BOMBAY MANAGEMENT ASSOCIATION
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INTERNATIONAL TAX PROGRAM

CHARACTERIZATION OF SIGNIFICANT CROSS BORDER TRANSACTIONS: FOCUS ON SOFTWARE ISSUES

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Short Biography

Walt is a tax partner with the firm Fenwick & West in Palo Alto, California, and specializes in handling sophisticated tax planning and compliance issues with regard to domestic and multinational corporate taxation matters. He was named one of the outstanding tax lawyers in the US by the ***International Tax Review*** publication (July/August 1995 issue). He was also named one of the leading tax lawyers in the US in Euromoney's 1996 TO 2001 versions of the ***Guide to Leading US Tax Lawyers***. He was named one of the leading US transfer pricing lawyers in Euromoney's 1999 to 2001 version of the ***Guide to Leading Transfer Pricing Lawyers***. He was also named as one of the top Silicon Valley lawyers in the ***San Jose Magazine*** (July 2001 edition). He has extensive experience with large domestic and international merger, reorganization and joint venture transactions as well as with planning to optimize foreign tax credit, Subpart F and other pure international tax issues. He is an Adjunct Assistant Professor at Golden Gate University's School of Law and Graduate School of Taxation in the area of Advanced Corporate Taxation (Domestic and International). He is a frequent speaker in the international tax area for the World Trade Institute, Tax Executive's Institute, and a number of other national and international organizations. He has published several articles dealing with corporate and international tax issues, and he is a certified public accountant.

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CHARACTERIZATION OF SIGNIFICANT CROSS BORDER TRANSACTIONS: FOCUS ON SOFTWARE ISSUES

I. BACKGROUND AND INTRODUCTION.

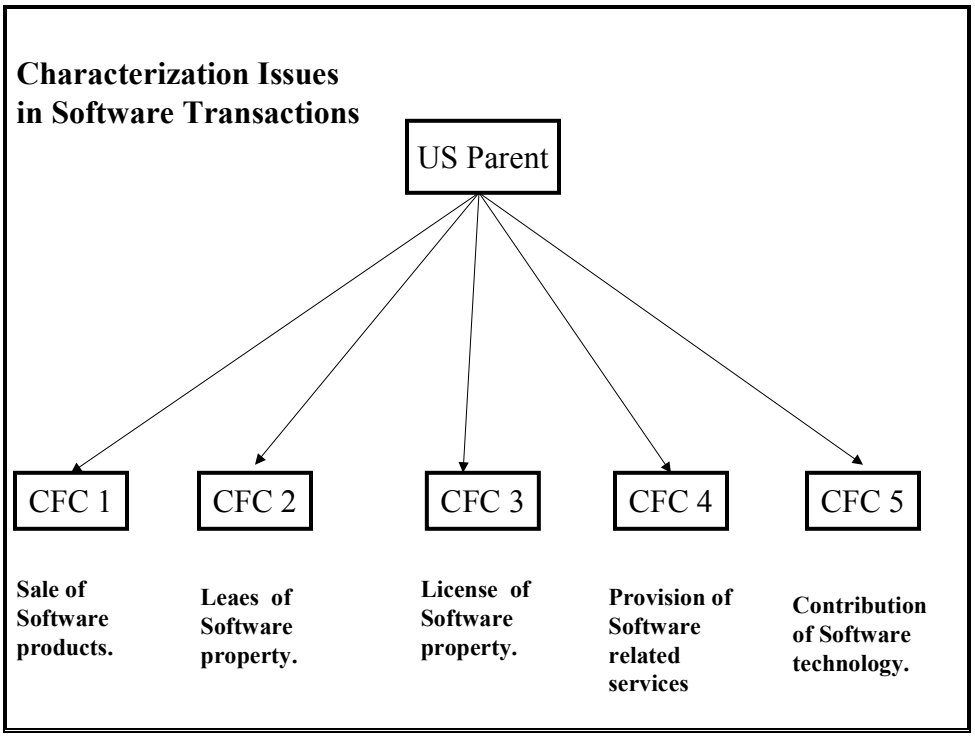
A. General. The concept of determining the character of a cross border transaction is at the root of every country's taxation system. The application of internal local country tax law, international treaties, withholding tax regimes, and similar rules all depend on the characterization of a transaction. For example, a transaction could be characterized as a sale, a license, a lease, or the provision of services. These characterization issues are most acute in the software industry.

