to withhold is unlikely. What happens, in effect, is that transfers by foreigners of patents and copyrights for domestic exploitation may be subject to tax; transfers between foreigners for the purpose of exploiting the United States market by producing the patented or copyrighted product abroad and importing it are not subjected to tax.

This makes no case for exemption of patent or copyright assignments by nonresident aliens or nonresident foreign corporations. It does at least make a *prima facie* case for re-examination of the current tax treatment. It also underscores the fact that capital gains concepts are not appropriate as criteria for either imposing a tax on a nonresident alien or exempting him from one,

238. Obviously some intangible rights are not capable of being fully exploited by conversion into tangible goods which are then sold—*e.g.*, plays and movies.

239. The deterrent effect of a tax levied by the United States on a foreigner will also vary considerably with the country in which the foreigner is resident. If the country of residence imposes no income tax or if it exempts from tax the income upon which the United States tax is levied, the tax will be a deterrent. If the country of residence imposes tax on its residents which includes in its base the income taxed by the United States, the foreigner's total tax burden will be increased only to the extent the United States tax is not fully creditable against the tax of the country of residence. The United States tax will discourage activities likely to result in imposition of United States tax both where the tax is not fully creditable against the tax of the country of residence, and where the latter country's decision on full creditability cannot comfortably be predicted.

The variations in foreign tax law are too detailed and complex to be gone into here. It should be noted, however, that the tax conventions contain provisions designed to assure that the country of residence will grant some relief, in the form of credit or otherwise, for taxes imposed by the country of source. The scope and meaning of these provisions is disquietingly doubtful. See generally, PHILLIPS, UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 230-33 (1952).

240. See, *e.g.*, Commissioner v. Wodehouse, 337 U.S. 369 (1949), discussed at text accompanying notes 70-83 *supra*.

although they are apparently employed for both purposes under present law.²⁴¹ Many of the distinctions created in capital gains criteria seem largely irrelevant in the taxation of non-nationals. Insofar as the policy of encouraging local exploitation of foreign owned intangibles is concerned, tax exemptions turning on whether the patent or copyright was used in a foreign trade or business, held for sale in the course of a foreign business, produced abroad by personal efforts, or purchased, seem misplaced. None of these factors would appear to affect the aliens' alternatives to exploitation free of United States tax.

II. SOURCE OF INCOME

Characterization of income as "fixed or determinable annual or periodical," or as one of the "capital gains" specified in sections 871 or 881 does not make it taxable. As earlier noted, the income of nonresident aliens and foreign corporations is taxed only if it is both within the taxing provision and is from sources within the United States.²⁴² Foreign taxpayers engaged in business in the United States are taxed on all income from domestic sources,²⁴³ so the source rules are the measure of their tax base. The source of income concept marks only the outer perimeter of the tax base of nonresident aliens and foreign corporations who have no United States business.

The concept of source of income first came into the Code in the Act of 1916²⁴⁴ as the base for a net income tax on nonresident aliens and foreign corporations. Elaborations were added in the 1921 Act²⁴⁵ in response to an opinion of the Attorney General construing the 1918 provisions as exempting from United States tax profits made by foreign corporations manufacturing or purchasing goods in the United States but selling them abroad.²⁴⁶ The 1921 Act codified the Attorney General's opinion that income from the purchase and sale of personal property is derived entirely from the country of sale but specified that income from property produced here but sold abroad, or pro-

241. To exempt under I.R.C. §§ 871(a)(1), 881(a); impose tax under I.R.C. § 871(a)(2).

242. "In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States." I.R.C. § 872(a). See also I.R.C. § 882(a) (foreign corporations).

243. I.R.C. § 871(c), § 882(a), (b).

244. "... there shall be levied . . . a tax of 2 percentum . . . upon the entire net income received . . . from all sources within the United States by every individual, a nonresident alien. . ." Revenue Act of 1916, § 1(a), 39 Stat. 756. A similar tax was imposed by § 10 upon foreign corporations.

The earlier acts had imposed a tax on income "from business transacted and capital invested within the United States." (Revenue Act of 1909, § 38, 36 Stat. 112, 113; Revenue Act of 1913, ch. 16, § II, para. G (a), 38 Stat. 172) and upon income "from all property owned and of every business, trade, or profession carried on in the United States" (Revenue Act of 1913, ch. 16, § II, para. A, 1, 38 Stat. 166). The 1909 version was characterized as an "excise" tax by the Supreme Court. *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

245. 42 Stat. 244 (1921).

246. 32 Ops. ATT'Y GEN. 336 (1920).

duced abroad but sold here, shall be allocated to sources partly within and partly without the United States.²⁴⁷ Provisions were also included allocating income from interest, dividends, personal services, transportation, rentals, royalties, and the sale of real property. Now sections 861-864, these provisions have been retained without substantial amendments for more than forty years.²⁴⁸ Ill equipped from the beginning to perform the task for which they were designed, the rules have periodically been given additional duties, differing substantially from their original purposes, obscuring their policies, and further befogging their already murky meaning.²⁴⁹ Only the concept of gross income is more basic. Yet few concepts in the Code have received less analysis or needed more than the source rules.

In their application to foreign owners of patents, copyrights, and their analogues, the rules produce a number of anomalies. It may be feasible for such persons to realize their income in any of three ways differing little, if at all, in economic consequences, but yielding drastically disparate tax results. If a foreign taxpayer "licenses" his patent or copyright for use in the United States, all his income may be from United States sources;²⁵⁰ if he "sells" such rights outside the United States, all his income may be foreign income.²⁵¹ A third possibility is producing the patent or copyright under a contract for "personal services," in which event the entire income is attributable to the country wherein the work was done.²⁵² Differences between "sales," "licenses,"

247. The Senate Report on the 1921 changes stated, "The present law is both obscure and economically unsound, inasmuch as the Attorney General has held that where goods are manufactured or produced in the United States and sold abroad, no part of the profit is derived from a source within the United States." S. REP. NO. 275, 67th Cong., 1st Sess. 16 (1921).

248. I.R.C. § 861(a) (3), which provides that "compensation for labor or personal services performed in the United States" shall be included in United States income, was amended in 1936 to exclude certain income of a nonresident alien present here for not more than 90 days and earning \$3,000 or less. A 1926 amendment provided for apportionment of income resulting from purchase in the United States and sale in one of its possessions, and *vice versa*. A 1938 amendment limited such apportionment to purchases in a possession and sale in the United States [See I.R.C. § 863(b) (3)], sales of goods purchased here but sold in a possession reverting to treatment as entirely foreign income. I.R.C. § 862(a), (b).

249. The most troublesome are I.R.C. §§ 921, 922 granting a reduced tax rate to a "Western Hemisphere trade corporation," one of the requirements of which is that 95 percent of its gross income must be derived "from sources without the United States." The policies behind this provision are obscure. See Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 830 (1956). Among other sections relying upon source of income concepts whose purposes may not be parallel are I.R.C. § 911 (exemption of certain foreign source income of citizens living abroad) and I.R.C. §§ 901-05 (foreign tax credit). For a catalogue of provisions raising source of income problems, see Dailey, *The Concept of the Source of Income*, 15 TAX L. REV. 415, 416 n.5 (1960).

250. I.R.C. § 861(a) (4).

251. I.R.C. § 862(a) (6).

252. I.R.C. §§ 861(a) (3), 862(a) (3).

and contracts for "services" may be mainly matters of form, yet they determine the source of the income yielded by the transactions. The source consequences of labeling a transaction as a "sale," "license," or contract for "services" will therefore be explored in the remainder of this article.²⁵³

Patent and copyright assignments as "sales of personal property"

There is no evidence that Congress considered the matter, but it has nevertheless been held that a patent or copyright is "personal property" which can be "sold within" or "sold without" the United States as those terms are used in the source rules.²⁵⁴ This assumption certainly puts no strain on the words of the statute. But in view of the significance of the place of sale under the source rules, its potential consequences merit evaluation, especially since the demise of the indivisibility doctrine.

Section 861(a)(6) provides that income from the "purchase of personal property without the United States . . . and its sale within the United States" is entirely from United States sources. The converse is specified in section 862(a)(6).²⁵⁵ Nothing is said about income from property both purchased and sold within or without the United States. This was apparently too obvious to require statement since the implication is clear that the place of purchase is immaterial in determining the origin of income.²⁵⁶ Not so obvious, however, is the criterion for allocating income derived from the sale of personal property which was not purchased by the taxpayer. Section 863(b)(2) provides that income from property "produced (in whole or in part) by the taxpayer within and sold without the United States" or *vice versa*, shall be treated as derived partly from domestic, partly from foreign sources and shall be apportioned as

253. The total United States tax consequences to a foreign taxpayer exploiting patents, copyrights, and similar property, are determined not only by his choice of the license, sale, or service methods of exploitation, but also by whether he is resident or engaged in business here. The latter two factors, however, are not matters of form or label and therefore will be disregarded, for the most part, in this analysis.

254. See Rafael Sabatini, 32 B.T.A. 705 (1935), *rev'd on other grounds*, 98 F.2d 753 (2d Cir. 1938); I.T. 2735, II-2 CUM. BULL. 131 (1933), quoted *infra* note 288. The commentators have also assumed that a patent may be "sold without the United States" within the meaning of the source rules. See, e.g., PHILLIPS, UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 82 n.129 (1952); cf. Eckstrom & Slowinski, *Tax Planning for Foreign Licensing of United States Industrial Property Rights*, N.Y.U. 19TH INST. OF FED. TAX 969, 984 (1961) (sale of foreign patent may occur in United States).

255. ". . . income derived from the purchase of personal property within the United States and its sale without the United States" is from sources without the United States. I.R.C. § 862(a)(6).

256. See Carding Gill, Ltd., 38 B.T.A. 669 (1938); *Helvering v. Suffolk Co.*, 104 F.2d 505 (4th Cir. 1939); Treas. Reg. § 1.861-7(a): "[I]ncome derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold." An exception not particularly relevant here is made in the statute for apportioning income from purchase of personal property within a possession and selling it in the United States. I.R.C. § 863(b)(3).

prescribed by the Secretary.²⁵⁷ Since the term "produced" is defined to include "created,"²⁵⁸ an author or inventor's gain would seem to be apportionable under section 863(b)(2). Thus, substantially different sources may be ascribed to income from sale of a patent or copyright depending upon whether the taxpayer created or purchased it.²⁵⁹ What provision governs, however, if the taxpayer is a donee, a legatee, or a corporation which acquired the property as a contribution to capital? The statute may be construed as expressing the purpose to make the place of sale the entire source of income unless the property is produced and sold by the taxpayer in different countries. The specification for property purchased and sold may be interpreted as covering all property sold but not produced by the taxpayer.²⁶⁰ But it need not follow from a congressional purpose to disregard the place of purchase that the mode of acquisition, if not production, is immaterial. Implicit in the practice of other governments which disregard the place of purchase in allocating income,²⁶¹ and at

257. Treas. Reg. § 1.863-3 specifies alternative methods of apportionment of such income. One method applies where an independent factory price can be established and the production and selling activities are in different countries. In such a case, the selling branch is treated as having bought the property at the factory price. Treas. Reg. 1.863-3(b)(2), Example (1). Another method is to allocate half the income according to the ratio of taxpayer's property used in producing and selling the product located within and without the United States; the other half is allocated according to gross sales. Treas. Reg. § 1.863-3(b)(2), Example 2. See also Example 3 (permitting allocation to be based on books of account, with permission of district director).

258. "[T]he word 'produced' includes 'created', 'fabricated', 'manufactured', 'extracted', 'processed', 'cured', or 'aged'." I.R.C. § 864.

