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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATED: February 11, 2000

MEMORANDUM FOR: Gerald A. Thorpe
District Counsel
CC:NER:CTR:HAR

FROM: Anne P. Shelburne
Assistant to Branch Chief
CC:INTL:6

SUBJECT:

This Field Service Advice responds to your memorandum dated August 31, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

a =
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Country A =

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Date A	=
Date B	=
Date C	=
Date D	=
Date E	=
Date F	=
Date G	=
Date H	=
Date I	=
Date J	=
Date K	=
Divisions	=
Entity A	=
Entity B	=
Entity C	=
Entity D	=
Entity E	=
Entity F	=
Entity G	=
Entity H	=
Factors	=
Generic Name	=
Names	=
Parent	=
Period A	=
Period B	=
Period C	=
Period D	=
Period E	=
Product A	=
Product B	=
Product C	=
Substance	=
Symbol	=
Tax Year A	=
Tax Year B	=
Tax Year C	=
Trademark A	=

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USHolding =

ISSUES:

1. Whether, in applying section 482 to determine the appropriate allocation between controlled parties of income from an intangible, the U.S. subsidiaries were entitled to income from a marketing intangible used in the United States, in years prior to execution of a formal agreement regarding the intangible.
2. Whether the formal agreement executed on Date E in Tax Year A, requiring the U.S. subsidiaries to pay a royalty to the foreign parent for use of the intangible in the United States, should be recognized under the section 482 regulations.
3. Whether the foreign parent's Date H application in Tax Year B for U.S. registration of the intangible should be given effect for purposes of section 482, as conferring on the foreign parent a right to the income from the intangible used in the United States.

CONCLUSIONS:

1. Yes. This advice sets forth the analysis by which, if the facts developed so indicate, Examination could conclude that the U.S. subsidiaries were properly classified as either the developers or the owners of the intangible in the United States within the meaning of the section 482 regulations, or the holders of a long-term, royalty-free right to use the intangible, in the years prior to the execution of the formal agreement regarding use of the intangible. The further conclusions below assume that Examination appropriately determines that the U.S. subsidiaries were in fact the developer/owners or the holders of a long-term royalty-free right to use Trademark A during the period prior execution of the formal agreement.
2. No. This conclusion assumes that Examination determines that the facts developed, including the entry into the formal agreement, are more consistent with the interpretation that in Tax Year A the U.S. subsidiaries continued as the developer-owners or the holders of a long-term royalty-free right to use the intangible, rather than with the conclusion that, by virtue of the formal agreement, in Tax Year A the subsidiaries transferred such ownership or right to the foreign parent. If the former conclusion were reached, then the royalty under the formal agreement would be disregarded. However, if the latter conclusion were reached, then the arm's length royalty owing to the foreign parent by the subsidiaries would effectively be offset, in whole or in part, by an arm's length consideration owing by the foreign parent to the subsidiaries on account of the transfer of the intangible to the foreign parent in Tax Year A.

3. No. This conclusion assumes that Examination appropriately reaches the conclusion that the intangible was not transferred to the foreign parent in Tax Year A, and determines that the facts developed, including the U.S. registration application, are more consistent with the interpretation that in Tax Year B the U.S. subsidiaries continued as the developer-owners or the holders of a long-term royalty-free right to use the intangible, rather than with the conclusion that, by virtue of the application, in Tax Year B the subsidiaries transferred such ownership or right to the foreign parent. If the former conclusion were reached, then the U.S. registration application (as well as the royalty under the formal agreement) would be disregarded. However, if the latter conclusion were reached, then the arm's length royalty owing to the foreign parent by the subsidiaries for their continuing use of the marketing intangible would effectively be offset, in whole or in part, by an arm's length consideration owing to the subsidiaries on account of the transfer to the foreign parent in Tax Year B.

FACTS:

USHolding is a domestic corporation and a wholly-owned subsidiary of a Country A entity, Parent. Parent was founded in Country A in Date A. During Period A, it ranked among the top a companies in Country A in terms of market value, and consisted of b primary operating Divisions.

Historically, Parent's predecessor manufactured Product A in Country A under the name Entity A. During Period B, Entity A merged with a manufacturer of Product B, and changed its name to Entity B. In Date B, the name changed again, to Entity C. In Date C, Parent's predecessor, through its then-U.S. holding company, Entity D, acquired Entity E, and renamed it Entity F. This was the first in a series of acquisitions by the holding company of going-concerns in the United States. In Date D, Entity C adopted its current name of Entity G. During that same year, Entity D and Entity F adopted the names Entity H and USHolding, respectively, and the individual U.S. operating subsidiaries began to use Trademark A in conjunction with sales of their own existing products in the United States.¹ At approximately the same time, Parent began to use Generic Name in connection with its sales of products in Country A and other countries, and phased out its use of trade names based on variants of the name Entity C, due to Factors associated with Substance.

¹ The intangibles consist of Trademark A (primarily Generic Name and Symbol), as well as related trade names, some of which may be amenable to legal protection in the United States. In the interest of simplicity, except as necessary to the discussion of a particular issue, this memorandum will refer to the intangibles in a collective sense as "Trademark A."

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During Period A, Entity H owned more than c distinct U.S. subsidiaries, which processed primary and secondary materials into Product C. These companies include: Names. From Date D forward, most or all of the U.S. subsidiaries sold these products under their respective, pre-existing trademarks, in addition to and in conjunction with Trademark A. The U.S. subsidiaries sold these products primarily to manufacturers or other industrial users, rather than to retailers or consumers. During Period A, the U.S. entities' sales accounted for approximately d% of total worldwide sales of Parent.

Entity H and the U.S. subsidiaries are operationally independent from Parent. Each entity performs its own product development, plant design, purchasing, production planning, shipping, maintenance, and administrative functions. Each entity performs research and development and has its own human resources and finance/accounting department. Each entity performs marketing and sales functions with respect to its product lines.

During Period C, the U.S. subsidiaries used Trademark A on an exclusive basis in the United States, without paying any royalty to Parent. However, USHolding, through its wholly-owned subsidiary Entity H, charged the individual subsidiaries a royalty of e% of net sales for use of Trademark A. No written agreement was in effect between the related parties with respect to this royalty. The royalty in question is eliminated for federal income tax purposes on the consolidated U.S. income tax return.

Although the U.S. subsidiaries purchased tangible merchandise from Parent, those transactions accounted for a small percentage of U.S. sales, as the subsidiaries primarily sold the same products as before their acquisition by Parent. During Period C, the U.S. subsidiaries incurred marketing and promotional expenses in the United States, which related to their respective, pre-existing trademarks as well as to Trademark A. It appears that Parent did not reimburse the U.S. subsidiaries for these promotional expenditures or compensate the U.S. subsidiaries for associating Trademark A with their pre-existing trademarks. Increases in the value of Trademark A in the U.S. market during Period C resulted from the U.S. marketing of products jointly under Trademark A and pre-existing trademarks, and from promotional activities and expenditures of the U.S. subsidiaries.