B. US Internal Law Issuees. Most of the time, the US internal law will be the starting point for any characterization issue. Typical characterization issues involve the following:

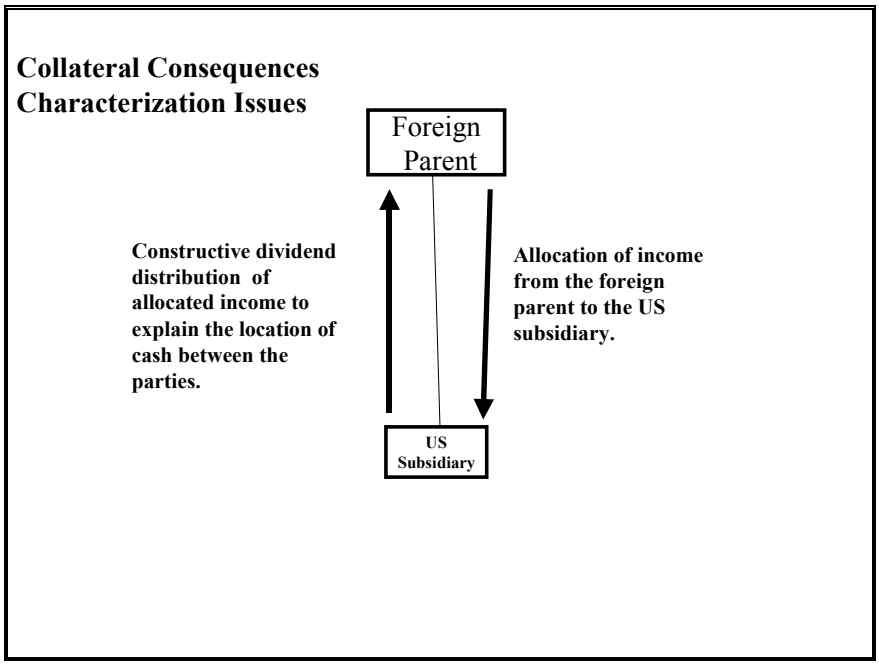
1. Sale versus Lease.
2. Sale versus license.
3. Sale versus provision of services.
4. Sale versus contribution.
5. Lease versus license.
6. Lease versus provision of services.
7. Lease versus contribution.
8. License versus provision of services.
9. License versus contribution.

While these issues can exist in any contractual situation, they are most acute in the

software industry and this will be the focus of this outline. .