259. It is yet unresolved, however, whether a patent or copyright is "produced" within the meaning of I.R.C. § 863(b)(2). I.T. 1231, I-1 CUM. BULL. 206 (1922), held that the income of a nonresident alien author who "sold" his novels and manuscripts to an American publisher was entirely from United States sources. But this ruling was under the 1918 Act which contained no provisions for apportionment. The question seems never to have been litigated. In another context, it has been argued that I.R.C. § 863(b)(2) does not apply to foreign patents on inventions produced in the United States on the ground that foreign rights are "created" under the law of the foreign country. Pugh, *Sales and Exchanges of Foreign Patents*, N.Y.U. 20TH INST. ON FED. TAX. 1305, 1316 (1962). This position, however, seems unpersuasive. The sale of any property, tangible or intangible, involves a transfer of rights which may theoretically be "created" by the laws of the country in which the transferred rights exist. There seems no reason to assume Congress was engaging in metaphysical sophistry. More likely, it seems to me, is that a patent or copyright is created or produced where the inventor or author does the work which results in an invention or literary product. As explained, *infra*, there may be substantial justification in terms of policy for this result.

260. This interpretation has support from commentators. See, e.g., PHILLIPS, *UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS* 90 (1952); Dailey, *The Concept of the Source of Income*, 15 TAX L. REV. 415, 445-46 (1960).

261. Most countries apparently do not attribute any income to the country of purchase. See Carroll, *Methods of Allocating Taxable Income*, IV TAXATION OF FOREIGN AND NATIONAL ENTERPRISES 117, 126 (League of Nations, 1933). See also, Smith, *The Functions of Tax Treaties*, TAXATION AND OPERATIONS ABROAD 276, 281 (Tax Institute, 1960): "A few countries have even deemed that foreign firms were in some way subject to income taxation by the mere act of purchasing goods for shipment abroad, a tax policy which seems quite incompatible with other policies designed to encourage exports."

least suggested in the history of the 1921 Act, is the desire to encourage sale of domestic goods for export.²⁶² Exempting foreign purchasers from domestic tax obviously has this effect. But the domestic economic benefits from encouraging gifts, bequests, and capital contributions to foreign taxpayers are not so apparent. Thus, the income of a foreign taxpayer from the sale of property neither purchased nor produced by him may also be apportionable.²⁶³ After forty years, however, no regulations have been adopted and no rulings issued indicating how, or whether, the income from such property should be apportioned between foreign and domestic sources.

If a patent or copyright may be sold "within" or "without" the United States as those terms are used in the source rules, then the entire income from the sale may be allocated to the country within which the sale occurs, provided the taxpayer acquired the property by purchase. Only if the taxpayer acquired the property other than by purchase does the statute permit apportionment. Could Congress have intended to permit a foreign taxpayer, even though engaged in business here, to sell a United States patent or copyright without incurring tax liability on all or at least part of the income? Could Congress have intended to tax all the income of a foreign owner of a patent or copyright, even though he sells worldwide rights, merely because the sale occurred within our borders rather than without? Could any policy conceivably be served by such results? Before suggesting some answers to these questions, it may help to clarify the problem by relating it to the tax-imposing provisions of the Code.

If a nonresident alien purchases a patent or copyright and sells it "without" the United States, he need not concern himself with the complexities of "fixed or determinable" income under section 871(a), gains from transfers described in section 1235, or capital gains if present here; he has no income from United States sources. Only if the sale is "within" the United States and the taxpayer is a nonresident, not engaged in United States business, must he enter the briarpatch of section 871(a).²⁶⁴ Conceivably, a patent or copyright could be

262. The proposed rule for allocating income from purchase and sale of goods was explained on the Senate Floor in 1921 as follows:

Mr. WALSH of Montana: . . . if the nonresident alien is here importing goods into the United States he pays?

Mr. SMOOT: He pays the tax.

* * *

Mr. HITCHCOCK: If he is buying goods in the United States and selling them abroad, he does not?

Mr. SMOOT: He does not.

Mr. HITCHCOCK: That is reasonable.

61 CONG. REC. 6735 (1921).

263. I.R.C. § 863(a) authorizes the Secretary to provide by regulations for allocating or apportioning income from sources "not specified" in § 861(a) and § 862(a).

264. If he "produced" the property within the United States or acquired it here other than by purchase, however, part of his income might be attributed to the United States even though the sale occurs elsewhere.

"sold" within the United States for purposes of the source rules yet not be a "sale" which is exempt from taxation as "fixed or determinable" income. The courts, however, seem to regard the issues as identical. A case or ruling characterizing an assignment as a "sale" or "license" under the source rules is considered equally relevant in determining whether or not the income is "fixed or determinable."²⁶⁵ There is, therefore, little likelihood that a foreign transferor of worldwide rights in a patent or copyright who sells the rights within the United States under the source rules would be taxed on the entire proceeds as "fixed or determinable" income under sections 871(a)(1) or 881(a). Thus, the nonresident foreign corporation—taxed only on "fixed or determinable" income—is probably not taxable on the "sale," even if it occurs within the United States. But the nonresident individual may be taxable on the gain from the sale of worldwide patent rights if the transaction is within section 1235 or if he has a capital gain and is present in the United States.²⁶⁶

If a nonresident alien or a foreign corporation is engaged in business in the United States, and thus is taxable on its entire income from United States sources, it may be taxed on the net income from a sale here of worldwide rights, whether or not the income arose out of United States business activities.²⁶⁷

Where is a patent or copyright sold?

The Code furnishes no criteria for determining whether a sale is "within" or "without" the United States. The Treasury Department in 1921 ruled that income from goods sold to residents of the United States and shipped from a foreign country F.O.B. shipping point, was not income from United States sources as "the sales were consummated and the title to the property" passed abroad.²⁶⁸ Subsequent rulings also applied the title passage concept.²⁶⁹ In 1930, however, the Commissioner retreated from the title passage test, holding instead that the "essential character of the transaction—the contract of sale—is the decisive factor in determining the place of sale. . . ."²⁷⁰ The new place-

265. See, *e.g.*, *Commissioner v. Celanese Corp.*, 140 F.2d 339 (D.C. Cir. 1944); *Estate of Marton*, 47 B.T.A. 184 (1942); *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946); *Molnar v. Commissioner*, 156 F.2d 924 (2d Cir. 1946). Sometimes it is not clear which question the court decided. See, *e.g.*, *General Analine & Film Corp. v. Commissioner*, 139 F.2d 759 (2d Cir. 1944); *cf.*, *Commissioner v. Wodehouse*, 337 U.S. 369 (1949).

266. If the alien purchased the property, his entire gain would be taxable by the United States if the sale occurred here. If he produced the property abroad, however, an allocation between foreign and United States sources would probably be required and he would be taxed on only a portion of his worldwide income.

267. If the property was created by the taxpayer abroad, however, an allocation would be required and only part of the income would be taxed here.

268. O.D. 1100, 5 CUM. BULL. 118 (1921).

269. I.T. 1569, II-1 CUM. BULL. 126 (1923); I.T. 2068, III-2 CUM. BULL. 164 (1924); G.C.M. 2467, VII-2 CUM. BULL. 188 (1928).

270. G.C.M. 8594, IX-2 CUM. BULL. 354, 358 (1930). This ruling was based on an interpretation of the Supreme Court's decision in *Compania General de Tabacos de Filipinas v. Collector*, 279 U.S. 306 (1929), which held that sales of goods imported here from the Philippines occurred in the Philippines.

of-contract test was not accepted by the courts,²⁷¹ however, and in 1947 the Commissioner reinstated the title passage test, adding a caveat that sales arranged to avoid taxes would be treated as consummated "where the substance of the sale occurred."²⁷² This is the present test set forth in the regulations.²⁷³ A destination test was considered by the American Law Institute but rejected on the ground it would encourage exports and discourage imports, would be subject to manipulation, and would be difficult to administer.²⁷⁴

The primary focus of the dialogues and decisions on the place of sale has been on tangible goods sold in international trade by manufacturers or merchandisers.²⁷⁵ In vacillating among tests of title, place of contract, substance and so forth, the Commissioner has presumably been concerned with such goods. Thus he says that passage of ownership and "risk of loss" constitute the all important passage of "title."²⁷⁶

The rulings and decisions are not clear on what is meant by "*where* title passes."²⁷⁷ The reference may be to the geographical location of the seller and buyer when title passes. This is unlikely, however, since seller and buyer are often in different places at the magic moment. The reference may be to the place where the last act is done which completes the sale and confers title on the buyer.²⁷⁸ There is also some evidence that the place of sale is ordinarily

271. See, e.g., *Commissioner v. East Coast Oil Co.*, 85 F.2d 322 (5th Cir. 1936), affirming 31 B.T.A. 558 (1934), cert. denied, 299 U.S. 608 (1936); *Ronrico Corp.*, 44 B.T.A. 1130 (1941).

272. G.C.M. 25131, 1947-2 CUM. BULL. 85, 86, revoking G.C.M. 8594, *supra* note 270.

273. Treas. Reg. § 1.861-7(c). In recent cases involving the Western Hemisphere Trade Corporation provisions, the Commissioner has been urging, without success, an "economic penetration" test. See, e.g., *A. P. Green Export Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960). The cases are collected and discussed in Krahmer, *Federal Income Tax Treatment of International Sales of Goods: A Reevaluation of the Title Passage Test*, 17 TAX L. REV. 235, 252-55 (1962).

274. See *Surrey & Warren, The Income Tax Project of the American Law Institute*, 66 HARV. L. REV. 1161, 1197 (1953). For an argument supporting a destination test on protectionist and balance-of-payments grounds, see Krahmer, *supra* note 273, at 259-60.

275. See Krahmer, *supra* note 273; Brainerd, *United States Income Taxation of International Sales of Personal Property*, 32 TAXES 359 (1954); *United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968 (1957).

276. "... the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and risk of loss." Treas. Reg. § 1.861-7(c).

277. See, e.g., *United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968 (1957).

278. This seems to be the position taken by the Treasury in a recent Western Hemisphere Trade Corporation case:

... under the law of taxation, the determination of the passage of title, although important to ascertain *when* it occurred, is not the controlling factor as to the source of income. It is the *event* causing that passage which is the determinative factor. *Where* did the event take place when title passed. . . . It is that place that is the situs of the sale.

Brief for Respondent, p. 78, *Barber-Green Americas, Inc.*, 35 T.C. 365 (1960). It should be noted, however, that the Treasury's position in a case of this sort should not be projected upon other source questions inasmuch as different policies are involved. See note 249 *supra*.

regarded as the location of the goods when title passes.²⁷⁹ The latter view seems consistent with the notion that transferring risk of loss is an important earmark of a sale under the source rules. But it seems inappropriate for intangibles because there is no meaningful "risk of loss" and no physical location of the property.

If the place of sale of a patent or copyright is the location of the property when title passes must we become immersed in rarified polemic about the "situs" of an intangible? Is the majestic maxim *mobilia sequuntur personam* applicable to locate the sale at the domicile of the seller or should we choose instead the notion that the situs of a copyright or patent is the country whose laws "created" it? If it is not the locus of the intangible that is determinative, is it where the contract is made or where the last event necessary to pass "title" occurs? If the latter, is it conceivable that registration of the patent or copyright is the "last event" necessary to complete the sale? Suppose the property is "sold" and exploited though never registered?

