Holding Intangibles Offshore May Produce Tangible Tax Benefits

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Recent estimates indicate that from 1998 to 2000, the profits earned in low-tax jurisdictions by U.S. multinationals increased by $33 billion or 64 percent. Of those profits, it is believed that a considerable portion were derived from the exploitation of intangible assets held outside the United States. The most significant reason for holding intangible property in a foreign jurisdiction is to avoid the U.S. international income tax system, which taxes its citizens, resident aliens, and U.S. corporations on their worldwide income. That should be contrasted with the tax regimes in many foreign jurisdictions, which impose taxes only on income derived from sources within their borders.

Consequently, a U.S. taxpayer who receives royalties from the license of intangible property for use both inside and outside the United States will be subject to U.S. income tax on all royalties, regardless of their source. A foreign taxpayer, on the other hand, who receives royalties from the license of intangible property for use both inside and outside the United States will be subject to U.S. income tax only on the royalties arising from U.S. sources. In addition, U.S. income tax may be eliminated entirely if the intangible property is located in a foreign jurisdiction that has concluded with the United States an income tax treaty that eliminates withholding tax on source-country royalty payments.

Several provisions have been enacted in an effort to prevent the perceived abuse of shifting intangible assets out of the United States, the most notable of which is section 367(d), which applies when a U.S. person transfers intangible property to a foreign corporation. Under that provision, the U.S. transferor is treated as having sold the intangible for payments contingent on the productivity, use, or disposition of the property and receiving the payments annually over the useful life of the property. The amounts included in the transferor’s gross income are treated as ordinary income and are required to be “commensurate with the income attributable to the intangible,” which essentially means that the IRS can retroactively adjust the value of the transfer based on subsequent income generated by the intangible, even after the statute of limitations on the transfer has expired.

Other provisions enacted, in part, to prevent the migration of intangibles offshore include reg. section 1.482-4, which requires that a transfer of intangible property between related parties be made for arm’s-length consideration commensurate with the income attributable to the intangible, and the controlled foreign corporation provisions (that

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3 All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

4 Reg. section 1.482-4(f)(2)(i).
is, sections 951-965), which subject a CFC’s U.S. shareholders to current U.S. income tax on certain categories of income (for example, royalties) earned by the CFC, regardless of whether any distributions are made.

If, however, an intangible asset is developed in a foreign jurisdiction, and therefore no outbound transfer is effected, and the CFC provisions can be avoided, significant tax savings can be achieved by holding intangible property outside the United States. This article will examine the benefits, as well as detriments, of owning and developing intangible assets outside the United States and certain structures that may not only reduce or eliminate U.S. income tax on U.S.-source royalty payments, but foreign tax as well.

U.S. International Tax System

As noted above, U.S. persons are subject to U.S. income tax on their worldwide income. For this purpose, a U.S. person includes a U.S. citizen or resident and a domestic corporation. In contrast, foreign persons are subject to U.S. income tax on two categories of income: certain passive types of U.S.-source income (for example, interest, dividends, rents, annuities, and other types of “fixed or determinable annual or periodical income,” collectively known as FDAP), and income that is effectively connected to a U.S. trade or business (ECI). FDAP income is subject to a 30 percent withholding tax that is imposed on a foreign person’s gross income (subject to reduction or elimination by an applicable income tax treaty) and ECI is subject to tax on a net basis at the graduated tax rates generally applicable to U.S. persons. For purposes of those provisions, royalties are sourced according to where the intangible is used.

Accordingly, if a foreign taxpayer holds an intangible asset that was developed outside the United States and that taxpayer licenses the intangible to a third party for use in the United States, any U.S.-source royalties received potentially will be subject to a 30 percent withholding tax. 

A CFC is defined as a foreign corporation that is more than 50 percent owned by 10 percent U.S. shareholders. Section 957(a).

For this purpose, a U.S. shareholder generally is defined as a U.S. person that owns, directly, indirectly, or constructively, 10 percent or more of a CFC’s voting stock. Section 951(b).

Section 61.

Section 7701(a)(30).

Sections 871(a) and (b), 881, and 882.

Sections 1441 and 1442.

Sections 871(b) and 882(a).