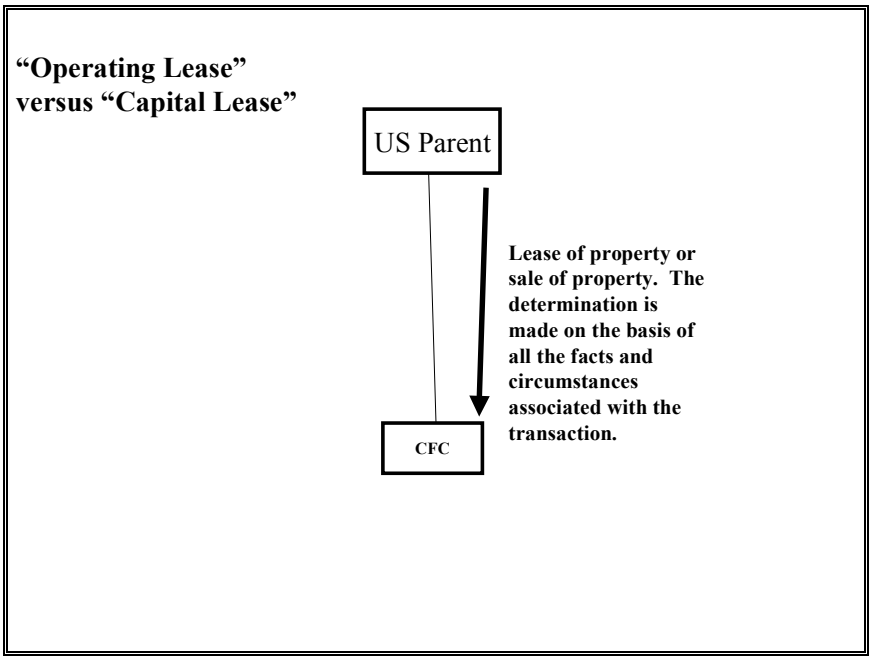
B. Collateral Charactization Issues. The characterization issues discussed in this outline, do not include the collateral issues can result from other income adjustments such as transfer pricing adjustments. For example, an allocation of income under § 482 of the Internal Revenue Code of 1986, as amended, could result in constructive dividend or constructive contribution transactions. These types of collateral consequences are not covered by this outline.



II. NON SOFTWARE TRANSACTION.

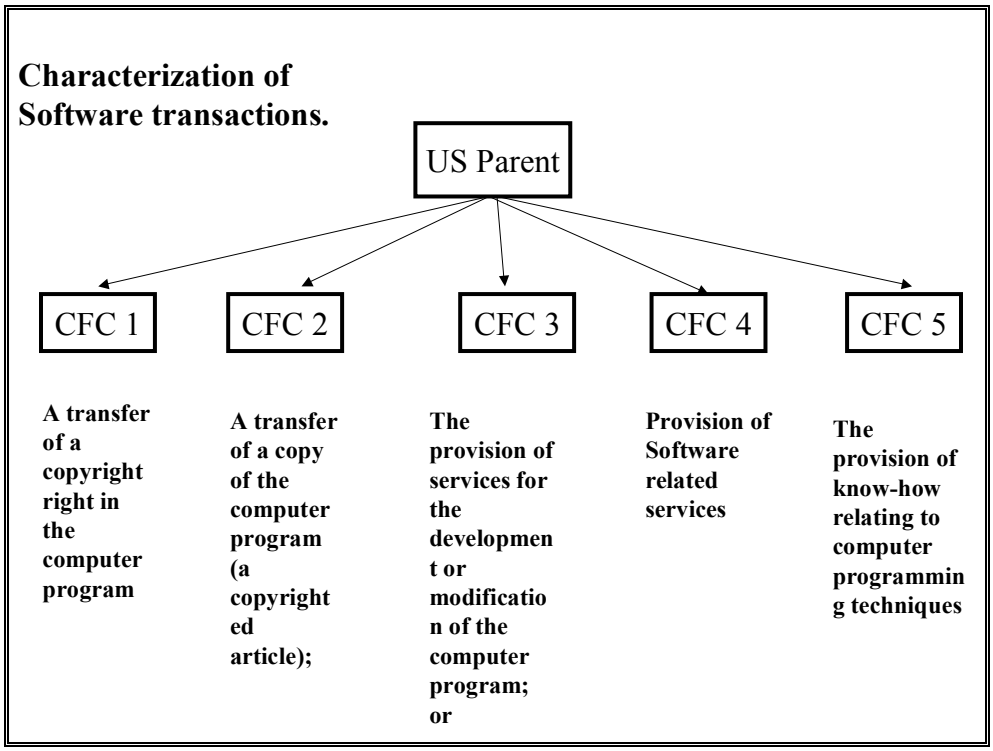
A. **General** There are several types of non software transactions which are subject to these characterization rules. For example, the most common of which involve the determination of whether the lease of property is, in substance, a sale of such property.

B. **Operating versus Capital Lease**. Often this is referred to as the determination of whether the transaction is a "capital lease" or an "operating lease".