Decisions on place of sale of patents and copyrights

In an early ruling the Commissioner held that a transfer of serial rights in "certain literary works" by a nonresident alien to a domestic corporation was not income from United States sources, since "the contract was made abroad, the sale took place abroad, and payment for such rights is made directly to the nonresident alien."²⁸⁰ Shortly thereafter, the Commissioner ruled that the profit of a nonresident alien from the "sale" to American publishers of certain novels and an option to purchase serial rights in future writings was from United States sources. The manuscripts were to be delivered in the United States, payment for the serial rights was to be made only if accepted by the American publishers, and the contracts were negotiated and payments received by an American agent.²⁸¹ Both of these rulings were issued during the first administrative reign of the title passage test. Yet they seem to reflect a place-of-contract test, not expressly adopted until 1930 for sales of goods.²⁸² Thus, the Commissioner may tacitly have recognized the irrelevance of a title passage test for copyrights and the like. Since reinstatement of the title passage

279. See Dailey, *supra* note 260, at 465; Dean & Leake, *How to Arrange Foreign Sales So Title Will Pass "Outside the U.S." for Tax Purposes*, 94 J. ACCOUNTANCY 457 (1952). But cf. Krahmer, *supra* note 273, at 251 n.88. The absence of clarity on this question may be due to the fact that ordinarily, the last "act" necessary to confer title has reference to the physical location of the goods. Thus, the title passing act is frequently delivery of the goods to the carrier or arrival of the goods at destination. Additional complications arise when documents of title are negotiated in a place other than the location of the goods. See *id.* at 246.

280. O.D. 988, 5 CUM. BULL. 117 (1921). This ruling was issued the same year as the Commissioner's adoption of the title passage test in O.D. 1100, 5 CUM. BULL. 118 (1921).

281. I.T. 1231, I-1 CUM. BULL. 206 (1922). In I.T. 2735, XII-2 CUM. BULL. 131 (1933), which adopted the indivisibility doctrine, O.D. 988 was revoked and I.T. 1231 modified on the ground that serial rights could not be the subject of a "sale."

282. See G.C.M. 8594, IX-2 CUM. BULL. 354 (1930).

test in 1947, there have been no reported rulings or decisions on the place of sale of a patent or copyright.

Inasmuch as the proceeds from a "sale" of a patent or copyright are not "fixed or determinable" income, there was little reason before 1954 for the courts to decide *where* a sale occurred. For even though the proceeds of a sale are deemed from United States sources, they are not taxable unless the foreign taxpayer is engaged in business here, or unless they are capital gains taxable because of the alien's presence here, or transfers described in section 1235. Although patent transactions and section 1235 would seem to create frequent disputes, none has as yet apparently been adjudicated.

In *Sabatini v. Commissioner*, however, the issue was presented since the case was decided under pre-1936 law which taxed the nonresident alien on all income from United States sources. Sabatini had granted various rights in his literary works to American corporations. The Board of Tax Appeals held that lump sum payments for worldwide movie rights in various books were proceeds from the "sale of personal property without the United States," apparently because the author was in England when the publishers' offers were accepted.²⁸³ None of the income from the movie rights was taxable, therefore, even though the negotiations for the contracts took place in the United States through American agents. The Board seems clearly to have held that a sale of such rights occurs where the buyer's offer is accepted.²⁸⁴ On appeal,²⁸⁵ the Commissioner did not question the place-of-contract test but denied that a sale occurred, relying on the doctrine of indivisibility.²⁸⁶ The Second Circuit also did not question the propriety of the place-of-contract test;²⁸⁷ instead, it held "there was no transfer of title necessary to a completed sale"—merely a "li-

283. 32 B.T.A. 705 (1935). The Board held that certain sums received for book, serial, and dramatic rights were "royalties," rather than sales proceeds.

284. *Id.* at 705 n.1, 713. Query, what would the Board have held if the buyer's offer had stated that the contract was not to become effective until the seller's notice of acceptance was received by the American buyer?

285. 98 F.2d 753 (2d Cir. 1938).

286. The Board of Tax Appeals had cited *Compania General de Tabacos de Filipinas v. Collector*, 279 U.S. 306 (1929), in support of its decision as had the Commissioner in adopting the place-of-contract test in 1930. In his Sabatini brief, however, the Commissioner distinguished that case on the ground it involved "tangible property located without the United States while here the intangible property had a fixed and immovable situs within the United States." Brief for the Commissioner, p. 15, *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938). There is a lot of other cant about "situs" in the brief (p. 13) but it was urged in support of the position that the grant of partial rights was a license—not that the place of sale was determined by the "situs" of the property.

287. In *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946), *cert. denied*, 328 U.S. 862 (1946), the court said about its Sabatini decision:

The tax on aliens at that time included a tax on the proceeds of a sale of personal property, but not if the property was produced without and sold without the United States; . . . we assumed that, because the contract was made in England, if the transaction was a "sale," it was not taxable; holding that it was not a sale, we held the proceeds were taxable as royalties.

Id. at 63.

cense" to use property within the United States which was taxable as a "royalty" under the predecessor of section 861(a)(4). Thus the court gave a big boost to the Commissioner's indivisibility theory and pretty much ended, for a time, fine arguments about the place of sale.²⁸⁸

When the issue is resurrected, the meagre precedents suggest that the Treasury will apply the place-of-contract test, garnished with whatever views are current in the Department about the "substance" of the transaction. If the current administrative concept of a "sale" as an exclusive grant of limited rights on a royalty basis is applicable to the source rules, then it is conceivable that a foreign taxpayer can exploit his rights here piecemeal and, if he is careful to negotiate the contract outside the United States, avoid all United States income tax. If he "effects" a sale in the United States, however, all his income may be from United States sources, even though he assigns worldwide rights, if he purchased the property. If he produced it, part of the income would probably be allocated to the country where the property was produced.

LICENSES

Whatever Congress' reason for exalting the place of sale in allocating income, it at least recognized that the country where the taxpayer produced the property was entitled to tax part of the income from the sale.²⁸⁹ Yet it also provided that if the property is rented or "licensed" abroad, all the income is derived from the country in which the property is "located" or "used."²⁹⁰ If the transfer is to cover the approximate useful life of the property, the choice between a "sale" and a "license" may be of little importance, apart from tax consequences.

If the difference between a "sale" and an exclusive license for the life of a patent or copyright has become one of nomenclature,²⁹¹ the resident foreign

288. In his 1933 ruling adopting the indivisibility test, the Commissioner included the following dictum:

Patents, copyrights, and other franchises have, from the earliest times, been regarded as having a fixed and immovable situs in the place where they are exercisable, the same as real property has in the place where it is situated, although patents, copyrights, and franchises are personal property. It is plain from the provisions of [§ 861] that Congress intended to treat lands, patents, copyrights, and franchises as a single class for the purpose of "rentals or royalties from . . . [or] for the use of or for the privilege of using," but for the purpose of sales it intended to treat real property as a class by itself and to treat patents, copyrights, and franchises in the class with all other personal property.

I.T. 2735, XII-2 CUM. BULL. 131-33 (1933). What was "plain" to the Commissioner in 1933 may not be so plain in 1963, particularly in view of the demise of the indivisibility doctrine and the consequent commercial feasibility of patent and copyright "sales."

289. I.R.C. § 863(b)(2).

290. I.R.C. § 861(a)(4) provides that "Rentals or royalties from property located or used in the United States . . . including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property" is entirely United States source income. The converse is specified in § 862(a)(4).

291. *I.e.*, if the concept of a "sale" contained in Rev. Rul. 60-226, 1960-1 CUM. BULL. 26 is applicable to the source rules.

corporation creating such property will presumably choose the license label when exploiting domestically created rights abroad, as there is no room in the statute for allocating a portion of royalty income to the country where the intangible was created.²⁹² Conversely, the nonresident alien or foreign corporation creating such property abroad and exploiting it here may, by labeling the transaction a "sale" and effecting the sale abroad, seek to avoid all United States tax.

There are two substantial differences in the methods of allocating income from a "sale" and from a "license." If the property is "sold," the income is attributed entirely to the place of sale, or allocated between the place of sale and the place of production.²⁹³ In a "license" transaction, neither the place where the license contract was negotiated nor the place of production are considered,²⁹⁴ and the criteria are the same whether the taxpayer produced or purchased the licensed property.

In determining where the licensed rights were "used," several early cases held that where the parties themselves put no price on the foreign and domestic rights, no segregation would be made—all income was attributed to the United States.²⁹⁵ Later this rule was relaxed and income from copyright licenses to American publishers with foreign subscribers was allocated among foreign and domestic sources according to testimony of experts upon the relative values of foreign and domestic rights, circulation figures, and the "economic common sense" of the matter.²⁹⁶ Apparently it is thought that intangible property is "used" or "located" in the United States²⁹⁷ only if the licensee sells the patented or copyrighted product to domestic consumers, or exhibits it here, or perhaps sublicenses it for exhibition or sale to domestic consumers.²⁹⁸ Yet this

292. All income from rentals or royalties of property "located" or "used" abroad is foreign source income. I.R.C. § 862(a) (4).

293. I.R.C. §§ 861(a), (b), 862(a), (b), 863(b) (2).

294. See note 290 *supra*.

295. Estate of Marton, 47 B.T.A. 184 (1942); Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946); Molnar v. Commissioner, 156 F.2d 924 (2d Cir. 1946).

296. Sax Rohmer, 14 T.C. 1467 (1950). See also Wodehouse v. Commissioner, 178 F.2d 987 (4th Cir. 1949).

297. Within the meaning of I.R.C. § 861(a) (4).

298. In I.T. 3296, 1939-2 CUM. BULL. 133, a nonresident alien, resident of the Philippines, wrote textbooks which were printed in the United States by a domestic corporation and "sold exclusively in the Philippines." Holding that the author's royalties were not income from United States sources, the Service said, "there is no commercial publication of the textbooks within the United States in that the textbooks are not sold within the United States. . . . M Company is engaged solely in printing and manufacturing books within the United States . . . and in the vending of such books in the Philippines, the Philippine copyrights are used and not the United States copyrights." Query, which copyright was used in reproducing the manuscript in the United States? Wasn't some of the money paid the author for this privilege? Suppose "title" to the books passed in the United States although the books were intended for Philippine use. Would the alien's royalties then be from United States sources?

conclusion is not obvious. If an American licensee produces a movie or publishes a book or builds a machine here, he is exercising rights in the United States regardless of where he ultimately exploits the product. Thus, it is not clear why the place where the licensee produces the patented or copyrighted product should not be included in the allocation formula. Tax law, however, is supposed to be "an intensely practical matter" and the courts may perhaps be excused for avoiding this thicket. The ultimate question seems to be what proportion of the consideration was received by the taxpayer for the rights he has granted in each country. The markets actually exploited by the licensee seem to the courts to have some relation to the "economic common sense" of the matter.²⁹⁹

All the decisions, however, have involved rights exploited by production and sale or distribution of a product. Suppose a foreign patentee were to assign to a domestic concern the exclusive patent rights in a machine for a fixed sum and the domestic concern during the first three years of the patent term produced 1,000 of the items, 200 of which it held in inventory, 300 of which it used on its own manufacturing process, and 200 of which it exported, hoping, however, to develop foreign markets for thousands. Dividing the consideration among foreign and domestic rights in such a case would seem largely a product of fancy. The parties would probably be left considerable latitude to make their own allocation between foreign and domestic rights.³⁰⁰ Yet any such allocation

299. An apparent exception is *Sanchez v. Commissioner*, 162 F.2d 58 (2d Cir.), *cert. denied*, 332 U.S. 815 (1947). There, a nonresident alien had invented and patented a process for refining sugar and a product used in the process. He granted a worldwide "license" to an American corporation, the agreement providing for "royalties" based on a percentage of the sales price of the patented product but specifying that the method of computing the "royalties" was merely a gauge for determining the royalties due for all the patents. The licensee sold the product to foreign customers and included in the sale a sub-license, royalty free, to use the patented process.

