Taxation of International Computer Software Transactions under Regulation 1.861-18

Jonathan Purcell

Follow this and additional works at: https://repository.uchastings.edu/hastings_comm_ent_law_journal

Part of the Communications Law Commons, Entertainment, Arts, and Sports Law Commons, and the Intellectual Property Law Commons

Recommended Citation
Available at: https://repository.uchastings.edu/hastings_comm_ent_law_journal/vol22/iss2/9

This Note is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings Communications and Entertainment Law Journal by an authorized editor of UC Hastings Scholarship Repository.
Taxation of International Computer Software Transactions under Regulation 1.861-18

by

JONATHAN PURCELL*

I. Scope......................................................................................... 327
II. Overview.................................................................................... 328
III. Copyright Rights........................................................................ 330
    A. Distribution “to the Public”................................................. 331
    B. De Minimus Definitions..................................................... 332
IV. The Transfer of Copyright Rights............................................ 333
    A. The “All Substantial Rights” Test ........................................ 334
V. The Transfer of Copyrighted Articles....................................... 336
    A. Benefits and Burdens Test.................................................. 337
VI. Planning Opportunities........................................................ 340
VII. Conclusion............................................................................... 343

* J.D. 2000, University of California, Hastings College of the Law, Tax Concentration. Mr. Purcell is principal and co-founder of MindPeak, a manufacturer of computer-based biological data acquisition equipment.
Introduction

The increasing sophistication of international business presents formidable challenges to taxpayers and taxing authorities. Borders have become more permeable and business enterprises can relocate with increasing ease.

The international transfer of computer software context introduces further complexity due to its ability to be embodied and transported using both physical media and electronic means. The apportionment of income between country of manufacture and country of sale is problematic if, for example, the transaction consists of downloading software from a web-site in exchange for a credit card payment. At least one observer predicts tensions between electronic commerce importing and exporting states over the allocation of the tax base arising from transactions involving digital information.

Central to the understanding of the international taxation of computer software transactions is the concept of source of income. For U.S. residents, source of income will determine the availability of foreign tax credits, which will offset domestic tax liabilities. The characterization of income will determine which sourcing rules apply.

Treasury regulation 1.861-18 attempts to bring some clarity to the characterization of income from the international transfer of computer software. At the heart of the regulation is a distinction between the transfer of copyright rights and the transfer of copyrighted articles. A transaction that involves the transfer of a non-de minimus copyright right will be characterized as the transfer of a

---

2. Traditional concepts of international taxation allocate most of the tax revenues arising from electronic commerce to the electronic commerce exporting states. Electronic commerce importing states will eventually try to lay claim to a portion of these revenues. Doernberg, in an effort to initiate a discussion in the tax community, proposes the following: 1. Retain the permanent establishment principle, and 2. impose a creditable withholding tax on business-to-business commerce when a transaction would have the effect of eroding the importing state’s tax base. See id. at 1014.
copyright right.\textsuperscript{6} Otherwise, the transaction will be characterized as the transfer of a copyrighted article.\textsuperscript{7}

The regulation uses a definition of copyright rights that has been adapted from copyright law to conform with general tax principles and to take into account the special circumstances that attend the transfer of software.\textsuperscript{8} These definitions may cause contractual designations in an international software agreement to be disregarded for tax purposes, and may result in the seller being subject to double taxation due to insufficient generation of foreign tax credits. For example, packaged software sold under a typical "shrink-wrap" license may be characterized as the transfer of a copyrighted article and generate at most 50\% foreign source income.\textsuperscript{9}

This note will explain the basic mechanics of the regulation as it affects the disposition of copyrights and copyrighted articles and explores some planning opportunities.