III. SOFTWARE TRANSACTION.

A. **Background**. On November 13, 1996, proposed regulations were published in the Federal Register. The IRS received written comments on the proposed regulations and held a public hearing on March 19, 1997. On October 2, 1998, the IRS issued TD 8785 effective October 2, 1998. These regulations were corrected in 63 FR 64868, on November 24, 1998. For the most part, the final regulations adopt the basic rules proposed in 1996, but there were some very important clarifications made in the final regulations.



B. Some Basics.

1. **Computer program**. For purposes of the regulations, a computer program is defined as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. A computer program 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.

2. **Categories of transfers**. The new regulations require that software transactions be treated as being solely within one of the following four categories.

   (i) A transfer of a copyright right in the computer program;

   (ii) A transfer of a copy of the computer program (a copyrighted article);

   (iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

3. Transactions consisting of more than one category. Any transaction involving computer programs which consists of more than one of the transactions shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

C. Transfers involving copyright rights and copyrighted articles.

1. Classification of Transfers treated as transfers of copyright rights. A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in Treas. Reg. § 1.861-18(c)(2)(i) through (iv). Whether the transaction is treated as being solely the transfer of a copyright right or is treated as separate transactions is determined pursuant to Treas. Reg. § 1.861-18(b)(1) and (b)(2). For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in Treas. Reg. § 1.861-18(c)(2)(i) through (iv) (and the transaction does not involve, or involves only a de minimis provision of services as described in Treas. Reg. § 1.861-18(d) or of know-how as described in Treas. Reg. § 1.861-18(e)), then, under Treas. Reg. § 1.861-18(b)(2), the transfer is classified solely as a transfer of a copyright right.

2. Classification of Transfers treated solely as transfers of copyrighted articles. If a person acquires a copy of a computer program but does not acquire any of the rights described in Treas. Reg. § 1.861-18(c)(2)(i) through (iv) (or only acquires a de minimis grant of such rights), and the transaction does not involve, or involves only a de minimis, provision of services as described in Treas. Reg. § 1.861-18(d) or of know-how as described in Treas. Reg. § 1.861-18(e), the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

3. Copyright rights. The copyright rights referred to in Treas. Reg. § 1.861-18(c)(1) are as follows:

(i) The right to make copies of the computer program 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.

4. **Copyrighted article**. A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

D. **Provision of services**. The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in Treas. Reg. § 1.861-18(b)(1) is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

E. **Provision of know-how**. The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of Treas. Reg. § 1.861-18 only if the information is:

1. Information relating to computer programming techniques;

2. Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and

3. Considered property subject to trade secret protection.

F. **Further classification of transfers involving copyright rights and copyrighted articles**.

1. **Transfers of copyright rights.** The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis

of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under § 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under § 861(a)(4) or 862(a)(4), as appropriate.

2. **Transfers of copyrighted articles.** The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under § 861(a)(6), § 862(a)(6), § 863, § 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under § 861(a)(4) or § 862(a)(4), as appropriate.

3. **Special circumstances of computer programs.** In connection with determinations under Treas. Reg. § 1.861.18(f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

G. Special Rules to apply Classification Rules.

1. **Term applied to transaction by parties.** Neither the form adopted by the parties to a transaction, nor the classification of the transaction under

copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of Treas. Reg. § 1.861-18(c) and (f) may nevertheless result in the transaction being classified as the sale of a copyrighted article.

2. Means of transfer not to be taken into account. The rules of Treas. Reg. § 1.861-18 shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

a. Transfers to the public.. For purposes of Treas. Reg. § 1.861-18(c)(2)(i), a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For the purposes, a related person is a person who bears a relationship to the transferee specified in § 267(b)(3), (10), (11), or (12), or § 707(b)(1)(B). In applying § 267(b), 267(f), 707(b)(1)(B), or 1563(a), "10 percent" shall be substituted for "50 percent."

b. Use by individuals. The number of employees of a transferee of a computer program who are permitted to use the program in connection with their employment is not relevant for purposes of Treas. Reg. § 1.861-18(g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of a computer program who are permitted to use the program in connection with the performance of those services is not relevant for purposes of this Treas. Reg. § 1.861-18(g)(3).

