

## Focus INTELLECTUAL PROPERTY

# Getting to the source of U.S. income

Law tricky on questions of taxing copyright, patents south of the border



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The United States taxes U.S. persons on their worldwide income. This includes U.S. citizens, permanent residents, and anyone deemed a U.S. tax resident by the IRS. There has been much publicity about this in the past year due to the Canada-U.S. Intergovernmental Agreement, which implemented the *Foreign Account Tax Compliance Act* (FATCA).

What isn't well known is that the U.S. also exercises a tax jurisdiction over non-U.S. persons by imposing a tax on their U.S. source income. It's important these people find out if their income is U.S. source or not.

Generally, compensation for personal services is sourced where the service is performed. But royalties from property—including royalties for the use of U.S. patents, copyrights, secret processes and formulas, as well as goodwill, trademarks, trade brands, franchises, and other like property—are sourced where the property is located, sold or exploited.

Income from a sale of personal property is generally sourced by the residence of the seller. Thus, if a U.S. person provides services outside the U.S., compensation received is non-U.S. source. And if that person sells their personal property, the money received is also non-U.S. source. But if that person receives royalties from a copyrighted property located in the U.S., then the royalty income is U.S. source. The difficulty is determining if the income received is compensation for services, or royalties, or another type of income.

Between 1938 and 1941, writer P. G. Wodehouse was a British citizen residing in France. He sold the right to publish and sell his stories to an American publisher, netting him US\$127,000. He treated this as money received for selling personal property, which is not taxable for a non-U.S. person. He said this was payment for selling his interest in a copyright, not a royalty payment for rights granted by him under the protection of his copyright. The case went to the U.S. Supreme Court and Wodehouse lost. The court found this was a license, not a sale. Since the license was used in the U.S., the payments were considered U.S. source income.

Paul Karrer, whose research on



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vitamins won the 1937 Nobel Prize, was Swiss. He worked for a Swiss company that owned all the patents on vitamins he developed. A contract between that company and its American affiliate gave the U.S. company the right to exploit his patented formula. His case went to the U.S. Federal Court, but he fared better than Wodehouse.

Under U.S. intellectual property law, the patent couldn't be registered by a company. It had to be registered by an individual, so Karrer was the owner of the patent in the U.S. while the Swiss company owned the patent in other countries. The court held that the payments were for services performed by Karrer in Switzerland, not payments for the right of the U.S. company to use the patents.

How was this different from the Wodehouse case? Karrer didn't sell anything to the U.S. company, since all rights in his patents were vested in the Swiss company.

In 1975, French composer Pierre Boulez was a resident of Germany working as an orchestra conductor. He contracted with the CBC to make recordings of orchestral works, some of them in the U.S. The contract said all recordings would be the property of the CBC, which would pay Boulez a percentage of its sales receipts. These were described as "royalties."

Germany deemed this income as royalties taxable exclusively in Germany, but the IRS said it was payment for services taxable in the U.S. The U.S. tax

court agreed. It said that before a person can derive income from royalties, he must have an ownership interest in the property whose licensing or sale gives rise to the income. Boulez had no copyrightable property

interest in the recordings he created because the CBC was the owner. Boulez lost his battle with the IRS.

And then we have Italian tenor Enrico Caruso, who recorded in the U.S. and had a contract with an

American record company which didn't permit him to sign with another record company. Caruso was paid according to the number of records sold with a guaranteed minimum compensation. The IRS challenged the monies received by Caruso on account of foreign sales of records, and won. The court reasoned that Caruso had not retained legal rights in the records, so he could not have licensed the records he did not legally own. The payment was considered to be for performance of services in the U.S. However, Caruso could have avoided U.S. tax by recording in his house in Italy or anywhere else during his world tour.

There are also other categories of income that are difficult to source such as cross-licensing where IP rights are bartered, and e-commerce.

Sourcing income from IP raises issues. The issue is who owns which rights. In a world increasingly populated with IP, whether you own it or sell or license it is not always clear. This is where a tax lawyer would help because the right to tax depends on the source.

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## Cops pay digital ransom to hackers

It's unnerving, to say the least, when police have to pay cyber criminals to unlock their own computers. But that's what happened when the Tewksbury, Mass., police department tried to call up arrest and incident files, and instead were greeted by a menacing popup telling them: "Your personal files are encrypted." The file decryption fee was US\$500. Police chief Timothy Sheehan said he went from thinking it was a simple glitch to realizing, "it was a little bit bigger than that. It was more like cyberterrorism." He was right. The hackers had used a ransomware program called KEYHolder. Although the Tewksbury authorities sent their infected computer server to the Commonwealth Fusion Center (where state and federal law enforcement agencies work on antiterrorism and cybercrime cases), the program proved unbreakable. The hackers then used a technology called Tor, which obscures the physical location of where the payment is received. Fittingly, the ransom was paid in coinage that every cybercriminal understands: untraceable bitcoins. — STAFF