\section*{I \hspace{1cm} Scope}

The regulation characterizes the income from the transfer of computer software for purposes of sourcing certain international transactions.\textsuperscript{10}

Computer software is defined as a set of instructions used on a computer that will bring about a certain result.\textsuperscript{11} The definition includes media, user manuals, documentation, databases or similar items if they are incidental to the operation of the computer program.\textsuperscript{12} The regulation is silent regarding non-incidental databases or other "content". In the pre-amble to the regulation the Treasury noted the

\begin{itemize}
\item[6.] See Treas. Reg. § 1.861-18(c)(1)(i).
\item[7.] See Treas. Reg. § 1.861-18(c)(1)(ii).
\item[8.] See Treas. Reg. § 1.861-18(c)(2).
\item[9.] See Treas. Reg. § 1.861-18(g)(1).
\item[10.] The regulation classifies transactions in computer programs for purposes of Subchapter N of Chapter 1 of the Internal Revenue Code, §§ 367, 404A, 482, 551, 679, 1059A, 842, 845, Chapter 3, Chapter 5, as well as transfers to foreign trusts not covered by § 679. See Treas. Reg. § 1.861-18(a)(1).
\item[12.] See id.
\end{itemize}
suggestion of commentators that non-incidental databases, content-based products, and entertainment products should be included in the definition of computer software. The Treasury, however, did not expand the definition in response to these suggestions. 13

II

Overview

Treasury Regulation Section 1.861-18 became effective on October 2, 1998.14 The regulation characterizes income from international transactions of computer software for purposes of sourcing under the U.S. tax code and international tax treaties.15 It characterizes transactions in computer software in four ways:

1. sales or licenses of copyright rights,
2. sales or leases of copyrighted articles,
3. the provision of services, or
4. the provision of know-how.16

Transactions are sourced according to the category in which they are placed.17 If a transaction consists of more than one category, each category of income is treated as a separate transaction.18 An exception provides that a transaction that falls primarily into one category and involves only a de minimus transfer of other rights, services, or articles, will be classified as a transaction involving the primary category.19 As explained below, the de minimus exception has the effect of characterizing more transactions as copyrighted articles, and which decreases the availability of foreign tax credits to U.S. companies.

A transaction that involves the transfer of computer software along with one or more of the rights enumerated in the regulation will be classified as the transfer of copyright

15. See id.
17. See id.
19. See id.
The transfer of copyright rights is further characterized as either a sale or license. In determining whether a transaction constitutes a sale or license, an examination is made as to whether "all substantial rights" in the copyright right have been transferred.

A transaction that involves the transfer of computer software without the rights enumerated in the regulation will be classified as the transfer of a copyrighted article. The transfer of copyrighted articles is further characterized as either a sale or lease. In characterizing a transaction in copyrighted articles as either a sale or lease, an examination is made as to whether the "benefits and burdens" of ownership have been transferred.

The provision of computer software services applies to newly developed or modified software according to the facts and circumstances of the situation. Appropriate factors for consideration include the intent of the parties and the allocation of risk of loss.

Transactions will be characterized as the provision of computer know-how if they meet the following three requirements – the information must:

1. relate to computer programming techniques;
2. be furnished under express contractual conditions preventing unauthorized disclosure; and
3. be considered property subject to trade secret protection.

The Regulation makes clear that neither the characterization under copyright law nor the form adopted by the parties will be determinative as to the classification of a transaction under the regulation. Software sold subject to a typical shrink-wrap license may be classified as the sale of a

A transaction will be characterized irrespective of means of transfer, i.e., whether the computer software is transferred on physical medium or by electronic means such as the Internet.

This note describes the treatment of computer transactions characterized as the transfer of copyright rights and copyrighted articles under the Regulation. The treatment of transactions characterized as the provision of services or provision of know-how are not explored. The implications of the Regulation under treaties and section 482 (transfer-pricing among related entities) are not analyzed. Finally, neither accounting changes nor pre-effective date transactions are covered.

