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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: February 10, 2000

MEMORANDUM FOR MARGARET C. TINAGERO
ASSOCIATE DISTRICT COUNSEL
LOS ANGELES DISTRICT, THOUSAND OAKS
CC:WR:LAD:THO
Attention: Leslie B. Van Der Wal, Attorney

FROM: Elizabeth G. Beck
Senior Technical Reviewer, CC:INTL:6

SUBJECT:

This Field Service Advice responds to your memorandum dated August 11, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Corp A =

Corp A-FSC =

Country A =

Date 1 =

Tax Year 1 =
Tax Year 2 =
Tax Year 3 =

ISSUE

Whether intangible rights in film characters developed by Corp A are export property within the meaning of I.R.C. § 927(a)(1).

CONCLUSION

Rights in film characters developed by Corp A are not export property within the meaning of I.R.C. § 927(a)(1) because they are subject to one or both of the major express exclusions under section 927(a)(2). First, section 927(a)(2)(B) excludes all trademark rights and those copyright rights that are not in films, tapes, records or similar reproductions. The copyright rights in film characters do not fall within any of these categories. Specifically, they are distinct and separate from the copyrights in the films in which the characters appear and are not "reproductions." Second, even if copyrights in characters were to be treated as copyrights in films, then section 927(a)(2)(A) and the regulations thereunder would exclude copyrights licensed to Corp A's related licensees that sell the resulting merchandise directly to the public. This exclusion would not, however, apply where the merchandise is ultimately sold to the public by an unrelated third person.

FACTS

The taxpayer, Corp A, is a U.S. corporation. Corp A-FSC is organized under the laws of Country A and is owned by Corp A and several of its affiliates. For all tax years at issue, Corp A-FSC had in place a valid election to be treated as a foreign sales corporation (FSC) pursuant to sections 922(a)(2) and 927(f)(1) and in all other respects continuously maintained its status as a FSC as defined in section 922(a). Pursuant to a Commission Agreement dated Date 1, Corp A-FSC provides certain services to Corp A with respect to Corp A's export sales, and Corp A pays Corp A-FSC a commission not to exceed the maximum amount permitted under the transfer pricing provisions of section 925. Pursuant to a Service Agreement also dated Date 1, Corp A-FSC retains Corp A to perform its service obligation under the Commission Agreement, for which Corp A-FSC pays to Corp A an annual fee determined under section 482 principles.

Corp A is engaged in the business of motion picture film production. Certain characters originating and appearing in Corp A's films have become well-known to the public and widely associated with Corp A. Corp A has licensed certain rights to use the film characters to several foreign corporations within the same "controlled group of corporations" (as defined under section 927(d)(4)) as Corp A and Corp A-FSC. Under the governing licensing agreements, the licensees are granted the right to use the characters in promotion, merchandising and advertising activities as

well as in production of various kinds of products within a defined geographical territory abroad. The licensing agreements state that the term "characters" includes "characters and personalities, designs, figures, and the names thereof." The licensing agreements reserve to Corp A the ownership of all copyrights, trademarks, patents and other rights in the characters, and the licensees agree to register copyrights, trademarks, patents, and any other type of protection that Corp A reasonably considers necessary to protect Corp A's rights and interests in the characters.

In its original income tax returns filed for Tax Years 1, 2 and 3, Corp A did not claim deductions for commissions payable to Corp A-FSC with respect to character licensing income. However, pursuant to Temp. Treas. Reg. § 1.925(a)-1T(e)(4), Corp A now claims a refund of income tax based on a redetermination of its commissions payable to Corp A-FSC for these taxable years. Corp A maintains that commissions on character licensing income are properly entitled to FSC benefits because its rights in the characters constitute export property within the meaning of section 927(a)(1) and are excepted from the exclusion of copyright rights from the definition of export property under section 927(a)(2)(B). Specifically, Corp A maintains that its copyright rights in characters are in the nature of copyright rights in the films in which the characters appear, or are "similar reproductions," and so are described by the parenthetical in section 927(a)(2)(B), under which copyrights in "films" and "similar reproductions" are not excluded from the definition of export property.

