Intercompany Royalties:
Foreign Tax Credit Category

It is common for a U.S. multinational parent company to receive substantial amounts of royalties from foreign subsidiaries for the use of intangible property outside the United States. Such royalty income generally is subject to U.S. taxation, even though attributable to foreign business operations.

Nevertheless, U.S. tax on foreign source royalty income can be reduced or eliminated by excess foreign tax credits in the same category as the income. There are two categories (or baskets): general (or active) and passive. Because it is unusual for a U.S. corporation to have excess foreign tax credits in the passive category, generally only U.S. tax on active basket royalties can be reduced by excess foreign tax credits.

For example, assume a U.S. company earns $1,000 of passive royalty income that is not subject to foreign withholding tax. It would pay $350 of U.S. tax on the income. On the other hand, if the foreign source royalty income fell within the active basket, and the U.S. company had sufficient excess foreign tax credits, the U.S. company would pay no U.S. tax on the royalty income (i.e., the $350 of U.S. tax would be offset with excess general basket foreign tax credits).

As a general rule, royalties are categorized as passive. For foreign tax credit purposes, passive income is any income which is of a kind which would be Subpart F foreign personal holding company income (FPHCI) as defined in Code Sec. 954(c). Code Sec. 954(c)(1)(A) defines FPHCI as including royalties.

Code Sec. 954(c) contains two exceptions to the treatment of royalties as FPHCI but neither would apply to royalties derived by a U.S. parent from its foreign subsidiaries. One exception applies to royalties received from a related person for the use of the intangible property in the recipient’s country of organization, but the intangibles here are assumed to be used outside the United States. The other exception applies only to royalties received from an unrelated person in the active conduct of a trade or business.

The foreign tax credit provisions, however, contain a look-through rule for categorizing royalty income. Under this rule, royalties received by a U.S. shareholder from a CFC generally are treated as active basket income. Such royalties fall within the passive basket only to the extent they are allocated or apportioned to passive income (as defined above) of the CFC licensee (“CFC-L”).
Thus, if the licensed intangible property is used by CFC-L to generate sales or services income, the royalties received by the U.S. parent should be categorized as general basket income. This would be the result even if the sales or services income was subpart F income (it would not be passive).

CFC-L may sublicense the intangible property to a related CFC (“CFC-SL”), and the expense resulting from the royalties paid to the U.S. parent would be allocated to the royalties received by CFC-L from CFC-SL. The royalties received by the U.S. parent would be within the general basket if the royalties received by CFC-L from CFC-SL qualified for the same country exception (i.e., they would not be FPHCI). If CFC-SL uses the intangible property in its sales or services business, then the royalty received by CFC-L from CFC-SL would be general basket income. In such case, the royalty paid by CFC-L to the U.S. parent would be general basket income under the look-through rule, even if the royalty received from CFC-SL was FPHCI.

CFC-L may sublicense the intangible property to unrelated persons. Under this scenario, the subpart F same-country exception and foreign tax credit look-through rule would not apply to the royalties received by CFC-L because they are not received from a related person.

CFC-L’s royalty income, however, would not be FPHCI if it satisfies the active business exception. Royalties are considered as derived in the conduct of an active trade or business if the CFC developed, created or produced the intangible property, or acquired the intangible property and added substantial value thereto. In addition, the active business test is satisfied if the CFC licensor, through its own employees, regularly engages in marketing and servicing the intangible property and such organization is substantial in relation to the royalties derived from licensing such intangible property.

Even if CFC-L’s royalty income does not qualify for the FPHCI exception, the royalties received by the U.S. parent from CFC-L may nevertheless fall within the general basket. The foreign tax credit regulations broaden the active business exception by taking into account the activities of the entire affiliated group. For example, CFC-L might license from its U.S. parent intangible property used in a franchise business, and sublicense the use of the intangible property to unrelated foreign franchisees. Assume that CFC-L does not satisfy, but the U.S. parent does satisfy, the active trade or business test. The royalty income earned by CFC-L would be FPHCI, but the royalties received by the U.S. parent from CFC-L would fall within the general basket because the U.S. parent satisfies the active business exception.

In sum, royalties received by a U.S. parent from a CFC, where the intangible property is not licensed to a third party, should generally fall within the active basket, even if the royalty expense reduces subpart F income of the CFC licensee. In addition, where the CFC sublicenses the intangible to third parties, the royalties should fall within the general basket as long as the U.S. parent’s affiliated group developed, created, enhanced or marketed the licensed intangibles. Only where the U.S. parent’s affiliated group acts as a passive intermediary with respect to intangibles licensed to third parties should intercompany royalties be passive category income.

### Endnotes

1 Code Secs. 901, 904.
2 Code Sec. 904(d)(2)(A); Although Code Sec. 954(c) applies to CFCs, Reg. §1.904-4(b)(1)(i)(A) provides that for purposes of the foreign tax credit limitation, the provision applies as if the taxpayer were a CFC. See also Code Sec. 954(c)(6) (temporary look-through exception).
3 Code Sec. 904(d)(3)(A); Reg. §1.904-5(b).
4 Code Sec. 904(d)(3)(C); Reg. §1.904-5(c)(3).
5 For this purpose, royalty expense is allocated and apportioned based on the income to which it relates under the principles ofRegs. §§1.861-8 through 1.861-14.
6 This exception does not apply to the extent the expense reduces subpart F income of CFC-SL. Code Sec. 954(c)(3).
7 Code Sec. 904(d)(3)(B) and Reg. §1.904-5(c)(1). Reg. §1.904-5(c)(1) specifies that income will be characterized under the rules ofReg. §1.904-4 before the Reg. §1.904-5(c) look-through rule applies.
8 If instead CFC-L owned the intangible property, and no subpart F exception applied to royalties received from CFC-SL, the amount included in the income of the U.S. parent under subpart F would fall within the general basket, Reg. §1.904-5(c)(1). See Lowell D. Yoder, The Incongruent Definitions of Active Royalties for Subpart F and Foreign Tax Credit Purposes, 37 Tax Mgmt. Int’l J. 128 (Feb. 10, 2006).
9 Code Secs. 904(d)(2)(A); Reg. §1.954-2(d).
10 Reg. §1.904-4(b)(2). An affiliated group is defined by reference to Code Sec. 1504(a), and includes CFCs.

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