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Memorandum

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subject: Depositary Receipts Programs

This memorandum responds to your request for generic legal advice. This advice may not be used or cited as precedent.

ISSUES[1]

1. What is the character and source of payments by a domestic depositary institution made on behalf of a foreign corporation in consideration for a grant of the exclusive right to offer American Depositary Receipts, and are those payments subject to withholding under section 1442 of the Internal Revenue Code?[2]

2. Are the payments made on behalf of the foreign corporation treated as “royalties,” ”business profits,” or “other income” under U.S. income tax treaties?

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[1] This memorandum does not readdress the issue of whether the form of payment, reimbursement of another’s expenses, would disqualify the payments from constituting gross income under Code section 61, and related issues. It is well established that the payment of expenses of a taxpayer by another is includible in the taxpayer’s gross income. See, e.g., Old Colony Trust v. Comm’r, 279 U.S. 716 (1929) (payment of employee’s income taxes by the employer made in consideration of employee’s services constituted additional taxable income of employee).

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

CONCLUSIONS

1. Payments made in consideration for a grant of the exclusive right to offer American Depositary Receipts represent compensation to the foreign corporation for its transfer of an interest in property in the United States, are sourced within the United States, and accordingly, are subject to 30 percent withholding under section 1442, unless the applicable rate of withholding is reduced under a U.S. income tax treaty.

2. The payments to the foreign corporation are treated as “other income” – not “royalties” or “business profits” – under U.S. and OECD model income tax treaties.

FACTS

Description of American Depositary Receipt Programs

Corporations (Issuers) use Depositary Receipts programs to make their stock more accessible to investors in foreign markets. Depositary Receipts programs that make stock of foreign Issuers available in U.S. markets are known as "American Depositary Receipt" (ADR) programs.

In an ADR program, an Issuer's stock is placed with, and maintained and controlled by, a Depositary Institution (DI), which is a U.S. financial institution. The DI then offers interests in the Issuer's stock in the form of ADRs to investors in the U.S. market. ADRs are priced in U.S. dollars, and the DI makes dividend equivalent payments in U.S. dollars to the investors based on dividends paid in foreign currency by the Issuer to the DI. U.S. investors can also trade ADRs on U.S. stock exchanges and over-the-counter (OTC) markets. ADRs help to meet the needs of American investors that want to invest easily in foreign companies, without the inconveniences of cross-border or cross-currency transactions.

An ADR program may exist in two forms: sponsored and unsponsored, both of which are subject, in varying degrees, to Securities and Exchange Commission (SEC) oversight. In an unsponsored ADR program, the Issuer does not agree to use an exclusive DI; any DI can acquire the Issuer’s stock and offer ADRs to U.S. investors. In a sponsored ADR program, the Issuer enters into an agreement providing that a specific bank will be its exclusive DI for a period of time. This memorandum pertains solely to payments by a domestic DI on behalf of an Issuer made in consideration for a grant of the right to be the exclusive DI.

Holders of sponsored ADRs (investors) generally have all the rights of other stockholders, including the right to receive reports, vote their shares, and receive dividends. If an investor relinquishes its ADR, the ADR is deemed "cancelled." The cancelled ADR is returned to the DI, which then either returns the stock to the Issuer or sells it to another investor.

A DI receives compensation from multiple sources. Investors are charged for various services in administering the ADR program, including fees charged for issuing the ADRs, dividend fees, fees passed on from corporate actions, and cancellation fees. A DI also incurs its own expenses with third parties for issuing the ADRs, including listing and SEC fees, legal and accounting fees, marketing fees, and proxy and reporting fees. These fees are generally passed on to the investors in the form of investor fees.

Payment Arrangements

The Issuer incurs expenses to institute an ADR program. As an inducement to grant an exclusive arrangement for a sponsored ADR program, it is common for a DI to offer to pay a portion of the expenses the Issuer will incur in setting up the program.[3] The terms of this arrangement are set forth in a contract between the DI and the Issuer. The contract also describes the ADR program, the role of the DI, and the fees that the DI will charge the investors.

