

INTERNATIONAL TAXATION OF COMPUTER SOFTWARE AND CLOUD COMPUTING TRANSACTIONS

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AGENDA

- Classification of Computer Software under Treas. Reg. Sec. 1.861-18 (the “-18 regs”)
 - -18 – Regulatory Framework
 - -18 – Examples
- Computer Software Progression
- Cloud Computing Basics
- Classification and Taxation of Cloud Computing



COMPUTER SOFTWARE

“-18 REGS”

APPLICATION OF -18 REGS

(A) GENERAL—

- **SCOPE; -18(a)(1):** (1) *Scope*. This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.
- **DEFINITION OF COMPUTER PROGRAM; -18(a)(3):** (3) *Computer program*. For purposes of this section, 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....
- **CATEGORIES; SOLELY WITHIN; -18(a)(2) :** (2) *Categories of transactions*. This section generally **requires** that such transactions be **treated as being solely within one of four categories** (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

APPLICATION OF -18 REGS

(B) CATEGORIES OF TRANSACTIONS—

- (1) **General.**a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—
 - (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.
- (2) Transactionswhich consists of more than one of the transactions treated as separate transactions... However, any transaction that is de minimis, not be treated as a separate transaction.

APPLICATION OF -18 REGS

(C)(2) COPYRIGHT RIGHTS. THE COPYRIGHT RIGHTS REFERRED TO IN PARAGRAPH (C)(1) OF THIS SECTION 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;
- -18(g)(3) - not considered ... 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.
- (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.

APPLICATION OF -18 REGS

(D) *PROVISION OF SERVICES.* ... 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.* ---- 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.

APPLICATION OF -18 REGS

(F) *FURTHER CLASSIFICATION OF TRANSFERS INVOLVING COPYRIGHT RIGHTS AND COPYRIGHTED ARTICLES—*

- (1) ***TRANSFERS OF COPYRIGHT RIGHTS***.SALE OR EXCHANGE OF PROPERTY IS MADE ON THE BASIS OF WHETHER,A **TRANSFER OF ALL SUBSTANTIAL RIGHTS IN THE COPYRIGHT**. A TRANSACTION THAT **DOES NOT CONSTITUTE A SALE** ... 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 SECTION 865(A), (C), (D), (E), OR (H), AS APPROPRIATE. INCOME DERIVED FROM THE LICENSING OF A COPYRIGHT RIGHT WILL BE SOURCED UNDER SECTION 861(A)(4) OR 862(A)(4), AS APPROPRIATE.
- (2) ***TRANSFERS OF COPYRIGHTED ARTICLES***.SALE OR EXCHANGE IS MADE ON THE BASIS OF WHETHER, **BENEFITS AND BURDENS OF OWNERSHIP HAVE BEEN TRANSFERRED**. A TRANSACTION THAT **DOES NOT CONSTITUTE A SALE** ...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 SECTIONS 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 SECTION 861(A)(4) OR SECTION 862(A)(4), AS APPROPRIATE.

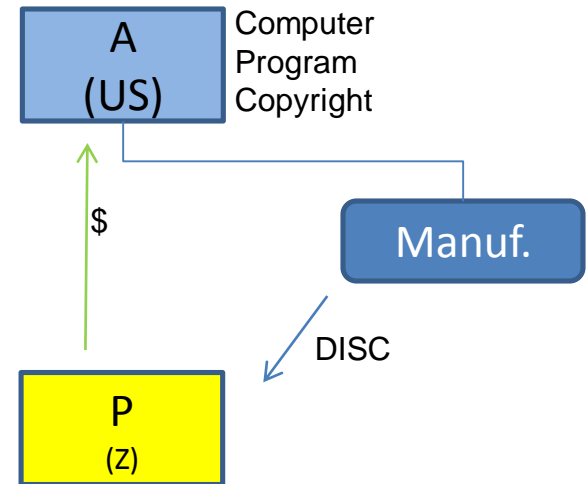
APPLICATION OF -18 REGS

(G) *RULES OF OPERATION—*

- (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.
- (2) ***MEANS OF TRANSFER NOT TO BE TAKEN INTO ACCOUNT.*** THE RULES OF THIS SECTION SHALL BE APPLIED IRRESPECTIVE OF THE PHYSICAL OR ELECTRONIC OR OTHER MEDIUM USED TO EFFECTUATE A TRANSFER OF A COMPUTER PROGRAM.