III

Copyright Rights

Regarding computer software, the Copyright Act grants the copyright owner the following exclusive rights, subject to certain exceptions:

1. the reproduction of a copyrighted work;
2. the preparation of derivative works based on the copyrighted work;
3. the distribution of copies of the copyrighted work to the public by sale, rental, lease or lending;
4. the public performance of the copyrighted work; and
5. the display of the copyrighted work.\(^{32}\)

The Regulation defines four "copyright rights:"

(i) the right to make copies of computer programs for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
(ii) the right to prepare derivative computer programs based upon the copyrighted computer program;
(iii) the right to make a public performance of the computer program; or
(iv) the right to publicly display the computer program.\(^{33}\)

The copyright rights defined in the regulation differ from the rights defined in the Copyright Act in several significant

---

30. See id.
33. See Treas. Reg. § 1.861-18(c)(2) (emphasis added).
ways. Under the regulation, the right of reproduction is only recognized if it occurs in conjunction with the right to distribute to the public. The rights to display, perform and make derivative works may be determined to be de minimus, in which case the transaction may be characterized as the transfer of a copyrighted article and the availability of foreign tax credits decreased.

A. Distribution “to the Public”

The Regulation uses the definition of distribution to the public to distinguish between enterprise licenses and rights of public distribution. The grant of rights of reproduction and distribution within an organization or among related persons will not constitute the transfer of a copyright right. An effect of this definition is to reduce the availability of foreign tax credits in transactions in which the transferee is given a limited right to copy and distribute software within an organization.

The Regulation states that if a transferee is granted the right to reproduce or distribute the transferred software to persons who may be identified by name or legal relationship, or statutorily defined “related persons” the transaction will not be defined as a transfer of copyright rights. The Regulation reduces the ownership requirements for a statutorily defined related person from 50% to 10%, thus including more parties as “related persons.” Transactions that are structured as licenses involving the installation of software within a large organization and include the rights to reproduce the software for use within the organization on

34. See id.
36. In this note “enterprise license” is used as a general term to describe arrangements commonly known as site and enterprise licenses. A site license is an agreement in which the transferee receives the right to copy and distribute software to its employees within one physical location. An enterprise license is a site license that applies to multiple locations of the transferee’s enterprise. Compensation may be a flat fee, per copy used or any other arrangement.
38. See id.
40. A "related person" is a person who bears the relationship to the transferee defined in the Internal Revenue Code section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). See Treas. Reg. § 1.861-18(g)(3).
multiple computers at different physical locations, may be characterized as the sale of copyrighted articles. These types of transactions will produce at most 50% foreign source income.

B. De Minimus Definitions

The Regulation provides that the incidental transfer of a copyrighted article may be regarded as de minimus if the transaction as a whole is characterized as the sale or license of copyright rights.

The Regulation further provides that certain transfers of copyright rights that would be recognized under the Copyright Act will be considered de minimus and disregarded for tax purposes. The de minimus rights described in the Regulation include rights of reproduction and distribution as well as derivative rights.

The de minimus rights of reproduction and distribution work in concert with the definition of distribution to the public. If the right to reproduce and distribute computer software is limited to related persons as defined in the Regulation’s “to the public” definition, these rights will be considered de minimus, causing the transaction to be treated as a sale of an article and theretofore receive unfavorable tax treatment. In addition, rights of reproduction allowed under a typical “shrink-wrap” license, for such things as archival purposes, may also be considered de minimus.

Example 18 of the Regulation describes a transfer of derivative rights that would constitute a de minimus right. The transferee in that example receives software along with source code that he or she may modify to correct minor errors and make minor adaptations to enable the software to execute its function properly. The transferee is given no right to distribute the software “to the public,” but may

42. See Treas. Reg. § 1.861-18(h), examples 10-11.
44. See id.
45. See Treas. Reg. § 1.861-18(h), examples 10, 11, 12, and 18.
47. See Treas. Reg. § 1.861-18(g)(1).
49. See id.
distribute it to related persons.\textsuperscript{50}

The effect of defining the transfer of these rights as de minimus will result in the characterization of more software transactions as sales of articles. This will create more domestic source income and less foreign source income for domestic software developers who export products that are so characterized.