The taxpayer contended that to the extent his process and product were used in foreign countries, his royalty income was from foreign sources. The Court of Appeals rejected his argument on the ground there were no "royalties" on the foreign patents as the foreign purchasers were permitted, "presumably as part of the inducement to buy at the sales price charged, to use those patents for nothing." Everything the taxpayer received was a portion of the sales price of the patented products. Hence, "the petitioner received only proceeds from a domestic exclusive license and nothing for the use of any foreign property." It seems difficult to square the court's rationale with the reasoning in *I.T. 3296*, *supra* note 298. The court seemed to assume that if the licensee sells products covered by a patent and pays the licensor royalties based on the sales proceeds, the income is all United States income even though the goods are sold by the licensee abroad for foreign consumption. The court's difficulties probably stem from its confusion of the question of the source and character of the licensee's income with the source and character of the licensor's income. Compare on this problem, *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932), discussed *infra* note 306.

300. *Cf. Estate of Marton*, 47 B.T.A. 184 (1942): "It would have been a simple matter for the parties to have segregated the purchase of the domestic from the foreign rights. This they did not do and we cannot supply that omission by surmise."

by the parties would be equally arbitrary or impelled solely by tax considerations.³⁰¹

INCOME FROM SERVICES

All income from "labor or personal services" is attributable under the Code to the country or countries in which the services were rendered.³⁰² This method of allocation conceivably could be construed to apply only to individuals and, perhaps, only to "employees." It has not, however, been so interpreted. Corporations as well as individuals can render "personal services" within the source rules³⁰³ and may render services through agents.³⁰⁴

In trying to distinguish between contracts for "services" and "sales" or "licenses," the courts, in the absence of apparent policy guides, frequently fall back on formalism. In *Karrer v. United States*,³⁰⁵ for example, a Swiss chemist entered into a "special employment contract" with a Swiss company. He performed basic research and the company supplied him with raw materials, a laboratory, and research assistance. The results, processes for making vitamins synthetically, were to be exploited by the company. Karrer, the chemist, applied for the United States patents, then assigned the patent applications to an American company with whom the Swiss company had a contract. The agreement between Karrer and the Swiss company provided that Karrer was to receive a percentage of the proceeds from the exploitation of the inventions. The American company paid royalties due under its contract with the Swiss company directly to Karrer, although it was not required by contract nor asked to do so. The Court of Claims held that Karrer had no income from United States sources because he owned no interest in the patents. His income was derived, not from the use of his property but from his services. The Swiss company "owned" the patents and the contract between it and Karrer was not a "royalty" contract as Swiss law treated it as an "employment" contract.

A decision which rests on reasoning that the taxpayer, who has a right to share in the proceeds, owns "no interest in the patent" has little to commend it. And a determination of source of income which depends at all upon a characterization under foreign law of a contract as one of "employment" seems a bit barren of policy.

Decisions involving copyrights are no more illuminating. In addition to nice distinctions on whether the taxpayer owned an "interest" in the property, the courts occasionally seem to consider important whether or not the taxpayer

301. Of course, the Commissioner may not be bound by the parties' evaluations, and there is evidence that he is not reluctant to rely on surmise in this area. See Rev. Rul. 55-17, 1955-1 CUM. BULL. 388 (allocation between license of "know-how" by a foreign corporation and services rendered abroad).

302. With a minor exception for certain compensation earned here by a nonresident alien present in the United States for 90 days or less. I.R.C. §§ 861(a)(3), 862(a)(3).

303. See, e.g., *Commissioner v. Hawaiian Philippine Co.*, 100 F.2d 988 (9th Cir. 1939), *cert. denied*, 307 U.S. 635 (1939).

304. See, e.g., *Helvering v. Boekman*, 107 F.2d 388 (2d Cir. 1939).

305. 152 F. Supp. 66 (Ct. Cl. 1957).

was obligated to produce the intellectual product.³⁰⁶ This suggests that the tax treatment may sometimes turn on whether the property was already in existence before the agreement was made. Yet it is far from clear that a taxpayer cannot earn income from personal services even though he supplies pre-existing property under a carefully worded agreement requiring him to "produce" property meeting certain specifications.³⁰⁷

At any rate, it is possible for an individual or corporate author or inventor to produce movies, books, inventions and the like in return for which payment is made as "compensation for personal services" within the source rules. The entire income would then be attributable to the country where the work was created. But if the producer retains "title" and "sells" or "licenses" the result of its efforts, income may be attributable to entirely different countries.

STATUTORY POLICIES OBSCURED

The paradox is thus completed when the allocation of income from sales and licenses is compared with the allocation of personal service income solely to the country where the services were rendered. Suppose X corporation is formed under a foreign charter to produce a movie or an invention in the United States. X corporation then enters into one of the following contracts with Y corporation which is going to exploit the property abroad:

- (1) *Contract for Services.* An agreement by X to produce the movie or invention for Y, "title" to be vested in Y, and X's compensation to be a percentage of the royalties (if Y "licenses" the property) and a percentage of the gross proceeds (if Y exhibits the film or produces and sells the patented product);

306. In *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932), Enrico Caruso got "royalties" from records made by Victor Co., some of which were sold abroad. Held: Caruso's income was entirely from personal services rendered in the United States; he owned no interest in the records and the character of his compensation was not determined by the character of the money received by Victor. I.T. 2735, X11-2 CUM. BULL. 131 (1933) ruled that "royalties" received by a nonresident alien author were not income from personal services where the author agreed with a domestic publisher that the publisher would have the serial rights in all works to be produced in the future. *Ingram v. Bowers* was distinguished on the ground that Caruso had agreed to sing; here, the taxpayer merely agreed that if he did write books or stories the publisher would have the right to publish them. *But cf.* E. Phillips Oppenheim, 31 B.T.A. 563 (1934), where a nonresident alien granted exclusive book rights in the United States and Canada "in all novels by him published" and agreed to deliver at least two novels per year. The publisher agreed to pay him advances against royalties, to pay royalties on all books sold, and to publish at least two books per year. The Board, citing *Ingram v. Bowers*, held the alien's income was from a license and was not from personal services. See also, G.C.M. 236, V1-2 CUM. BULL. 27 (1927); Rev. Rul. 55-636, 1955-2 CUM. BULL. 17. On the issue of whether the taxpayer "sold" a patent for capital gains purposes, or earned compensation for personal services, see Arthur N. Blum, 11 T.C. 101 (1948), *aff'd sub nom.* Blum v. Commissioner, 183 F.2d 281 (3d Cir. 1950); William B. Stout, 8 CCH Tax Ct. Mem. 988 (1949), *aff'd sub nom.* Stout v. Commissioner, 185 F.2d 854 (6th Cir. 1950).

307. *Cf.* Irving Berlin, 42 B.T.A. 668 (1940). For more on the distinction between "property" and "services" see note 337 *infra*.

(2) *Sale*. An agreement by X to "sell" and Y to "buy" the property when it is produced, X's compensation to be on the same terms as in (1);

(3) *License*. An agreement by X to grant an exclusive "license" of the property to Y, when it is produced, X's compensation to be on the same terms as in (1) and (2).

Under the first arrangement, a contract for "services," all the income received by X is apparently from United States sources; under the second, a contract of "sale," all the income is from United States sources only if the "sale" occurs within the United States; if the "sale" occurs without the United States, part of the income is allocable to foreign sources. Under the third contract, none of the income is from United States sources, unless the "licensee" sells or sublicenses the product here; then only the portion, if any, which is attributable to the "use" of the property in the United States³⁰⁸ would be United States income.

Should a decision-maker, confronted with a "sale" or "license" contract, and desiring to disregard the "form" and grasp the "substance," treat the transaction as a contract for services, productive of United States income? "Substance over form," "sham," and similar doctrines are appropriate when the transaction is not what it purports to be, or when congressional policy would be thwarted by giving literal content to the statutory terms.³⁰⁹ But where Congress has specified divergent tax treatment of transactions differing little in substance, how is a decision maker to distill the essence of the statutory policy? Why couldn't each of these transactions rationally be treated as a "sale" or as a "license"? Suppose the movie or invention were produced by X corporation abroad and exploited here by Y corporation? Only by treating the transaction as a "license" would any of X's income be attributed to the United States, assuming that a "sale" could be effected abroad.

It often seems to be assumed that since United States rights granted by an alien are creatures of American law, the income from such rights in a patent, or copyright, or similar property is derived from United States sources. Without the protection of United States law the alien would have nothing of value. This rationale ignores the protection given the author or inventor by the country or countries in which he had the inspiration and did the work to produce the property, and without which there would also be no income. The principle would seem to apply not only to the patent or copyright owner but also to the foreigner who hires out to invent or create. The value of his services, and the compensation he receives, is dependent upon the legal protection and the market for the patent or copyright given his employer. Thus the principle, if valid, would seem to support a tax on the income of the foreigner employed to produce patents or copyrights exploited (or even exploitable) by his employer in countries other than the country where the property was

308. See text accompanying notes 295-99 *supra*.

309. See generally, Blum, *Kuetsch v. United States: A Pronouncement on Tax Avoidance*, SUPREME COURT REVIEW 135 (1961).

created. Conversely, it would deny to the country where the work was done the allocation of any of the income of the author or inventor. This rationale, therefore, is consistent with the statutory treatment of royalties but inconsistent with the treatment of compensation and with the allocation of income from sales. It may satisfy abstract notions of jurisdiction to tax, but it falls short of supplying a basis for allocation or a justification for the extant divergencies in treatment of sales, licenses, and services.³¹⁰

The statute gives no clue to the policies which might be served by these seemingly artificial distinctions. Nor does the statute indicate which of apparently conflicting policies was regarded by Congress as paramount. If the place of production has the primary claim on income—as indicated by the treatment of income from services—this policy is totally rejected by the treatment of licenses and at least partially scrapped in allocating income from a sale.

THE RATIONALE OF THE PLACE OF SALE FACTOR IN INCOME ALLOCATION

The place of sale is considered an important factor by most states in apportioning interstate income³¹¹ and by other countries in determining the origin of international income.³¹² Only recently has there seemed to be much analysis of its justifications, and most of this has been on the interstate level.³¹³ The prominent place of the concept in the Code may be due in part to confusion of the problem of source with the concept of realization. An early case decided by the Board of Tax Appeals illustrates the confusion. Deciding under the 1918 Act (before the Code provided for apportionment) that the income of nonresident aliens who manufactured lace in England and sold it here was entirely from United States sources, the Board said:

It may be quite reasonable from the standpoint of cost accounting or other statistical study to say that because manufacturing is part of the cause of the whole income a reasonable part thereof should be so attributed and allocated to manufacture. But this does not establish as a fact that the source of such aliquot part is not sale. Sale was necessary to its existence and was the most recent if not the entire source. *If not the entire supporting arch, it was the indispensable keystone.*³¹⁴

310. Another difficulty with this theory is applying it to assignments of "rights" in intellectual products which are in the public domain. The taxability of a license of a copyright, for example, is not dependent on whether the "rights" granted by the taxpayer were his to grant. See *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938).

311. See *Developments in Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 1012 (1962). There is little uniformity, however, in the weight attached to the sales factor or in the criteria employed in locating the place of sale. See HELLERSTEIN, *STATE AND LOCAL TAXATION* 293, 307-09 (2d ed. 1961).