“-18 REGS” – EXAMPLE 1

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, DECOMPILE, 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.



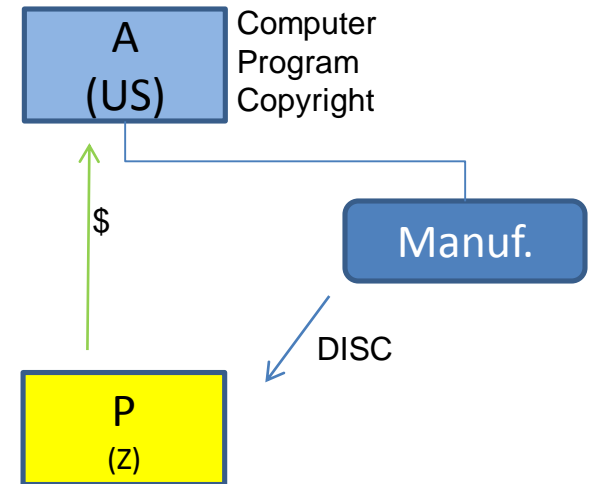
“-18 REGS” – EXAMPLE 1

ANALYSIS. (A) UNDER PARAGRAPH (G)(1) OF THIS SECTION, THE LABEL LICENSE IS NOT DETERMINATIVE.

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

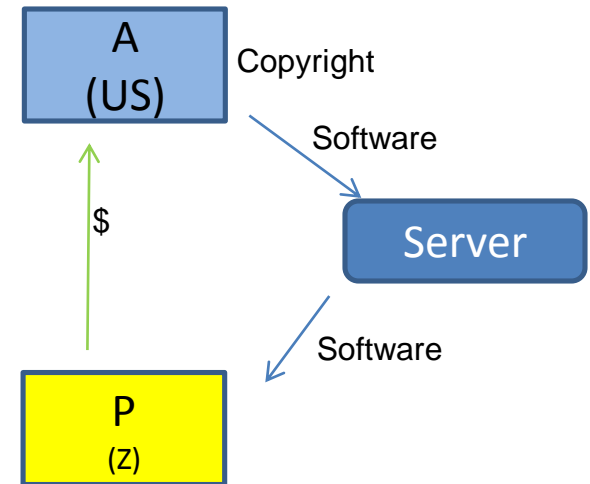
NONE OF THE COPYRIGHT RIGHTS DESCRIBED IN PARAGRAPH (C)(2) OF THIS SECTION HAVE BEEN TRANSFERRED IN THIS TRANSACTION. P HAS RECEIVED A COPY OF THE PROGRAM, HOWEVER, AND, THEREFORE, UNDER PARAGRAPH (C)(1)(II) OF THIS SECTION, P HAS ACQUIRED SOLELY A COPYRIGHTED ARTICLE.

SALE OR LEASE? (B) TAKING INTO ACCOUNT ALL OF THE FACTS AND CIRCUMSTANCES, P IS PROPERLY TREATED AS THE OWNER OF A COPYRIGHTED ARTICLE. THEREFORE, UNDER PARAGRAPH (F)(2) OF THIS SECTION, THERE HAS BEEN A SALE OF A COPYRIGHTED ARTICLE RATHER THAN THE GRANT OF A LEASE.



“-18 REGS” – EXAMPLE 2

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.