On Date E, near the end of Tax Year A, the parties executed an agreement that required payment to Parent of a royalty of f% of net sales for all of Tax Year A, and for future years, for the use of Trademark A in the United States. Total royalties paid to Parent were \$g in Date F and \$h in Date G. No other subsidiaries of Parent paid comparable royalties.

For U.S. income tax purposes, the taxpayer, USHolding, documented the royalty paid to Parent by a contemporaneous transfer-pricing study, which used the comparable profits method (CPM), with the U.S. entity as the tested party. The taxpayer also applied an alternative methodology, based on a proprietary database of trademark-royalty rates. Under either approach, the royalty to Parent allegedly fell within the range of arm's length rates. Parent described the

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royalty as follows to tax authorities in Country A: "[Parent] reestablished itself during [Period D] after its problems of [Period E]. By [Date F], the Company was firmly back into sustainable profits growth and the new management could be seen to have delivered value, which was now being consistently recognized under the [Generic Name] name."

Parent filed an application with the U.S. Patent and Trademark Office (PTO) on Date H, near the end of Tax Year B. That application sought U.S. registration of Trademark A and related trade names in the name of Parent. The PTO granted the application as to the trade names on Date I, and granted the application as to the trademark on Date J.

Parent's application for U.S. registration evidently relied on the "use in U.S. commerce" of Trademark A on the part of the U.S. subsidiaries as the basis for its registration of that mark. See Citation ("first use" in the United States of Date K corresponds to date of initial use by the U.S. subsidiaries). This suggests that the controlled parties' informal arrangement, as in effect prior to execution of the Date E formal agreement, afforded the U.S. subsidiaries exclusive rights to use of Trademark A within the United States, as authorized use of the mark by uncontrolled parties may have compromised the Parent's ability to obtain U.S. registration.

The Service proposes to deny the U.S. subsidiaries' deductions for royalties paid to Parent in Tax Years A and B or, in the alternative, to use a royalty rate determined by the Service economist.

LAW AND ANALYSIS:

The issues in this case involve the appropriate allocation of income between controlled parties, based on the use in the United States of Trademark A by wholly-owned U.S. subsidiaries of Parent, which is domiciled in Country A. Section 482 applies under these circumstances to determine the appropriate allocation of income from the intangible and to evaluate the royalties paid by the U.S. subsidiaries to Parent in Tax Years A and B. We also discuss certain aspects of intellectual property law that are potentially relevant to this case.

A. Section 482

Section 482 provides as follows:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such

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organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

I.R.C. § 482 (emphasis added). "Trademarks, trade names, and brand names" are specifically included in the class of intangibles subject to section 482. See I.R.C. § 936(h)(3)(B)(iii).

Section 482 vests the Commissioner with authority to re-allocate income, deductions, credits, and other items among controlled parties. In evaluating a transaction between controlled parties, the critical inquiry is "whether the transaction in question would have been similarly effected by unrelated parties dealing at arm's length." Ciba-Geigy Corp. v. Commissioner, 85 T.C. 172, 221 (1985). If not, the Commissioner has authority to re-allocate income and deductions in order to achieve an arm's length result.

A controlled-party royalty that satisfies the arm's length standard under section 482 by definition also constitutes an "ordinary and necessary" expense for purposes of section 162(a). R.T. French Co. v. Commissioner, 60 T.C. 836, 849 (1973). In the event that a particular expense item between controlled parties, such as a royalty, does not satisfy the arm's length standard, courts generally prefer an allocation of income pursuant to section 482 to a complete disallowance of the deduction pursuant to section 162. See, e.g., Rubin v. Commissioner, 56 T.C. 1155, 1163-64 (1971), aff'd per curiam, 460 F.2d 1216 (2d Cir. 1972). However, in appropriate factual circumstances, courts will uphold an outright inclusion or disallowance, without an intermediate allocation. United Parcel Service, Inc. v. Commissioner, T.C. Memo. 1999-268 ("expenses incurred in furtherance of a sham transaction are not deductible.").

1. Section 482 Commensurate with Income Standard

In 1986, Congress added a second sentence to section 482, which required that the income reported from the transfer or license of intangible property to a controlled party be "commensurate with" the income attributable to that intangible. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986). The commensurate-with-income standard was primarily intended to prevent U.S. taxpayers from transferring high-profit intangibles to foreign related parties, in exchange for lump-sum payments or royalty streams that were unrelated to the intangibles' underlying profit potential. See generally H.R. Rep. No. 831, Vol. II, 99th Cong., 2d Sess. 637-38 (1986). Importantly, this standard applies to all related-party transactions that involve intangibles, not merely to "outbound" transfers. See H.R. Rep. No. 831 (Vol. II) at 637. In addition, Treasury and the Service view the 1986 amendment to section 482 as a "clarification of existing law," rather than a significant amendment of prior law. E.g., Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, 1988-2 C.B. 458, 472.

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The 1986 amendment controls the effective date of the subsequent 1994 regulations as they pertain to certain transfers of intangibles. After the effective-date technical amendment in 1988, the provision applies to taxable years beginning after December 31, 1986, but only with respect to transfers (or licenses) to foreign persons after November 16, 1985, or to other persons after August 16, 1986 (or before such date with respect to property not in existence or owned by the taxpayer on such date). Technical and Miscellaneous Revenue Act of 1988, § 1012(n), Pub. L. No. 100-647, 102 Stat. 3342, 3514 (1988). See also S. Rep. No. 445, 100th Cong. 2d Sess. 279-80 (1988).

2. Effective Date of 1994 Regulations Applicable to Intangibles

The U.S. subsidiaries used Trademark A for a number of years prior to the specific tax years at issue, Tax Years A and B. Thus, it may be necessary to evaluate whether the transactions involving the intangible were at arm's length by reference to both the 1968 regulations and the 1994 regulations. The 1994 section 482 regulations apply to tax years beginning after October 6, 1994, and may also apply to prior open tax years upon election by the taxpayer. Treas. Reg. § 1.482-1(j)(1), (2) (1994). To be consistent with the effective date of the 1986 amendment to section 482 (as that date was amended in 1988), the 1994 regulations state as follows:

These regulations will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date.

Treas. Reg. § 1.482-1(j)(4) (1994). See also Technical and Miscellaneous Revenue Act of 1988, § 1012(n).