Commentators urged the Treasury to clarify the rights to display and perform computer software.\textsuperscript{51} While no changes were made in the final regulation to address these concerns, in the pre-amble to the regulation the Treasury stated that, "[i]n many cases, . . . the transfer of [the] right for public display or performance of a computer program, such as marketing or advertising the program, to the extent that it constitutes the transfer of a copyright right, would be considered a de minimus grant . . . . "\textsuperscript{52}

The application of the "to the public" definition and the de minimus rules may have significant tax consequences. Income from the sale of a copyrighted article will generate at most 50% foreign source income.\textsuperscript{53} Income from the license of a copyright right or the lease of a copyrighted article may generate 100% foreign source income.\textsuperscript{54} A domestic software developer may have a limitation placed on the availability of foreign tax credits if a transaction is characterized as the sale of a copyrighted article because it may not be able to generate sufficient foreign source income. As discussed below, the tax consequences for a domestic taxpayer using a Foreign Sales Corporation (FSC) may be even more pronounced.

\section*{IV
The Transfer of Copyright Rights}

The transfer of computer software along with a non-de minimus copyright right will generate income classified as the transfer of copyright rights.\textsuperscript{55} If all substantial rights to the

\textsuperscript{50} See \textit{id}.


\textsuperscript{52} See \textit{id}.

\textsuperscript{53} See generally Treas. Reg. \S 1.863.


copyright rights are transferred, the transaction will be characterized as a sale of personal property.\textsuperscript{56} If all substantial rights are not transferred, the transaction will be characterized as the license of copyright rights generating royalty income.\textsuperscript{57}

Income characterized as the sale of personal property arising from the sale of copyright rights will be sourced on the basis of the residence of the seller.\textsuperscript{58} A United States resident will generally recognize U.S. source income.\textsuperscript{59} A non-resident will generally recognize foreign source income.\textsuperscript{60} There are exceptions, however, to these general principles. A resident alien who receives income from the sale of personal property attributable to a fixed place of business in a foreign country will recognize foreign source income.\textsuperscript{61} A non-resident alien who receives income from the sale of personal property attributable to a fixed place of business within the United States will recognize domestic source income.\textsuperscript{62}

Income characterized as royalties arising from the license of copyright rights will be sourced where the rights are used.\textsuperscript{63} A license of a copyright right used in a foreign country will generate foreign source royalty income.\textsuperscript{64} A license of a copyright right that is used within the United States will generate U.S. source royalty income.\textsuperscript{65}

\textbf{A. The “All Substantial Rights” Test}

If all substantial rights in software have been transferred, the transaction will be characterized as the sale of copyright rights. In determining whether all substantial rights have been transferred, the regulation states that the principles of

\begin{itemize}
\item \textsuperscript{56} See Treas. Reg. § 1.861(f)(1).
\item \textsuperscript{57} See id.
\item \textsuperscript{58} See 26 U.S.C. § 865(a) (1999).
\item \textsuperscript{59} See 26 U.S.C. § 865(a)(1).
\item \textsuperscript{60} See 26 U.S.C. § 865(a)(2).
\item \textsuperscript{61} See 26 U.S.C. § 865 (e)(1)(A).
\item \textsuperscript{62} See 26 U.S.C. § 865 (e)(2)(A). An exception to this exception: A non-resident alien with a fixed place of business in the United States who receives income from the sale of property that is for use in a foreign country, and a fixed place of business outside the United States materially participated in the sale will recognize foreign source income. See 26 U.S.C. § 865(e)(2)(A)-(B).
\item \textsuperscript{63} See 26 U.S.C. § 864(c)(4).
\item \textsuperscript{64} See id.
\item \textsuperscript{65} See 26 U.S.C. § 864(a)(4)(A).
\end{itemize}
sections 1222 and 1235 may be applied.\textsuperscript{66} Section 1235 gives the transferor capital gains treatment on the disposition of all substantial rights in a patent regardless of actual holding period.\textsuperscript{67} While the regulation invokes sections 1222 and 1235, the pre-amble clarifies that relevant case law not specifically addressing these sections will be applicable.\textsuperscript{68}