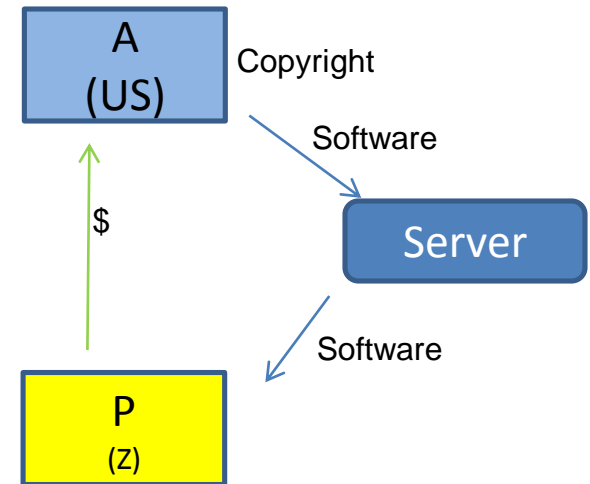


“-18 REGS” – EXAMPLE 2

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW

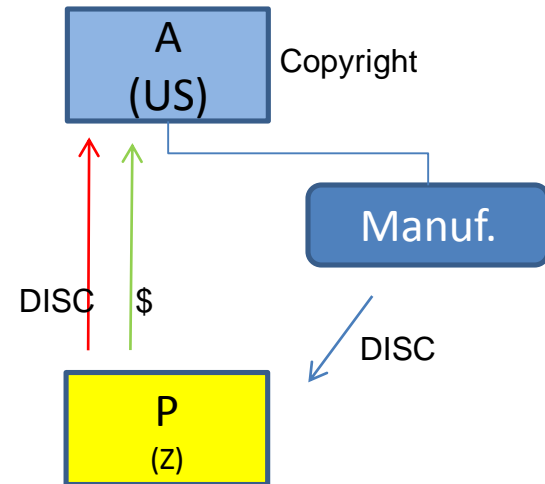
HOW: (II) ANALYSIS. (A) NONE OF THE COPYRIGHT RIGHTS DESCRIBED IN PARAGRAPH (C)(2) OF THIS SECTION HAVE PASSED TO P. ALTHOUGH P DID NOT BUY A PHYSICAL COPY OF THE DISK WITH THE PROGRAM ON IT, PARAGRAPH (G)(2) OF THIS SECTION PROVIDES THAT THE MEANS OF TRANSFERRING THE PROGRAM IS IRRELEVANT. THEREFORE, P HAS ACQUIRED A COPYRIGHTED ARTICLE.

SALE OR LEASE? (B) AS IN *EXAMPLE 1*, P IS PROPERLY TREATED AS THE OWNER OF A COPYRIGHTED ARTICLE. THEREFORE, UNDER PARAGRAPH (F)(2) OF THIS SECTION, THERE HAS BEEN A SALE OF A COPYRIGHTED ARTICLE RATHER THAN THE GRANT OF A LEASE.



“-18 REGS” – EXAMPLE 3

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.



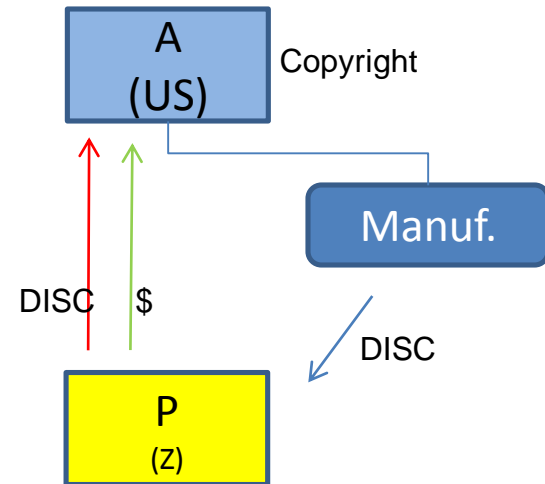
“-18 REGS” – EXAMPLE 3

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a **copyrighted article**.

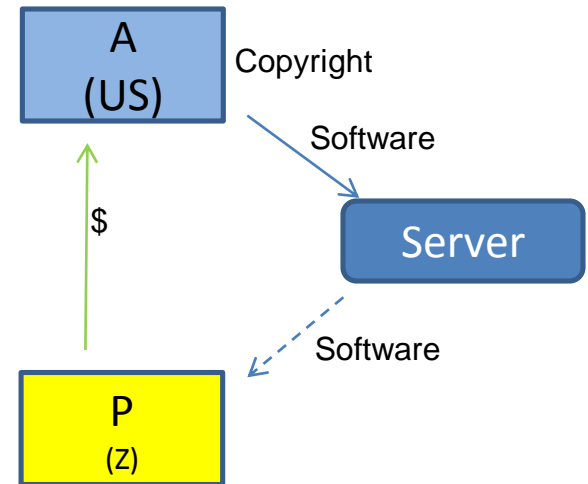
SALE OR LEASE?