The royalties paid in Tax Years A and B relate to an intangible that may be deemed to have been transferred or licensed prior to the effective date of the 1994 regulations. For this reason, the 1968 regulations may be relevant to royalties paid in Tax Years A and B, to the extent the status of Trademark A prior to Date F (and thus prior to Tax Years A and B) is in issue.²

3. 1994 Regulations -- Developer or Owner of an Intangible

The 1994 section 482 regulations contain threshold rules relevant to the allocation of

² The 1993 Temporary Regulations may also be relevant to one or more of the years under consideration. See Temp. Treas. Reg. §§ 1.482-1T(h) (effective date), 1.482-4T(e)(3) (development of an intangible), T.D. 8470, 1993-1 C.B. 90.

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income with respect to intangible property. See generally Treas. Reg. § 1.482-4(f)(3) (1994). In particular, the regulations contemplate a determination of the owner of a legally protected intangible, or of the developer/owner of a non-legally-protected intangible, as a means of evaluating whether an allocation of income under section 482 is necessary or appropriate with respect to a transfer, license, or use of the intangible. See Treas. Reg. § 1.482-4(f)(3)(ii) (1994).

In the case of intangible property that is legally protected, the legal owner is "ordinarily" considered the owner of the intangible for purposes of section 482. Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994). The term "legal owner" is broadly defined, and consists of the holder of formal legal title to the intangible (e.g., formal patent, trademark, copyright, or similar interest), as well as the holder of rights obtained pursuant to contract (e.g., a license to use intellectual property). In this context, contractual rights may be either express or implied, and the regulation specifically cross-references Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994), which deals with imputation of contractual terms in accordance with the substance of the controlled parties' dealings. Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994). The regulation also recognizes that "ownership" of an intangible may be subdivided, as by licensing the right to exploit the intangible in a specific geographic area, and that an intangible may therefore have "multiple owners," for purposes of the regulation. See Treas. Reg. § 1.482-4(f)(3)(i) (1994).

In the case of intangible property that is not legally protected, the owner of the intangible is determined as follows:

In the case of intangible property that is not legally protected, the developer of the intangible will be considered the owner. Except as provided in § 1.482-7T, if two or more controlled taxpayers jointly develop an intangible, for purposes of section 482, only one of the controlled taxpayers will be viewed as the developer and owner of the intangible, and the other participating members will be regarded as assisters. Ordinarily, the developer is the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible.

Treas. Reg. § 1.482-4(f)(3)(ii)(B) (1994) (emphasis added).

In general, arm's length consideration is payable to the owner or developer of an intangible in the event of a transfer of the intangible to a controlled party, or a transfer to a controlled party of a right to use the intangible. See Treas. Reg. § 1.482-4(f)(3)(i) (1994). In addition, an allocation of income may be appropriate with respect to assistance provided to the owner or developer in connection with the development or enhancement of an intangible, although such allocations are generally limited to instances where expenditures are non-routine (from the perspective of the provider). Treas. Reg. § 1.482-4(f)(3)(iii) (1994); see also Treas. Reg. § 1.482-4(f)(3)(iv), Ex. 2 and 3 (1994).

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4. 1968 Regulations -- Developer of an Intangible

The 1968 regulations look to which controlled party is the developer of an intangible as one means of determining whether an allocation of income under section 482 is appropriate, in the event of a license or transfer of the intangible. See generally Treas. Reg. § 1.482-2(d) (1968). In this regard, the regulations apply a facts-and-circumstances analysis:

Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity

Treas. Reg. § 1.482-2(d)(1)(ii)(c) (1968) (emphasis added).

If intangible property, or an interest in an intangible, is "transferred, sold, assigned, loaned, or otherwise made available in any manner" by one member of a controlled group to another for other than arm's length consideration, the District Director is authorized to make appropriate allocations of income to reflect arm's length consideration for that transfer, sale, etc. See Treas. Reg. § 1.482-2(d)(1)(i), (d)(2) (1968). In the case of intangible property subject to the developer rules, if a party other than the developer acquires an interest in the intangible (as by formal registration, or otherwise), "the developer shall be deemed to have transferred [an] interest in such property." Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968). Thus, an allocation of income to the developer is appropriate only in the event of a deemed or actual transfer, and an allocation of income from the developer is appropriate only where assistance is provided by controlled parties. See Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968). Under the 1968 regulations, it may be necessary to determine which controlled party legally owns the intangible within the meaning of intellectual property law, or which party holds long-term exploitation rights in the intangible, in order to evaluate whether a "transfer, sale, loan, etc." of the intangible has taken place, within the meaning of Treas. Reg. § 1.482-2(d)(1)(i) (1968).

Thus, although the 1968 and 1994 regulations use distinct terminology, the substantive approach under both regulations is similar.

5. Imputed Contract and Substance Over Form

In applying section 482, although the Commissioner generally must respect the transaction as it is structured by the taxpayer, he is authorized to allocate income between controlled parties in order to reach an arm's length result. E.g., Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), aff'd, 933 F.2d 1084 (2d Cir. 1991) (Commissioner must respect license agreement

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between related parties, but he may challenge amount of royalty under section 482). Consistent with this concept, the 1968 and the 1994 regulations authorize the District Director to disregard contractual provisions that conflict with the substance of the controlled-party transaction, and to impute contractual terms that conform with that substance. See Treas. Reg. §§ 1.482-1(a)(6), 1.482-1(d)(1)(1968); Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). Arm's length income is determined by reference to income of parties in a comparable transaction, where comparability is evaluated in accordance with the regulatory guidance based on all the facts and circumstances, including resources employed, risks assumed, and functions performed by the parties. See, e.g., Treas. Reg. § 1.482-1(c) (1994) (best method rule); see also Treas. Reg. § 1.482-1(a) (6) (1968) ("true taxable income" determined by reference to arm's length dealings).

The 1994 regulations, citing Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994), specifically authorize the District Director to impute an agreement that accords with the controlled parties' conduct:

The legal owner of a right to exploit an intangible ordinarily will be considered the owner for purposes of this section. Legal ownership may be acquired by operation of law or by contract under which the legal owner transfers all or part of its rights to another. Further, the District Director may impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement. See § 1.482-1(d)(3)(ii)(B).

Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994) (emphasis added). Under the 1994 regulations, ownership of an intangible for section 482 purposes may be determined on the basis of rights contained in a contract executed by the controlled parties, or a contract imputed by the District Director. See id.