Regulation 1.1235-2 provides guidance on the interpretation of the "all substantial rights" test.\textsuperscript{69} Regulation 1.1235-2 provides that the circumstances of the whole transaction will be considered when determining whether all substantial rights have passed.\textsuperscript{70} Examples are given of three categories of rights: rights that will be considered substantial; rights that will not be considered substantial, and rights that may or may not be considered substantial.\textsuperscript{71}

Example 6 of Regulation 1.861-18 describes a transaction that does not constitute a transfer of all substantial rights in the software.\textsuperscript{72} In that example, the transferee is granted the right to reproduce and distribute software within a country.\textsuperscript{73} The grant is non-exclusive, for less than the remaining life of the copyright, and does not permit sub-licensing.\textsuperscript{74}

Example 5 of the regulation describes a transaction that does constitute a transfer of all substantial rights.\textsuperscript{75} In that

\textsuperscript{67} See 26 U.S.C. § 1235.
\textsuperscript{69} See Treas. Reg. § 1.1235-2.
\textsuperscript{70} See id.
\textsuperscript{71} Examples of rights which, if limited, would preclude the transfer of all substantial rights include: grants geographically smaller than a country, less than the remaining life of the copyright, or less than all the rights granted. Examples of rights which, although retained by the transferor, the transaction will nonetheless be considered a transfer of all substantial rights include: retention of the title to secure payment or performance, retention of security interest, or reservation in the nature of a condition subsequent. Examples of rights which may or may not be substantial include: an absolute right to prohibit sub-licensing or sub-assignment of the transfer, or the failure to convey the right to use or sell the property. See Treas. Reg. § 1.1235-2.
\textsuperscript{72} See Treas. Reg. § 1.861-18(h) (1999), example 6.
\textsuperscript{73} See id.
\textsuperscript{74} See id.
\textsuperscript{75} See Treas. Reg. § 1.861-18(h), example 5.
example, the transferee is granted the exclusive, country-wide right to copy, distribute, make public performances, publicly display, and make derivative works of the software. The example further provides that a royalty payment will be paid for a time deemed the expected period during which the program will have commercially exploitable value.76

Combining the examples from regulation 1.861-18 together with the “all substantial rights” test in Regulation 1.1235-2, a transfer of copyright rights exclusive within the entire geographic area of a country and unlimited with respect to duration and assignability would be considered the transfer of “all substantial rights.” Many transactions will not exactly track these characteristics and will necessitate the application of principles from case law and Regulation 1.1235-2 to determine whether “all substantial rights” have passed.

V

The Transfer of Copyrighted Articles

Computer software that is transferred without any “copyright rights” or de minimus copyright rights will be characterized as the sale or lease of a copyrighted article.77

The regulation defines a copyrighted article as a computer program that can be perceived, reproduced or communicated, and that may be fixed in any medium.78 A transaction that transfers the “benefits and burdens” of ownership will be characterized as the sale of a copyrighted article.79 A transaction that does not transfer the “benefits and burdens” of ownership will be characterized as the lease of a copyrighted article.

How the income characterized as the sale of inventory property arising from the transfer of copyrighted articles will be sourced will depend on whether the taxpayer produced or purchased the inventory.80 Income from purchased inventory is sourced where title passes.81 Income from manufactured

76. See id.
80. See Treas Reg. §§ 861(a)(6), 862(a)(6), 863.
81. See Treas. Reg. § 1.861-7(c).
inventory is apportioned between the place of manufacture and place of title passage. In the preamble to the regulation, the Treasury stated that “[a]lso to the issue of determining the place of sale under the title passage rule of § 1.861-7(c), the parties in many cases can agree on where title passes for sales of inventory property generally.”

