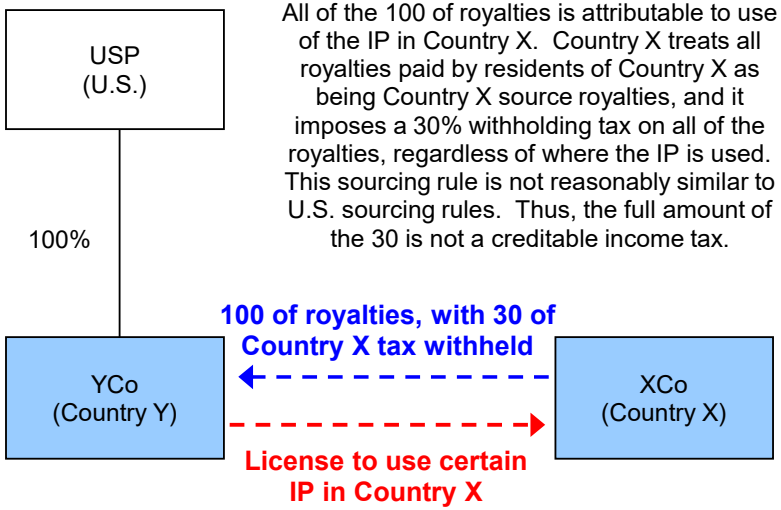
**Reg. 1.903-1(d)(4), Example 4**

# Withholding Tax On Royalties; Attribution Requirement (IP Only Used In-Country)



Facts. YCo, a resident of Country Y, is a controlled foreign corporation wholly-owned by USP, a domestic corporation. In Year 1, YCo grants a license to XCo, a resident of Country X unrelated to YCo or USP, for the right to use YCo's intangible property (IP) in Country X. Under Country X's domestic tax law, all royalties paid by a resident of Country X to a nonresident are sourced in Country X and are subject to a 30% withholding tax on the gross income, regardless of whether the nonresident payee has a taxable presence in Country X. Country X's withholding tax on royalties is a separate levy under Reg. 1.901-2(d)(1)(iii).




All of the 100 of royalties is attributable to use of the IP in Country X. Country X treats all royalties paid by residents of Country X as being Country X source royalties, and it imposes a 30% withholding tax on all of the royalties, regardless of where the IP is used. This sourcing rule is not reasonably similar to U.S. sourcing rules. Thus, the full amount of the 30 is not a creditable income tax.

In Year 1, XCo withholds 30u (units of Country X currency) tax from 100u of royalties owed and paid to YCo under the licensing arrangement, all of which is attributable to XCo's use of the YCo IP in Country X. The United States and Country X have an income tax treaty (U.S.-Country X treaty); under the royalties article of the treaty, Country X agreed to impose its withholding tax on royalties paid to a U.S. resident only on royalties paid for IP used in Country X. Country X and Country Y do not have an income tax treaty.

Analysis. Under Reg. 1.901-2(d)(1)(iv), the Country X withholding tax on royalties, as modified by the U.S.-Country X treaty, is a separate levy from the unmodified Country X withholding tax to which YCo was subject (because YCo is not a U.S. resident eligible for benefits under the U.S.-Country X treaty). The Country X withholding tax on royalties, unmodified by the U.S.-Country X treaty, does not meet the attribution requirement in Reg. 1.901-2(b)(5)(i)(B) because Country X's source rule for royalties (based upon residence of the payor) is not reasonably similar to the sourcing rules that apply under the Internal Revenue Code. Thus, under Reg. 1.903-1(c)(2)(iii), the Country X withholding tax paid by YCo is not a covered withholding tax, and none of the 30u of Country X withholding tax paid by YCo with respect to the 100u of royalties for the use of the IP is a payment of foreign income tax.