The expenses of the Issuer typically paid by the DI under these arrangements include legal fees, accounting fees, SEC registration costs, marketing expenses, expenses for participating in investor conventions, costs for acquiring and maintaining electronic communications systems, exchange and listing fees, filing fees, underwriting fees, mailing and printing costs in connection with sending out financial reports, annual reports, proxy mailings, and other administrative costs.

Normally, the Issuer must seek payments from the DI within a specified time. Payments are usually made after the Issuer presents acceptable documentation substantiating payment by the Issuer of ADR program-related fees or expenses. If the Issuer does not incur or does not timely submit its proof of expenditures, the Issuer will not receive any payments from the DI. The DI may make payments on behalf of the Issuer to third party vendors (usually to exchanges, law firms, investment banks and investor relations firms), or it may make payments directly to the Issuer.

The expenses of the Issuer that the DI agrees to pay are typically subject to a cap, either a fixed dollar amount or an amount calculated by reference to the size of the ADR program. Also, the expenses must be of the kind that the Issuer would not have incurred but for the ADR program. The Issuer's operating costs, such as salary or overhead expenses, are not paid by the DI.

APPLICABLE LAW AND ANALYSIS

Section 881 imposes a 30 percent tax on the gross amount of U.S. source fixed or determinable, annual or periodical (FDAP) income derived by a foreign corporation that

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[3] In addition, a DI normally charges fees to the Issuer for setting up and administering the ADR program. In some instances, the DI will waive some of those fees as an inducement for an exclusive (sponsored) arrangement. However, the tax treatment of these waivers is not discussed in this memorandum.

is not effectively connected with the conduct by that corporation of a U.S. trade or business. Sections 1441 and 1442 require any person making a payment of FDAP, to the extent that such item constitutes gross income from sources within the United States, to a nonresident alien or a foreign corporation to withhold from the payment a tax equal to 30 percent, unless such withholding rate is reduced pursuant to a provision of the Code or a treaty or the income is effectively connected with a U.S. trade or business. Payments of FDAP include all amounts included in gross income under section 61 other than gains from the sale of property. See Treas. Reg. § 1.1441-2(b).

Section 861(a)(4) treats as income from sources within the United States rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. See also Treas. Reg. § 1.861-5 ("The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States").

The section 1442 withholding requirements, which are subject to modification under certain income tax treaties, rely in part on the character and source of payments made to foreign corporations. Accordingly, this memorandum addresses the character and source of the payments made by a DI to an Issuer under the Code and relevant case law, then addresses the potential applicability of income tax treaties to those payments.

ISSUE 1: Character and Source of ADR Program Payments for Purposes of Section 1442

The analysis of the character of particular ADR program payments will depend on all the relevant facts and circumstances. The ADR Program payments in question represent consideration for the transfer from the Issuer to the DI of exclusive rights to institute a sponsored program covering the Issuer's stock. The ADR program payments are an inducement for the Issuer to enter into a sponsored ADR program with the DI. Specifically, the DI agrees to pay the Issuer's ADR program expenses to obtain the exclusive right to be the sole distributor of ADRs with respect to stock in the Issuer. The payments therefore are consideration for the assurance of exclusive distribution rights, and the right to be able to exploit those exclusive rights, inter alia, to generate fees from the investors as a result of corporate actions. The DIs do not make ADR program payments to Issuers in unsponsored programs. In a sponsored ADR program, the DI obtains from the Issuer, for a period of time, the right to profit from the distribution of shares in the Issuer in the U.S. market without competition from other DIs.