- (B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, 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 paragraph (f)(3) of this section, 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.



“-18 REGS” – EXAMPLE 4

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.



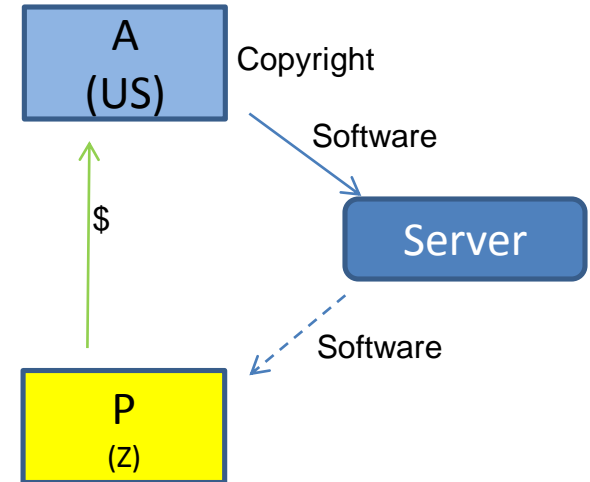
“-18 REGS” – EXAMPLE 4

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- As in *Example 3*, under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant. P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

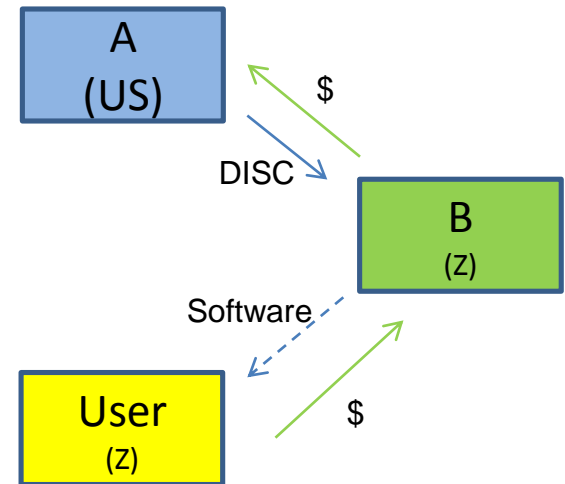
SALE OR LEASE?

- As in *Example 3*, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, 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 paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3*.



“-18 REGS” – EXAMPLE 5

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 COMMERCIALY EXPLOITABLE VALUE.



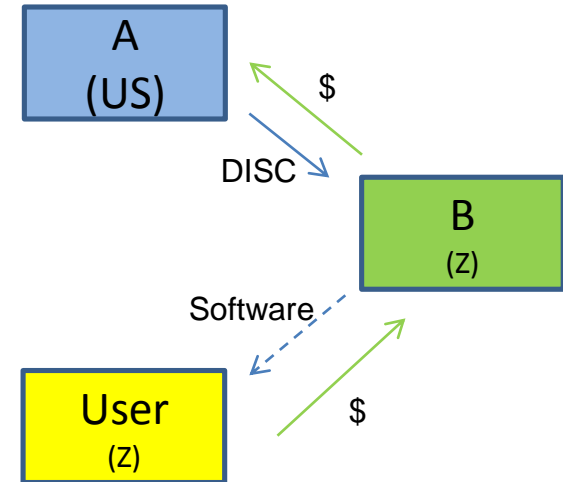
“-18 REGS” – EXAMPLE 5

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

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

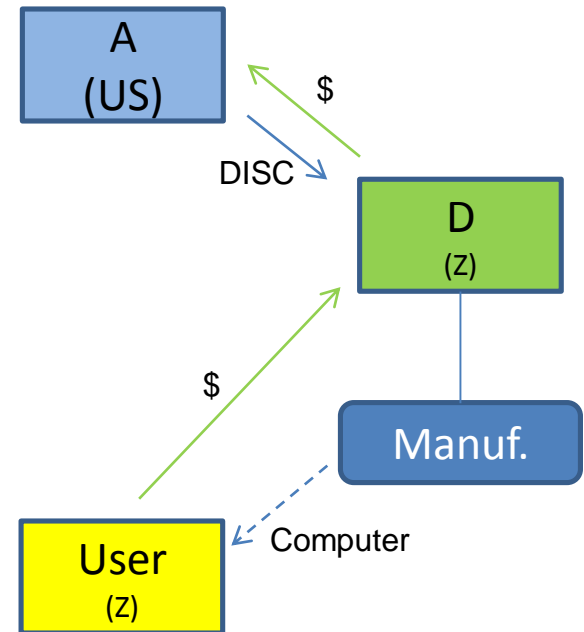
SALE OR ROYALTY?