Section 861(a)(4). The code defines an intangible as any (i) patent, invention, formula, process, design, pattern, or knowhow; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; (vi) or any similar item, which has substantial value independent of the services of any individual. Section 936(h)(3)(B).
withholding tax in the United States. In order to reduce or eliminate the U.S. tax burden, the intangible should be held in a favorable treaty jurisdiction. There are a number of income tax treaties that eliminate entirely the withholding tax on royalties paid from U.S. sources to residents of those foreign jurisdictions. Those countries include Austria, Belgium, Canada, Cyprus, Denmark, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Pakistan, Russia, South Africa, Sweden, Switzerland, and the United Kingdom. Therefore, U.S.-source royalties received by a foreign taxpayer resident in one of those jurisdictions will not be subject to the 30 percent withholding tax in the United States if that person is eligible to benefit under the applicable treaty.

For a foreign taxpayer to be eligible for the treaty benefits discussed above, the taxpayer must be considered a resident of the particular treaty jurisdiction and must satisfy any limitation on benefits (LOB) provision in the treaty. Under most U.S. income tax treaties, a foreign corporation will be considered a resident for treaty purposes if the corporation is formed in that jurisdiction or is liable to tax therein by reason of its place of management, place of incorporation, or "any other criterion of a similar nature." Similarly, under most "modern" income tax treaties, the LOB provision generally will be satisfied if the foreign corporation is at least 50 percent owned by citizens or residents of the United States or by residents of the jurisdiction where the corporation is formed and not more than 50 percent of the gross income of the foreign corporation is paid or accrued, in the form of deductible payments, to persons who are neither citizens nor residents of the United States or residents of the jurisdiction where the corporation is formed.13

CFC Provisions

In general, the CFC rules were designed to address the concern that some types of passive income and operating income from related-party transactions earned by U.S.-controlled foreign corporations would not be subject to U.S. income tax until that income was repatriated to the United States in the form of dividends. Accordingly, Congress required that any subpart F income earned by a CFC be included in the current income of the CFC’s U.S. shareholders in the year in which the income is earned, regardless of whether any distributions are made to those shareholders. When the CFC’s earnings are subsequently distributed to those shareholders, those amounts are not included in the shareholder’s gross income because they will have been previously taxed under the subpart F provisions.

Among the categories of subpart F income that are subject to current U.S. income tax by the CFC’s U.S. shareholders is foreign personal holding company income, which includes royalties.14 Accordingly, unless an exception applies, any royalties earned by a CFC will be subject to current U.S. income tax by the CFC’s U.S. shareholders, even though no distributions will have been made to those shareholders.

An important exception from foreign personal holding company income exists for royalties that are derived in the active conduct of a trade or business and are received from a person who is not a related person with respect to the CFC.15 For purposes of the provision,

13 See, e.g., Article 17 of the Sweden-U.S. income tax treaty.
14 Section 954(c)(1)(A).
15 Section 954(c)(2)(A). Another exception exists for royalties received from a related corporation for the use
royalties will be considered derived in the active conduct of a trade or business if those royalties are from licensing:

(i) property that the CFC has developed, created, or produced, or has acquired and added substantial value to, but only if the CFC is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of that kind; or

(ii) property that is licensed as a result of the performance of marketing functions by the CFC if, through its own officers or staff of employees located in a foreign country, the CFC maintains and operates an organization in that country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of that property.

A person will be considered related to the CFC if the person is an individual, corporation, partnership, trust, or estate that controls, or is controlled by, the CFC, or is controlled by the same persons who control the CFC. For this purpose, control means owning more than 50 percent of the vote or value of the stock of the CFC.

Accordingly, if one of those exceptions is satisfied, the U.S. income tax on the royalties received by the CFC will be deferred until the royalties are repatriated to the United States in the form of dividends or the stock of the CFC is sold. (Furthermore, if those dividends are paid to individual U.S. shareholders, either directly or through flow-through entities before January 2009, and the CFC is organized in a treaty jurisdiction, those dividends may be eligible for the 15 percent tax rate in the United States.)