As noted, in general, in the section 482 context as elsewhere, the Service will evaluate transactions as the taxpayer has structured them, unless such structure lacks economic substance. Treas. Reg. § 1.482-1(f)(2)(ii). In that regard, the Service will respect the actual written contractual terms adopted between controlled taxpayers for their transactions, again provided such terms are consistent with the economic substance. Treas. Reg. § 1.482-1(d)(3)(ii)(B). Where, however, the controlled parties have not spelled out the terms of their transactions, or have done so only ambiguously or in a manner inconsistent with the economic substance, then the Service has the authority to impute a transaction that is consistent with the economic substance. Id. This case presents the more difficult situation for the Service, in that the controlled parties did not spell out their transactions, or did so only in an ambiguous or inconsistent manner. In such a case the Service may be faced with a choice of potential alternative constructions of the economic substance that are more or less consistent with the facts of the controlled taxpayers' actual course of conduct and their respective legal rights. The Service's task in such a case is to try to ascertain which alternative construction of the substance better reflects these facts. Where the available facts are equally consistent with one or more alternative constructions (which Examination may

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determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

B. U.S. Trademark Law Applicable to Foreign Registrants

The United States applies a territorial as opposed to a universal or worldwide theory of trademarks: "The concept of territoriality is basic to trademark law; trademark rights exist in each country solely according to that country's territorial scheme." Persons' Co. v. Christman, 900 F.2d 1565, 1569 (Fed. Cir. 1990) (footnote omitted).

Section 1(a) of the Trademark Act of 1946 ("Lanham Act") provides that the "owner" of a trademark used in commerce is entitled to apply for U.S. registration of the mark. 15 U.S.C. § 1051(a).

Section 5 of the Lanham Act provides that, in the event of legitimate use of a mark by a related party in the United States, such use shall not affect the validity of the mark, and such use may inure to the benefit of the registrant or applicant for registration, provided that there was no intent to deceive the public. 15 U.S.C. § 1055

Section 44 of the Lanham Act provides that a prior foreign registrant of a trademark, if domiciled in a treaty country, may obtain U.S. registration for that mark upon complying with the requirements of the statute. 15 U.S.C. § 1126.

Section 44(e) of the Lanham Act, 15 U.S.C. § 1126(e) provides that a "qualified foreign applicant" that owns a registered mark in its "country of origin" need only demonstrate intent to use the trademark (rather than actual use) in the United States. However, a company that is incorporated within the United States may not invoke section 44(e) of the Lanham Act to support its application for registration. See In re ETA Systems, Inc., 2 U.S.P.Q.2d 1367 (T.T.A.B. 1987).

In 1984, the Trademark Trial and Appeal Board ruled en banc that section 44 of the Lanham Act (as in effect at that time) provided foreign applicants independent grounds for U.S. registration of a trademark, without regard to the requirement of "use," as contained in section 1 of the Lanham Act. See Crocker Nat'l Bank v. Canadian Imperial Bank of Commerce, 223 U.S.P.Q. 909 (T.T.A.B. 1984).

As amended by the Trademark Law Revision Act of 1988, Pub. L. No.100-667, 102 Stat. 3935, U.S. law requires that a foreign national applying to register a foreign trademark in the United States demonstrate a bona fide intent to use the mark in U.S. commerce, but the application need not demonstrate actual use of the mark in U.S. commerce. See 4 McCarthy on Trademarks § 29:14, p. 29-29 (4th Ed. 1996). Thus, a foreign-national applicant need not show actual "use" of the marks in the United States, assuming that it proceeds under 15 U.S.C. § 1126.

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See id.

The U.S. Patent and Trademark Office generally will not deny registration of a U.S. trademark to the foreign owner of a U.S. corporation solely on the basis of "likelihood of confusion" among U.S. consumers regarding the origin of the trademarked merchandise, provided that a related party (e.g., the U.S. subsidiary) holds U.S. registrations of certain related trademarks. See In re Wella A.G., 858 F.2d 725 (Fed. Cir. 1988) (interpreting Section 2(d) of the Lanham Act, 15 U.S.C. § 1052(d)). Therefore, U.S. registration may be sought by any "related party" of a prior U.S. registrant. Id.

The Trademark Manual of Examining Procedure provides:

Frequently, related companies comprise parent and wholly-owned subsidiary corporations. Either a parent corporation or a subsidiary corporation may be the proper applicant depending on the facts concerning ownership of the mark. The filing of an application either by the parent or by the subsidiary should be considered by the examining attorney to be the expression of the intention of the parties as to ownership in accord with the arrangements between the parties.

T.M.E.P § 1201.03(c) (emphasis added). Provided that the applicant's representations regarding ownership of the mark and the corporate affiliations within the controlled group are internally-consistent, it is irrelevant which specific party in a controlled group is the "owner" of the foreign trademark. See T.M.E.P. § 1201.04.

DISCUSSION

Issue 1: Allocation of Income from Use of Trademark A in the United States Prior to Tax Years A and B

The section 482 regulations permit the Commissioner to determine arm's length income with respect to a "transfer" or "use" of intangible property by a controlled party. See Treas. Reg. § 1.482-2(d) (1968) (transfer or use of intangible); Treas. Reg. § 1.482-4(a), (f) (1994) (transfer[s] of intangible). In determining arm's length income and in evaluating the arm's length nature of the royalties paid by the U.S. subsidiaries to Parent in Tax Years A and B, the Service must consider which controlled party was the owner or developer of Trademark A in the United States within the meaning of the section 482 regulations, or whether the U.S. subsidiaries possessed a long-term, royalty-free right to use Trademark A in the United States, prior to Date E. We stress that this determination will turn on a detailed consideration of the facts of the controlled-party relationship with respect to Trademark A, and that only certain of those facts are available to us at present. Accordingly, although we attempt to describe the appropriate analysis to be applied under the regulations, we do not seek to state definitively the final outcome of that

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analysis.

In this regard, we note that this case is a difficult one for the Service, in that the controlled parties did not spell out their transactions, or did so only in an ambiguous or inconsistent manner. In such a case the Service may be faced with a choice of potential alternative constructions of the economic substance that are more or less consistent with the facts of the controlled taxpayers' actual course of conduct and their respective legal rights. The Service's task in such a case is to try to ascertain which alternative construction of the substance better reflects these facts. Where the available facts are equally consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

Examination may be able to establish that, during Period C, the U.S. subsidiaries were properly classified as the developers or the developer/owners of Trademark A, under either of two theories: (1) the U.S. subsidiaries were the developers of Trademark A in the United States within the meaning of the section 482 regulations (and thus the owners under the 1994 regulations); or (2) based on the parties' conduct, the Commissioner may impute a contract affording the U.S. subsidiaries long-term, royalty-free U.S. exploitation rights in Trademark A. Because some events involving the use of Trademark A in the United States occurred prior to the effective date of the 1994 regulations, we consider the 1968 and the 1994 regulations separately, although both regulations lead to substantially the same analysis.

