U.S. SOFTWARE REGULATIONS
20 YEARS AFTER

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Treas. Reg. §1.861-18

- The regulations classify transactions in computer programs for certain international provisions of the Code.

- The regulations are [also] intended to apply for purposes of applying and interpreting U.S. tax treaties.

- The Software Regulations first appeared as proposed regulations in 1996.

- They were finalized in 1998, with minimal changes made to the regulations as proposed.

When the Software Regulations were released…

- iMac was relaunched and it looked like this…

- This was an "iPhone"

- Mark Zuckerberg was 14 years old.

- A typical internet connection would download 1GB in approximately 48 hours.

- In adopting the final regulations, the IRS stated:

  ➢ "One commentator suggested that the words "carrier medium" should be substituted for the words "the magnetic medium of a floppy disk" <u>because computer programs may be distributed on a non-magnetic medium, such as a CD-ROM.</u>"

Why Classify?

- When a foreign corporation or a nonresident alien sell software in the U.S., what type of income is being generated?

  ➢ Royalties?

  ➢ Rents?

  ➢ Services?

  ➢ Gains on the sale of property?

  ➢ Some combination of the above?

Source Matters

- Once the income is characterized, its source can be determined.

- If the nonresident alien is receiving U.S. sourced royalty or rental income, a 30% withholding tax can apply.

- If the nonresident alien is selling products into the U.S., or performing services, there may be no U.S. tax imposed.

When do the Software Regulations apply?

- When there is a transaction:

  ➢ Relating to a <u>computer program</u>

  AND

  ➢ One or more of the following:

    - a <u>transfer</u> of the computer program,

    - a <u>provision of services</u> for the <u>development or modification</u> of the computer program, <u>or</u>

    - the <u>provision of know-how</u> relating to computer programming techniques

Computer Program

- A computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.

- Includes any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.

Transfer of a Computer Program

- Is classified as:

  ➤ A transfer of a <u>copyright right</u> if the person acquires one or more copyright rights.

  ➤ A transfer of a <u>copyrighted article</u> if the person does <u>not</u> acquire one or more copyright rights.

Four Copyright Rights

- The right to <u>make copies</u> of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

- The right to <u>prepare derivative computer programs</u> based upon the copyrighted computer program;

- The right to make a <u>public performance</u> of the computer program; or

- The right to <u>publicly display</u> the computer program.

If A Copyright Right Was Transferred

- Has there been a transfer of <u>all substantial rights</u> in the copyright?

  ➤ <u>If yes</u>, the transfer of the copyright right is treated as a <u>sale or exchange</u> [of the copyrighted property].

  ➤ <u>If no</u>, the transaction is treated as a <u>license generating royalty income</u>.
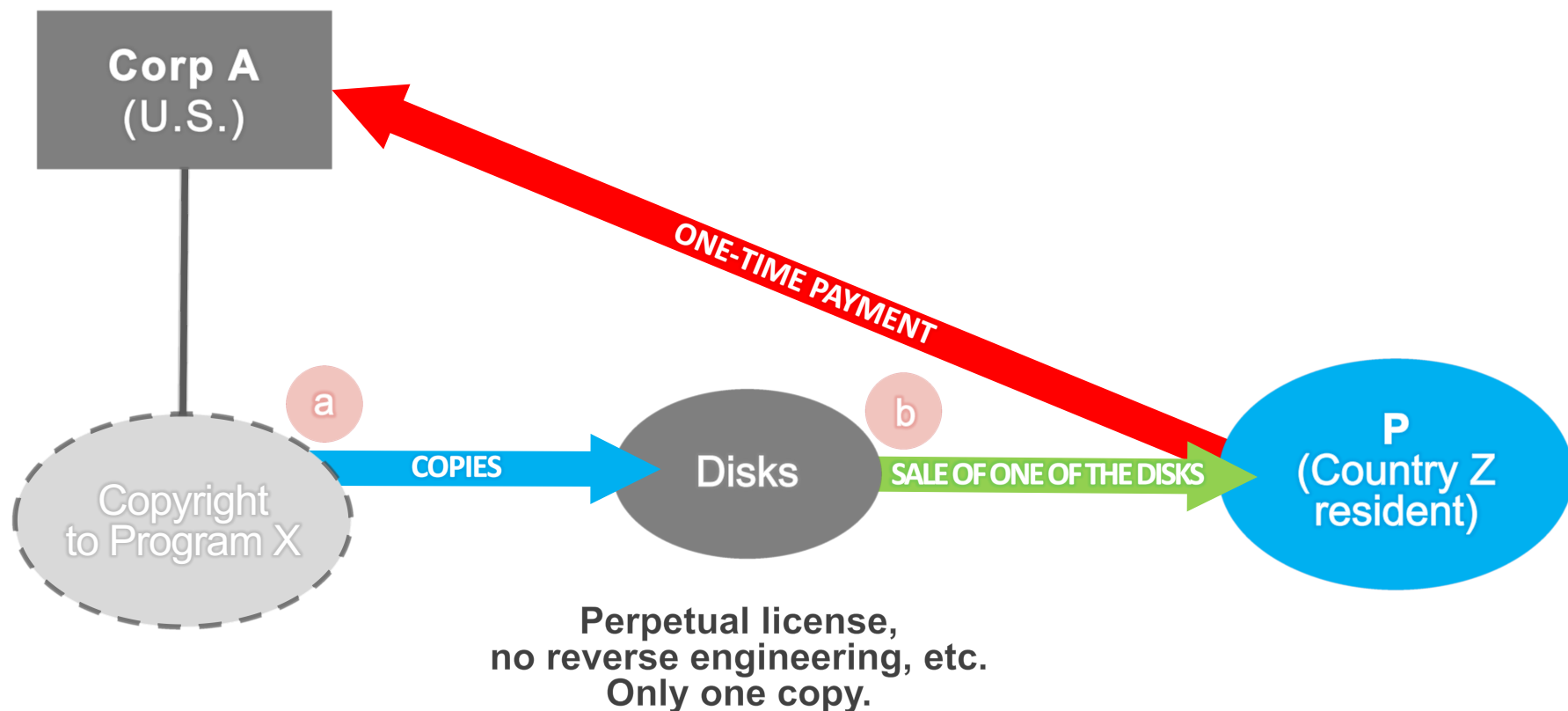
If No Copyright Rights Were Transferred

