R. T. French Co. v. Commissioner, 60 T. C. 836 (1973)

Royalty payments between commonly controlled entities are deductible if they reflect arm's length transactions.

Summary

R. T. French Co. challenged the IRS's disallowance of royalty deductions for payments to its affiliate MPP under section 482, which allows income reallocation among controlled entities. The Tax Court upheld the deductions, finding that the royalty agreements were similar to those an unrelated party would negotiate, despite changes made after common control was established. The court also rejected the IRS's claim that French's intangible assets used by affiliates constituted constructive dividends to the parent, as the benefits to the parent were merely derivative of the subsidiaries' operations.

Facts

R. T. French Co. (French) entered into a licensing agreement with M. P. P. (Products) Ltd. (MPP) in 1946 for an instant mashed potato process patented by MPP. The agreement required French to pay royalties of 3% of net sales. In 1956, the royalty structure was modified to 3% on the first $800,000 of sales and 2% thereafter. By 1960, both French and MPP were wholly owned by Reckitt & Colman interests. A new agreement was executed that year to address patent infringement issues, changing the license to a nonexclusive one for know-how and reducing royalties to 2% until 1961, then 1% until 1967. The IRS disallowed royalty deductions for 1963 and 1964, asserting the transactions were not at arm's length.

Procedural History

The IRS determined deficiencies in French's income and withholding taxes for 1963 and 1964, disallowing royalty deductions and treating the payments as dividends. French contested these determinations in the Tax Court, which upheld the deductions and rejected the constructive dividend claim.

Issue(s)

1. Whether the royalty payments made by French to MPP in 1963 and 1964 were deductible as ordinary and necessary business expenses under section 162(a) of the Code, or whether they should be disallowed under section 482 as not reflecting arm's length transactions.
2. Whether the free use of French's intangible assets by its foreign affiliates constituted constructive dividends to the common parent, requiring French to withhold income tax under section 1442(a).

Holding

1. Yes, because the royalty payments were made pursuant to agreements that would have been negotiated by parties dealing at arm’s length, reflecting the original 1946 agreement’s terms before common control.
2. No, because the benefits to the parent from the affiliates’ use of the intangibles were merely derivative, not warranting constructive dividend treatment.

Court’s Reasoning

The court applied the arm’s length standard to evaluate the royalty payments, focusing on the agreements’ terms at inception and subsequent modifications. The 1946 agreement was deemed arm’s length due to MPP’s minority ownership by an independent party, Chivers, which would have prevented unfair terms favoring MPP. The 1960 agreement, made after common control, was considered a reasonable modification to address patent infringement issues without substantially altering the parties’ rights and obligations. The court rejected the IRS’s argument that post-1962 royalties were unenforceable under *Brulotte v. Thys Co.* , as the agreements provided for know-how royalties at a reduced rate after patent expiration. Regarding the constructive dividend issue, the court found that the parent’s benefits were incidental to the subsidiaries’ operations, not warranting dividend treatment. Key quotes include: “The critical inquiry for the purpose of revealing distortions in income. . . is generally whether the transaction in question would have been similarly effected by parties dealing at arm’s length,” and “a distribution by a corporation to a ‘brother-sister’ corporation will be regarded as a dividend to the common shareholder only if the distribution was made for the benefit of the shareholder. “

Practical Implications

This decision reinforces the importance of the arm’s length standard in evaluating intercompany transactions for tax purposes. It suggests that royalty agreements made before common control can continue to be enforced as arm’s length, even after control changes, if the agreements’ substance remains unchanged. The ruling also clarifies that derivative benefits to a parent from subsidiaries’ use of intangibles do not constitute constructive dividends. Practitioners should ensure that intercompany agreements are structured to withstand IRS scrutiny under section 482, particularly when control changes occur. This case has been cited in subsequent rulings on intercompany pricing and constructive dividends, such as *B. Forman Co. v. Commissioner* and *Sammons v. Commissioner*, emphasizing its ongoing relevance in transfer pricing and international tax law.