4 T.C. 539 (1945)

A U.S. company receiving royalties from a British licensee cannot claim a tax credit for British income taxes paid by the licensee when those taxes were assessed under Rule 19(2) of the British Income Tax Act of 1918 because the tax is considered the licensee's obligation, not the licensor's.

Summary

O. K. Tool Co. sought a tax credit under Section 131 of the Internal Revenue Code for income taxes paid to Great Britain by its British licensee, Richard Lloyd & Co., Ltd. The royalties were subject to British income tax. The Commissioner of Internal Revenue denied the credit, arguing that the British tax on royalties was a tax against the licensee, not the licensor. The Tax Court upheld the Commissioner's determination, relying on the precedent set in *Irving Air Chute Co.*, which held that under Rule 19(2) of the British Income Tax Act, the tax is levied on the licensee's profits, and the licensee's payment is considered its own tax obligation, not the licensor's. The court found no basis to distinguish the case from *Irving Air Chute*.

Facts

The O. K. Tool Company, Inc. (a New York corporation) owned U.S. and British patents for cutting tools and tool holders. In 1939, the company granted a license to Richard Lloyd & Co., Ltd. (a British company) to manufacture and sell products covered by the patents, with royalties set at 5% of net selling prices. The agreement stipulated a minimum total consideration of £10,000 for the first five years, inclusive of all British income taxes levied against the licensor. The licensee provided O. K. Tool with a certificate showing a gross payment of £13,846.3.1 and a deduction of £4,846.3.1 for income tax. O. K. Tool reported the gross royalty amount as income and claimed a tax credit for the deducted amount representing the British tax.

Procedural History

The Commissioner of Internal Revenue denied O. K. Tool's claimed tax credit for foreign taxes paid. O. K. Tool petitioned the Tax Court for review of the Commissioner's determination. The case was submitted to the Tax Court based on a written stipulation of facts.

Issue(s)

Whether O. K. Tool is entitled to a tax credit under Section 131(a)(1) of the Internal Revenue Code for income taxes paid to Great Britain by its British licensee on patent royalties.

Holding

No, because under Rule 19(2) of the British Income Tax Act of 1918, the tax on

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patent royalties is the tax of the British licensee of the patents, not that of the American licensor.

Court's Reasoning

The Tax Court relied heavily on its prior decision in *Irving Air Chute Co.*, which addressed a similar issue involving British taxes on royalties paid to a U.S. licensor. In *Irving Air Chute*, the court held that under Rule 19(2) of the British Income Tax Act, the tax was imposed on the entire profits of the licensee without deduction for royalties paid. Therefore, the licensee's payment of the tax was considered its own tax obligation, not a tax paid on behalf of the American licensor. The court rejected O. K. Tool's argument that *Irving Air Chute* was incorrectly decided. The court also rejected O. K. Tool's argument that Rule 21(1) of the British Income Tax Act applied instead of Rule 19(2). The court interpreted Rule 19(2) to apply when the licensee had sufficient income to cover the royalties, while Rule 21(1) applied when the licensee did not. The court found that the British licensee in this case had sufficient profits, making Rule 19(2) applicable. The court stated, "Apparently they thought that if the licensee had profits equal to the amount of the royalties, the British Government could safely rely upon such a company to pay its taxes and need not *require* that company to withhold any amount from the licensor which it desired to pay."

Practical Implications

This case clarifies that a U.S. company cannot claim a foreign tax credit for taxes paid by a foreign licensee on royalties if the tax is assessed under a provision like Rule 19(2) of the British Income Tax Act, which treats the tax as the licensee's obligation. This ruling emphasizes the importance of understanding the specific provisions of foreign tax laws to determine whether a tax is actually imposed on the U.S. licensor or merely collected from the licensee. The decision highlights that the form of the transaction (i.e., withholding by the licensee) does not necessarily determine the substance (i.e., who bears the legal incidence of the tax). Later cases will likely scrutinize the specific foreign tax law at issue to determine its true nature and effect on the U.S. taxpayer.

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