**Forgone U.S. Tax Benefits**

It should be noted that certain U.S. income tax benefits may be lost by the development of intangible property outside the United States. Section 174 allows a deduction for amounts paid to fund research and development, provided the expenses are incurred in connection with a

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16  Reg. section 1.954-2(d)(1). Whether an organization in a foreign country is substantial in relation to the amount of royalties is based on all of the facts and circumstances. A safe harbor exists, however, if the active licensing expenses equal or exceed 25 percent of the CFC’s adjusted licensing profit. Reg. section 1.954-2(d)(2)(ii).

17  Section 954(d)(3).

18  Id.

19  Section 1248.

trade or business and are not otherwise required to be capitalized. While a foreign taxpayer will be eligible to take advantage of this provision, this will be possible only if the R&D expenses are connected with income that is effectively connected with the conduct of a U.S. trade or business, the existence of which would cause that income to be subject to U.S. income tax.  

Similarly, section 41 grants a 20 percent tax credit for incremental research expenses paid or incurred in a trade or business, but only if the research is performed in the United States. Therefore, a foreign taxpayer who develops an intangible asset outside the United States will not be eligible for this credit. Although beyond the scope of this article, one alternative available to U.S. taxpayers who hold certain intangible property rights outside the United States and wish to take advantage of sections 174 and 41 and avoid the adverse tax consequences of section 367(d) is to enter into a qualified cost sharing agreement, as defined in reg. section 1.482-7.

### Holding Intangible Property

As noted above, there are at least 19 jurisdictions that have concluded tax treaties with the United States under which no withholding taxes will be imposed on source-country royalty payments. While the average tax rate in many of those jurisdictions is about 30 percent, there are a few jurisdictions that are quite favorable for obtaining treaty benefits and a low rate of corporate income tax. For example, the Hungary-U.S. income tax treaty has no LOB provision, and royalties only will be taxed in Hungary at an 8 percent effective corporate tax rate. Similarly, the corporate tax rates in Ireland and Switzerland are only 12.5 percent and 8 percent, respectively, and the LOB provisions contained in those treaties may not be that difficult to satisfy.

On the other hand, it may not be possible to satisfy the LOB provisions in the treaties concluded with Cyprus and Iceland, where the corporate tax rates are as low as 10 percent and 5 percent,

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21 Sections 871(b) and 882(c).
22 Section 41(d)(4)(F).
25 While the LOB provision contained in the Ireland-U.S. treaty can be satisfied if at least 50 percent of the vote and value of the Irish company is owned by U.S. citizens or residents, the LOB provision in the Switzerland-U.S. income tax treaty requires, among other items, that at least 95 percent of the aggregate vote and value of the shares of the Swiss corporation be owned by seven or fewer U.S. residents. See Ann. 2003-59, 2003-40 I.R.B. 746, Doc 2003-21818, 2003 TNT 193-17, which describes the revised Memorandum of Understanding for the Switzerland-U.S. income tax treaty.
respectively. To obtain benefits under the Cyprus-U.S. income tax treaty, a Cypriot corporation must at least be owned 75 percent by residents of Cyprus. Similarly, to obtain benefits under the Iceland-U.S. treaty, U.S. tax residents must own less than 25 percent of the share capital of an Icelandic corporation. Accordingly, despite the low corporate tax rates in those jurisdictions, treaty benefits may not always be available.

**Royalty Structures Using Hybrid Entities**

To achieve a lower effective foreign tax rate than the 8 percent or 12.5 percent rate available in Hungary, Switzerland, or Ireland, a back-to-back licensing arrangement using a hybrid entity may be a better alternative. A number of the treaty jurisdictions discussed above do not impose withholding taxes under their local laws on royalties paid to nonresidents. Those countries include Hungary, the Netherlands, Norway, Sweden, and Switzerland. By licensing an intangible from a low-tax jurisdiction to one of those jurisdictions and then sublicensing the intangible to third parties for use in the United States, it may be possible to avoid U.S. income tax on the royalties and incur very little foreign tax. Furthermore, depending on the jurisdiction, it may be possible for U.S. individuals to subsequently repatriate the royalties to the United States as qualified dividends and be taxed at the preferential 15 percent rate.