- The transfer of the computer program is classified solely as a transfer of a <u>copyrighted article</u>.

- Have the <u>benefits and burdens</u> of ownership been transferred?

  ➢ <u>If yes</u>, the transaction is treated as a <u>sale or exchange</u>.

  ➢ <u>If no,</u> the transaction is treated as a <u>lease generating rental income</u>.

Treas. Reg. §1.861-18(h), Ex. 1 FACTS

- Corp A, a U.S. corporation, owns the copyright in a Program X. Corp A copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license.

- The license is stated to be perpetual. Under the license no reverse engineering, decompilation, or disassembly of the computer program is permitted.

- The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted to sell the copy of Program X so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy.

- In return for valuable consideration, P, a Country Z resident, receives one such disk.

Treas. Reg. §1.861-18(h), Ex. 1 CHART

Corp A
(U.S.)

ONE-TIME PAYMENT

a

Copyright
to Program X

COPIES

Disks

b

SALE OF ONE OF THE DISKS

P
(Country Z
resident)

**Perpetual license,
no reverse engineering, etc.
Only one copy.**

Treas. Reg. §1.861-18(h), Ex. 1 RESULTS

- The label license is not determinative. No copyright rights have been transferred. P has received a copy of the program, and, therefore, P has acquired a copyrighted article.

- Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, there has been a sale of a copyrighted article rather than the grant of a lease.

- How would Canada treat this?

Treas. Reg. §1.861-18(h), Ex. 5 FACTS

- Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X.

- Corp B will pay Corp A a royalty of $ a year for three years, which is the expected period during which Program X will have commercially exploitable value.

