American Air Liquide, Inc. v. Commissioner, 116 T. C. 23 (2001)

Royalties received by a U. S. subsidiary from its foreign parent are classified as passive income for foreign tax credit purposes under section 904(d)(1)(A), unless explicitly excepted by statute or regulation.

Summary

American Air Liquide, Inc. (AAL) sought to classify royalties received from its French parent, L'Air Liquide, as general limitation income under section 904(d)(1)(I) for foreign tax credit purposes. The IRS recharacterized these royalties as passive income under section 904(d)(1)(A). The Tax Court held that the royalties were passive income, rejecting AAL's arguments based on a reserved regulation, the U. S. -France Treaty, and Treasury statements. The decision underscores the importance of explicit statutory or regulatory exceptions for deviating from the general classification of royalties as passive income.

Facts

American Air Liquide, Inc. (AAL) is the parent of a consolidated group that includes Liquid Air Corp. (LAC). AAL's ultimate parent is L'Air Liquide, S. A. , a French corporation. In 1986, AAL acquired LAC's research facilities and rights to technical information. Under license agreements, AAL and LAC received royalties from L'Air for the use of this intellectual property outside the U. S. AAL treated these royalties as general limitation income under section 904(d)(1)(I) on its tax returns for the years 1989-1991. The IRS recharacterized the royalties as passive income under section 904(d)(1)(A), resulting in deficiencies.

Procedural History

AAL filed a petition in the U. S. Tax Court challenging the IRS's recharacterization of the royalty income. Both parties filed cross-motions for summary judgment. The Tax Court recharacterized the motions as cross-motions for summary judgment under Rule 121 due to exhibits attached by AAL. The court ultimately granted summary judgment to the Commissioner and denied AAL's motion.

Issue(s)

1. Whether royalties received by AAL from its foreign parent, L'Air Liquide, should be classified as passive income under section 904(d)(1)(A) or general limitation income under section 904(d)(1)(I) for the purpose of calculating AAL's foreign tax credit?

Holding

1. Yes, because the royalties are classified as passive income under section 904(d)(1)(A) as they fit the statutory definition of foreign personal holding company

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income, and no explicit exception in the statute, regulations, or treaties applies to reclassify them as general limitation income.

Court's Reasoning

The court applied the statutory rule under section 904(d)(1)(A), which classifies royalties as passive income. AAL's arguments were rejected: the reserved paragraph in section 1. 904-5(i)(3) of the Income Tax Regulations did not provide an exception, as it merely reserved space for future regulations. The court cited *Connecticut Gen. Life Ins. Co. v. Commissioner* to support this view. The U. S. -France Treaty's nondiscrimination provision did not apply, as AAL was treated the same as any other U. S. corporation receiving royalties from a non-controlled foreign corporation. Treasury statements and proposed regulations did not support AAL's position, as they indicated no intent to retroactively change the classification of such royalties. The court emphasized that without clear statutory or regulatory language, the general rule classifying royalties as passive income must be followed.

Practical Implications

This decision reinforces the strict application of section 904(d)(1)(A) in classifying royalties as passive income for foreign tax credit purposes. Taxpayers cannot rely on reserved regulations or treaty nondiscrimination clauses to recharacterize income without explicit statutory or regulatory support. The ruling impacts U. S. subsidiaries of foreign parents by limiting their ability to claim foreign tax credits against general limitation income baskets. Practitioners should advise clients to carefully consider the source and classification of income when planning foreign tax credit strategies. Subsequent cases like *Connecticut Gen. Life Ins. Co. v. Commissioner* have similarly upheld the classification of royalties as passive income in the absence of clear exceptions.

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