1. The U.S. Subsidiaries As the Developers of Trademark A

Although the 1968 and 1994 regulations use distinct terminology regarding the developer of an intangible, the substantive analysis under both regulations is very similar. Compare Treas. Reg. § 1.482-2(d)(1)(ii)(c) (1968) with Treas. Reg. § 1.482-4(f)(3)(ii)(B) (1994). (Developer status under the 1994 regulations is potentially relevant, given that Trademark A might not be viewed as legally protected prior to Date H, at the earliest.) Under either regulation, notwithstanding the labels applied by the controlled parties, the relevant inquiry is: which controlled party bore the risk and expense of developing the intangible in the particular geographic market in question? That controlled party must both: (1) receive arm's length consideration in the event of a full or partial transfer to another controlled party of rights to exploit the intangible, and (2) pay arm's length consideration to another controlled party that provides assistance in connection with development of the intangible (i.e., an assister). Treas. Reg. § 1.482-4(f)(3)(i) (1994); see also Treas. Reg. § 1.482-2(d)(1)(i), (d)(1)(ii)(b) (1968).

In this case, Examination may be able to establish that the U.S. subsidiaries were the developers of Trademark A under the 1968 regulations. Applying a similar analysis, the U.S. subsidiaries would also be the developers (and therefore the owners) of Trademark A under the 1994 regulations, assuming that Trademark A was not viewed as legally protected, because not

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yet registered in the United States.

When the U.S. subsidiaries began to use Trademark A in the United States pursuant to the informal arrangement with Parent, the facts appear to indicate that Trademark A possessed little or no value in the U.S. geographic market. For example, Trademark A was a new name, with no prior track-record in the United States, and no recognition among purchasers of the U.S. subsidiaries' products. For that matter, it does not appear that Trademark A was used in Country A for any significant period prior to Date D. In short, there may not have been any independent basis for U.S. purchasers to associate Trademark A with quality products or services. Throughout Period C, the U.S. subsidiaries actively associated Trademark A with their own pre-existing products and trademarks. These pre-existing trademarks presumably possessed substantial capital value, reflecting association with quality products or services of the U.S. subsidiaries, as well as promotional and advertising expenses incurred in prior years. The U.S. subsidiaries also incurred promotional expenses with respect to Trademark A. The facts available at present indicate that Parent did not reimburse the U.S. subsidiaries' expenditures in promoting Trademark A, nor did Parent otherwise compensate the U.S. subsidiaries for activities undertaken to increase the value of Trademark A (including associating Trademark A with pre-existing intangible property).

If Examination establishes that the U.S. subsidiaries incurred the "largest portion of the costs of developing the intangible" in the United States, including by furnishing value attributable to associating Trademark A with their own existing, valuable trademarks, then the U.S. subsidiaries would properly be classified as the "developers" of Trademark A in the United States, pursuant to Treas. Reg. § 1.482-4(f)(3)(ii)(B) (1994) and Treas. Reg. § 1.482-2(d)(1)(ii)(c) (1968). Accord Medieval Attractions, S.A. v. Commissioner, T.C. Memo 1996-455 (1996) (use of then-non-proprietary concept by U.S. subsidiary, prior to U.S. registration by any party, led to conclusion that U.S. subsidiary was the "developer" of the intangible). This conclusion would be reasonable, if Trademark A's value in the United States resulted from its association with successful U.S. intangibles and products, and from non-reimbursed promotional expenditures incurred by the U.S. subsidiaries. Under those circumstances, in the absence of a transfer by the developers to another controlled party, no allocation of income with respect to Trademark A would be appropriate. See Treas. Reg. § 1.482-4(f)(3)(i) (1994); Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968).

2. U.S. Subsidiaries As Holders of Implied, Long-Term Contractual Rights to Use Trademark A

The District Director may be able to impute a long-term contract affording the U.S. subsidiaries the right to exploit Trademark A in the United States on a royalty-free basis, based on the substance of the controlled parties' dealings during Period C. Under this approach, Parent would be viewed as having transferred full or partial rights in Trademark A (or as having permitted the U.S. subsidiaries to use Trademark A in the United States) at some point during

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Period C.

The District Director is authorized to impute such an agreement, in accordance with substance-over-form analysis under the 1968 regulations. See Treas. Reg. §§ 1.482-1(a)(6) (1968) ("true taxable income" may be an amount other than required under legally binding contract), 1.482-1(d)(1) (1968) (amounts allocated in accordance with substance of underlying transactions). The 1994 regulations also permit the District Director to impute an agreement. See Treas. Reg. §§ 1.482-4(f)(3)(ii)(A) and 1.482-1(d)(3)(ii)(B)(1994). That is, the District Director may be able to impute an agreement affording the U.S. subsidiaries long-term exploitation rights to Trademark A in the United States, in order to reflect the substance of the controlled parties' dealings during Period C.

Substantially the same result may obtain under the 1994 regulations. See, e.g., Treas. Reg. §§ 1.482-1(d)(3)(ii)(B), 1.482-1(d)(3)(ii)(C), Ex. 3 (1994). In Example 3, during Years 1-6, a U.S. corporation (USD in the example) incurred above-normal, non-reimbursed promotional expenses with respect to a previously-unknown marketing intangible owned by its foreign parent (FP in the example), in the course of acting as the exclusive U.S. distributor of FP-manufactured products in association with such intangible. USD did not have any formal arrangement with FP regarding use of the intangible. In Year 7, when the intangible had become valuable, such that FP products commanded a price premium in the U.S. market, USD became a commission agent for FP. The Example states in pertinent part:

In determining the arm's length result for Year 7, the District Director considers the economic substance of the arrangements between USD and FP throughout the course of their relationship. It is unlikely that at arm's length USD would incur these above-normal expenses without some assurance that it could derive a benefit from these expenses. In this case, these expenditures indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP tradename in the United States. Such conduct is inconsistent with the contractual agreements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP. Therefore, the District Director may impute an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP tradename.

Treas. Reg. § 1.482-1(d)(3)(ii)(C), Ex. 3(ii) (1994) (emphasis added).

This analysis would also be consistent with Treas. Reg. § 1.482-4(f)(3)(iv), Ex. 4 (1994). In that example, FP and USSub had a long-term agreement that provided USSub with exclusive U.S. distribution rights to a trademarked product. Although the promotional expenditures of USSub were "significantly larger than the expenses incurred by independent distributors under similar circumstances," no allocation for these services was appropriate, given that USSub rather

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than FP was the ultimate beneficiary of these services. Id. In the present case, although the long-term agreement is imputed by Examination (rather than executed by the controlled parties), the basic rationale of Example 4 might apply.

Thus, Examination might conclude that the facts in this case are analogous to the two regulatory examples above. An uncontrolled party operating at arm's length would not likely act as the U.S. subsidiaries may have in this case, i.e., applying an unknown trademark to existing, successful products that possessed their own pre-existing valuable trademarks, without compensation, unless it held long-term rights in the underlying intangible. That is, "[a] licensee . . . has no reason to take steps to increase the value of a mark where the increased value will be realized by the owner." Nestlé Holdings, Inc. v. Commissioner, 152 F.2d 83, 87 (2d Cir. 1998). See also Treas. Reg. § 1.482-4(f)(3)(iv), Ex. 3 (1994).