312. See generally, Carroll, *op. cit. supra* note 261, at 116-30.

313. See, e.g., Studenski, *The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint*, 46 VA. L. REV. 1121, 1131 (1960); Harriss, *Interstate Apportionment of Business Income*, 49 AM. ECON. REV. 399 (1959); Kust, *State Taxation of Interstate Income: New Dimensions of an Old Problem*, 12 TAX EXEC. 45, 60 (1959).

314. Richard Birkin, 5 B.T.A. 402, 406 (1926) (emphasis added).

This bit of logic was matched by the Second Circuit in denying a similar claim by English manufacturers:

An enhanced value of manufactured goods prior to sale is an increment but does not become a profit until reduced to possession by sale. . . . [T]here is no way of determining the profit until a sale be realized and the price becomes known. . . . It was the . . . sale . . . which was the determining factor of whether it sustained a loss or made a profit. The gross income thus came from sources within the United States.³¹⁵

There are good reasons for not imposing a tax on accretions to wealth in the form of appreciation in property values until they are brought to fruition and given some finality by a sale or other disposition of the property. But something a bit more solid is needed to justify the determination that the place where the income is realized is also the place where the tax on the income should be levied. If this were an adequate basis for allocating income it might be argued that income is realized where the seller gets his money, or at his domicile, or where the buyer parts with the money, or where the buyer lives, and so forth. To determine when a realization of income occurs is difficult but necessary; to locate it geographically is whimsical and unnecessary.

The emptiness of the notion that the place of sale, because it is the "indispensable keystone" of the realization of income is therefore the origin of the income need not be belabored. Any other factor in the income producing process might as logically be assigned the "keystone position" in the income arch. All may be *sine quibus non*. Congress did not completely embrace such a view, since in the 1921 Act it provided for apportionment where the taxpayer manufactured property in one country and sold it in another.³¹⁶ Moreover, the principle would seem equally applicable to income from rentals, royalties, or even personal services, requiring attribution of the income to the country in which the realization occurred. Thus the place of contract, place of payment, or most any other place might be selected as the origin of such income. Congress, however, decided that the source of rental and royalty income is the country where the property is located or used³¹⁷ and that compensation for labor or personal services shall be attributed to the country where the services were performed.³¹⁸

At the opposite extreme from the position regarding the sale as the critical event is the view put forth by some economists that because income is ordi-

315. *Tootal Broadhurst Lee Co. v. Commissioner*, 30 F.2d 238, 239-40 (2d Cir. 1929). Some of this formalism may have been spawned by *Eisner v. Macomber*, 252 U.S. 189 (1920), where the Court, holding stock dividends not taxable, uttered the unfortunate dictum that "Income may be defined as the gain from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale . . . of capital assets. . . ." *Id.* at 207. This statement has somehow been read into the foreign income area and quoted for the proposition that a "sale" of property is the source of the seller's income. See, e.g., 8 MERTENS, LAW OF FEDERAL INCOME TAXATION § 45.26 at 59 (1957).

316. Revenue Act of 1921, § 217(e), 42 Stat. 245, now I.R.C. § 863(b)(2).

317. I.R.C. §§ 861(a)(4), 862(a)(4).

318. I.R.C. §§ 861(a)(3), 862(a)(3).

narily the product of human effort and capital resources, the sale merely marks the end of the process and is not responsible for any of the taxpayer's income, except to the extent that labor and capital are employed in making the sale. "Economic reality" requires that the factors in the allocation formula should not stray too far from the physical location of the activities and the capital employed by the taxpayer in creating the income.³¹⁹ This is roughly the approach taken by some of our states in interstate apportionment³²⁰ and appears to be the postulate applied in some of the cases in the federal field where the transaction does not seem clearly to fit any of the specific source rules.³²¹

Yet, ineluctable verity cannot be claimed for this notion. There is no reason why tariff or sumptuary policies cannot, or should not, be reflected in an income tax. If income is apportioned by a place of sale factor to protect against foreign competition there is nothing inherently wrong with the method if the protection is valued enough to offset the resulting disadvantages in lost revenues, retaliation, resource allocation and other consequences of protectionist decisions. If this was the original congressional purpose, however, reexamination is overdue. Such a purpose is thwarted by either the place-of-contract or title passage tests since either test gives the parties themselves ample freedom to allocate the income to the country of their choice without significantly restricting their economic alternatives.

A bit of the benefit theory

As a theoretical justification for imposing taxes on non-nationals, various versions of the benefit theory have received judicial sanction.³²² An older version of the theory, rooted in the philosophy of the social contract, was that tax burdens should be apportioned according to the cost of the governmental services or the benefits received from the government by the taxpayer. Used as a slogan by those opposing tax exemption of the nobility and clergy in eighteenth century France, the theory in this form has largely been abandoned by the twentieth century, retaining pristine favor only among reactionary elements using it as an emotive weapon against progressive rates.³²³ In contemporary jurisdictional theory, the concept—often phrased in terms of "protection"—

319. See Harriss, *supra* note 313, for an elaboration of the theory.

320. Of course, gross sales are often used in the states' apportionment formulas, but often, it seems, as merely a rough gauge of the sales activity within the state. See HELLERSTEIN, *op. cit. supra* note 311, at 305.

321. In *Commissioner v. Piedras Negras Broadcasting Co.*, 127 F.2d 260 (5th Cir. 1942), the court was confronted with a claim that a radio broadcasting station operating just over the Mexican border had income from U.S. advertisers. Held: The entire income was from foreign sources inasmuch as all the broadcasting facilities and substantially all the activities occurred in Mexico. *But see* *Korfund Co.*, 1 T.C. 1180 (1943).

322. See Lord Forbes, 25 B.T.A. 154, 161 (1932); Wurzel, *Foreign Investment and Extraterritorial Taxation*, 38 COLUM. L. REV. 809, 830 (1938).

323. See SIMONS, *PERSONAL INCOME TAXATION* 3-4 (1938). The principle still has some vitality, however, in allocating the cost of certain governmental services of a quasi-commercial nature, e.g., toll highways. See SMITH, *FEDERAL TAX REFORM* 17-19 (1961).

seems to mean little more than that the taxpayer must have received some benefit or protection from the state seeking to tax him.³²⁴ Little effort is made to quantify and relate the cost or value of the benefits received to the amount of the levy.³²⁵

Ability to pay is a currently more respectable criterion, both in domestic and international tax matters, although the factor of benefits is related to the ability to pay.³²⁶ To the extent that benefits increase economic faculty, they are relevant in allocating tax burdens. Definitions of source of income should be pragmatic concepts, reflecting a balance of the need for revenue, the desire to encourage investment, efficient resource allocation, and reciprocal accommodations by other countries. Yet the benefit concept may still be useful if for no other reason than it may help us fully to focus on the factors and policies affecting, and being affected by, the tax system.

To the extent that the tax imposed on the foreign taxpayer exceeds the benefits he receives from the taxing country, the tax will tend to keep him out. Therefore, to the extent that revenue is the goal of a tax, substantial correlation between the benefits received and the tax imposed is necessary. "Benefits" in this sense, however, are those privileges or conditions necessary to the production of income, the magnitude of which is relative to the availability of alternatives and the taxing nation's effective control over the income producing conditions. In evaluating a particular source rule, existing alternatives should be considered, and their relative attractiveness and disadvantages should be compared with the alternative to which the source rule applies. The method of allocation should then be judged by considering the effective control of the government over the more alluring alternatives and the price it will have to pay to modify or remove them.

Substitute methods of realizing income may exist over which the United States lacks effective control or which would be too costly to change. It may be possible, for example, for a foreigner to exploit copyrights, patents, and their analogues by assigning his rights to a foreign firm which produces the product and imports it here tax free under the current title passage test. The greater the tax burden on methods of exploitation over which the United States has effective control—*e.g.*, production of the property here or assignment to a local entrepreneur—the more advantageous the former alternatives will become. In considering the maximum revenue which may be raised by a

324. *E.g.*, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959): There must be some "'definite link, some minimum connection'"; the "'controlling question is whether the state has given anything for which it can ask a return.'" *Id.* at 465.

325. On the difficulties of such a task, see Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 451-55 (1952).

326. See generally, Report on Double Taxation, General Principles which Govern International Competence in Taxation, Part II, The Principle of Ability to Pay (League of Nations, 1923). There is, of course, a good deal of ambiguity in the ability to pay concept and insofar as the theory has been urged as the final answer to questions of tax justice, it has been rejected. See Buehler, *Ability to Pay*, 1 TAX L. REV. 243 (1946); Blum & Kalven, *supra* note 325, at 480.

tax, these alternatives will also have to be weighed and a judgment made as to the extent to which a given tax scheme may induce taxpayers to avoid the activity upon which the tax is measured, and hence pay no tax. But revenue directly raised by the tax is not the only consideration. A tax designed to produce the most revenue will always have other consequences and these may be undesirable, either because they may indirectly result in losses of revenue or because other values are adversely affected. Thus, there are two basic questions: (1) What are the appropriate criteria for levying a tax which will result in maximum revenue? (2) How should these criteria be modified to eliminate consequences more costly in community values than the loss of revenue resulting from the modification?

In the case of a tax on patents, copyrights, and the like, exploited by non-resident aliens, it would seem probable that a tax designed to raise maximum revenue would be an undesirable tax, and that substantial modification of a hypothetical revenue raising scheme would be required. Even if revenue were the sole consideration, however, the present scheme is defective.

The basic alternative to local exploitation—foreign production and import—could be minimized by several methods. The title passage test for sales of tangibles could be jettisoned in favor of a destination test; domestic patent or copyright protection could be denied such imports; tariffs or import restrictions could be erected to keep them out. It is not the purpose of this article fully to evaluate such possibilities; merely to suggest them and, further, to advance the possibility that any such efforts would be too costly and complex. They would, in many cases, require renunciation of treaties and would involve the hazards of retaliation. Yet tax alternatives which apply to substantially the same activity, *i.e.*, the “sale,” “license,” and “service” methods of exploiting intangibles, are arguably not so involved and pervasive as to preclude unilateral reform.

A SINGLE SOURCE FACTOR

All that has been seriously claimed for the title passage test is its “practicality” or “certainty.”³²⁷ Similar claims might be advanced for a place-of-contract test for determining where an intangible is sold. Yet it is doubtful that either of these descriptions is apt. The “certainty” and “practicality” of such tests depends on the probability of substantial agreement among nations as to where the contract was “executed” or “negotiated,” or where “title passed.” This seems Utopian, particularly in light of the substantial variations in concepts of contract and sales law. Moreover, when the decision turns upon formalism unrelated to external reality, the tendency—if the United States decisions are exemplary—is to decide the way which appears most likely to enhance the coffers of the decision-maker’s country.

The place-of-contract test, however, if uniformly applied by different countries, would at least have the virtue of reducing or eliminating multiple tax

327. See *United States v. Balanovski*, 236 F.2d 298, 306 (2d Cir. 1956); articles cited in note 279 *supra*.

claims and burdens of compliance. If uncluttered by the necessity of allocating a portion of the income to the country of production, such a test would in theory at least attribute the worldwide income from patents or copyrights to a single country. There is, therefore, something to be said for a single factor for allocating income. If the same factor is adopted by countries whose economies and international intercourse are relatively balanced, little revenue need be lost by any. There are several weaknesses, however, in a single factor as arbitrary and nebulous as the place-of-contract test. As already noted, it is likely that decision-makers in both the country of the seller and the country of the buyer—and possibly also in other countries—will attribute the entire source of income to their own country. The threat of such a result would be injurious to international trade and would destroy the whole basis for the single factor formula. Secondly, it is not unlikely that the sale contract will be negotiated in a country having no substantial connection with the parties, but a salubrious tax climate. Insofar as the likelihood of success in such ventures exists, the efficacy of the test would be destroyed. Finally, even if some consensus can be reached on the principles for determining the place of contract, differences in tax rates of the countries furnish a constant inducement to negotiate the contract in the country imposing the lesser tax, and thus the balance essential to the success of the single factor is destroyed.