Income characterized as the lease of a copyrighted article will be sourced where the article being leased is used. The lease of a copyrighted article in the United States will generate U.S. source income, while a lease of a copyrighted article in a foreign country will generate foreign source income.

A. Benefits and Burdens Test

Whether sufficient benefits and burdens have passed to the transferee to constitute ownership for tax purposes is a question to be decided by the facts and circumstances of the particular situation. Much of the law in this area developed from disputes over the characterization of sale-lease arrangements prior to the reform of the passive loss tax rules in 1986. Transactions were structured that involved depreciable assets purchased with non-recourse loans. The assets were typically leased to credit-worthy institutions. These transactions generated depreciation adjustments that

82. Manufactured inventory is sourced in a three step process. First, gross income is allocated between sales activity and production activity. Next, sales income is sourced according to place of title passage. Production activity gross income is sourced according to the relative distribution of manufacturing assets used in the production of the inventory property. Finally, expenses are allocated accordingly. The default allocation between sales and production activity is 50/50. Alternatively, the independent factory price may be used. See Treas. Reg. § 1.863-3.


86. See id.


89. See id.

90. See id.
were deductible as losses.\textsuperscript{91}

In \textit{Frank Lyon Co.}, the Court held that where "there is a genuine multiple party transaction with economic substance that is compelled or encouraged by business or regulatory realities, and the transaction is imbued with tax independent considerations and is not shaped solely for tax avoidance reasons that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."\textsuperscript{92}

The tax court developed tests to determine if the benefits and burdens of ownership have been transferred in sales\textsuperscript{93} and in sale-lease-back arrangements.\textsuperscript{94} The court decided

\begin{itemize}
\item \textsuperscript{91} See \textit{id}.
\item \textsuperscript{92} \textit{Frank Lyon Co.} involved the purchase and lease of a bank building by a third party to a bank. The bank's balance sheet was not strong enough to allow the bank to finance the purchase itself due to federal banking law requirements. The government argued that the taxpayer should not be allowed to deduct depreciation on the building because the taxpayer was not the owner of the building for tax purposes. While the bank had the option to repurchase the building at various times for amounts equal to the cost to the taxpayer, the Court found that the taxpayer was the owner of the building and that the transaction did have economic substance. The Court reasoned that the transaction was not a sham because the taxpayer was an independent entity, who alone was liable for the mortgages which the bank could not obtain itself. \textit{See} \textit{Frank Lyon Co. v. United States}, 435 U.S. 561, 583-84 (1978)
\item \textsuperscript{93} Some factors relevant to determining if a sale has occurred are:
\begin{enumerate}
\item whether legal title passed;
\item whether the parties treated the transaction as a sale;
\item whether the alleged purchaser acquired an equity interest in the property;
\item whether the contract of sale creates a present obligation on the seller to execute and deliver a deed, and a present obligation on the purchaser is vested with the right of possession;
\item whether the purchaser pays property taxes following the transaction;
\item whether the purchaser bears the risk of loss or damage to the property; and
\item whether the purchaser receives the profits from the operation and sale of the property.
\end{enumerate}
\item \textsuperscript{94} In \textit{Estate of Thomas v. Comm'r}, the following factors were considered in the context of a sale-leaseback arrangement:
\begin{enumerate}
\item the existence of useful life of the property in excess of the leaseback term,
\item the existence of a purchase option at less than fair market value,
\item renewal rental at the end of the lease-back term set at fair market rent, and
\item the reasonable possibility that the purported owner of the property can recoup his investment in the property from the income-producing potential
\end{enumerate}
\end{itemize}
some cases that involved sale-lease arrangements for large commercial computer installations.\textsuperscript{95} Example 3 of the regulation describes a transaction in which the benefits and burdens of ownership of a copyrighted article are not transferred.\textsuperscript{96} That example is characterized as the lease of a copyrighted article.\textsuperscript{97} The transaction involves a transfer that is contingent on the periodic payment of a fee, with no right to use the copyrighted article in perpetuity.\textsuperscript{98}