Treas. Reg. §1.861-18(h), Ex. 5 CHART

License, for remaining term
of the copyright, derivative works
allowed, unlimited number of copies
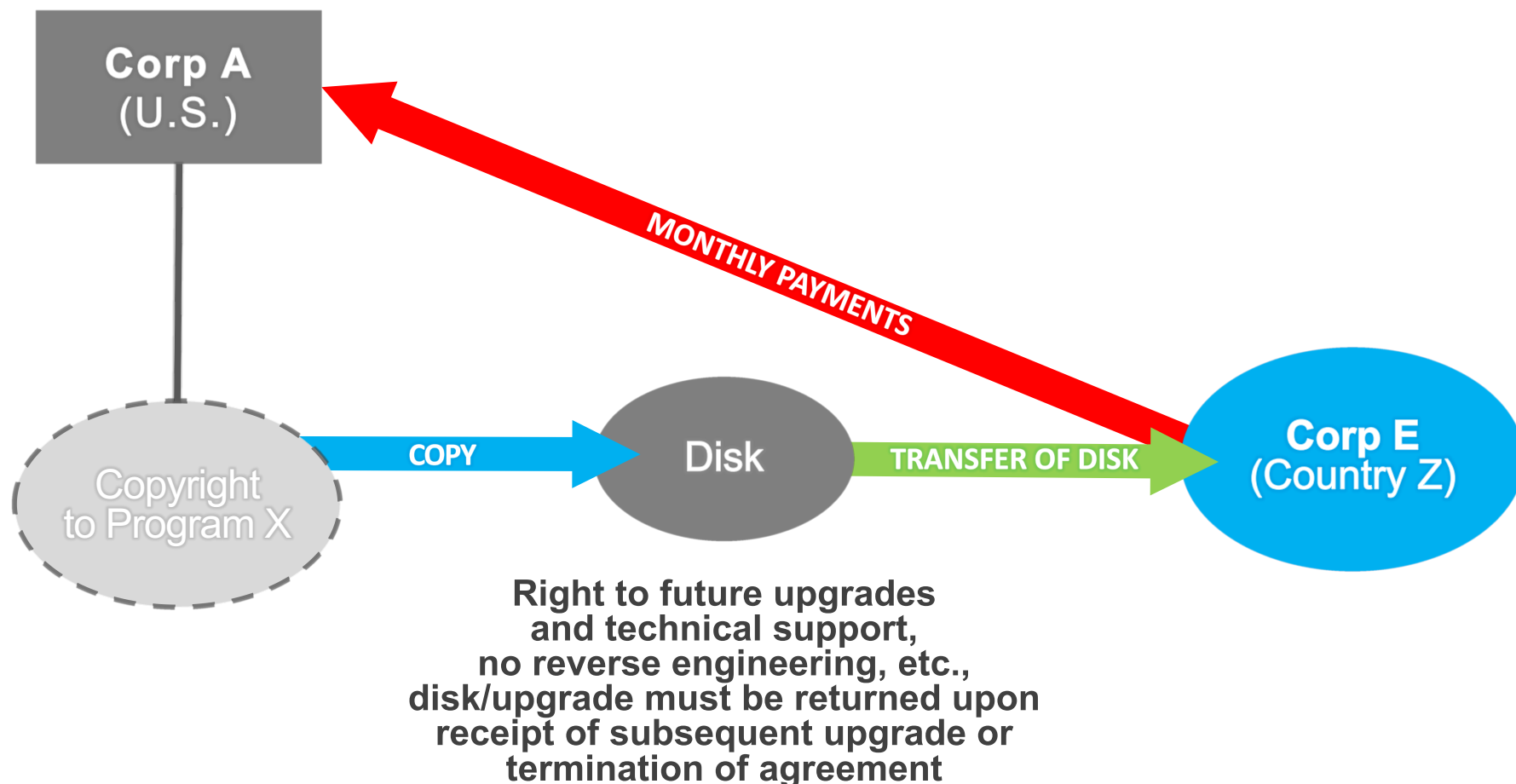can be sold in Country Z
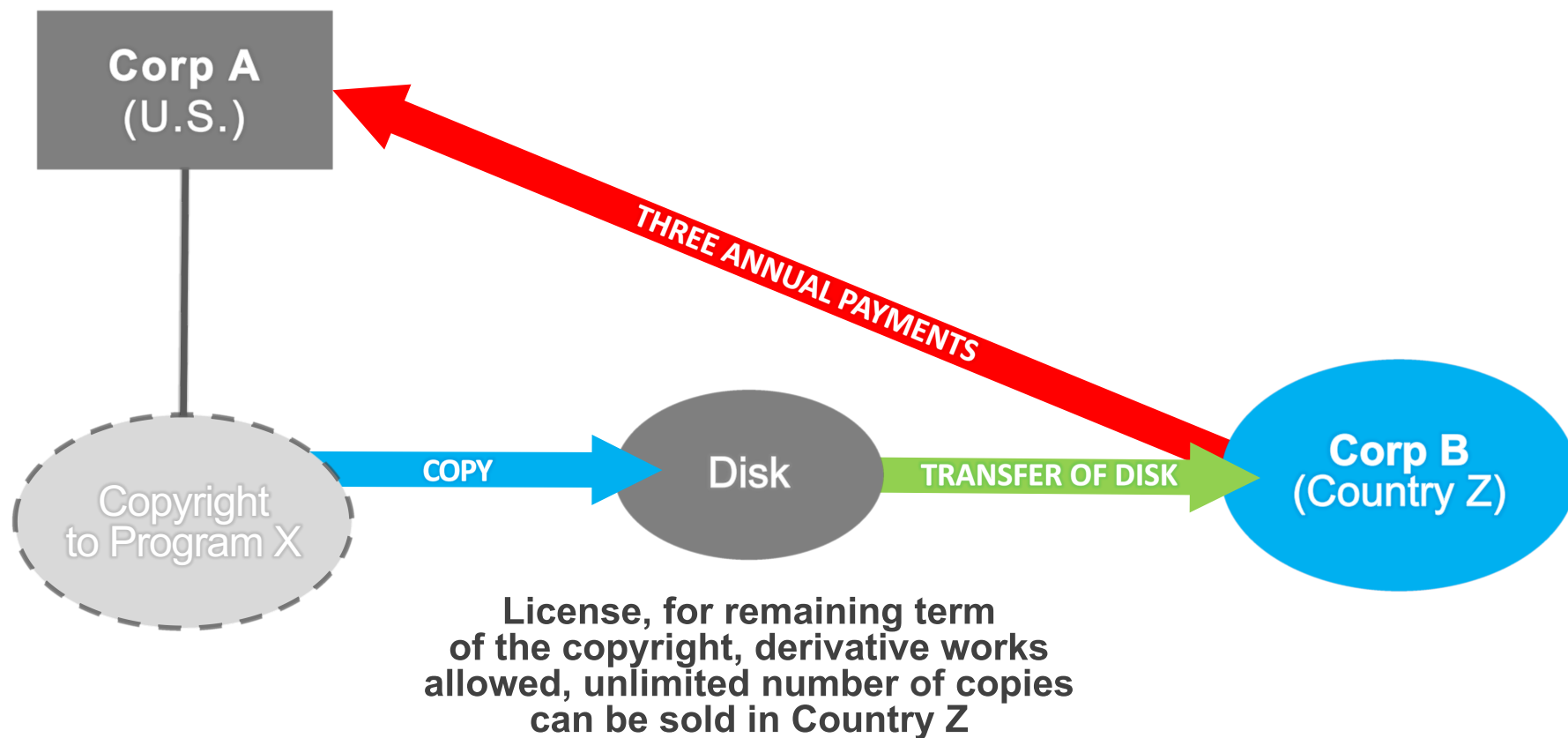
Treas. Reg. §1.861-18(h), Ex. 5 RESULTS

- Although Corp A has transferred a disk with a copy of Program X on it to Corp B, because this transfer is accompanied by a copyright right, this transaction is a transfer of copyright rights, not of copyrighted articles.