Place of production

If a single factor is to work, it should be something with some empirical content, such as the place of production—where the invention or intellectual product was conceived and developed. Even a place of production factor would not be a panacea. Frequently, production is not confined to a single country. Some allocation would therefore be required. There is no clear boundary where production ends and promotion or selling begins. All these activities might reasonably be included in the concept of production, frequently making allocation to a single source impossible. The concept, however, could be defined as the principal place of production, or where most of the activity and assets used in producing or marketing the property were located.

There are other problems, however. No account is taken in such a test of property not produced by the taxpayer. Should the income be attributed to the country of production even though the taxpayer purchased the property or received it as a gift, bequest, or capital contribution? If the taxpayer purchased the property, the country of production would presumably have been allocated the income of the seller-producer and would have the option of imposing or exempting a tax on that income. It seems impracticable to continue to view the income of subsequent transferors as derived from the country where the first transferor created the property. A purchaser's income on resale should presumably be treated as derived from his activities in purchasing, improving, and marketing the property. If substantial improvements were made by him, the place where made might be treated, in allocating his income, as the country of production. But, if, as is often the case, most of his activity was

in promoting and marketing, the place where most of the activity occurred might be selected. In either event, whether the taxpayer produced or purchased the property, his income might be attributed to the country where his principal activities in creating, developing, or marketing the property occurred.

Treatment of the income of a seller of a patent or copyright who acquired the property by gift, bequest, or contribution to capital is complicated by the present tax treatment of such transactions. A contribution to capital of a controlled corporation which qualifies for nonrecognition under section 351,³²⁸ a gift,³²⁹ and a bequest,³³⁰ produce no taxable income under the current statutory provisions. Thus if a foreign corporation produced a patent in the United States, transferred it to a foreign based subsidiary under section 351, and the subsidiary then sold the patent, all United States income tax at the corporate level might be avoided. The parent would have income from United States sources but no *taxable* income because of section 351;³³¹ and if all the subsidiary's

328. I.R.C. § 351 permits property to be transferred to a controlled corporation in exchange for stock or securities without recognition of gain or loss. The corporation acquires the property with the transferor's basis. I.R.C. § 362(a). I.R.C. § 367 limits the applicability of § 351, in the case of transfers to a foreign corporation, to those transactions upon which the Commissioner is satisfied, before the exchange, that one of the principal purposes of the plan is not tax avoidance. If a shareholder transfers property to a foreign corporation without taking stock in exchange, however, there is a remote possibility that § 351, and hence, § 367 will not apply and that the Commissioner's approval is not a condition to nonrecognition. The theory would be that the transfer was a contribution to capital—or perhaps, even, a gift—for which no stock was received in exchange, and that no gain should be recognized even though § 351 is inapplicable. See generally, Pugh, *Sales and Exchanges of Foreign Patents*, N.Y.U. 20TH INST. ON FED. TAX. 1305, 1319-21 (1962); Eckstrom & Slowinski, *Tax Planning for Foreign Licensing of United States Industrial Property Rights*, N.Y.U. 19TH INST. ON FED. TAX. 969, 987-91 (1961).

329. A gift may result in a gift tax under I.R.C. § 2501(a) if made by a citizen or resident or a nonresident alien engaged in business in the United States. Gifts of intangibles by nonresident aliens not engaged in business here are exempt. The nonresident alien engaged in business is taxed only on gifts of such property "situated" in the United States. I.R.C. § 2511(a). On the question of the "situs" of a copyright for gift tax purposes, compare P. G. Wodehouse, 19 T.C. 487 (1952) with Sax Rohmer, 21 T.C. 1099 (1954). See generally LOWNDES & KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 755-60 (2d ed. 1962) [Hereinafter cited as LOWNDES & KRAMER]. A corporation is not subject to the gift tax. A gift by a corporation, however, may be treated as a constructive gift by the shareholders. See *id.* at 580.

330. Although a bequest produces no taxable income, the fair market value of the property bequeathed will be subject to the estate tax if the decedent was a resident or citizen of the United States. I.R.C. §§ 2001, 2031(a). Property of a nonresident alien decedent is subject to the estate tax only if "situated" in the United States at the time of death (I.R.C. § 2103) or, in the case of certain inter vivos transfers, either at the time of death or the time of transfer. I.R.C. § 2104(b). It has been suggested that patents or copyrights are "situated" here for estate tax purposes to the extent they "have a value because of the protection afforded by American law." LOWNDES & KRAMER at 503. If so, the tentacles of the U.S. tax collector extend far beyond his grasp. Almost any European author, movie producer, or inventor may be a potential source of United States estate tax.

331. But see discussion of I.R.C. § 367 at note 328 *supra*.

activities in connection with the patent were outside the United States, none of its income, under the postulated place-of-production method, would be attributed to the United States. Similar results would follow from gifts or bequests to foreign taxpayers.³³² To prevent such siphoning off of United States income, further tax restrictions might be imposed on gifts and bequests to foreign taxpayers and section 351 might be modified so that gain would be recognized on transfers of patents, copyrights, and similar property by resident foreign corporations to foreign subsidiaries or by aliens engaged in business here to controlled nonresident foreign corporations.

Alternatively, the place of production method of allocating income might be modified so that part of the income of a donee, legatee or contributee would be allocated to the country where the previous owner produced the property. Thus, when the foreign subsidiary in the previous example sold the patent it would have United States income, even though it had no other substantial contacts with the United States. There seems no apparent reason why a gift or a contribution to capital, or any other tax free transfer should shift the source of income from one country to another. If an English author would have English income were he to sell his copyright, surely a tax free gift to his wife, or a transfer to his solely owned corporation, followed by a sale, should not produce a substantially dissimilar result.

Thus, in allocating income from the sale of a patent, copyright or similar property, it would seem feasible to allocate all the income to the country in which the taxpayer had his center of activities in connection with the creation, management and marketing of the intangible property. Where the taxpayer acquired the property other than through a purchase or taxable exchange, the center of activities of the transferor with respect to the property could be considered, together with the activities of the transferee, in determining the source of the transferee's income.³³³

Close questions doubtless would arise in locating the principal place of production. Various factors would have to be weighed. Where, for example, would

332. Although as suggested in notes 329, 330 *supra*, the transfers in some cases would have been subject to gift or estate tax.

333. Drawing the line between taxpayers who should be treated as "purchasers," and whose income should be allocated without reference to their transferor, and taxpayers whose transferors should be considered in determining source is not easy. As far as producers located in the United States are concerned, the source of their transferee's income could be determined by reference to the center of activities of the transferor whenever the transferee acquired the property with a carryover basis, or, alternatively, whenever the transferor was not subject to income tax on the transfer (thus, including transfers by bequest). But how about the transfer from a non-national who produced the property abroad? Should the transferee be treated as a purchaser if he acquired the property in a transaction which would have been taxable to the transferor by the United States if the transferor had had any United States source income? Or should an attempt be made to "borrow" from the tax laws of the country of production, treat the transferee as a purchaser if his transferor was taxed by the country of production? These problems are formidable. But since the present source rules draw distinctions between taxpayers who "purchased" the property and those who "produced" it—and leave a lacuna for those who did neither—they exist under the present scheme as well.

the source of income be if movie rights were sold, the movie's production having been planned, financed and managed in the United States but actually filmed in Mexico? The decision might go either way; and decision-makers in the United States and in Mexico might be expected to disagree. But at least the choice would have been narrowed to two countries, each of which has a substantial connection with the income producing activity. This would seem preferable to a rule attributing all or a considerable chunk of the income to a third country wherein the movie maker merely negotiated a contract of sale.

The reasons for preferring a place-of-production test go beyond the desire for certainty, however. No substantial benefits are conferred on a taxpayer by a country merely because it provides him with a forum in which to negotiate a contract disposing of his patent or copyright. He will not suffer severely if he moves the negotiations elsewhere. Indeed, a substantial tax based upon the fact that a contract is made in one country rather than another would seem to serve little purpose other than harassment of foreigners. Providing a place to produce a patent or copyright is another matter. Most patents and many copyrights are products, or by-products, of commercial and industrial activity, and few choices of business location are likely to be greatly influenced by a tax on patents or copyrights derived from that activity. The advantages of doing business in the United States, for example, are usually sufficient to stand the strain of a tax on the income from a patent developed in that business and exploited abroad. Avoiding a tax levied by the country of production is a much more costly and complicated performance than eluding a tax based solely on where a contract was executed. At least it would seem so unless merely by choosing a "license" label for foreign exploitation that task could be accomplished.

Allocating income from a "sale" to the country of production would substantially coincide with the present treatment of income from services, diminishing incentives for artificial attempts to circumvent one rule or the other. But it would still leave an unsatisfactory disparity between sales, services, and licenses. It would still permit the American based movie producer, filming his movie in Mexico, to shift a substantial portion of the income to Europe by "licensing" or renting the film there rather than "selling" his foreign rights. It would still permit a United States based foreign corporation producing patents here to avoid all United States tax on foreign licensing.

A possible solution to the problem of overlap between "sales" and "licenses" would be merely to do away with the distinction for determining source of income; allocate income from both to the country in which the property was created.³³⁴

334. Changes in current methods of allocating income from "licenses" would create a new problem of reconciling the changes with the method of allocating rentals from tangible property solely to the country where the property is located. I.R.C. §§ 861(a)(4), 862(a)(4). The problem may be illustrated by the movie producer who creates a "copyright" when he produces a negative. If he "rents" the negative for foreign reproduction and exhibition, or reproduces film from it and "rents" the film for foreign exhibition, does he have income from "rentals" of tangible property, "royalties" from a copyright, or some

A less extreme resolution of the problem would be to define a "sale" quite narrowly, as, for example, an assignment of all rights within a particular country for a fixed sum. A "license" could be defined as an assignment of partial rights in a particular country, or of all rights subject to a retained economic interest. A portion of the "license" income might then be allocated to the countries where the license was exploited. At least two reasons might support such a bifurcation. First, such a result would be a less drastic departure from current concepts of source. Many other countries, in addition to the United States, regard license income as attributable to the country where in the license is exercised.³³⁵ Second, dispositions on a piecemeal basis, or subject to a retained royalty interest, may be economically more desirable and income-productive than larger transfers for a guaranteed sum in which the transferee assumes all risk and exacts a price for it. Moreover, marketing of intangibles in slices often involves substantial activity by the taxpayer. When a novel is written in one country and the author disposes separately of book, movie, dramatic and television rights in another, a lot of promotion by him is often involved in the second country. And when his compensation is based on successful exploitation, the licensees, if not his agents or partners in law, nevertheless have joint interests with him and in pursuing their own, also further his interests. Since the author is getting a share of the profits from these activities, it does not seem unreasonable that this should be taken into account in allocating his income.

These notions should not be stretched so far, however, as to deny the country of production an ample share of the income, as there still is not a great deal of difference between a "sale" and a "license" as thus defined. Perhaps a taxpayer who purchased the property and then licensed it should have all his income allocated, as is now the case, to the countries where the rights are exploited. But other taxpayers would have the "personal service" alternative with which to shift the entire income into different countries, particularly if, as in *Karrer*,³³⁶ the author's or inventor's compensation from a personal service contract can be geared to the exploitation of the copyright or patent. Conceivably, an author in England could agree simultaneously with American, Canadian, English, French, and German publishers to write the same book for each, with each paying for and getting the local copyright. To subdue motivations for such arrangements and keep disparities to a minimum com-

of both? It would seem that the policies supporting the allocation of some, or all, of the income from royalties on intangible property to the country of production would likewise support a similar allocation of income from rentals of tangible property produced by the taxpayer. The method of allocating rental income should probably also be changed if modifications are made in the rules relating to royalties. Thus, the question of characterizing the income as "rents" or "royalties" would become academic, as it is under the present source rules.

