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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
FC1 =

Year 1 =
Date 1 =
Date 2 =
Date 3 =

$x =

ISSUE:

Whether a payment by Taxpayer to a Swiss entity pursuant to a non-compete agreement is subject to the 30 percent tax on fixed or determinable annual or periodical gains, profits and income under § 881 of the Internal Revenue Code and, therefore, subject to withholding under § 1442?

FACTS:

Taxpayer is a domestic corporation that manufactures product in the United States. Taxpayer is currently owned, 50 percent each, by two United States citizens. Prior to Year 1, Taxpayer was a C corporation owned one third each by the two current shareholders and FC1, a Swiss entity.

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On Date 1, pursuant to a Non-Compete Agreement ("Agreement") between Taxpayer and FC1 executed on Date 2, Taxpayer paid FC1 $x. The payment was in consideration for FC1's covenant not to compete with Taxpayer's business within North America for a period ending on Date 3.

During Year 1, FC1 did not have a permanent establishment within the United States. Prior to Year 1, other than its investment in Taxpayer, FC1 did not have an investment in any United States operations.

Taxpayer contends that its payment to FC1 is "industrial and commercial profits" exempt from U.S. tax under Article III of the Income Tax Treaty between Switzerland and the United States, signed on May 24, 1951 (Convention). Taxpayer contends that the payment is in lieu of the industrial and commercial profits that FC1 otherwise could have earned by engaging in commercial activity in the United States, citing Korfund Co. v. Commissioner, 1 T.C. 1180 (1943); Montesi v. Commissioner, 340 F2d 97 (6th Cir. 1995); and LTR 84-01-041 (Oct. 4, 1983). In addition, Taxpayer argues that because FC1 received a payment from a business competitor in return for FC1's agreement not to move into the geographic area of and compete in Taxpayer's business, the payment is a commercial settlement arising from the business of FC1 and, therefore, must be industrial or commercial profits to FC1. Therefore, under the Convention there would be no income subject to United States tax because FC1 does not have a permanent establishment within the United States.

In the alternative, Taxpayer argues that its payment to FC1 is a royalty under Article VIII of the Convention. Taxpayer points to the language in Article VIII of the Convention that refers to "other like property and rights" and argues that because a payment for a non-compete agreement is not specifically excluded from the treaty definition of a royalty it should be included under the above language. Article VIII of the Convention reserves taxation of royalty payments to a Swiss entity that does not have a permanent establishment in the United States to Switzerland. Therefore, under the Convention there would be no income subject to United States tax because FC1 does not have a permanent establishment within the United States.

LAW AND ANALYSIS:

Section 881(a) imposes for each taxable year a tax, except as provided in subsection (c), of 30 percent of the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income.

Section 1442(a) provides that, in the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as provided in § 1441 a tax equal to 30 percent thereof.

Section 1441(a) provides that, except as otherwise provided in § 1441(c), all persons in whatever capacity acting, having control or payment of any of the items of income specified in § 1441(b), to the extent that any of such items constitute gross income from sources within the United States, of nonresident aliens shall deduct and withhold from such items a tax equal to 30%. The items of income described in § 1441(b) include wages, compensation, and other fixed or determinable annual or periodical income. Section 1.1441-2(a)(2) of the Income Tax Regulations provides, in part:

> Income is fixed when it is to be paid in amounts definitively predetermined. Income is determinable whenever there is a basis for calculation by which the amount to be paid may be ascertained.

Section 1461 provides in part that every person required to deduct and withhold tax under § 1442 is liable for such tax.

Section 894 states the provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.

Consequently, the determination of the applicability of United States income tax and withholding obligations, depends upon the application of the provisions of the Convention. The key question is whether the income from the Agreement is characterized as "industrial or commercial profits" under Article III, as "royalties" under Article VIII, or as neither and thus taxed under § 881. If the income from the Agreement is characterized as industrial or commercial profits governed by Article III or as royalties governed by Article VIII, there would be no income subject to United States tax because FC1 does not have a permanent establishment within the United States. If the income is neither industrial or commercial profits nor royalties under the Convention, then it is taxable under § 881 and subject to withholding under § 1442.

<u>Income from the non-compete agreement is not "industrial or commercial profits" under Article III of the Income Tax Treaty between Switzerland and the United States.</u>

Article III(1)(a) of the Treaty, entitled "Permanent Establishments", provides:

A Swiss enterprise shall not be subject to taxation by the United States in respect of its industrial and commercial profits unless it is engaged in a trade or business in the United States through a permanent establishment situated therein. If it is so engaged the United States may impose its tax on the entire income of such enterprise from sources within the United States.

Article II(h) of the Treaty, entitled "Treaty Terms Defined," provides:

As used in this Treaty the term "industrial or commercial profits" includes manufacturing, mercantile, mining, financial and insurance profits, but does not include income in the form of dividends, interest, rents or royalties, or remuneration for personal services: provided, however, that such excepted items of income shall, subject to the provisions of this Treaty, be taxed separately or together with industrial or commercial profits in accordance with the laws of the Contracting States.

The language of the Convention does not explicitly address income derived from non-compete agreements. Article II(h) provides a noninclusive list of types of profits that are "industrial and commercial" profits because they are derived from the active conduct of a business. By contrast, the essence of a non-compete agreement is an agreement to refrain from engaging in business. It follows that consideration for an agreement not to engage in an active business cannot be characterized as business profits.