- The disk containing a copy of Program X is a *de minimis* component of the transaction.

- Applying the all substantial rights test, Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within Country Z, and has received the rights for the remaining life of the copyright in Program X.

- The fact the payments cease before the copyright term expires is not controlling.

- The fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

- The result in this case would be the same if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B.

Treas. Reg. §1.861-18(h), Ex. 12 FACTS

- Corp A transfers a disk containing Program X to Corp E, a Country Z corporation. Corp E may make Program X available to workstations used by its employees. Corp E is prohibited from selling the disk or reverse engineering the Program.

- Corp E receives the right to receive upgrades of Program X. Upon receipt of an upgrade disk, Corp E must return the disk of the earlier version to Corp A.

- Corp A provides technical support to Corp E.

- Corp E pays a monthly fee based on the permitted number of users (which can be changed) and the computing power of Corp E's server. The agreement does not allocate the fee between the upgrades and the technical support services. The technical support is expected to be *de minimis*.

- The agreement may be terminated by either party, at which point Corp E must delete (or otherwise destroy) all copies of the current version of Program X.

- The agreement specifies that Corp E is not granted an option to purchase Program X.

Treas. Reg. §1.861-18(h), Ex. 12 CHART

Corp A (U.S.)

Copyright to Program X

COPY

Disk

TRANSFER OF DISK

Corp E (Country Z)

MONTHLY PAYMENTS

Right to future upgrades and technical support, no reverse engineering, etc., disk/upgrade must be returned upon receipt of subsequent upgrade or termination of agreement
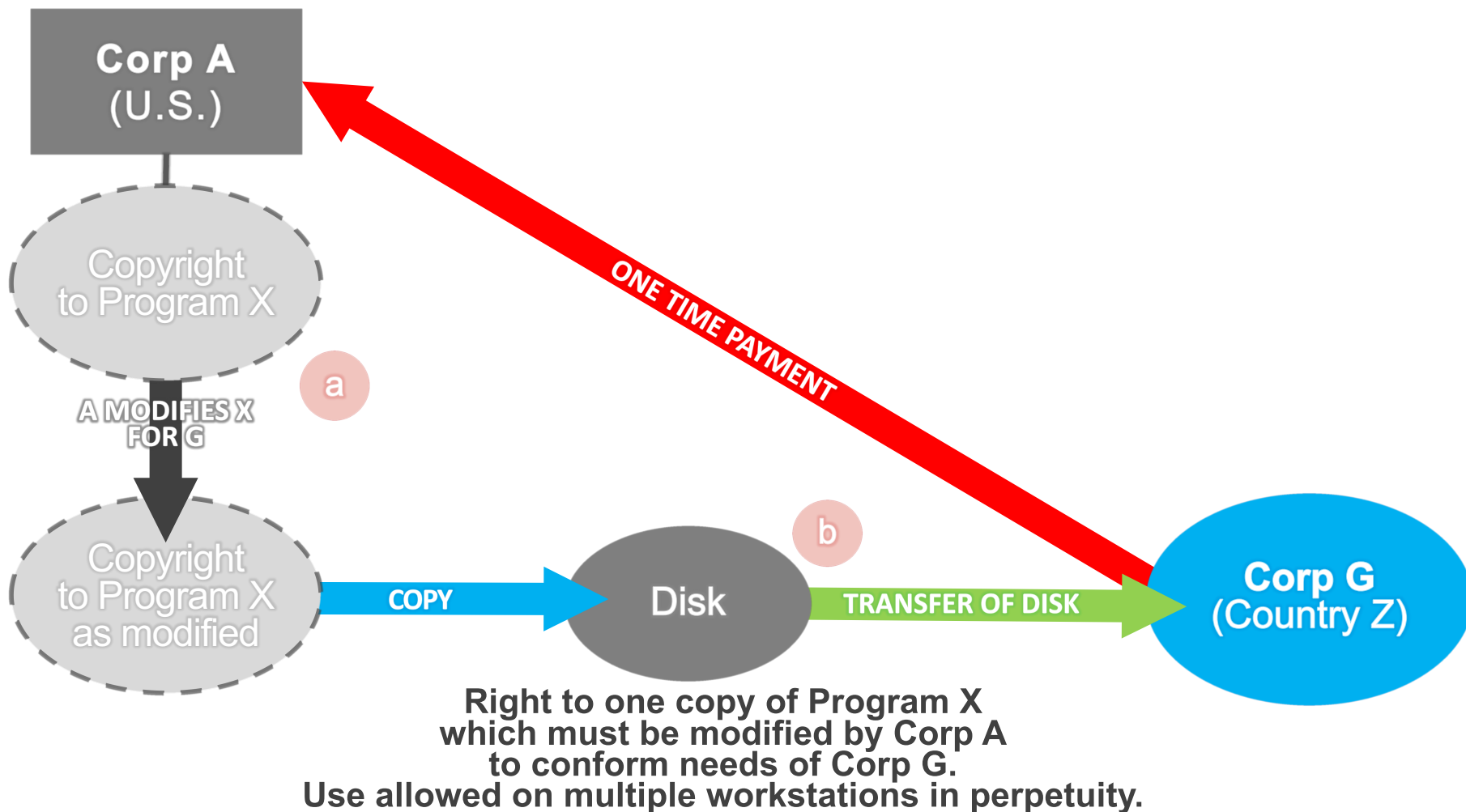
Treas. Reg. §1.861-18(h), Ex. 12 RESULTS

- This is a transfer of a copyright article:

    - No copyright rights have been transferred to Corp E.