These exclusive ADR program rights constitute an interest in property in the United States for purposes of the taxation of foreign persons conveying those rights. In Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938), the taxpayer was a nonresident alien author who was not present in the United States before or during the years in

issue. Mr. Sabatini entered into a number of contracts with a U.S. publisher under which he granted to that company the right to publish certain books, some of which were not subject to copyright (i.e., the works were in the public domain). As to those, the taxpayer agreed to exclusively authorize the publisher to publish the books in the United States so long as the publisher left in print its editions of the books. The taxpayer was to receive under the contracts amounts determinable from the number of volumes sold. In holding that the author's income was from sources within the United States, the Second Circuit said:

> Though we are not fully advised as to what copyrights were actually secured, in so far as any which might have been obtained were not, receipts by the author nevertheless fall within the statute as rentals or royalties for the use of or the privilege of using other like property. In this last named category fall also the payments received by the author from his contracts covering the publication of his uncopyrightable works. The payments were received in consideration of his granting the publisher the exclusive right to publish [in the United States]. To be sure, that may not have been of great value but the parties did value it and the author received the payments as agreed. We are not now concerned with the quality of the consideration he gave but only with the taxability of that which he received. The payments were made to him for foregoing his right to authorize others for a time to publish the works here. Though others may, perhaps, lawfully have published them they could not do so under his express authority. *The rights he granted were an interest in property in the United States*, in the one instance the statutory copyrights obtainable and in the other the exclusive right to publish with his permission.

98 F.2d at 755 (emphasis added).

Similarly, the payments here were an inducement for the Issuer to enter into a sponsored ADR program with the DI, namely one which conveyed exclusive ADR program rights to the DI. Absent this agreement, the Issuer could have conveyed rights to a different DI. Thus, here, as in Sabatini, the foreign Issuer is foregoing its right to authorize another, for a time, to perform certain activities in the United States. The payments made in consideration for a grant of the exclusive right to offer American Depositary Receipts represent compensation to the foreign corporation for its transfer of an interest in property in the United States, and therefore constitute FDAP from sources within the United States. See § 861(a)(4); Sabatini, 98 F.2d at 755 (holding that conveyance of exclusive authorization to publish works that could not be copyrighted constituted royalty income from sources within the United States). These payments are subject to 30 percent withholding under section 1442, unless the applicable rate of withholding is reduced under a U.S. income tax treaty, or unless the withholding agent receives valid documentation with respect to the payments establishing that the income is being taken into account as effectively connected with a trade or business in the United States. See Treas. Reg. §§ 1.1441-4(a) and 1.1441-1(b)(2)(vii).

ISSUE 2: Characterization of ADR Program Payments under U.S. Income Tax Treaties

The 30 percent withholding tax required under section 1442 may be reduced by a U.S. income tax treaty if the Issuer is entitled to the benefits of such treaty. The "other income" article of a treaty will apply if no other article of the treaty describes the type of income received by the Issuer in connection with the establishment of a sponsored ADR program. While the specific provisions and explanations of an applicable treaty must be consulted before drawing conclusions under a particular treaty, this memorandum discusses in general the treatment of the payments in question by reference to the United States Model Income Tax Convention of November 15, 2006 (US Model) and the OECD Model Tax Convention on Income and on Capital (July 2010) (OECD Model).

ADR Program Payments are not "Royalties" within the meaning of the OECD and US Models

The definition of royalties in the US Model generally follows the definition of "royalties" in the OECD model. The OECD Model defines "royalties" as

> payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

OECD Model art. 12, ¶ 2; accord, US Model art. 12, ¶ 2. As a term explicitly defined within the model treaties, "royalties" generally will not be interpreted by reference to domestic law. See art. 3, ¶ 2 of both the OECD and US Models (General Definitions); see also Technical Explanation to the US Model art. 12, ¶ 2 ("[t]he term royalties is defined in the Convention and therefore is generally independent of domestic law"). Thus, the definitions of "royalties" under the US and OECD Models, being (as described) restricted to payments for intellectual property, cover a narrower range of transactions than those covered by section 861(a)(4), which covers payments from any interest in property located in the United States, including for example, rentals of tangible property in addition to payments for the use of intellectual property described in the model treaties. See ¶ 8 of the OECD Commentary on OECD Model art. 12 (the "royalties" definition "relate[s], in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience").