Examples 1 and 2 describe a transaction that transfers the benefits and burdens of ownership of a copyrighted article.\textsuperscript{99} Those examples are characterized as sales of a copyrighted article.\textsuperscript{100} The transactions in those examples involve computer software that is transferred by means of a floppy-disk or downloaded from a web-site with a perpetual "shrink-wrap license."\textsuperscript{101}


\textsuperscript{95} Estate of Thomas v. Commissioner concerned a tax deferral vehicle that involved commercial computer sale/lease arrangements. An investment company created limited partnerships that purchased mainframe computers with non-recourse borrowings. Limited partnership interests were offered to individuals as a way to generate deductions. The partnerships net-leased the IBM mainframe computers on a long-term basis with large credit-worthy corporations. The leases were sufficient to service the borrowing and to generate limited cash flows. Depreciation deductions were passed through to the limited partners as losses.

The government's position was that the transactions did not constitute a transfer of ownership and therefore were not eligible for depreciation deductions. The net-leases involved substantial quantities of money and had been analyzed by experts in the valuation of commercial computer systems. The analysts determined that the computer equipment would have a significant residual value upon the conclusion of the net-leases and repayment of the non-recourse funds. When IBM, against all predictions, brought out a new line of main-frame computers, the residual value of the leased computers disappeared. The Tax Court held that because at the time the net-leases were entered into the parties had a realistic expectation that the transactions would involve real economic benefits, the form of the transaction should be respected. See Estate of Thomas v. Commissioner, 84 T.C. 412 (T.C. 1985).

\textsuperscript{96} See Treas. Reg. § 1.861-18(h) (1999), example 3.

\textsuperscript{97} See id.

\textsuperscript{98} See id.

\textsuperscript{99} See Treas. Reg. § 1.861-18(h), examples 1, 2.

\textsuperscript{100} See id.

\textsuperscript{101} The examples describe a shrink-wrap license which is perpetual. Reverse engineering, decompilation, and disassembly are not permitted. The end-user has the right to use the computer software on two of its computers provided that only one copy is used at a time, and the end-user has the right to
Parties may limit the duration of rights in an article of computer software in a number of different ways. The regulation states that an express agreement to destroy software after a specified period of time is functionally equivalent to either the automatic deactivation of the software, or the legal obligation to return the medium containing the software.

VI
Planning Opportunities

Domestic software developers who export will generally maximize the availability of foreign tax credits by structuring transactions as leases or licenses. While leases and licenses may generate 100% foreign source income, sales of copyrighted articles will only generate at most 50% foreign source income.

Sales of copyrighted articles are sourced under the mixed-source rules of section 863. If a developer arranges for passage of title outside the United States, it will realize 50% foreign source income. If title passes within the United States, no foreign source income will be realized.

If copyrighted articles are sold through a Foreign Sales Corporation (FSC), foreign source income may be reduced even further. While the byzantine minutiae of FSCs are far beyond the scope of this note, the effect of the regulation in the context of FSCs should be noted. Under the mixed-source rules of sections 927(e), the 50% maximum foreign source income allocation will be effectively reduced to 25%.

6. making copies of the computer software on each computer "as an essential step in utilization." The copies may be transferred, provided they carry with them the original conditions and the transferor destroys any copies it has made. See Treas. Reg. 1.861-18(h), examples 1-2.