    - No services have been provided to Corp E (the technical support services provided to by Corp A are *de minimis)*.

- Corp E does not receive the right to use Program X in perpetuity, and has no right to purchase Program X after any amount of payments made or time elapsed (which might indicate a sale).

- Once the agreement is terminated, Corp E no longer has access to current or previous versions of Program X.

- Therefore, under benefits and burdens test, Corp E is not treated as the owner of the copy of Program X and the transaction is thus lease of a copyrighted article.

Treas. Reg. §1.861-18(h), Ex. 14 FACTS

- Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used by G's facility in Country Z.

- Corp G acquire one copy of the Program on a disk and the right to use the Program on 5,000 workstations.

- Corp A must rewrite elements of Program X so that it will conform to Country Z's accounting standards and states that Corp A retains all copyright rights in the modified Program.

- The agreement calls for a one-time per-user fee.

- The term of the agreement is perpetual.

- Corp G is prohibited from selling the disk of Program X, or the modified version.

Treas. Reg. §1.861-18(h), Ex. 14 CHART

Corp A
(U.S.)

Copyright
to Program X

a

**A MODIFIES X
FOR G**

Copyright
to Program X
as modified

ONE TIME PAYMENT

COPY

Disk

b

TRANSFER OF DISK

Corp G
(Country Z)

**Right to one copy of Program X
which must be modified by Corp A
to conform needs of Corp G.
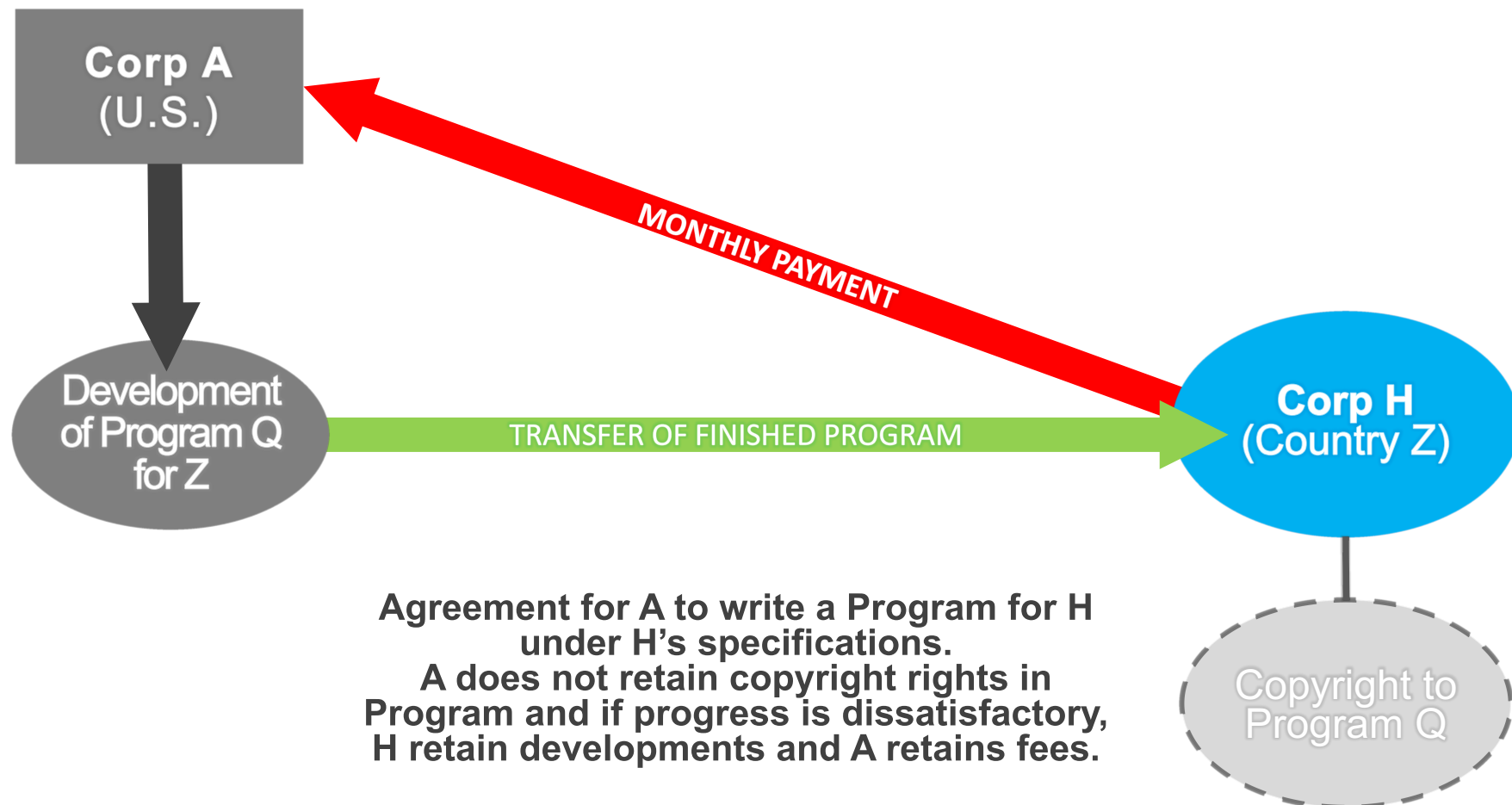Use allowed on multiple workstations in perpetuity.**

- 24 -

Treas. Reg. §1.861-18(h), Ex. 14 RESULTS

- This is a transfer of a copyright article:

  - All copyright rights in the modified Program remain with Corp A and Corp G is not granted any copyright right.