LAW AND ANALYSIS

The partial exemption of foreign trade income under the FSC provisions applies only to "foreign trading gross receipts," which generally are restricted to receipts from sales, leases or licenses of "export property." I.R.C. §§ 921(a), 923, 924(a); Temp. Treas. Reg. § 1.924(a)-1T(a)(2). Section 927(a)(1) generally defines the term "export property" to mean property that is manufactured or produced in the United States, held primarily for sale or lease in the ordinary course of trade or business by a FSC or its related supplier for direct use, consumption or disposition outside the United States, and not more than 50% of the fair market value of which is attributable to articles imported into the United States.

Section 927(a)(2) sets forth several categories of property that are expressly excluded from the general definition of export property. Two of these exclusions, the "intangibles" and the "related-lessee" exclusions, are relevant in this case.

I. The "intangibles" exclusion

Section 927(a)(2)(B) as in effect for the tax years at issue excludes from export-property status:

> patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property,... [Emphasis added]

Section 1.927(a)-1T(f)(3) of the Temporary Treasury Regulations provides:

> Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied.... A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property.

Corp A maintains that its rights in the licensed characters are not excluded from export-property status because they are in the nature of copyrights in the films in which the characters have appeared, or constitute "similar reproductions," within the meaning of the parenthetical clause in the Code and regulations that carves enumerated types of copyrights out of the list of excluded intangibles (the "parenthetical"). For the following reasons, we disagree.

A. At least some of the licensed intangible rights in the characters are not copyrights at all but rather trademark rights, which are plainly excluded as export property without exceptions.

Corp A has acknowledged that it "registers character names and designs for trademark purposes because there is no name protection under copyright law." As summarized above, the licensing agreements expressly grant licensees the right to use the character names and designs while reserving ownership of these trademark rights to Corp A and obligating licensees to register trademarks or other intellectual property rights that may be necessary in foreign jurisdictions to protect Corp A's

interests. Indeed, the reported case law reveals that the regular industry practice for film production companies is to enforce trademark rights in film characters together with the copyrights in those characters.[1] See, e.g., Dr. Seuss Enterprises, L.P. v. Penguin Books USA, Inc.,109 F.3d 1394 (9th Cir. 1997); Silverman v. CBS Inc., 870 F.2d 40 (2d Cir. 1989); Warner Bros. Inc. v. American Broadcasting Companies, Inc., 720 F.2d 231 (2d Cir. 1983); Lyons Partnership, L.P. v. AAA Entertainment Inc., 1999 U.S. Dist. Lexis 18996 (S.D.N.Y. 1999); Williams v. Columbia Broadcasting Systems, Inc., 57 F. Supp.2d 961 (C.D. Cal. 1999); Scholastic Inc. v. Speirs, 28 F. Supp.2d 862 (S.D.N.Y. 1998); Danjac, LLC v. Sony Corp., 1998 U.S. Dist. Lexis 22231 (C.D. Cal. 1998); The Walt Disney Company v. DeFabiis, 168 F.R.D. 281 (C.D. Cal. 1996); Time Warner Entertainment Company, L.P. v. Jane Does, 876 F. Supp. 407 (E.D.N.Y. 1994); New Line Cinema Corp. v. Easter Unlimited, Inc., 1989 U.S. Dist. Lexis 17340 (E.D.N.Y. 1989); The Walt Disney Company v. Powell, 698 F. Supp. 10 (D.D.C. 1988), aff'd in part and vacated in part, 897 F.2d 565 (D.C. Cir. 1990); Walt Disney Productions v. Filmation Associates, 628 F. Supp. 871 (C.D. Cal. 1986).

Thus, even if the copyrights at issue are treated as being in films qualifying as export property, the portion of the licensing income attributable to trademarks, as distinct from copyrights, should be treated as received from a license of an intangible that does not constitute export property. We recommend further factual development to determine how much of the licensing income is attributable to the value of trademark rights and how much to copyrights.

B. The licensed copyrights in the characters do not fall within any of the categories in the parenthetical.

1. As a matter of plain language and common sense, the licensed character rights are not properly classified in the "films" or the "similar reproductions" category of the parenthetical.