Under both the 1968 and 1994 regulations, therefore, it may be appropriate to impute a contractual agreement affording the U.S. subsidiaries long-term U.S. exploitation rights in Trademark A. As a result, the U.S. subsidiaries would be considered to be the owners of certain property rights in Trademark A in the United States.³ Whether any royalty would be due to Parent under this imputed long-term agreement would turn on an appropriate analysis, under relevant provisions of the regulations, of the facts and circumstances, including consideration of any comparable transactions, and reference to the resources employed, the functions performed, and the risks assumed by the controlled parties in connection with Trademark A. If the evidence and analysis that Examination develops warrant, it may conclude that no royalty is due to Parent in connection with Trademark A. In effect, this would be equivalent to a conclusion that Trademark A possessed no value in the United States market before the contributions to its value by the U.S. subsidiaries, and a determination that such contributions were undertaken at the subsidiaries' own expense and risk.

Issue 1 Summary - Use of Trademark A in the United States Prior to Tax Years A and B

Under the 1968 and 1994 regulations, the U.S. subsidiaries would be properly classified as the developers of the U.S. intangible prior to Date F, if Examination can establish that they incurred the largest portion of the costs (including by furnishing value through association with the pre-existing marks without adequate compensation) of adding value to Trademark A in the United States market. Treas. Reg. § 1.482-2(d)(2)(1)(ii)(a) (1968); Treas. Reg. § 1.482-4(f)(3)(ii)(B) (1994). Under the 1994 regulations, the U.S. subsidiaries would then have the status of owners of Trademark A. See Treas. Reg. § 1.482-4(f)(3)(ii)(B) (1994). The net result under both the 1968 and 1994 regulations would be the same: no consideration would be payable

³ If Trademark A were considered to be legally protected within the meaning of Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994), the U.S. subsidiaries could be considered to be the legal owners of all or part of Trademark A in the United States under the 1994 regulations.

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by the U.S. subsidiaries to any other controlled party for the use of Trademark A, absent a transfer of the intangible. See Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968); Treas. Reg. § 1.482-4(f)(3)(i) (1994). Had the U.S. subsidiaries made a post-development transfer of Trademark A to Parent, arm's length consideration for that transfer would be payable to the developer(s) (*i.e.*, the U.S. subsidiaries), at which point payment of a royalty to the transferee (Parent) from other controlled parties to whom Parent on-transferred its interest, might be appropriate. Treas. Reg. § 1.482-2(d)(1)(i) (1968); Treas. Reg. § 1.482-4(f)(3)(i) (1994).⁴

Consistent with the substance of the controlled parties' dealings, Examination may also be able to impute an agreement affording the U.S. subsidiaries long-term exploitation rights in Trademark A. See Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994); see also Treas. Reg. § 1.482-1(d)(1) (1968). If Parent is deemed to have transferred full or partial rights in Trademark A, or, at a minimum, to have provided contractual rights permitting the U.S. subsidiaries to use Trademark A in the United States, that imputed transfer or imputed contract may have predated the effective date of the 1994 regulations (see Treas. Reg. § 1.482-1(j)(4) (1994)), and may therefore be subject to the 1968 regulations. However, assuming arguendo that the deemed transfer took place after the effective date of the 1994 regulations, an identical contract may be imputed under those regulations. See Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). In either event, the Service must also consider whether a royalty to Parent was appropriate, based on an appropriate analysis of the facts and circumstances under relevant provisions of the regulations, including consideration of any comparable transactions, and reference to the resources employed, functions performed, and risks assumed by the controlled parties.

In this regard, we note that this case is a difficult one for the Service, in that the controlled parties did not spell out their transactions during Period C, or did so only in an ambiguous or inconsistent manner. In effect, the Service may be faced with a choice of potential alternative constructions of the economic substance that are more or less consistent with the facts of the controlled taxpayers' actual course of conduct and their respective legal rights. The Service's task in such a case is to try to ascertain which alternative construction of the substance better reflects these facts. Where the available facts are equally consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

⁴ An example in the 1968 regulations views the obtaining of patent rights by a controlled party other than the developer as constituting a transfer of the intangible between the controlled parties. Treas. Reg. § 1.482-2(d)(1)(ii)(d), Ex. 3 (1968) ("The property is deemed to have been transferred to Y at that time by virtue of the fact that Y obtained the patent rights to product M."). See also Temp. Treas. Reg. § 1.482-4T(e)(3)(iv), Ex. 3 (same). In the event that such a transfer occurs, arm's length consideration is payable. Treas. Reg. § 1.482-2(d)(1)(i) (1968); Treas. Reg. § 1.482-4(f)(3)(i) (1994).

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If Examination concludes that, during Period C, the U.S. subsidiaries were the developers or the developer/owners of Trademark A in the United States, and/or that they held long-term, royalty-free rights to exploit Trademark A in the United States, the District Director should consider whether subsequent events, *i.e.*, events occurring in Date F or thereafter, changed the status of the controlled parties with respect to Trademark A, and affected the appropriate allocation of income from Trademark A in Tax Years A and B. We address these events in the following sections.

Issue 2: Effect of Date E Agreement Requiring Royalty to Parent

The agreement executed on Date E (at the end of Tax Year A) required the U.S. subsidiaries to pay Parent a royalty of $f\%$ of net sales for use of Trademark A, effective for all of Tax Year A and for subsequent years. To the extent the analysis of the previous issue leads Examination to conclude that some royalty were owing to Parent based on the substance of the transactions for Period C, the agreement entered into on Date E might be viewed as a ratification of the pre-existing situation. As noted, however, the magnitude of the royalty would still have to be evaluated in light of the standards in the regulations, in order to determine whether it was at arm's length.

On the other hand, to the extent that the analysis of the previous issue leads to the conclusion that the U.S. subsidiaries were the developer/owners of the intangible, or holders of a long-term royalty-free right in the intangible, then a further inquiry would be necessary. Examination would need to determine whether the facts developed, including the entry into the formal agreement, are more consistent with the conclusion that in Tax Year A the U.S. subsidiaries continued as the developer-owners or holders of a long-term royalty-free right to use the intangible, or the conclusion that, by virtue of the formal agreement, in Tax Year A the subsidiaries transferred such ownership or right to the foreign parent.

If the former conclusion is reached, then the royalty under the formal agreement would be disregarded. However, if the latter conclusion is reached, then the arm's length royalty owing to the foreign parent by the subsidiaries would effectively be offset, in whole or in part, by an arm's length consideration owing by the foreign parent to the subsidiaries on account of the transfer of the intangible to the foreign parent in Tax Year A.

It is recognized that Examination's task is made difficult by the ambiguity introduced, for example, by the prior course of conduct of the controlled parties and the belated adoption of a purported formal agreement only at the end of Tax Year A. As noted, where the available facts are equally consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

Issue 3: Effect of Parent's Date H Application for U.S. Trademark Registration

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Finally, assuming Examination reaches the conclusion that Trademark A was not transferred to Parent in Tax Year A, it must determine whether Parent's Date H application for U.S. registration of Trademark A (at the end of Tax Year B) had any effect, for purposes of section 482, in Tax Year B.