H. Illustration of Rules. The 1998 regulations can be illustrated by the following examples:

1. Example 1.

(i) Facts. Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It 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 by the shrink-wrap license to sell the copy 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. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) Analysis.

(A) Under Treas. Reg. § 1.861-18(g)(1), the label license is not determinative. None of the copyright rights described in Treas. Reg. § 1.861-18(c)(2) have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under Treas. Reg. § 1.861-18(c)(1)(ii), P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a sale of a copyrighted article rather than the grant of a lease.

2. Example 2.

(i) Facts. The facts are the same as those in Example 1, except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to

those in Example 1, except that in this case P may make a back-up copy of the program on to a disk.

(ii) Analysis.

(A) None of the copyright rights described in Treas. Reg. § 1.861-18(c)(2) have passed to P. Although P did not buy a physical copy of the disk with the program on it, Treas. Reg. § 1.861-18(g)(2) provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in Example 1, P is properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a sale of a copyrighted article rather than the grant of a lease.

3. Example 3.

(i) Facts. The facts are the same as those in Example 1, except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) Analysis.

(A) Under Treas. Reg. § 1.861-18(c)(2), P has received no copyright rights. Because P has received a copy of the program under Treas. Reg. § 1.861-18(c)(1)(ii), he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in Treas. Reg. § 1.861-18(f)(3), the result would be the same if P were required to destroy the disk at the end of the one week period

instead of returning it since Corp A can make additional copies of the program at minimal cost.

4. Example 4.

(i) Facts. The facts are the same as those in Example 2, where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) Analysis.

(A) As in Example 3, under Treas. Reg. § 1.861-18(c)(2), P has not received any copyright rights. P has received a copy of the program, and under Treas. Reg. § 1.861-18(g)(2), the means of transmission is irrelevant. P has, therefore, under Treas. Reg. § 1.861-18(c)(1)(ii), received a copyrighted article.

(B) As in Example 3, P is not properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P's computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in Example 3, P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in Treas. Reg. § 1.861-18(f)(3), the result in this Example 4 is the same as in Example 3.

5. Example 5.

(i) 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 $y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) Analysis.

(A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under Treas. Reg. § 1.861-18(c)(1)(i) because this transfer is accompanied by a copyright right identified in Treas. Reg. § 1.861-18(c)(2)(i), this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of Treas. Reg. § 1.861-18(b)(2), the disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under Treas. Reg. § 1.861-18(f)(1), Corp A will be treated as having sold copyright rights to Corp B. 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. Under Treas. Reg. § 1.861-18(g)(1), the fact that the agreement is labeled a license is not controlling (nor is the fact that Corp A receives a sum labeled 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, as a result of the application of the rule of Treas. Reg. § 1.861-18(g)(2) of this section.

6. Example 6.

(i) Facts. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce (either directly or by contracting with either Corp A or another person to do so) and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and

sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) Analysis.

(A) As in Example 5, the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under Treas. Reg. § 1.861-18(c)(1) because Corp B has also acquired a copyright right under Treas. Reg. § 1.861-18(c)(2)(i), the right to reproduce and distribute to the public. For purposes of Treas. Reg. § 1.861-18(b)(2), the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under Treas. Reg. § 1.861-18(f)(1), there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

7. Example 7.

(i) Facts. Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time-to-time request. Corp C will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the license described in Example 1).

(ii) Analysis.

(A) Corp C has not acquired any copyright rights under Treas. Reg. § 1.861-18(c)(2) with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under Treas. Reg. § 1.861-

18(g)(1). Under Treas. Reg. § 1.861-18(c)(1)(ii), Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a sale of copyrighted articles.