A copyright in either a "film" or a "similar reproduction" is restored to export-property status under the parenthetical in section 927(a)(2)(B). Neither of these terms, nor the term "character," is defined for any special purpose of Federal tax law in the Code or Treasury Regulations. Accordingly, we must presume that Congress used these words in their ordinary sense, and the rules of statutory construction require us to give these words the meanings commonly attributable to them. Greyhound Corp. v. United States, 495 F.2d 863, 869 (9th Cir. 1974); CWT Farms, Inc. v. Commissioner, 79 T.C. 86, 93 (1982).

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First, a character is not a film. In no dictionary or thesaurus that we are aware of is "character" listed as a synonym for "film." Webster's Third New International Dictionary (1986) defines "film," in pertinent part, as a "motion picture," which in turn is defined as "a representation of a story or other subject matter by means of [technology described]." By contrast, "character" is defined, in pertinent part, as a "personality as represented or realized in fiction or drama" or "a given representation or realization of this kind" or "the personality or part which an actor recreates."

To be sure, a particular character may bear some relationship to a particular film. Thus, for example, a character may appear or be portrayed or depicted in a film. In such a case, the character in some sense is an element of the work that is the film, but it is only one of many such elements. The parenthetical unambiguously applies to the film in toto. Conversely, the personality or the unique bundle of traits constituting the character is not necessarily confined to the bounds of a particular film in which the character appears, as amply demonstrated by the non-film uses of its characters in which the taxpayer itself engages and with respect to which the taxpayer routinely grants the very licenses at issue. The character is thus both narrower and broader than the film. Accordingly, although a relationship may be perceived between a character and a film, the fact remains that on the most basic level of semantics and common sense, they are not equivalent but are very distinct things.

Similarly, a character is not a "reproduction," much less a "similar reproduction." Webster's Third New International Dictionary (1986) defines "reproduction," in pertinent part, as "something reproduced ... as ... a representation in another form or medium" or a "copy, likeness, counterpart, [or] reconstruction." Since films and characters are intrinsically distinct in kind, a character cannot be a "reproduction" of a film within any generally accepted meaning of the word.

Corp A maintains that its characters are "similar reproductions" with respect to its films because one of the rights of a copyright owner is the right to reproduce the work and authorize others to do the same. Corp A argues that "the taking of an entire motion picture or any or all copyrightable elements within a motion picture, including a film character, is considered a 'reproduction' of the motion picture film." We believe that in focusing on the "taking" of the film by the licensee, the taxpayer fundamentally distorts the plain meaning of the parenthetical. The term "reproduction," like the terms "film," "tape" and "record," is used in the parenthetical to refer to the copyrighted work in the hands of the licensor, who owns the intangible property the status of which as export property is at issue. These

enumerated terms in the parenthetical do not refer to what is subsequently produced by the licensee.

The term "similar reproduction" simply recognizes that the parenthetical is to apply to copyrightable motion picture or sound content owned by the licensor even if the licensor has reproduced such content in a format other than a traditional film, tape or record. Modern examples of such "similar reproductions" using alternative media may include digital versatile disks (DVDs), laser disks and compact disks (CDs). If the licensor licenses a right, for example a trademark (or, in our view, a character copyright), not constituting export property, then licensing income from any product of the licensees, whether or not the product is similar to a film, tape or record, will not be entitled to FSC benefits.

Accordingly, a character may not be restored to export-property status by describing it as a "film" or as a "reproduction" of a film within the meaning of the parenthetical.

2. As a matter of copyright law, it appears that characters are recognized as separate from the films in which they originated.