  - Since no copyright right is transferred to Corp G, this transaction does not involve provision of services by Corp A.

- Although Corp G was prohibited from selling Program X other factors, for example, the risk of loss and the right to use the copies in perpetuity outweigh the restriction.

- Under all facts and circumstances, Corp G is properly treated as the owner of a copy of Program X and thus the transaction is a sale of a copyrighted article.

Treas. Reg. §1.861-18(h), Ex. 15 FACTS

- Corp H, a Country Z corporation, enters into a license agreement for a new computer program. Program Q is to be written by Corp A, a U.S. corporation.

- Corp A is writing the Program but when Program Q is completed, the copyright in Program Q will belong to Corp H.

- Corp H gives instructions to Corp A programmers regarding specifications.

- Corp H agrees to pay Corp A a fixed monthly sum during the development of the Program.

- If Corp H is dissatisfied with the development of the Program, it may cancel the contract at the end of any month. In the event of termination, Corp A retain all payments, while any procedures, techniques or copyrightable interests will be property of Corp H.

- No provision for any continuing relationship between Corp A and Corp H such as furnishing of updates.

- Payments are labeled royalties.

Treas. Reg. §1.861-18(h), Ex. 15 CHART

Corp A
(U.S.)

MONTHLY PAYMENT

Development
of Program Q
for Z

TRANSFER OF FINISHED PROGRAM

Corp H
(Country Z)

**Agreement for A to write a Program for H
under H's specifications.
A does not retain copyright rights in
Program and if progress is dissatisfactory,
H retain developments and A retains fees.**

Copyright to
Program Q

Treas. Reg. §1.861-18(h), Ex. 15 RESULTS

- This transaction is treated as provision of services

  - Corp H bears all the risk of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q.

  - The fact that the agreement is labeled as license is not controlling.

  - Neither is the fact that Corp A received a sum labelled a royalty.

Classify the Transaction

- How is Microsoft Office 365 treated?

  ➢ Rental

- Microsoft Windows

  ➢ Sale or exchange

- Transfer from a developer to an online software distributor (Steam, Amazon)

  ➢ It depends, royalty or a sale or exchange

- Online tax and legal research such as BNA, Lexis, and Westlaw

  ➢ ????

Relevance today…

- Today, many of the e-commerce transactions take place on the "cloud"

- Instead of purchasing or downloading software, we use the internet to access software located on remote computer networks operated by someone other than the creator of the program

- Is there a "transfer" of a software program in a cloud transaction?

- Would the Software regulations still be relevant?
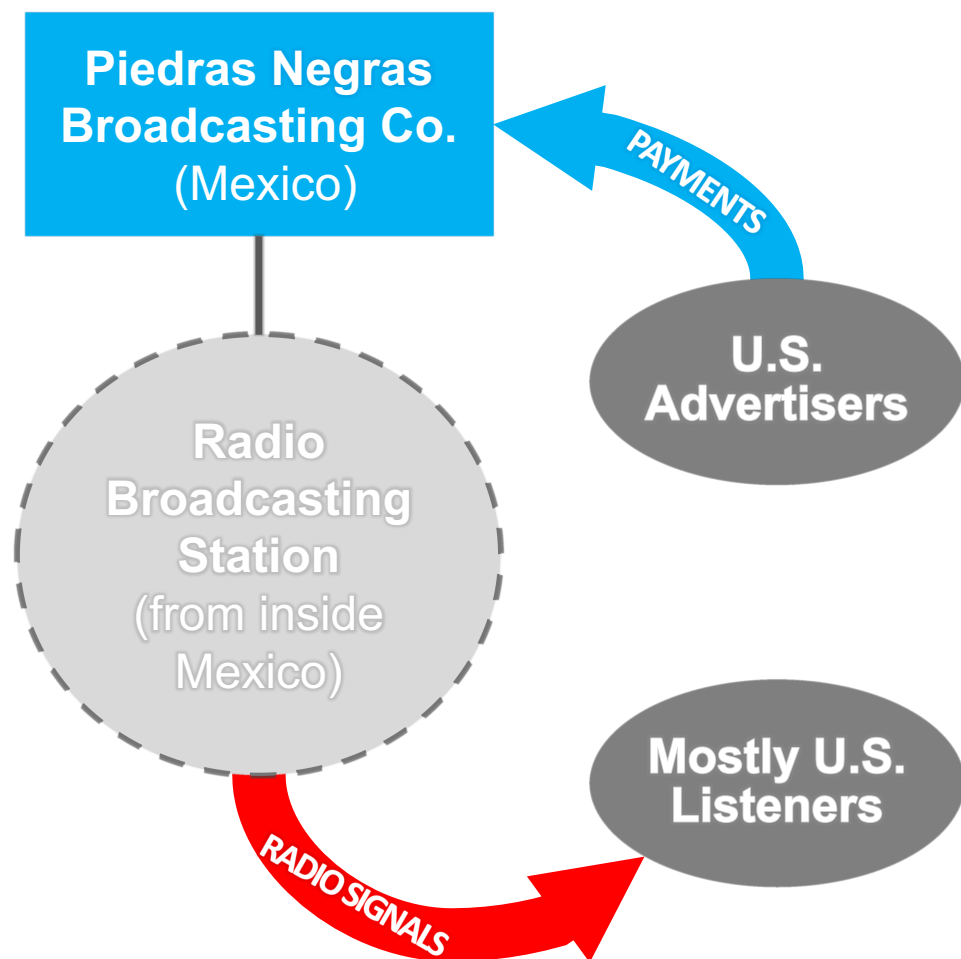
Software as a Service