8. Example 8.

(i) Facts. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) Analysis. The analysis is the same as in Example 6. Under Treas. Reg. § 1.861-18(c)(2)(i), Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of Treas. Reg. § 1.861-18(b)(2), the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under Treas. Reg. § 1.861-18(f)(1), this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties. (The result would be the same if Corp D included with the computers it sells an archival copy of Program X on a floppy disk.)

9. Example 9.

(i) Facts. The facts are the same as in Example 8, except that Corp D, the Country Z corporation, receives physical disks. The disks are

shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in Example 1). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) Analysis.

(A) As in Example 7 (unlike Example 8) no copyright right identified in Treas. Reg. § 1.861-18(c)(2) has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under Treas. Reg. § 1.861-18(c)(1)(ii).

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under Treas. Reg. § 1.861-18(f)(2), the transaction is classified as the sale of a copyrighted article. The result would be the same if Corp D used a single physical disk to copy Program X onto each computer, and transferred an unopened box containing Program X with each computer, if Corp D were not permitted to copy Program X onto more computers than the number of individual copies purchased.

10. Example 10.

(i) Facts. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) Analysis.

(A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under Treas. Reg. § 1.861-18(c)(2). Therefore, under Treas. Reg. § 1.861-18(c)(1)(ii), this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of copyrighted articles. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

(C) The result would be the same if Corp E were permitted to copy Program X onto an unlimited number of workstations used by employees of either Corp E or corporations that had a relationship to Corp E specified in Treas. Reg. § 1.861-18(g)(3).

11. Example 11.

(i) Facts. The facts are the same as in Example 10, except that Corp E, the Country Z corporation, acquires the right to make Program X available to workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) Analysis. Under Treas. Reg. § 1.861-18(g)(2) the mode of utilization is irrelevant. Therefore, as in Example 10, under Treas. Reg. § 1.861-18(c)(2), no copyright right has been transferred, and, thus, under Treas. Reg. § 1.861-18(c)(1)(ii), this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of Treas. Reg. § 1.861-18(f)(2), this transaction is a sale of copyrighted articles. The result would be the same if an unlimited number of Corp E employees were permitted to use

Program X on the LAN or if Corp E were permitted to copy Program X onto LANs maintained by corporations that had a relationship to Corp E specified in Treas. Reg. § 1.861-18(g)(3).

12. Example 12.

(i) Facts. The facts are the same as in Example 11, except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated, Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support to Corp E but the agreement does not allocate the monthly fee between the right to receive upgrades of Program X and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable at the time the contract is entered into but is expected to be de minimis. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) Analysis.

(A) Corp E has received no copyright rights under Treas. Reg. § 1.861-18(c)(2). Corp A has not provided any services described in Treas. Reg. § 1.861-18(d). Based on all the facts and circumstances of the transaction, Corp A has provided de minimis technical services to Corp E. Therefore, under Treas. Reg. § 1.861-18(c)(1)(ii), the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase

Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under Treas. Reg. § 1.861-18(f)(2) there has been a lease of a copyrighted article.

13. Example 13.

(i) Facts. The facts are the same as in Example 12, except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) Analysis. For the reasons stated in Example 10 the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

12. Example 14.

(i) 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 at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in Example 10.

(ii) Analysis.

(A) As in Example 10, no copyright rights are being transferred under Treas. Reg. § 1.861-18(c)(2). In addition, since no copyright rights are being transferred to Corp G, this transaction does not involve the provision of services by Corp A under Treas. Reg. § 1.861-18(d). This transaction will be classified, therefore, as a

transfer of copyrighted articles under Treas. Reg. § 1.861-18(c)(1)(ii).

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been the sale of a copyrighted article rather than the grant of a lease.

15. Example 15.

(i) 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 and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during 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 will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labeled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) Analysis. Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under Treas. Reg. § 1.861-18(d), Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Under Treas. Reg. § 1.861-18(g)(1), the fact that the agreement is labeled a license is not controlling (nor is the fact that Corp A receives a sum labeled a royalty).