335. See Carroll, *Methods of Allocating Taxable Income*, IV TAXATION OF FOREIGN AND NATIONAL ENTERPRISES 117, 126 (League of Nations, 1933).

336. *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957), discussed at text accompanying note 305 *supra*.

mensuate with their economic attributes, half, say, of the income from "licensing" might be attributed to the country of production, the other half to the countries where the property is exploited.³³⁷

Some less radical refinements

It cannot easily be assumed that Congress in 1921 understood that a "sale of personal property" within the source rules encompassed a "sale" of exclusive rights to publish a literary production in a particular medium or a

337. The basic problem considered in Part II of this article is the arbitrariness, uncertainty, and inadequacy of the source rules insofar as they encourage a foreign taxpayer to shift the source of his income among and between countries by the judicious use of labels and a little foresight. The proposed changes would tend to bring the results into line regardless of which label was chosen. This presupposes, however, that the taxpayer stays put. If he actually leaves the country where he created or acquired the patent, copyright, process, or idea and travels to another country to transfer it, a prickly problem remains of determining whether the compensation he receives is for "property" or for "services." When the taxpayer's efforts are traceable into an invention or a writing upon which a statutory patent or copyright can be obtained, or where his efforts have been transformed into a concrete, durable, and transferable form having value independent of the future efforts of the creator, there may be little difficulty in determining that the income was from a transfer of "property" and allocating the income accordingly. Suppose, however, that a Frenchman develops, over a period of years in France, a secret process which an American company is interested in acquiring. If the Frenchman "sold" or "licensed" the process, all or a substantial part of the income would be attributed to France under the approaches suggested here. But if he casts the transaction in the form of a contract for the rendition of "services" and agrees to come to the United States for a week to explain the process and instruct in its use, it might be argued that his compensation was solely for services rendered in the United States, hence, entirely from United States sources. What criteria should be employed in determining whether the taxpayer transferred "property" or merely rendered services? When a taxpayer receives compensation for communicating an unpatentable secret process or valuable information, how is he to be distinguished from any other taxpayer who gets paid for his accumulated knowledge and skill? A possible answer is that unless the taxpayer had some sort of legal monopoly, like a patent or copyright, his accumulated skills, secrets, and knowledge do not rise to the status of "property" and any pay he gets is for services. See *Commissioner v. United Aircraft Corp.*, 68 *Commw. L.R.* 525 (Austl. 1943), reproduced in part in BITTKER & EBB, *TAXATION OF FOREIGN INCOME* 149 (1960). This is apparently not the view in the United States, however. See Duffy, *Doing Business Abroad: Use of American Know-How*, N.Y.U. 20TH INST. ON FED. TAX 1269 (1962); Rev. Rul. 55-17, 1955-1 CUM. BULL. 388. It would seem that such factors as the legal protection given the idea or process, its uniqueness, whether it has been, or is capable of being given concrete form, though relevant, should not be conclusive. It would seem reasonable to consider, in determining whether "property" has been transferred, the relationship of the amount of compensation received to the services and capital actually involved in rendering the "service." Thus, if the Frenchman in our example received \$500,000 for the alleged "services" which took him a week to perform, one might conclude that the information he communicated was of sufficient importance and value to be classed as "property"; that in essence the source of his compensation was the accumulation of knowledge and the research undertaken in France. The standard is admittedly imprecise and needs refinement. Yet it seems necessary to preserve the integrity of the proposed place-of-production factor. No substantial contribution to the creation of the income in our example was made by the United States merely because it provided a forum in which to communicate the process. Arrangements could have been made to communicate it in France, or Canada, or Brazil—wherever the climate, taxwise and otherwise, was most salutary.

"sale" of exclusive rights to manufacture, use, and sell a patented product within a narrowly limited geographical area. Nor is the conclusion clear that a "sale" of an intangible was understood in 1921 to include the royalty arrangements now so widespread. International trade in artistic and industrial property was then in its infancy. Piracy was still pervasive. Consumer demand varied far more from country to country than it does today; Telstar, television, and sound movies were things of the future. The economic value of the foreign rights to even the most successful book or invention was often insignificant; and taxpayer sophistication in 1921 in the use of foreign charters, letterheads, and exploitation techniques seems to us more antediluvian in retrospect than movies with subtitles and player pianos. It is not surprising that little thought was given to these problems.

The congressional conception of a sale of a patent or copyright in 1921 may have been a lump, or fixed sum transfer of all rights within a particular country, or, perhaps, throughout the world. It may also have included the notion that a United States patent or copyright had an immovable situs in the United States and that any sale of United States rights would necessarily occur within the United States.³³⁸ It is also conceivable that the special method of allocation for property "produced" in one country and sold in another was not intended to apply to intangibles.³³⁹ As alternatives to the complete overhaul of the source rules already suggested, these possibilities should be considered.

A. Restrictive definition of "sale"

Congress may have intended to allocate income under the "sale" criterion of sections 861(a)(6), 862(a)(6) only where the consideration was a fixed sum and the taxpayer assigned all his rights within a particular country. This would no doubt diminish the significance of these sections in allocating income from patents and copyrights, since such transfers are seldom commercially feasible, except between related taxpayers, because of the high risks involved. Yet if this view of a "sale" is combined with the place-of-contract test, invitations to manipulation are still open. The owner of the property may sell it to a controlled corporation and negotiate the sale in a country with favorable tax treatment of the gain. A foreign corporation producing the property here, for example, might avoid all United States tax by selling the rights abroad to a subsidiary or to the controlling shareholder. The "buyer" might then license the rights in the United States and elsewhere. The only income attributable to the United States would be that paid for "use" of the property

338. As suggested in I.T. 2735, XII-2 CUM. BULL. 131 (1933) quoted at note 288 *supra*, however, it seems fairly clear that Congress did not have this in mind, for it specified that income from the sale of real property located in the United States was United States income, I.R.C. § 861(a)(5). If Congress had intended to tax all income from copyrights and patents "located" in the United States (*i.e.*, United States patents and copyrights), regardless of where the contracts were executed, etc., it presumably would have said so as it did in the case of realty. An interpretation that would locate the sale in the country where the rights are exercisable, regardless of other circumstances, seems a bit farfetched.

339. See note 259 *supra*.

in the United States.³⁴⁰ Moreover, the subsidiary or the shareholder might not even be taxed on these receipts. If the buyer is not engaged in business here through a permanent establishment, the royalties might be exempt by treaty. Even if the buyer were engaged in a United States business through a permanent establishment and was taxable on the royalties, he could presumably deduct a ratable portion of the cost of the property, *i.e.*, the price paid the seller, leaving him with little or no taxable income.

Pressures for such schemes would be diminished if "personal property produced" in the United States, within the meaning of section 863(b)(2), applies to patents and copyrights. Then part of the income of the corporation which created the property would be allocated to the United States regardless of where the sale occurred. The statute could,³⁴¹ and should, be so construed.

This method would still seem unsatisfactory so long as a significant factor in the allocation formula is the place of contract. There seems no reason why all the income should be allocated to the country of production if the contract was made there, but only a part if the negotiations were elsewhere. All this approach has to commend it is that income would be fragmented among few countries and the divergent methods of allocating income of "sales" and "licenses" would apply to different transactions. Paradox would be reduced to anomaly.

B. "Situs" as the place of sale

The source provisions regarding sales of property "within" or "without" the United States may have included the notion that a patent or copyright had an immovable "situs" in the country whose laws "created" it; that a "sale" of a United States patent could occur only "within" the United States and a "sale" of foreign rights could take place only outside the United States. Thus if patent rights were "sold," the income would be allocable among all countries wherein the seller granted rights. If the property were created by the taxpayer in the United States, all income from the "sale" of United States rights would be domestic income. Whether any portion of the proceeds attributable to foreign rights would be allocable to the United States would depend upon whether a foreign patent or copyright is "produced" in the United States, as that term is used in section 863(b)(2), by reason of the invention or artistic work having been conceived and created here.³⁴² If so, then a portion of the proceeds from foreign rights would also be allocated to the United States as the place of production. Conversely, if the property were created abroad, the United States would claim none of the income from foreign rights and only a portion of the income from domestic rights.

This interpretation of the statute, though founded on a fiction, would seem more sensible than a place-of-contract test. A substantial part of the income

340. See text accompanying notes 295-99 *supra*.

341. See notes 257-59 *supra* and related text.

342. As suggested at text accompanying note 341 *supra*, I.R.C. § 863(b)(2) should be so construed, whether or not the "situs" approach is adopted for locating the place of sale.

from worldwide rights would be allocated to the place of production, provided the taxpayer or his donor produced the property.³⁴³ Only if the taxpayer purchased the property would the treatment of "sales" coincide with the treatment of licenses, the income being attributed to the countries where the rights were "used," *i.e.*, in which the rights were granted. The discrepancy in allocation of income from sales and services would be reduced to tolerable dimensions. But as to rights not purchased by the taxpayer there would still be extreme variations, and hence attractive alternatives, between sales and services, on the one hand, and licenses, on the other. If the taxpayer produced the property under a contract for services, or if he produced and "sold" it, all or a large portion of the income would be attributed to the place of production. Yet if he "licensed" the property, none of the income would be so allocated. Something would still have to be done with the license alternative. A "sale" could be redefined, as earlier suggested,³⁴⁴ to include only an assignment of all rights within a particular country and without a retained royalty interest.³⁴⁵ This would put a price upon the choice between the "sale" and "license" devices, but it would leave undisturbed the lacuna between "licenses" and "services." A redefinition in reverse might be preferable: "sales" could be defined quite broadly, as the Commissioner has defined the concept,³⁴⁶ to include piecemeal dispositions on a royalty basis, leaving the "license" label for only very minute assignments. The purpose, of course, would be to throw most assignments into the "sale" category. But framing a definition to withstand the corrosive pressures of tax manipulators would be a formidable feat. Under the present administrative definition, for example, one of the conditions of "sale" classification is that the grant be for the entire term of the patent or copyright.³⁴⁷ Yet it is seldom of much economic import to an author or inventor whether he grants rights for ten years or in perpetuity. Permitting him to determine the source of his income by choosing one method or another would be little improvement over the present imbroglio. If the "situs" approach were adopted for treatment of "sales," subtle distinctions between "sales" and "licenses" should probably be abolished. Unless the taxpayer purchased the property, a substantial part of the income from either method of disposition should be allocated to the country of production.³⁴⁸

343. I have here assumed that since the statute does not specify the method of allocation where the taxpayer neither produced or purchased the property, that apportionment should be made as if the taxpayer had produced the property, *i.e.*, the taxpayer and his transferor would be viewed as one for purposes of the allocation. This approach is discussed at note 333 *supra* and related text.

344. See text following note 334 *supra*.

345. Some of the formidable difficulties presented by the necessity of allocating "sales" price (a fixed sum) among various countries wherein the rights were granted is suggested by the hypothetical at text accompanying note 300 *supra*.

346. Rev. Rul. 60-226, 1960-1 CUM. BULL. 26.

347. *Ibid.*

348. This could not be done by re-interpretation of the statute. I.R.C. §§ 861(a)(4), 862(a)(4) clearly forbid allocation of any income from rentals and royalties to the country of production.