As Corp A points out, the Copyright Act itself contains only a broad mention of "motion pictures and other audiovisual works" and is silent on any narrower kind of property such as a character. 17 U.S.C. § 106. However, the case law is replete with references to the existence of a separate and independent copyright that may develop in a film character. See Warner Bros., Inc. v. Stephen J. Cannell Productions, 654 F.2d 204 (2d Cir. 1981) ("Plaintiffs are the owners of the copyrights and other rights in the character Superman and the works embodying him....") (emphasis added); Walt Disney Productions v. The Air Pirates, 581 F.2d 751 (2d Cir. 1978) (holding that independent copyrightability is clearer for cartoon characters than for literary characters); Nichols v. Universal Pictures Corp., 45 F.2d 119 (2d Cir. 1930), cert. denied, 282 U.S. 902 (1931) (characters may be protected "quite independently of the 'plot' proper"); Toho Co., Ltd. v. William Morrow & Co., Inc., 1998 U.S. Dist. Lexis 11920 (C.D. Cal. 1998) (holding Godzilla character "subject to copyright protection separate and apart from any film in which it appears"); Metro-Goldwyn-Mayer, Inc. v. American Honda Motor Co., Inc., 900 F. Supp. 1287 (C.D. Cal. 1995) ("Plaintiffs claim that the Honda commercial: (1) 'infringes Plaintiffs' copyrights in the James Bond films' ... ; and (2) 'independently infringes Plaintiffs' copyright in the James Bond character....'"; held that "James Bond is a copyrightable character"; court noted that "audiences do not watch Tarzan, Superman, Sherlock Holmes, or James Bond for the story, they watch these films to see their heroes at work. A James Bond film without James Bond is not a James Bond film"); New Line Cinema Corp. v. Easter Unlimited, Inc., 1989 U.S.

Dist. Lexis 17340 (E.D.N.Y. 1989) ("The appearance of Freddy ... gives copyright protection to the character of Freddy, independent of the films' copyright protection").

Corp A stresses that it relies upon its copyrights in films to enforce its rights in its characters. Similarly, in the cases cited above, the copyright holders generally were able to enforce a copyright in a film that also covered the character. It does not follow, however, that characters are not separately copyrightable, and in fact the cited opinions stated, albeit in dicta, that they are. Although the separateness of the characters in those cases was not critical to the courts' decisions, a leading copyright treatise offers an example where the distinction could have legal significance -- a work introducing a character followed by a series of other works featuring the character. It is suggested that "once the copyright in the first work that contained the character enters the public domain, then it is not copyright infringement for others to copy the character in works that are otherwise original with the copier, even though later works in the original series remain protected by copyright." Nimmer on Copyright, § 2.12 at 2-177-78.

Other than the provision of the Copyright Act discussed above, the only specific legal authority invoked by Corp A is the following statement found in the copyright registration regulations at 17 C.F.R. § 202.3(b)(2): "In cases where a work contains elements of authorship in which copyright is claimed which fall into two or more classes, the application should be submitted in the class most appropriate to the type of authorship that predominates in the work as a whole." From this language, the taxpayer apparently would have the Service determine that characters are subsumed in the film because film is the "most appropriate" registration class. In our view, this language is quoted out of context, and reliance on it, even by analogy, is misplaced. The referenced "classes" are the four broad registrable categories prescribed by paragraph (b)(1) of the regulation, one of which – "works of the performing arts" – includes all films and other audiovisual works. The cited regulation appears merely to simplify paperwork in a situation where, for example, an original painting, ordinarily belonging in the "visual arts" class, is depicted in a film; assuming the cinematic elements predominate, the copyright in the painting could be covered by the film's registration in the "performing arts" class. Accordingly, we believe this administrative language is not relevant to treatment of characters as films under copyright law.

Moreover, Corp A's own practices undermine its argument. At one time Corp A registered separate copyrights on individual poses of a character, later abandoning the practice in favor of reliance on the broader film copyright to protect such poses. It is not surprising that the taxpayer would choose to dispense with filing a large number of separate copyright registrations where there is a less

burdensome procedure. Nevertheless, the availability of separate registrations is inconsistent with a position that copyrights in a film character cannot be separately protected.

3. Separate treatment of characters and films for FSC purposes has a justification under the purpose of and policy underlying the FSC provisions, even if inconsistent with intellectual property law.