Examination would then need to determine whether the facts developed, including the U.S. registration application, are more consistent with the conclusion that in Tax Year B the U.S. subsidiaries continued as the developer-owners or the holders of a long-term royalty-free right to use the intangible, or the conclusion that, by virtue of the application, in Tax Year B the subsidiaries transferred such ownership or right to the foreign parent.

As a preliminary matter, we note that under U.S. law, the "registrant" of a trademark may generally be any party in the controlled group. For example, if a wholly-owned U.S. subsidiary uses a trademark that is owned by its parent in a foreign jurisdiction, either the parent or the subsidiary may become the registered owner under U.S. law. See T.M.E.P §§ 1201.03(c), 1201.04. See also 15 U.S.C. § 1055 ("use" of trademark in the United States by member of controlled group inures to benefit of other members for registration purposes). Thus, designation of the registered owner is a matter entirely within the power of the controlled group.

Under the 1994 regulations, a party that holds formal legal title to an intangible is not always viewed as being entitled to exclusive exploitation of the intangible under section 482. See Treas. Reg. § 1.482-4(f)(3)(ii)(A) (1994) (legal owner of right to exploit is "ordinarily" the owner). Rather, legal title is a relevant factor to be considered, in conjunction with the contractual rights to exploit the intangible in the particular geographic market and the economic substance of the controlled parties' underlying relationship. See Treas. Reg. §§ 1.482-4(f)(3)(i) (owner may subdivide ownership via licensing to others), 1.482-4(f)(3)(ii)(A) (1994) (legal owner of right to exploit is "ordinarily" the owner). See also Preamble, T.D. 8552, 1994-2 C.B. at 108 ("[L]egal ownership does not refer solely to the registered holder of the intangible . . ."). Applying this rationale to registration of an intangible, obtaining legal title should not be controlling with respect to ownership for purposes of section 482. Rather, an action that purports to confer legal title (e.g., registration of a trademark) within a controlled group must be evaluated in the context of the economic substance of the controlled-party relationship, as well as any actual or implied contractual provisions that may be in effect between the parties.

In determining whether the first view is more appropriate, i.e., that the U.S. subsidiaries continued to be the developer/owners of Trademark A or the holders of a long-term royalty-free right to the use thereof, notwithstanding the trademark registration application, Examination should consider the case of Medieval Attractions, T.C. Memo 1996-455. There the Tax Court evaluated the U.S. trademark registration of an allegedly-proprietary, medieval dinner theater concept. At issue in that case were a Netherlands corporation engaged in business in the United States (MTNV), a Spanish affiliate (TM), and several other controlled parties. The facts found by the court supported the view that MTNV had developed the "Medieval Times intangibles" during

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the period 1983-86. In subsequent years, 1987 and 1988, the intangibles were registered under state and Federal law in the name of another controlled party, Manver.

The court analyzed the issue as follows:

When the intangibles became legally protected by the registration of the intangibles in 1987 and 1988, there was no consideration paid to MTNV/MSI. C&L [Coopers & Lybrand] and the Spanish investors were undecided as to whether Manver or Gatetown should hold the trademarks in their name. The decision to hold the trademarks in Manver's name was not made until December 1986, when C&L received a favorable tax ruling from the Netherlands Antilles. The licensing agreements between Manver and MSI and Manver and MDT were dated May and July 1986, several months before the final decision to use Manver was made. Additionally, the language in the licensing agreements was almost verbatim language from a draft licensing agreement that Hokanson at LL provided to the Spanish investors on November 11, 1986.

The chronology shows that the trademarks could have been registered in the name of any of the entities controlled by the Spanish investors. The decision was driven by tax considerations and had no relation to who actually developed the intangibles. The choice of which corporate entity to use occurred, and the chain of possession, and the subsequent licensing agreements were created after the favorable tax ruling and attempted to alter the facts to fit the tax planning.

Medieval Attractions, T.C. Memo 1996-455 (bracketed material and emphasis added). Medieval Attractions thus supports the view that the initial registration of a trademark by a controlled party must be viewed critically, and should in any event be evaluated in the context of the controlled-party relationship. A similarly critical evaluation is in order where the event in question is an application for registration rather than registration itself.⁵

In determining whether the second view is more appropriate, i.e., that the registration application evidenced a transfer of intangible rights from the U.S. subsidiaries to Parent, Examination should consider an example in the 1968 regulations. That example treats the grant of a patent to a controlled party other than the developer as constituting a transfer of the intangible. See Treas. Reg. § 1.482-2(d)(1)(ii)(d), Ex. 3 (1968) (obtaining a patent for manufacturing formula constitutes a "transfer"). See also Temp. Treas. Reg. § 1.482-

⁵ We have not considered whether, as a matter of substantive trademark law, Parent's Date H application to register Trademark A took effect when filed or only later, when actually granted.

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4T(e)(3)(iv), Ex. 3 (1993). This example would support the view that the initial registration of an intangible may be sufficient to confer tax ownership (i.e., subject to payment of consideration for the transfer).⁶

If Examination concludes that the better construction is that the U.S. subsidiaries continued as the developer/owners or holders of long-term rights to use Trademark A, then the U.S. registration application (as well as the royalty under the formal agreement) would be disregarded. However, if Examination concludes that the substance of the transactions is better reflected by giving effect to the trademark registration application as a transfer of the intangible in Tax Year B, then an arm's length consideration would be payable by Parent to the U.S. subsidiaries. See Treas. Reg. § 1.482-4(f)(3)(i) (1994). See also Treas. Reg. § 1.482-2(d)(1)(i) (1968). Under this approach, any royalties that were payable to Parent in Tax Year B would effectively be wholly or partially offset by consideration payable by Parent in connection with the U.S. subsidiaries' transfer to Parent of Trademark A rights.

It is recognized that Examination's task is made difficult by the ambiguity introduced by the prior course of conduct of the controlled parties and the belated application for registration only at the end of Tax Year B. As noted, where the available facts are equally consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

CONCLUSION

This advice has outlined the analysis which Examination needs to undertake to ascertain an allocation of income with respect to Trademark A as between the U.S. subsidiaries and Parent during Tax Years A and B. As discussed, a preliminary analysis must address the status of Trademark A rights during Period C. The object of that analysis would be to ascertain, as between the U.S. subsidiaries and Parent, which was the developer/owner of the rights or, in the alternative, whether Parent should be viewed as having conveyed to the U.S. subsidiaries a long-term right to use Trademark A. To the extent the U.S. subsidiaries were the developer/owners of

⁶ Note, if a party uses a proprietary formula (as in the 1968 regulation example) without the benefit of a patent, the formula may be appropriated by third parties, and the developer will be without a legal remedy. In contrast, a trademark, such as Trademark A in this case, may be used commercially for many years without thereby compromising the trademark or the inchoate right to seek registration. In fact, "use" in the United States by a controlled party of a non-registered trademark provides a basis for registration by a member of the controlled group. See 15 U.S.C. § 1055. Therefore, these considerations may suggest that a distinction should be drawn concerning the significance of a registration or an application for registration, as between patents and trademarks.