8. See id.


10. See id.

11. See id. at 1726.


13. See id.

14. See id.

15. See id. at 1726.


17. See id.
domestic software developer operating through an FSC, the sale of an article will generate at most 25% foreign source income, whereas a lease or license may generate 100% foreign source income.\textsuperscript{112}

Domestic software developers that require the generation of foreign source income to credit taxes paid in a foreign country against United States tax liability may consider a number of strategies. Licensing software to a related or unrelated foreign entity for distribution outside the United States may generate 100% foreign source income.\textsuperscript{113}

A transaction that involves the sale of copyrighted articles should include express language in the sales agreement that passage of title occurs outside the United States.\textsuperscript{114} This will ensure that the transferor will generate 50% foreign source income.\textsuperscript{115} Developers who transfer software over the internet should include such title passage language in all agreements that the purchaser of their software must assent to before downloading the software from the internet.\textsuperscript{116} Developers who are reluctant to pass title to software for legal reasons not related to taxation may include provisions in their agreements that describe the location where the "benefits and burdens" of ownership pass along with the risk of loss.\textsuperscript{117}

In some cases, developers may be able to structure the transfer of a copyrighted article as a lease by limiting the duration of the agreement and by requiring periodic payment for subsequent use.\textsuperscript{118} This may be of particular importance to developers who sell under a site or enterprise license.

In the regulation, the Treasury has defined the distribution right so as to exclude the transfer to certain related parties from constituting the right to distribute.\textsuperscript{119} The exclusion of these persons from the "to the public" definition makes it more difficult to characterize site and enterprise licenses as the transfer of rights. Software developers may want to try to limit enterprise licenses to a duration shorter

\textsuperscript{112} See id.
\textsuperscript{113} See id. at 1726.
\textsuperscript{114} See id.
\textsuperscript{115} See id.
\textsuperscript{116} See Levenson, supra note 104, at 1726.
\textsuperscript{117} See id.
\textsuperscript{118} See id.
than the life of the software in order to generate income from the lease of copyrighted articles.

Developers selling software to original equipment manufacturers (OEMs), may be able to structure transactions to accommodate required tax results by controlling the means of software delivery as well as the terms of the agreement.

In examples 8 and 9, the Treasury reached a strange result. These examples describe a foreign computer OEM who receives software from a U.S. software developer. The software is loaded onto the hard-drives of the computers that the OEM sells. The OEM receives the software subject to a non-exclusive right to copy the software onto an unlimited number of computers, which it will distribute to the public. The term of the agreement is less than the life of the copyright.

In example 8, the OEM receives the software on a single disk which it copies onto each computer's hard-drive that it manufactures. This example is characterized as the license of copyright rights and would generate 100% foreign source income.

In example 9, the computer manufacturer receives a separate disk for each computer it manufactures. The disk is then copied onto the hard-drive and transferred along with the computer when the computer is sold. Example 9 is characterized as the sale of copyrighted articles. This transaction will generate 50% foreign source income if the parties arrange for passage of title outside the United States.

Though the distinction between loading software from a single disk as compared to multiple disks may seem petty, considering the extent of possible tax ramifications, the distinction is consistent with the notion of a copyright right (unlimited reproduction) and an article (limited to one user

---

120. See Treas. Reg. § 1.861-18(h), examples 8, 9.
121. See id.
122. See id.
123. See id.
124. See id.
126. See id.
128. See id.
129. See id.
who may resell the article). Developers who transfer software overseas under an enterprise license and are seeking maximization of foreign source income will want to structure transactions to conform with example 8.

VII
Conclusion

Attorneys and business people need to be aware of the possibility of the recharacterization of software licensing agreements for tax purposes. Agreements should be drafted so that the seller receives optimum tax treatment while retaining intellectual property rights as defined under copyright law.

In the final regulation, the Treasury has provided badly needed clarification to an area of law that demonstrates historical changes in the nature of property and territoriality. Property has become less tangible making it more difficult to locate for tax purposes. Borders have become more permeable to the flow of products and relocation of business enterprises. The regulation is an important step in the development of an international consensus for the taxation of computer software transactions.