- Applying the all substantial rights test under paragraph (f)(1) of this section, 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 paragraph (g)(1) of this section, 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, as a result of the application of the rule of paragraph (g)(2) of this section.)



“-18 REGS” – EXAMPLE 8

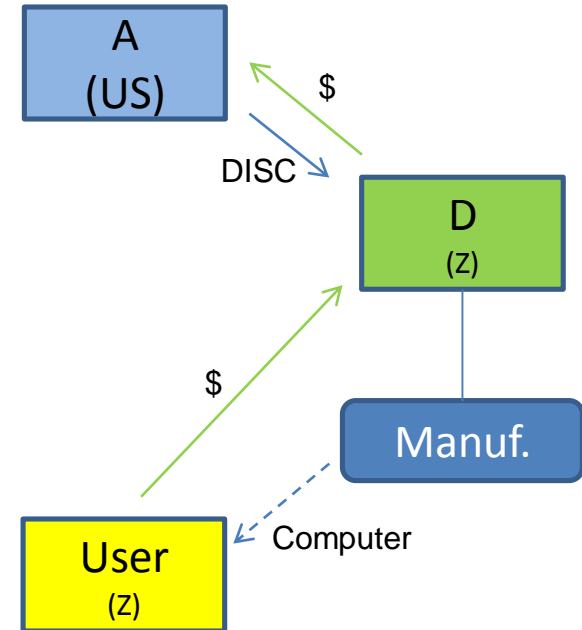
CORP A, A U.S. CORPORATION, TRANSFERS A DISK CONTAINING PROGRAM X TO CORP D, A FOREIGN CORPORATION ENGAGED IN THE MANUFACTURE AND SALE OF PERSONAL COMPUTERS IN COUNTRY Z. CORP A GRANTS CORP D THE NON-EXCLUSIVE RIGHT TO COPY PROGRAM X ONTO THE HARD DRIVE OF AN UNLIMITED NUMBER OF COMPUTERS, WHICH CORP 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.



“-18 REGS” – EXAMPLE 8

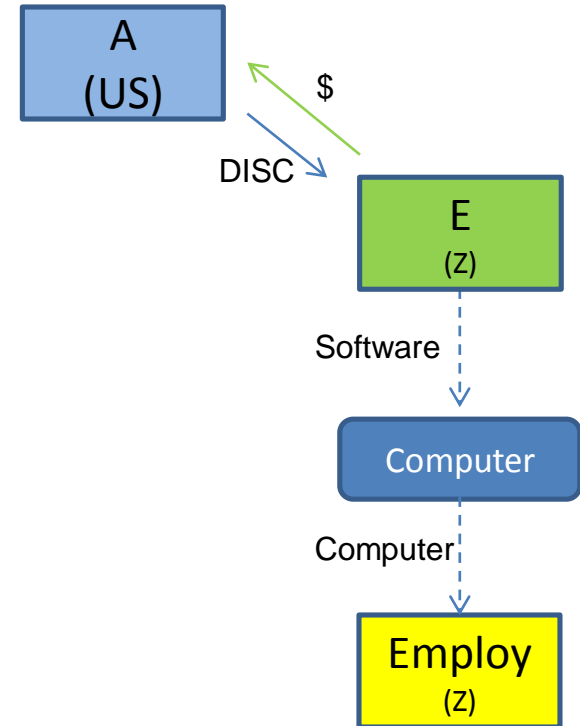
COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- The analysis is the same as in *Example 6*. Under paragraph (c)(2)(i) of this section, 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 paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.
- Sale or Royalty?
 - 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 paragraph (f)(1) of this section, 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.)



“-18 REGS” – EXAMPLE 10

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.