For example, assume U.S. tax residents organize a Norwegian corporation that owns 100 percent of the stock of a Madeira entity, which in turn owns an intangible asset. Madeira, which is part of Portugal and thus part of the EU, has a 0 percent tax rate for companies formed before January 2001, a 1 percent rate for companies formed in 2001 and 2002, a 2 percent rate for companies formed in 2003 and 2004, and a 3 percent rate for companies formed in 2005 and 2006. Also assume that a check-the-box election (Form 8832) is filed on behalf of the Madeira entity to treat it as a branch of the Norwegian company. The Madeira entity licenses the intangible to its Norwegian parent, which then sublicenses the intangible to third parties for use in the United States.

Assuming the royalties are not treated as subpart F income in the hands of the Norwegian parent (for example, they are derived in the active conduct of a trade or business), no U.S. income tax would be incurred on the royalties until they are brought back to the United States as dividends, and no U.S. withholding tax would be imposed on the U.S.-source royalties paid to Norway under the Norway-U.S. treaty. Also, the royalties paid from Norway to Madeira would not be subject to withholding tax and would give rise to a deduction in Norway (leaving a small spread in Norway). Madeira would impose little, if any, tax on the royalties, depending on when the Madeira company was formed.

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26 Since January 1, 1999, international trading companies formed in Iceland are only subject to a 5 percent tax rate.
27 See Article 26 of the Cyprus-U.S. income tax treaty.
28 See Article 27 of the Iceland-U.S. income tax treaty. It should be noted, however, that there is no restriction on the amount of stock that U.S. citizens can own in Icelandic corporations to obtain treaty benefits.
29 Reg. section 301.7701-2(a).
30 It is possible to purchase a “shelf” Madeira entity formed before January 2001, and therefore, obtain the 0 percent tax rate. Also, prop. reg. section 1.954-9 would
When the earnings are repatriated from Madeira to the United States, it may be possible to route the income in a tax-efficient manner through Norway as a qualified dividend and therefore be taxed at a 15 percent rate. There are no withholding taxes imposed on dividends paid out of Madeira, and, as a result of Norway’s participation exemption, dividends received from jurisdictions within the European Economic Area (EEA) (the EU, Norway, Iceland, and Liechtenstein) are not subject to Norwegian corporate income tax.31 Because Madeira is in the EEA, Norway’s CFC rules -- which would make the participation exemption inapplicable -- would not apply. Also, Norway is a qualified foreign jurisdiction eligible to pay a qualified dividend to U.S. individual shareholders, assuming the qualified dividend income provisions are otherwise satisfied.32

It also may be possible to substitute Hungary or Switzerland for Norway in this structure because neither jurisdiction imposes withholding tax on royalty payments to nonresidents, both have very favorable participation exemptions, and both are qualified foreign jurisdictions.33 Singapore may also be substituted for Madeira: Singapore has a territorial tax system and will exempt from corporate income tax royalties received from Norway,34 there are no withholding taxes on dividends paid out of Singapore, and Singapore has an tax treaty with Norway under which Norway will exempt from corporate income tax the dividends received from Singapore.35

Similar results may be achieved by using a U.S. single-member limited liability company disregarded for U.S. tax purposes -- rather than a foreign disregarded entity -- as the owner of the intangible property. Many foreign jurisdictions, including Norway and Switzerland, treat a U.S. single-member LLC as a separate company for foreign tax purposes, regardless of whether the LLC is disregarded for U.S. tax purposes. Therefore, a U.S. LLC that owns an intangible could license the property to a Norwegian or Swiss parent company, which could then sublicense the intangible to third parties for use in the United States.

not apply to tax the “hybrid branch payment” because it would not be foreign personal holding company income in the hands of the branch, if the branch was treated as a separate CFC, assuming the royalties were derived from the active conduct of a trade or business.