- Do the Software Regulations apply to Software as a Service ("SaaS")?

  ➢ Is the transaction relating to a <u>computer program</u>?

  ➢ Has there been a <u>transfer</u> of the computer program?

- Typically, under the SaaS model there is no transfer of a computer program and no person acquires a copy of a computer program.

- Instead of transferring the program, the user accesses the software remotely through a web browser.

- The U.S. software classification regulations do not appear to apply to the SaaS model.

Sourcing SaaS Income

- Assuming that the SaaS model should be considered services, in order to determine the source of the income, we need to determine where the services are performed:

  ➢ Where the computer servers are located?

  ➢ Where the humans are that code the software put on the computer servers?

  ➢ Where the customers are located?
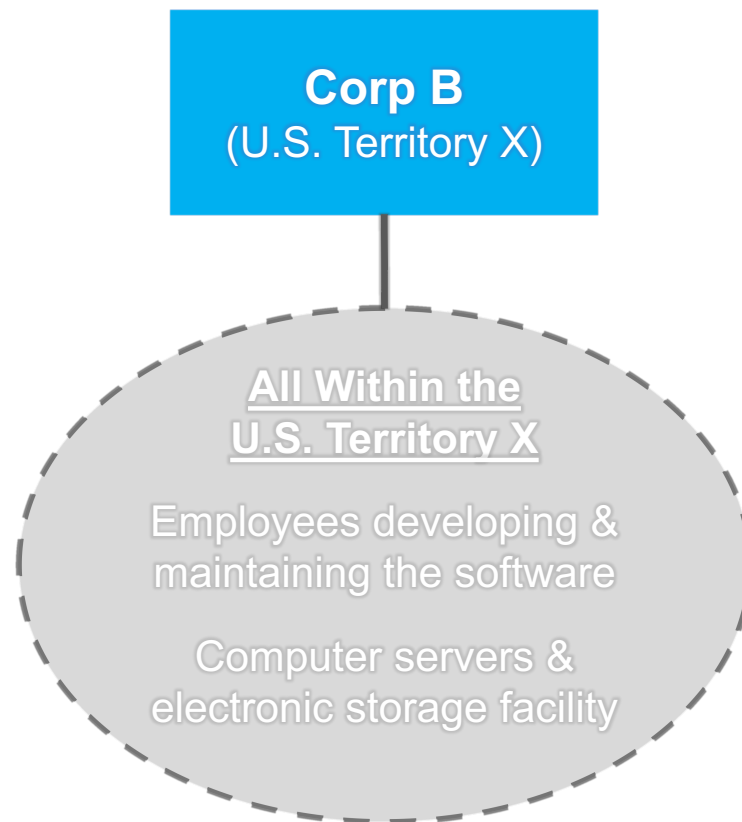
  ➢ A combination of the above?

Piedras Negras Broadcasting Co.

- A Mexican corporation owned and operated a radio broadcasting station in Mexico, from which it broadcast programs primarily for listeners in the U.S. and paid for predominantly by U.S. advertisers.

- The Court held that the Mexican corporation was not engaged in a U.S. trade or business and <u>did not have U.S. source income</u>.

Piedras Negras Broadcasting Co.
(Mexico)

PAYMENTS

U.S. Advertisers

Radio Broadcasting Station
(from inside Mexico)
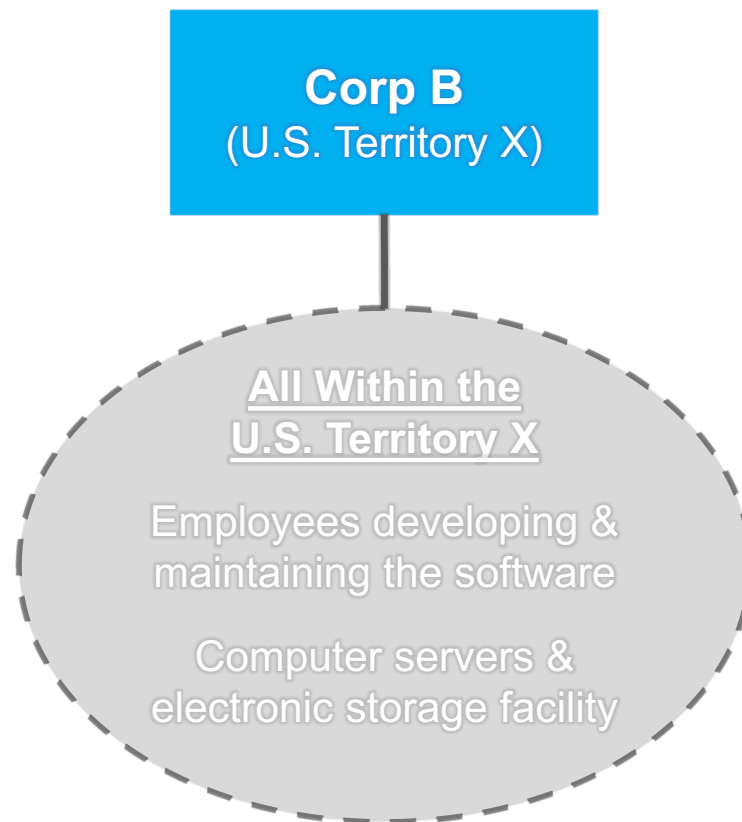
RADIO SIGNALS