16. Example 16.

(i) Facts. Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel

to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) Analysis. This transaction contains the elements of know-how specified in Treas. Reg. § 1.861-18(e). Therefore, this transaction will be treated as the provision of know-how.

17. Example 17.

(i) Facts. Corp A, a U.S. corporation, transfers a disk containing Program Y to Corp E, a Country Z corporation, in exchange for a single fixed payment. Program Y is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. No element of these libraries is a significant component of any overall new program. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the libraries with any program developed using Program Y. The license agreement is otherwise identical to the license agreement in Example 1.

(ii) Analysis.

(A) No non-de minimis copyright rights described in Treas. Reg. § 1.861-18(c)(2) have passed to Corp E. For purposes of Treas. Reg. § 1.861-18(b)(2), the right to distribute the libraries in conjunction with the programs created using Program Y is a de minimis component of the transaction. Because Corp E has received a copy of the program under Treas. Reg. § 1.861-18(c)(1)(ii), it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been the sale of a copyrighted article rather than the grant of a lease.

18. Example 18

(i) Facts.

(A) Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a country Z Corporation. The disk contains both the object code and the source code to Program X and the license agreement grants Corp E the right to: (1) Modify the source code in order to correct minor errors and make minor adaptations to Program X so it will function on Corp E's computer; and (2) Recompile the modified source code.

(B) The license does not grant Corp E the right to distribute the modified Program X to the public. The license is otherwise identical to the license agreement in Example 1.

(ii) Analysis.

(A) No non-de minimis copyright rights described in Treas. Reg. § 1.861-18(c)(2) have passed to Corp E. For purposes of Treas. Reg. § 1.861-18(b)(2), the right to modify the source code and recompile the source code in order to create new code to correct minor errors and make minor adaptations is a de minimis component of the transaction. Because Corp E has received a copy of the program under Treas. Reg. § 1.861-18(c)(1)(ii), it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under Treas. Reg. § 1.861-18(f)(2), there has been the sale of a copyrighted article rather than the grant of a lease.

I **Effective date**.

1. **General**. The new regulations apply to transactions occurring pursuant to contracts entered into on or after December 1, 1998.

2.. **Elective transition rules.**

a. **Contracts entered into in taxable years ending on or after October 2, 1998**. A taxpayer may elect to apply the regulations to transactions occurring pursuant to contracts entered into in taxable years ending on or after October 2, 1998. A taxpayer that makes an election must apply this section to all contracts entered into in taxable years ending on or after October 2, 1998.

b. **Contracts entered into before October 2, 1998.** A taxpayer may elect to apply the new regulations to transactions occurring in taxable years ending on or after October 2, 1998, pursuant to contracts entered into before October 2, 1998, provided the taxpayer would not be required under this section to change its method of accounting as a result of such election, or the taxpayer would be required to change its method of accounting but the resulting § 481(a) adjustment would be zero. A taxpayer that makes an election must apply this section to all transactions occurring in taxable years ending on or after October 2, 1998, pursuant to contracts entered into before October 2, 1998.

c. Manner of making election. Taxpayers may elect to apply the retroactive election by treating the transactions in accordance with the regulations on their original tax return. There is no election form.

3. **Illustrations**. The following examples illustrate application of the transition rule of Treas. Reg. § 1.861-18(i)(2)(ii):

a. **Example 1**. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program in that year, and to provide updates for each of the following four years. Under the contract, the computer program and the updates are priced separately, and Corp A is entitled to receive payments for the computer program and each of the updates upon delivery. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the payments under the contract in gross income in the taxable year the payments are received and the computer program or updates are delivered. Corp A properly deducts the cost of developing the computer program and updates when the costs are incurred. Year 3 includes October 2, 1998. Assume under the rules of this section, the provision of updates would properly be accounted for as the transfer of copyrighted articles. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would not be required to

change its method of accounting for income under the contract as a result of the election. Corp A would also not be required to change its method of accounting for the cost of developing the computer program and the updates under the contract as a result of the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, because Corp A is not required to change from its method of accounting for the contract as a result of the election.