33 For Switzerland, however, Article 22(4) of the Switzerland-U.S. income tax treaty needs to be carefully analyzed.
34 The royalties would not be subject to tax in Singapore so long as they are not received within Singapore (that is, the royalties are paid to a bank account outside of Singapore).
35 See Article 24(2)(c) of the Norway-Singapore income tax treaty.
Assuming the structure is respected, any U.S.-source royalties paid from the United States to Norway or Switzerland would be exempt from U.S. withholding under the respective treaties. Any royalties paid from Norway or Switzerland to a disregarded wholly owned U.S. LLC would be deductible for Norwegian or Swiss tax purposes (leaving a small spread in those jurisdictions to be taxed) and not subject to withholding tax. Because the LLC would be disregarded for U.S. tax purposes, the royalties paid from Norway or Switzerland should similarly be disregarded for U.S. tax purposes.

The earnings eventually could be paid from the LLC to the U.S. shareholders of the Swiss or Norwegian corporations in a tax-efficient manner. As noted earlier, Norway recently amended its participation exemption regime and, as a result, not only exempts from corporate income tax the dividends received from within the EEA, but also exempts dividends received from outside of the EEA, so long as the jurisdiction is not considered a low-tax jurisdiction (that is, a jurisdiction where the corporate tax rate is less than 18.67 percent or two-thirds of Norway’s corporate tax rate of 28 percent). The United States would not appear to be a low-tax jurisdiction. Similarly, Switzerland has a very favorable participation exemption. Therefore, a dividend paid from a U.S. LLC may be exempt from corporate income tax in those jurisdictions, and then repatriated to the United States as a qualified dividend.

Possible IRS Attacks

Because of the back-to-back nature of the royalty payments, a number of potential arguments are available to the IRS to challenge the substance of those structures, the most likely one is that the royalty payments from the foreign parent to the hybrid entity should be treated as U.S.-source income under section 861(a)(4) and subject to a 30 percent withholding tax. In Rev. Rul. 80-362, a resident of a nontreaty jurisdiction licensed a patent to a Dutch corporation, which in turn sublicensed the patent to a Dutch corporation, which in turn sublicensed the patent to a U.S. corporation for use in the United States. The royalties paid from the United States to the Netherlands were exempt from withholding tax under the Netherlands-U.S. income tax treaty. The IRS ruled, however, that the royalties paid from the Netherlands to the nontreaty jurisdiction were U.S.-source royalties under section 861(a)(4) because they were paid in consideration for the privilege of using a patent in the United States. Therefore, those

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36 This assumes that Norway looks at the U.S. corporate tax rate in making the determination, rather than the effective corporate tax rate paid by a disregarded U.S. LLC. If the dividend is received from an EEA jurisdiction, it will be exempt regardless of the tax rate in that jurisdiction. Norway is expected to issue a white list of the non-tax-haven jurisdictions and a blacklist of the tax haven jurisdictions.


royalties were subject to a 30 percent withholding tax in the United States.39

Other grounds available to the IRS to challenge the nature of these arrangements include Aiken Industries v. Commissioner40 and the conduit financing regulations (reg. section 1.881-3). In Aiken Industries, the IRS successfully argued that interest payments made by a U.S. corporation to a Honduran corporation -- which collected the interest on behalf of a Bahamian corporation -- were not exempt from U.S. withholding tax under the Honduras-U.S. income tax treaty then in effect. The Tax Court agreed with the IRS and reasoned that the Honduran corporation, while a valid resident under the Honduras-U.S. treaty, had no “dominion and control” over the funds and was a mere collection agent or “conduit for the passage of interest payments” from the U.S. entity to the Bahamian entity.

Similarly, under the conduit financing regulations, the IRS has the authority to disregard, for purposes of section 881, the participation of one or more intermediate entities in a “financing arrangement” where the entities are acting as conduit entities.41 If the intermediate entity is disregarded under those regulations, the financing arrangement is recharacterized as a transaction directly between the remaining participants to the transaction. A financing arrangement would include a back-to-back licensing arrangement. Therefore the IRS would have the ability to disregard the existence of the foreign parent in the structures above if those provisions are otherwise satisfied.

The weakness in applying the rationale of Rev. Rul. 80-362, Aiken Industries, or the conduit financing regulations, however, is that the entity owning the intangible property (the hybrid entity) is disregarded for U.S. tax purposes and treated as a branch of the parent company. As a result, there are no back-to-back payments for U.S. tax purposes. The IRS would have a much more difficult time contending that the payment from the foreign parent to the hybrid entity should be treated as U.S.-source income subject to the 30 percent withholding tax or that the parent company is acting as a mere conduit for payments between the United States and the hybrid entity.