Mostly U.S. Listeners

Treas. Reg. §1.937-3(e), Ex. 5

- Corp B is organized in Territory X (such as the U.S. Virgin Islands) & has its sole place of business there

- B is not engaged in a U.S. trade or business

- B employs a software business model generally referred to as an "application service provider"

- Employees of B in Territory X develop software and maintain it on B's server in Territory X

- B's customers in the U.S. and around the world transmit detailed data about their own customers to B's server and electronic storage facility in Territory X
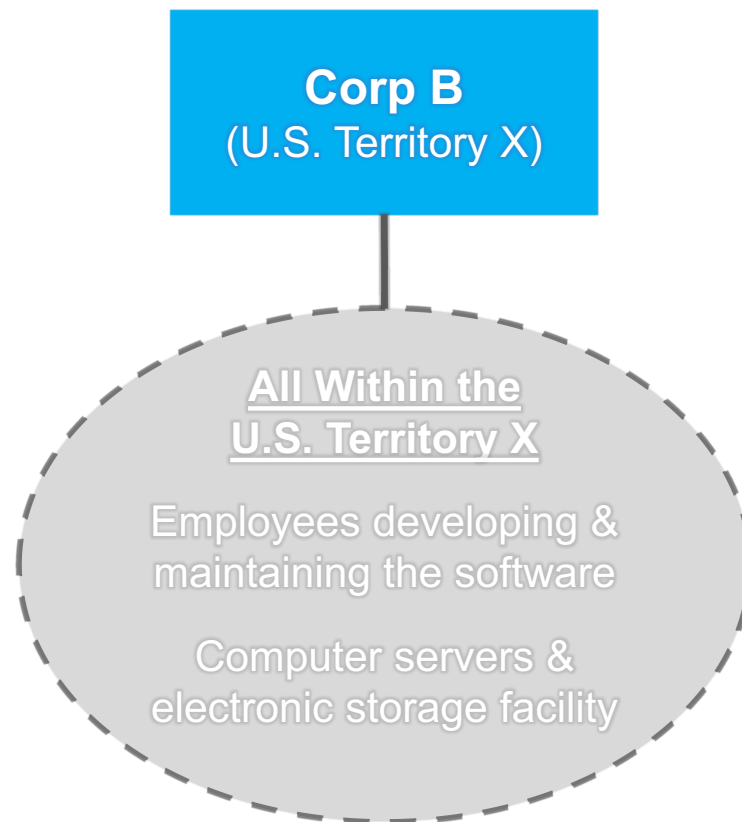
Corp B
(U.S. Territory X)

All Within the U.S. Territory X

Employees developing & maintaining the software

Computer servers & electronic storage facility

Treas. Reg. §1.937-3(e), Ex. 5 CONTINUED

- The customers pay a monthly fee to B under a "Subscription Agreement"

- The customers do not receive a copy of the software

- B's software allows its customers to generate the reports from their location and to keep track of their relationships with their own customers

- The example assumes B's income is from the provision of services

Corp B
(U.S. Territory X)

All Within the
U.S. Territory X

Employees developing & maintaining the software

Computer servers & electronic storage facility

Treas. Reg. §1.937-3(e), Ex. 5 CONTINUED

- The example concludes that because B performs personal services wholly within Territory X, the compensation B receives is sourced wholly to Territory X and none to the U.S.

Corp B
(U.S. Territory X)

**All Within the
U.S. Territory X**

Employees developing &
maintaining the software

Computer servers &
electronic storage facility

Customer Location Doesn't Matter for SaaS

- Under *Piedras Negras* and Treas. Reg. §1.937-3(e), Example 5, we can rule out the location of the customer as location of where the services are provided.

- Should the services be sourced based on the location of the server that is hosting the software?

  ➢ Servers are easily moved, shifting the associated profits

  ➢ Is web hosting a low value commodity?

Should the services be sourced to where humans developed the software?

- The significance and costs associated with the human component and server component varies between different services

  ➢ Online tax and legal research services: Humans must constantly update the database for newly released cases, laws, and exclusive treatises. The humans likely provide much of the value.

  ➢ Dropbox: Humans code the Dropbox server software and may update it as needed. Once the software is developed, the servers that run it and store the customers data become more critical. The speed and storage capacity of the servers determine the quality of the service.

- Should the services be split 50/50 between where the human developers are and where the servers are?

- Should something akin to a transfer pricing study be done to determine an appropriate split between the humans and the servers?

Important Notice

This presentation is not intended to be legal advice. Reading these materials does not create an attorney-client relationship. The outcome of each case stands on its own merits.