Payments by a DI made on behalf of a foreign corporation in consideration for a grant of the exclusive right to offer ADRs, despite being payments for transactions in property rights, are not "royalties" within the meaning of the OECD and US Models. As described above, this is because the property right transferred, essentially the forbearance by the Issuer to authorize a different DI to issue its ADRs, is not described

by any of the terms contained in the model treaties. The terms contained in the royalties articles of the OECD and US Models only include "rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience."[4]

ADR Program Payments do not give rise to "business profits" within the meaning of the OECD and US Models

Like the royalties articles, the ADR program payments similarly do not fit within the scope of "business profits" articles of the OECD and US Models. While neither "business" nor "profits" is fully defined in the model treaties, "profits" is intended to be read broadly to include "all income from carrying on an enterprise." ¶ 71 of the OECD Commentary on OECD Model art. 7. Under the model treaties, "business" is defined to the extent that it must include "the performance of professional services and of other activities of an independent character." US Model art. 3, ¶ 1.e; OECD Model art. 3, ¶ 1.h. Otherwise, "business" is intended to have the meaning it would have for local law. US Model art. 3, ¶ 2; OECD Model art. 3, ¶ 2.

The ADR program payments received by the Issuer do not arise out of, nor support, the conduct of the Issuer's business, whatever that may be. Instead, the payments relate to the establishment of an ADR program that permits U.S. investors to own an interest in securities of foreign issuers by holding ADRs traded in the United States in substantially the same manner as the equity securities of domestic issuers. ADR programs provide the Issuer with increased access to U.S. capital markets, and are an activity engaged in by the Issuer to offer maximum flexibility to its potential and actual investors. Neither issuing stock, nor contracting with DIs to conduct ADR programs is by itself a business. Rather, as discussed in preceding sections, the transaction consists of a transfer by the Issuer to the DI of an interest in property in the United States, i.e., the exclusive right for a time to offer American Depository Receipts with respect to the Issuer's stock. Therefore the ADR program payment income is not properly classified as "business profits" of the issuer under the model treaties.

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[4] Several U.S. income tax treaties include the phrase "other like right or property" in the definition of royalties. Absent some further indication with regard to a particular treaty however, notwithstanding the inclusion of this language, under application of the doctrine of ejusdem generis, the payments in question should not be considered royalties because the payments are still not for intellectual property. Under the doctrine, where general words follow specific words, the general words are construed to embrace only objects similar in nature to those objects described by the preceding specific words. See 2A Sutherland Stat Const § 47:17 (7th ed. 2007). Further, at least one treaty includes "franchise rights" in the list of items that generate royalty payments. While the sponsored ADR programs might appear similar to a franchise arrangement, ADR programs do not involve the distribution of any product or the performance of any service of the Issuer.

ADR Program Payments are "Other Income" within the meaning of the OECD and US Models

Both the US Model and OECD Model contain "Other Income" articles that allocate taxing rights between treaty countries with respect to payments not mentioned in any other article of the treaty. In both Models, only the country of residence may tax income that falls within the scope of this article. Considering the nature of the ADR program payments, as described above these amounts are not described in any other article, and thus would fall within the "Other Income" article of the model treaties.

By consequence, assuming the Issuer is a resident under a specific tax treaty and satisfies the "Limitation on Benefits" article of the US Model, the Other Income article would eliminate the U.S. withholding tax on the ADR program payments. Under typical facts, Issuers would satisfy the US Model limitation on benefits because publicly traded companies are permitted to claim treaty benefits in the country where they are listed. However, the other income article and limitation on benefits article of each applicable treaty should be consulted.[5]

[5] For instance, specific treaties may recognize certain stock exchanges and not others. In addition, several U.S. tax treaties have Other Income articles that would allow either concurrent or solely source based taxation of the other income (e.g., sometimes described as an exception for "income aris[ing] in the Other Contracting State"). Under these treaties, the United States is entitled to withhold absent a separate mutual agreement between the countries limiting such withholding.