Even if it were found that characters are not separately copyrightable but are completely subsumed in the copyrights on their films of origin as a matter of copyright law, it would not follow that the same classification must or should be used for Federal income tax purposes. As noted above, it rarely matters for purposes of copyright law whether the copyright is in the film or in the character. By contrast, the Federal tax law in general, and the FSC provisions in particular, concern themselves with precise characterizations of transactions because such distinctions make a difference in taxation. We must look to the legislative purpose underlying the particular provision at issue. Albertson's, Inc. v. Commissioner, 42 F.3d 537, 546 (9th Cir. 1994); Goldstein v. Commissioner, 364 F.2d 734, 741 (2d Cir. 1966).

Historically, the rules of section 927(a)(2)(B) trace their roots as far back as 1971, when they first appeared in substantially similar form under the corresponding rule (codified at section 993(c)(2)(B)) in the Domestic International Sales Corporation (DISC) regime. Neither the DISC nor the FSC legislative history, however, addresses the treatment of characters or their relationship to film copyrights. Nevertheless, based on the statutory framework, the regulations, and general principles of statutory construction, we find ample support for the separate treatment of characters and films.

The parenthetical in section 927(a)(2)(B) is limited, by its terms, to sound and motion picture content. Thus, for example, section 1.927(a)-1T(f)(3) of the Temporary Treasury Regulations distinguishes among book copyrights (not qualifying as export property) and a master recording tape (qualifying). For reasons similar to those negating equivalency between film and character on a plain-language level (see discussion at section I.B.1. above), characters intrinsically are not motion picture content, even if they originate in a film. Indeed, Corp A itself regularly exploits its characters in non-cinematic vehicles such as clothing, toys, books and magazines. Thus, in carrying out the purpose of the parenthetical, the Service should not treat characters as films.

By its terms, the exclusion under section 927(a)(2)(B) has the purpose of excluding intangibles generally as export property eligible for FSC benefits, while

the purpose of the parenthetical is to except from that exclusion specified copyrights. The FSC provisions in general, and the parenthetical in particular, confer an exemption from the usual taxability of income. As a matter of tax policy and statutory construction, the Supreme Court and Circuit Courts of Appeal have consistently held that such provisions must be narrowly construed. See United States v. Burke, 504 U.S. 229, 248 (1992) (Title VII back-pay award held not within scope of section 104 exclusion of damages for personal injury; "exclusions from income must be narrowly construed"); Commissioner v. Clark, 489 U.S. 726, 739 (1989) ("In construing provisions such as § 356, in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision"); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (rate exception for capital gain "has always been narrowly construed so as to protect the revenue against artful devices"); Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1956) ("Since [capital gain treatment] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied...."); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("[O]nly in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year"); Finley v. United States, 123 F.3d 1342, 1348 (10th Cir. 1997) ("[W]e must narrowly construe the 'reasonable cause' exception to § 6672 liability in order to ... further the basic purpose of § 6672 to protect government revenue"); Estate of Shelfer v. Commissioner, 86 F.3d 1045, 1050 (11th Cir. 1996) ("Because the terminable property rule is an exception to this general public policy, it should be narrowly construed"); Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990) (defamation damages held not within scope of section 104 exclusion of damages for personal injury; "it is a well-recognized, even venerable, principle that exclusions to income are to be narrowly construed"); Commissioner v. Baertschi, 412 F.2d 494, 499 (6th Cir. 1969) (deferral of gain on residence denied; "income tax provisions which exempt taxpayers under given circumstances from paying taxes (or as here, postponing them) are strictly construed"); Kentucky Utilities Co. v. Glenn, 394 F.2d 631, 637 (6th Cir. 1968) (dividend credit denied; "[i]t is standard tax law that income deductions and tax credits are narrowly construed. And the taxpayer has the burden of showing he comes within the provision relied upon"); Holt v. Commissioner, 364 F.2d 38, 40, 42 (8th Cir. 1966) (income of Native American lessee of tribal land not entitled to statutory exemption relating to fee interests; "exemptions from taxation are matters of legislative grace" while here there was "no treaty or statute expressly or impliedly exempting such income"); United States v. Foster, 324 F.2d 702, 706 (5th Cir.