b. **Example 2**. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program and to provide one update the following year. Under the contract, the computer program and the update are priced separately, and Corp A is entitled to receive payment for the computer program and the update upon delivery of the computer program. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the portion of the payment relating to the computer program in gross income in year 1, the taxable year the payment is received and the program delivered. Corp A properly includes the portion of the payment relating to the update in gross income in year 2, the taxable year the update is provided, under Rev. Proc. 71-21, 1971-2 CB 549 (see section 601.601 (d)(2) of this chapter). Corp A properly deducts the cost of developing the computer program and update when the costs are incurred. Year 2 includes October 2, 1998. Assume under the rules of this section, provision of the update would properly be accounted for as the transfer of a copyrighted article. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would be required to change its method of accounting for deferring income under its contract as a result of the election. However, the section 481(a) adjustment would be zero because the portion of the payment relating to the update would be includible in gross income in year 2, the taxable year the update is provided, under both Rev. Proc. 71-21 and section 1.451-5. Corp A would not be required to change its method of accounting for the cost of developing the computer program and the update under the contract as a result of

the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the update in year 2, because the section 481(a) adjustment resulting from the change in method of accounting for deferring advance payments under the contract is zero, and because Corp A is not required to change from its method of accounting for the cost of developing the computer program and updates under the contract as a result of the election.

c. **Example 3**. Assume the same facts as in Example 1 except that Corp A is entitled to receive payments for the computer program and each of the updates 30 days after delivery. Corp A properly includes the amounts due under the contract in gross income in the taxable year the computer program or updates are provided. Assume that Corp A properly uses the nonaccrual-experience method described in § 448(d)(5) and Treas. Reg. § 1.448-2T to account for income on its contracts. If Corp A made an election under Treas. Reg. § 1.861-18(i)(2)(ii) of this section, Corp A would be required to change from the nonaccrual-experience method for income as a result of the election, because the method is only available with respect to amounts to be received for the performance of services. Therefore, Corp A may not elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, under Treas. Reg. § 1.861-18(i)(2)(ii), because Corp A would be required to change from the nonaccrual-experience method of accounting for income on the contract as a result of the election.

J. **Change in method of accounting.**

1. **Consent**. A taxpayer is granted consent to change its method of accounting for contracts involving computer programs, to conform with the classification prescribed in this section. The consent is granted for contracts entered into on or after December 1, 1998, or in the case of a taxpayer making a retroactive election, the consent is granted for contracts entered into in taxable years ending on or after October 2, 1998. In addition, a taxpayer that makes a retroactive election is granted consent to change its method of accounting for any contract with transactions subject to the election, if the taxpayer is required to change its method of accounting as a result of the election.

2. **Year of change**. The year of change is the taxable year that includes December 1, 1998, or in the case of a taxpayer making a retroactive election, the taxable year that includes October 2, 1998.

3. **Time and manner of making change in method of accounting.** A taxpayer changing its method of accounting in accordance with this section must file a Form 3115, *Application for Change in Method of Accounting*, in duplicate. The taxpayer must type or print the following statement at the top of page 1 of the Form 3115: ***"FILED UNDER TREASURY REGULATION section 1.861-18."*** The original Form 3115 must be attached to the taxpayers original return for the year of change. A copy of the Form 3115 must be filed with the National Office no later than when the original Form 3115 is filed for the year of change. The copy of the Form 3115 is required to be sent to the national office should be sent to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington DC 20044 (or in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW., Washington, DC 20224).

4. **Effect of consent and Internal Revenue Service review**. A change in method of accounting granted is subject to review by the district director and the national office and may be modified or revoked in accordance with the provisions of Rev. Proc. 97-37 (1997-33 IRB 18) (or its successors) (see Treas. Reg. § 601.601(d)(2)).

IV. TREATY CHARACTERIZATION ISSUES.

A. General. Many treaties do not provide for definitive characterization rules and most of the time, the lack of treaty language requires a careful examination of the internal rules of the taxing country.