This conclusion is supported by Korfund Co., Inc. v. Commissioner, 1 T.C. 1180 (1943). In Korfund, the Tax Court examined the source of income paid to a nonresident alien individual and a nonresident foreign corporation pursuant to a noncompetition agreement outside the treaty context. It focused in particular on the source issue because there would have been no basis under domestic law to tax the income if it was foreign source. However, in order to determine the source the court had to determine the character of the income. The Tax Court held that the source of income was in the United States and in the course of its opinion, characterized the income from noncompetition agreements as income from "*interests in property in this country*," and did not characterize the income as from the performance of business activity. 1 T.C. 1187 (emphasis added). By reasoning that the nonresident aliens "might have received amounts here for services or information, but were willing to forego that right and possibility for a limited period for consideration", id., the court in its analysis concludes that income received was not "for services." The court reasoned that:

[The nonresident foreign corporation] had the right to compete with petitioner in the United States and Canada and for that purpose to form a

> competitive company or to assist others in forming one. Likewise, [the nonresident alien individual] had the right to serve other corporations or individuals in the United States engaged in a business similar to petitioner's as a consultant and to furnish them information of value to their business. They were willing to and did give up rights in this country for a limited time for a consideration payable in the United States.... The Circuit Court in [Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938)] calls the exclusive right to publish an interest in property in the United States; so here, in our opinion, *the rights of [the nonresident aliens] were interests in property in this country*. They might have received amounts here for services or information, but were willing to forego that right and possibility for a limited period for consideration. What they received was in lieu of what they might have received. The situs of the right was in the United States, not elsewhere, and the income that flowed from the privileges was necessarily earned and produced here.... These rights were property of value and the income in question was derived from the use thereof in the United States.

Id. (emphasis added).

The court's conclusion that the noncompetition income is from "interests in property in this country," runs counter to Taxpayer's assertion that the income is from the conduct of business activity.[1] Consequently, since income from a non-compete agreement does not derive from an actual income producing activity, but rather from inaction or forbearance of income producing activity, which is a property right of value, such income is not industrial or commercial profits within the meaning of Article III of the Convention.

Income from the non-compete agreement is not a royalty under Article VIII of the Income Tax Treaty between Switzerland and the United States.

Article VIII of the Convention, entitled "Royalties," provides:

> Royalties and other amounts derived, as consideration for the right to use copyrights, artistic and scientific works, patents, designs, plans, secret processes and formulae, trademarks, and other like property and rights (including rentals and like payments in respect of motion picture films or

[1]Taxpayer cites LTR 84-01-041 (Oct. 4, 1983). However, the letter ruling was issued to a different taxpayer and does not constitute precedent. Section 6110(j)(3); Estate of Jalkut v. Commissioner, 96 T.C. 675, 684 (1991); Beck v. Commissioner, T.C. Memo. 1994-122; Barnes v. Commissioner, T.C. Memo. 1994-95.

> for the use of industrial, commercial or scientific equipment), from sources within one of the contracting States by a resident or corporation or other entity of the other contracting State not having a permanent establishment in the former State shall be exempt from taxation in such former State.

The Letter of Submittal from the Department of State to the President, dated June 13, 1951 on the convention between the United States and Switzerland for the avoidance of double taxation with respect to income taxes, (Letter) further elaborates on Article VIII of the Convention. The Letter's discussion of Article VIII provides, in part,

> Articles VI, VII, and VIII deal with moveable capital items, such as dividends, interest, and *certain types of royalties*. (emphasis added)

Income from non-compete agreements is not explicitly mentioned in the definition of royalties. However, all of the examples constitute income from the use or disposition of intellectual property. In addition, the Letter contemplates that not all types of royalties are included in the definition in Article VIII. After the list of examples, the treaty language provides that royalty income includes payments from "other like property or rights." Under the doctrine of ejusdem generis, where general words follow specific words, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words.[2] Since the examples only include royalties from the use of intellectual property, under application of the doctrine of ejusdem generis, "other like property or rights" should not include payments for rights that are not similar in nature, such as from non-compete agreements, which involve inaction or forbearance of income producing activity.

Since income from the Agreement is not industrial or commercial profits within the meaning of Article III, and is not a royalty payment under Article VIII, it is taxable under § 881 and subject to withholding under § 1442.

As described above, the Tax Court in Korfund has held that income from non-compete agreements in which parties agree to forebear from competition in the United States are from sources within the United States. Under the Agreement, FC1 agreed to refrain from competition with Taxpayer within North America. Therefore under the rationale of Korfund, the portion of the payment that is attributable to FC1's forbearance from competition in the United States will be from sources within the United States. We express no opinion regarding the allocation of the payment to forbearance by FC from competition with Taxpayer within the United States. To the extent any portion of the

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[2] SUTHERLAND STAT CONST § 4717 (5th ed. 1992).

payment is allocable to portions of North America outside the United States, such portion of the payment would be foreign source.

In this case, the amount paid pursuant to the non-compete agreement was fixed at $x, and falls within the definition of fixed or determinable annual or periodical payments. Accordingly, since the source of at least some of the income is the United States, petitioner had an obligation to withhold on at least a portion of the payment to FC1 pursuant to the Agreement.

CONCLUSION

As set forth above, the payment made under the Non-compete Agreement is a fixed and determinable annual or periodical payment not covered by the Convention, and is taxable by the United States at least in part since the source of at least a portion of the income is from within the United States. Accordingly, since the source of at least a portion of the income is the United States, petitioner had an obligation to withhold at a 30 percent rate on the portion of the payment which reflects the portion of the non-compete agreement attributable to the United States.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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