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trademark rights during Period C and did not make any transfer thereof to Parent during that time, the initial position entering Tax Years A and B would not require any royalty owing to Parent. On the other hand, to the extent that Parent were found to be the developer/owner, or to have conferred a long-term right to use Trademark A, a further analysis would address what would be the appropriate level, if any, of a royalty owing by the U.S. subsidiaries to Parent. As noted, the failure of the taxpayer to define the controlled transactions consistently and without ambiguity may in effect afford the Service greater latitude in determining which construction of the economic substance best conforms to the facts developed in this case.

Assuming Examination appropriately concludes that Trademark A rights belonged to the U.S. subsidiaries in the first instance as the developer/owners during Period C, or appropriately determines that a long-term royalty-free right to use Trademark A belonged to them, then it would need to proceed to consider what significance, if any, should be accorded to either the entry into the formal royalty agreement in Tax Year A, or the application for registration of Trademark A in Tax Year B. In each case the issue would be whether the substance of the transactions in those years were more appropriately reflected by concluding that the U.S. subsidiaries had transferred Trademark A rights to Parent, or not. If the conclusion is that no transfer from the U.S. subsidiaries occurred, then the U.S. registration application and the royalty under the formal agreement would be disregarded. However, if the conclusion is that in either Tax Year A or B a transfer of Trademark A rights from the U.S. subsidiaries to Parent occurred, then an arm's length consideration would be owing from Parent to the U.S. subsidiaries, and that consideration would effectively offset, in whole or in part, the arm's length royalty owing from the U.S. subsidiaries to Parent for their continuing use of the marketing intangible in the United States in Tax Year A or B, as the case may be.

It is recognized that Examination's task is made difficult by the ambiguity introduced, for example, by the prior course of conduct of the controlled parties, the belated adoption of a purported formal agreement only at the end of Tax Year A, and the application for trademark registration only at the end of Tax Year B. As noted, where the available facts are equally consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

Assuming arguendo that a transfer of Trademark A rights from the U.S. subsidiaries to Parent occurred in Tax Year A or B, you have not inquired, and we do not consider, whether such a transfer would constitute a dividend distribution of appreciated property rights subject to I.R.C. §§ 311(b) and 312(b), with the income tax consequences attendant thereto.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Fundamental to this case is factual development concerning the respective contributions of the U.S. subsidiaries and Parent to Trademark A's value. The developer-assister rules discussed

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above arguably only require that Examination establish that the U.S. subsidiaries bore the largest portion of the trademark development costs (including for this purpose, as a cost, the value of other intangible property, such as the U.S. subsidiaries' pre-existing marks, made available without adequate compensation). However, as discussed below,

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] In DHL, the Tax Court sought to value a trademark originally owned by a U.S. entity that was subject to promotional

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expenditures by a controlled party located outside the United States, DHL International (DHLI). The taxpayer in DHL argued that DHLI's expenditures rendered it the developer of the "DHL" trademark in markets outside the United States (i.e., the reverse scenario of the present case).

The court in DHL accepted the argument which the Service advanced that, in order to demonstrate that DHLI was the developer of the trademark rights there at issue, the taxpayer had the burden to come forward with evidence that DHLI bore more costs than an arm's length licensee would have borne. See DHL, T.C. Memo. 1998-461 at text accompanying footnote 19 ("Petitioners have not shown . . . that DHLI bore more of the cost than an arm's-length licensee would have borne."). Since the taxpayer failed to carry that burden, even though it did produce evidence that DHLI incurred promotional expenditures that were significant in absolute terms, the court concluded that DHL (U.S.) was the developer of the trademark within the meaning of the regulations, and declined to make any adjustment for the value of expenditures made by DHLI with respect to the trademark in the non-U.S. geographic markets.

As a separate matter, we note that the comparable profits method (CPM), which the taxpayer used to evaluate the royalty paid to Parent, may not constitute the "best method" pursuant to Treas. Reg. § 1.482-1(c) (1994). Under the CPM, "in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables." Treas. Reg. § 1.482-5(b)(2)(i) (1994) (emphasis added). As noted above, the U.S. subsidiaries owned pre-existing valuable intangibles, independent of Trademark A. Based on the explanation provided by Parent to Country A tax authorities, the taxpayer may attempt to argue that, provided U.S. taxable income net of the royalty is within the interquartile range, the royalty is arm's length. There is authority contrary to such an approach. See, e.g., Medieval Attractions, T.C. Memo 1996-455 ("The thrust of petitioners' position is that they could pay unlimited royalties so long as they received an adequate rate of return; and the reported and taxed income was an adequate rate of return by comparison to various industry standards . . . we agree that we need not belabor or even discuss this evidence.").

The validity of the taxpayer's [REDACTED] analysis may also be questionable. First, that analysis apparently presumes that Parent is entitled to some royalty, as either the owner or the developer of the U.S. intangible. However, this premise may be in doubt, at least absent a prior (taxable) distribution of Trademark A to Parent. Second, as noted in your memorandum, this analysis relies upon a proprietary database of agreements, which is not subject to verification or examination by the Service. This factor may reduce the reliability of the results obtained under this approach. See Treas. Reg. § 1.482-1(c)(2)(ii) (1994) (reliability criteria).

We should also make the following observation concerning the potential relevance of Federal trademark law, which is a complex and specialized area. This case is particularly difficult because it involves the use of intangible property within a controlled group over a period of almost fifteen years, pursuant to both informal and formal agreements. [REDACTED]



As noted, we have not considered whether any transfer of Trademark A rights from the U.S. subsidiaries to Parent would constitute a dividend of appreciated property triggering gain taxable to the U.S. subsidiaries, as well as liability for a U.S. dividend withholding tax. See generally I.R.C. §§ 311(b), 312(b), 1442; Pope & Talbot, Inc. v. Commissioner, 162 F.3d 1236 (9th Cir. 1999). If you wish to explore this issue, we would suggest coordination with CC:DOM:CORP, as well as consideration of seeking additional field service advice. Issues might include whether "property" for purposes of I.R.C. § 311(b) is limited to property concepts under non-tax law, or whether property for that purpose might include rights which the Service is authorized to determine to exist between controlled parties under section 482.

If you have any additional questions, please contact Branch 6 at (202) 874-1490.

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