The IRS also may attempt to challenge those arrangements based on the LOB provisions contained in the treaties. While the argument may be successful for Switzerland, the IRS likely will not prevail for Hungary or Norway. As previously indicated, the Hungary-U.S. treaty does not have an LOB provision. The Norway-U.S. treaty also does not have a LOB provision, but it does have an “Investment or Holding Companies” provision, which denies treaty benefits to residents in some situations. Specifically, Article 20 of the Norway-U.S. treaty provides:

A corporation of one of the Contracting States (Norway) deriving . . . royalties from sources within the other Contracting State (the United States) shall not be entitled to the benefits of . . . Article 10 (Royalties) if—

39 It should be noted that the Tax Court in SDI Netherlands v. Commissioner, 107 T.C. 161, Doc 96-27031, 96 TNT 194-5 (1996), rejected the rationale of Rev. Rul. 80-362 and did not impose U.S. withholding tax in a back-to-back licensing arrangement.

40 56 T.C. 925 (1971).

41 Reg. section 1.881-3(a)(1).

(a) By reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State (Norway) with respect to such . . . royalties is substantially less than the tax generally imposed by such Contracting State (Norway) on corporate profits, and

(b) 25 percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (Norway) (or, in the case of a Norwegian corporation, who are citizens of the United States).

Under the structures discussed above, when the Norwegian parent owns the disregarded entity, this provision should not be applicable because the tax imposed in Norway on the royalty payments would not be less than the tax generally imposed on corporate profits. Rather, the tax imposed in Norway would be the same as the tax generally imposed on corporate profits, but the amount of royalties subject to tax would be less because of the back-to-back nature of the arrangement.

On the other hand, it is not entirely clear whether the LOB provision contained in the Switzerland-U.S. treaty would be satisfied. To comply with that provision, no more than 50 percent of the gross income of a Swiss company can be paid out in the form of deductible expenses -- such as royalties -- to persons who are not entitled to benefits under the respective treaties. The question is whether the second leg of the royalty payments made from a Swiss corporation to a disregarded entity in Madeira or Singapore, or a disregarded U.S. LLC, would be considered a deductible payment under the treaty. If a royalty payment from Switzerland to a disregarded entity is considered a deductible payment, the LOB provision would not be satisfied. Because of the lack of guidance in this area, it would be more prudent to use Hungary or Norway in this structure.

Finally, the IRS may argue that the regulations under section 894(c)(2) should apply to deny treaty benefits. Reg. section 1.894-1(d)(1) provides:

an item of income received by an entity (which includes disregarded entities)," wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction. For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction. An item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder’s jurisdiction.

Reg. section 1.894-1(d)(3)(i).
jurisdiction with respect to the item of income (emphasis added).

Admittedly, the provision would deny treaty benefits if the royalties were paid directly to the hybrid entity (Madeira, Singapore, or U.S. LLC), rather than through the parent company to the hybrid entity. That follows because the income would not be considered to be derived by a resident of the treaty jurisdiction. For example, a payment of royalties from the United States to a disregarded U.S. LLC owned by a Norwegian corporation would not be considered derived by the Norwegian corporation to obtain treaty benefits because the U.S. LLC would not be treated as fiscally transparent under the laws of Norway.

The regulations under section 894(c)(2) should not be applicable, however, because the royalty payments are not being made from the United States directly to the hybrid entity but instead are being made to a nonfiscally transparent entity organized in a treaty jurisdiction. The IRS would be facing an uphill battle by attempting to deny treaty benefits in that situation.

Conclusion

The holding and development of intangibles outside the United States can produce significant tax savings if structured correctly. Not only should the intangible property be held in a favorable treaty jurisdiction, but the development of the intangible should be part of an active trade or business conducted outside the United States to ensure that the royalties are not treated as subpart F income. In addition, by taking advantage of the check-the-box regulations, it may be possible to use a hybrid entity to hold the intangible and reduce the foreign tax imposed on the royalties as well.

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