The "situs" concept has no support in the legislative history and could come only from a laborious interpretation of the statute.³⁴⁹ It does not seem ever to have been suggested by courts or the Commissioner.³⁵⁰ Moreover, for this method to be palatable, present treatment of licenses would have to be modified. Legislation is therefore necessary.³⁵¹ It would probably be preferable to junk the present concepts and start over.

CONCLUSION

A number of changes and refinements in the taxing provisions are needed whether or not the source rules are revised; whether other reforms are required in the taxing provisions depends on the changes made in the source of income concepts. The following suggestions seem applicable in any event:

1) The provisions imposing tax on "capital gains" of aliens present here³⁵² should be revised or repealed. Capital gains criteria are inappropriate for non-resident aliens. Whatever it is that is sought to be taxed by these prescriptions, it is not, or should not, be the heterogenous species of income grouped under "capital gains."

2) Section 871(a)(1)'s imposition of a tax on patent assignments "described in section 1235" should be repealed. Section 1235, providing a tax bounty for domestic inventors, supplies no sensible criteria for taxing or exempting nonresident aliens.

3) The alternative tax in section 871(b), providing for domestic rates, including capital gains rates, on certain nonresident aliens with taxable income of more than \$15,400, needs refinement. Since capital gains concepts are inappropriate, a tax which is measured in part by such concepts is dubious.

4) The proviso in section 871(b)(2) that a nonresident alien not engaged in business is taxable at a minimum rate of 30 per cent of gross income, is an indefensible trap for the hapless alien, particularly if his gross receipts from royalties are "fixed or determinable income."³⁵³ The alien with a substantial basis on his property should be permitted to amortize a portion of it against United States income where gross receipts and net income are greatly at variance. Perhaps instead of requiring the alien to pay domestic rates, after deductions, if his income exceeds \$15,400 and this method produces a *greater* tax than the flat rate before deductions,³⁵⁴ he should be given the option of calculating his tax at the flat rate or at progressive rates after deductions, whichever method produces the *lesser* tax.

5) New definitions of the gross income of a nonresident alien or foreign corporation should be enacted. The "fixed or determinable annual or periodical" concept should be scrapped along with the capital gains criteria. Overlapping and contradictory concepts should be eschewed and interdependence

349. See note 338 *supra*.

350. In fact, the Commissioner has rejected it. See I.T. 2735, XII-2 CUM. BULL. 131 (1933) quoted at note 288 *supra*.

351. See note 348 *supra*.

352. I.R.C. § 871(a)(2).

353. See note 58 *supra*.

354. As is now provided in I.R.C. § 871(b)(2).

of rules applicable to foreigners with those fashioned for domestic taxpayers should be minimized.

More specific proposals cannot be made except in relation to source concepts. The source rules seem larded in even a thicker coat of conceptualism than the taxing provisions. They seem too obsolete to be patched up by statutory interpretation. A new model is needed and only some rough sketches have been offered here.

If the principal place of production of a patent or copyright were accepted as the source of the income from such property, however, it would appear that many of the anomalies in the taxing provisions could be eliminated in one stroke. Nonresident aliens and foreign corporations, whether engaged in United States business or not, could be taxed on all income from patents, copyrights and similar property which was from United States sources. This would work as follows:

- 1) If the alien or foreign corporation's principal activities in connection with the production of the invention or artistic work occurred in the United States, all income, whether from a "sale" or a "license," wherever disposed of, would be taxable by the United States.
- 2) If the principal activities in producing the property occurred abroad, all income would be foreign income unless the taxpayer purchased the property. Then his income on disposition would be taxable here if his principal activities in purchasing, improving and marketing occurred within the United States.

Taxing the nonresident alien or foreign corporation on all patent or copyright income from United States sources would also seem appropriate if a modified place of production factor were adopted. Under the method outlined, a dichotomy would be retained, but perhaps new names, such as "sole" and "license," should be used. A "sole" would be defined to include only a transfer of all rights within at least a single country and subject to no retained royalty interest. Income from a "sole" would be allocated to the country of production as above. Assignments of lesser magnitude, "licenses," would involve a different allocation:

- 1) If an alien or foreign corporation purchased a patent or copyright, or an interest in same, and granted a "license," all income would be allocated among the various countries in which rights are granted. The place where the property was created would be disregarded.
- 2) If the alien or foreign corporation acquired the patent or copyright other than by purchase, then the "license" income would be allocated between the place of production of the property and the various countries wherein rights were granted.

Limitless permutations are possible. Detailed study is needed before any radical renovations of basic concepts are enacted. That such study is needed seems incontestable.

Obstacles to reform

Few would regard a statute regulating securities transactions which is two generations old as appropriate for the 1960's, much less embodying immutable verity, and there is no reason why the source rules should be so regarded.

There are, however, a number of practical impediments to reform occasioned by the transnational nature of the problem.

The first concern is reciprocity. If our source rules were shared by a substantial number of major countries, not only in their statement but in their application, then it might be unwise for the United States to charge off in different directions. There is, however, little uniformity in these matters. And even though some countries have rules resembling ours, it cannot be assumed that their interpretations bear more than a rough resemblance to ours, especially since our rules have remained so fleshless over forty years. Moreover, it is not unlikely that many of the nations having rules similar to ours copied them from us and will be willing to do so again.

Another possible barrier to statutory reform is the tax treaty structure. Whether our treaty obligations hinder unilateral reform depends in part on the direction the reforms take. If definitions of source are aimed at taxing foreigners who have substantial activities in creating, marketing and managing property within the United States and exempting those who do not, the source rules will complement the treaties and will recognize, as the treaties do, substantial economic connection as the touchstone of taxation. As earlier noted, the treaties commonly grant relief from taxation of royalties remitted to nationals of one contracting state from another, provided there is no "permanent establishment" in the latter country. They do not, however, require that royalties be taxed by us when there is a permanent establishment here.

Existing source rules no doubt figured as background in the bargaining over the treaties. Yet the treaties do not, generally, attempt to establish a country's source rules; they mainly just exempt specified persons or entities and certain kinds of income. As to persons not exempt under the treaties, each country is apparently free to claim as much of an individual's income as its own interests dictate.³⁵⁵ Whether, in spite of this, it would be within the spirit of our treaty obligations to tax all the income of, say, a foreign corporation creating a patent here and licensing it throughout the world, is not easily answered. If further study reveals doubt on the matter, our treaty obligations can be excepted from the statutory provisions.³⁵⁶

355. One instance in which our source rules are arguably modified by the treaties is when a foreign enterprise is subject to tax here because it has a branch which is a permanent establishment. Then, in allocating income and expenses between the branch and the home office, the treaties customarily provide that an allocation should be made as if the home office and the branch had dealt at arms length. See, e.g., Treaty with United Kingdom, April 16, 1945, Art. III(3), (4). These provisions would seem inapplicable to most patent and copyright transactions.

Some of the treaties also contain source rules relating to the foreign tax credit, but these provisions affect only our own residents. See generally, Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 *RUTGERS L. REV.* 428, 438-41 (1963).

356. I.R.C. § 7852(d) has this effect, as it provides that treaty obligations prevail over provisions of the 1954 Code. See also I.R.C. § 894 (income exempt by treaty is also exempt under the Code). A disturbing trend may be portended, however, by § 31 of the Revenue Act of 1962, which provides that I.R.C. § 7852(d) does not apply to the 1962 Act. See generally, Lidstone, *Liberal Construction of Tax Treaties—An Analysis of Congressional and Administrative Limitations of An Old Doctrine*, 47 *CORNELL L.Q.* 529 (1962).

A third impediment, probably the clearest, is rectifiable. That is the parasitic growth and piling on of various divergent statutory provisions relying substantially on the source rules.³⁵⁷ New, separate rules could be enacted for each where its policies were inconsistent with the source rules. There is no *a priori* reason why the concept of foreign source income in the Western Hemisphere Trade provisions,³⁵⁸ for example, or even in the tax credit provisions,³⁵⁹ needs to be tied to the same rules allocating income for purposes of taxing non-nationals. It would seem salutary if these provisions were self-contained and fresh thought was required to define their scope.

The foreign tax credit presents special problems. The credit is limited to income taxes imposed by foreign countries upon income from foreign sources,³⁶⁰ according to United States concepts of source.³⁶¹ Thus, if the United States were to decide that all of the income from a patent was allocable to the United States, where the invention was conceived and created, a foreign tax on the royalties remitted to the United States might not be creditable by the domestic taxpayer subject to tax on his worldwide income. There is nothing immutable about such a result, however. The credit might be granted even though the foreign tax was not technically on foreign source income. Or partial relief might be granted in the form of a deduction for such foreign taxes.³⁶² The only question would be whether the domestic taxpayer having such income and such a foreign tax was deserving of a tax preference.³⁶³ On the other hand, there may be good reasons for denying a credit for such taxes inasmuch as the limitation might have a significant effect in encouraging reciprocal adoption of source rules in line with ours. Taxes imposed by a foreign country have no appreciable effect upon investment or exploitation in that country by a national of the United States so long as the foreign tax is fully creditable. When not creditable, as for example, when the foreign tax is upon income not deemed allocable to foreign sources under United States law, the foreign tax acts as a deterrent to the taxed activity. By denying the tax credit the United States retains a hefty helpmate in the form of an indirect economic sanction to encourage reciprocal modifications of source of income criteria.³⁶⁴

The United States, as the world's leader in foreign trade and investment, also occupies a potent position of leadership in international taxation and

357. See note 249 *supra*.

358. I.R.C. §§ 921, 922.

359. I.R.C. §§ 901-05.

360. I.R.C. § 904.

361. See Treas. Reg. § 1.901-2(d) providing that the source rules in I.R.C. §§ 861-64 are applicable in determining source of income under the tax credit provisions.

362. Foreign income taxes, even though not creditable, are presently deductible under I.R.C. § 164(b) (6), but only if the taxpayer does not also elect a foreign tax credit on other foreign income taxes.

363. See generally on the rationale of the foreign tax credit, Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815 (1956).

364. As pointed out *supra* note 239, however, the tax conventions contain provisions which seem to limit the freedom of the United States to deny credit of taxes imposed by many signatory countries. See also note 355 *supra*.

ought to exercise it more resourcefully. The recent tax haven legislation was a promising start but it should be merely a prelude to further rethinking and revision. Reams have been written on the problems of interstate taxation. Recent federal legislation was passed, and a special study group was set up.³⁶⁵ Yet the interstate problems do not seem so grave when compared to the international. Most states attempt to apportion on some reasonable basis. Few, if any, are as greedy about some sources and as myopic about others as the federal rules appear to be. Moreover, the state tax rates are much lower than the rates of most countries and are generally creditable against the tax imposed by the state of incorporation. Congress should have the source rules thoroughly restudied. It should not wait until other countries demand it. The paucity of foreign complaints might be read as a sign that the United States is not treating itself fairly.

The concept of nationality of business enterprise and the enchantment of the corporate charter are no longer adequate for today's internationality of economic interests. There is no necessary correlation between the nationality of a corporation and the location of its commercial interests and its economic allegiance. The same is true, to a lesser extent, of individuals. The trend toward further internationalization promises perpetuation of anonymous, ephemeral corporate and personal identities. As the forms and the forces for confusion continue to evolve and combine, new effort is needed to maintain the marriage of effective taxing power with economic substance.

365. See 73 Stat. 555, 556, 15 U.S.C. §§ 381-84 (1962); Note, *State Taxation of Interstate Commerce: Public Law 86-272*, 46 VA. L. REV. 297 (1960).

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