1963) (“This treatment is an exception to the general rule of taxing all net income as ordinary income, and, as an exception, it should be narrowly construed”); O'Gilvie v. United States, 92-2 USTC ¶ 50,344 (D. Kan. 1992), mot. for recons. granted, 92-2 USTC ¶ 50,567, rev’d, 66 F.3d 1550 (10th Cir. 1995), aff’d, 519 U.S. 79 (1996) (punitive damages held not within scope of section 104 exclusion; “[i]t is a cardinal rule of taxation that exclusions to income are to be narrowly construed”).

The Tax Court has applied the doctrine of narrow construction of tax exemptions to issues under the DISC regime. See Napp Systems, Inc. v. Commissioner, T.C. Memo. 1993-196 ("[S]ince the regulation results in a tax deduction, we are ... required to construe it narrowly"). Applying the same principle to this case, the scope of “export property” (including the parenthetical) generating “foreign trading gross receipts” eligible for exemption from taxation should be narrowly construed.

Furthermore, recent statutory amendments to the depreciation rules are consistent with our approach of analyzing the particular statutory purpose in determining whether characters should be treated separately from the films in which they appear. Prior to 1996, the Service's position as stated in technical advice was to exclude character licensing income from the calculation of the income forecast method of depreciation with respect to films. See, e.g., Technical Advice Memorandum 7918012 (Jan. 24, 1979). In its consideration of the Small Business Job Protection Act of 1996, Congress perceived that combining character income with film income would better meet the method's theoretical objective of matching the capitalized costs related to a film with income produced by such costs. Income from exploitation of characters is generally earned later than the receipts from the showings of the film through which the character becomes recognizable and marketable. Thus, inclusion of character income in the “income forecast” to which depreciation deductions are to be matched tends to spread depreciation over the longer period corresponding to the full income-producing “life” of the film and the related character. For that reason, Congress enacted section 167(g)(5)(C), which specifically requires certain character licensing income to be included in the depreciation calculation. H.R. Rep. No. 586, 104th Cong., 2d Sess. 139-40 (1996).

Corp A suggests that this statutory change supports its position because the change reflects a considered Congressional conclusion that characters are an undifferentiated part of the film. To the contrary, if Congress had engaged in such broader issue analysis, one might have expected concurrent enactment, or at least consideration, of provisions broadening the film concept elsewhere in the Code, including section 927(a)(2)(B). In fact, none was enacted or considered. The legislative history rather demonstrates that the treatment of the depreciation issue was issue-specific -- as should be the treatment of characters

and films in applying the FSC provisions. In the FSC area, as noted above, we believe that the statutory framework points to separate and distinct treatment of characters and films.

4. Corp A's character rights did not all derive from films.

Even if it were found for FSC purposes that copyrights with respect to characters originating in films are not sui generis but rather must be subsumed within the copyrights in works from which the character rights derive, the facts suggest that the works of Corp A from which the licensed copyrights derive are not exclusively, or even predominantly, films. It appears that a significant incremental portion of the value of Corp A's characters was built not through the films in which the characters first appeared but through other content which, unlike film, is not described in the parenthetical. Long after the lucrative first runs of a film in which a character initially appears, Corp A continues to develop the character in a variety of non-film content such as clothing, books, magazines and toys. Copyrights in such items are not within any of the categories of sound or motion picture content in the parenthetical. We recommend further factual development to determine the extent to which Corp A has enhanced the value of the characters through copyrights in such non-qualifying content. The portion of the licensing income traceable to such non-qualifying copyrights should be denied FSC benefits because that portion of the copyrights is not export property.

In summary, since Corp A's rights in its film characters are either trademarks or types of copyrights not described in the parenthetical, the character rights are excluded from status as export property under section 927(a)(2)(B).

II. The "related-lessee" exclusion

Section 927(a)(2)(A) excludes as export property any "property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member." For purposes of determining foreign trading gross receipts, and therefore for purposes of identifying export property, a license is treated as a lease. Temp. Treas. Reg. § 1.924(a)-1T(a)(2).

Like the intangibles exclusion, the related-lessee exclusion was originally enacted as part of the DISC regime. See I.R.C. § 993(c)(1)(A). Its purpose was to prevent a leasing transaction from effectively converting income from production of property outside the United States, which ordinarily would not be entitled to DISC benefits, into DISC-benefitted leasing income, while preserving DISC benefits in cases where the only operational income of the taxpayer and related entities with respect to the property was from leasing. S. Rep. No. 437, 92d Cong., 1st Sess.

102 (1971), reprinted in 1972-1 C.B. 559, 616; H.R. Rep. No. 533, 92d Cong., 1st Sess. 69 (1971), reprinted in 1972-1 C.B. 498, 535.

> The Senate Report sets forth the following example:
>
> Thus, if a DISC leases a movie film to a foreign corporation which is a member of the same group of controlled corporations and that foreign corporation then leases the film to persons not members of that group for showing to the general public, the film is not to be considered non-export property by reason of the lease from the DISC to the foreign corporation. However, if the persons showing the film to the general public are members of the same group of controlled corporations as the DISC, the film is not to be considered export property.

S. Rep. No. 437, 92d Cong., 1st Sess. 102 (1971), reprinted in 1972-1 C.B. 559, 616. The DISC regulations adopted this example from the legislative history to illustrate the principle that in applying the statutory rule, if property is leased to a person within the same controlled group (a term defined in section 927(d)(4)), it will constitute export property only if the lessee holds it for sublease or subleases it to a third person outside the controlled group for the ultimate use of such unrelated third person outside the United States. Treas. Reg. § 1.993-3(f)(2). This rule and the example were carried forward into the FSC regulations as Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(i).

Section 1.927(a)-1T(f)(2)(iv) sets forth an example (also having a substantially identical DISC predecessor, at section 1.993-3(f)(2)(iv)) specifically addressing the application of the related-lessee exclusion to copyrights, such as those in records and films, that are not excluded under the “intangibles” exclusion because they are within the parenthetical under sections 927(a)(2)(A) and 1.927(a)-1T(f)(3):

> [T]he ultimate use of the property is the sale or exhibition of the property to the general public. Thus, if A, a FSC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this paragraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records *(i.e.*, property produced from the recording tape).

Thus, under this exclusion, if a film copyright is licensed to a related licensee, its status as export property depends upon the subsequent activities and functions of the licensee. If the licensee itself engages in the ultimate use of the fruits of the copyright by sales or exhibition of the film directly to the general public, the copyright is not export property. If, however, the licensee only sublicences the copyright to an unrelated person for sales or exhibition to the public, it is not excluded from export-property status.

In this case, the licensees under the licensing agreements are within the same controlled group as Corp A within the meaning of section 927(d)(4). Therefore, if it were found that the licensed character rights may not be treated separately from copyrights in films or are copyrights in "similar reproductions," the "related-lessee" exclusion would still deny export-property status to such rights to the extent that Corp A's related licensees sell the resulting merchandise directly to the public at retail. We recommend further factual development to determine how much of the claimed licensing income is from licensees so situated as distinct from licensees who sublicense the copyright to unrelated retailers.

Accordingly, we conclude that copyright rights in film characters are not export property within the meaning of section 927(a)(1), and the income from licensing such characters is not foreign trading gross receipts within the meaning of section 924(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

If this case is litigated, a court may find that characters are equivalent to films for copyright-law purposes and that the tax law must be interpreted consistently. As indicated above, there is no DISC or FSC legislative history on this issue, and the helpful language from copyright cases is all dictum. This places a premium on developing each of the other positions we have noted, viz.:

1. The trademark component of this bundle of rights should be quantified and disallowed, thus reducing the copyright component, which is an area of some legal uncertainty. [redacted]

2. An expert may also find that a very significant portion of the character-licensing income is economically attributable to non-qualifying copyrights in toys, clothing and books, rather than film copyrights. This theory should be developed for use in the event that film characters are found not to carry their own separate and distinct copyright.

3. Although we believe that the Service is not bound to follow intellectual-property-law characterizations, we also believe, based on our cursory research noted above, that there is a viable position to be taken under copyright law with respect to the separate copyrightability of characters. [redacted]

4. The "related-lessee" exclusion under 927(a)(2)(A) could, depending on the amount of direct retailing activity, prove as important as the character-vs.-film issue, and subject to less legal uncertainty. As stated above, we recommend further factual development in this area.

Please call if you have any further questions (202-874-1490).

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