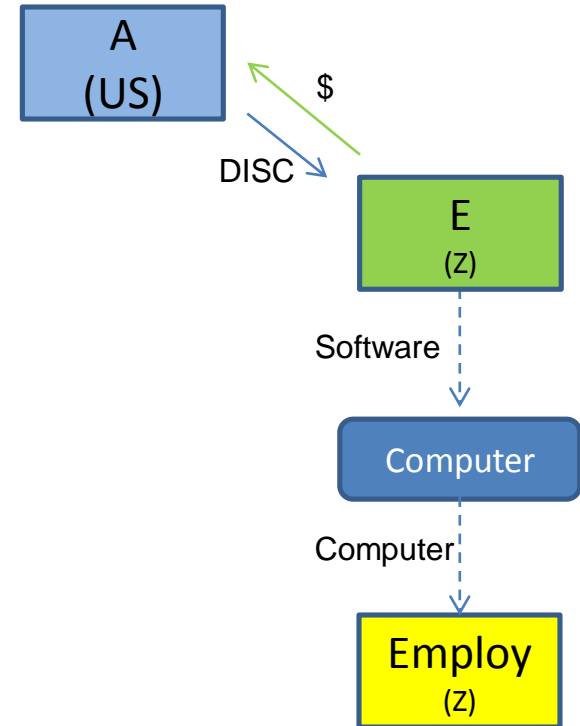
“-18 REGS” – EXAMPLE 10

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- 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 paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

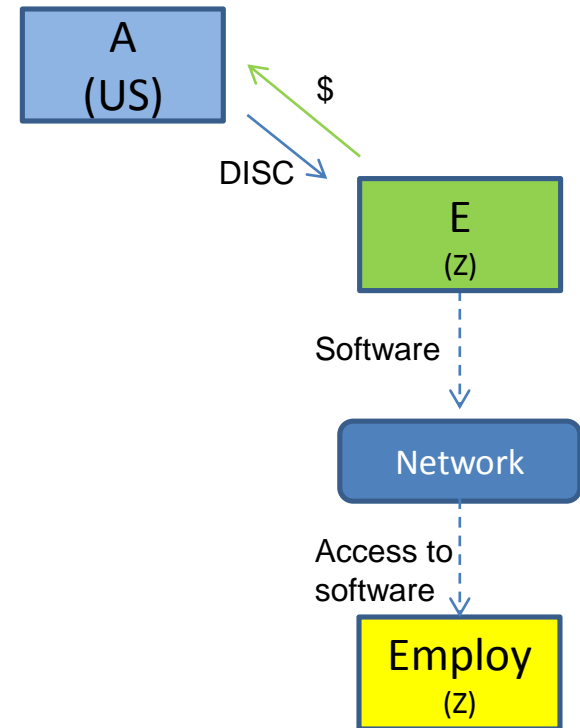
SALE OR LEASE?

- Taking into account all of the facts and circumstances, P is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, 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.
- 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 paragraph (g)(3) of this section.



“-18 REGS” – EXAMPLE 11

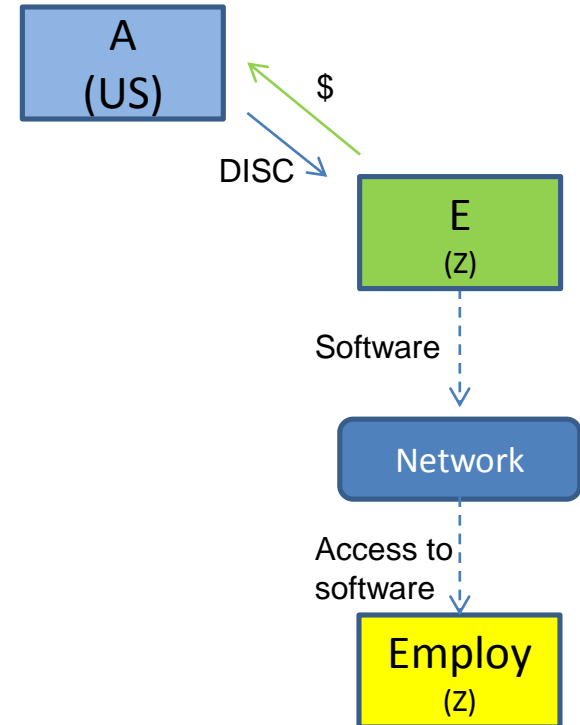
THE FACTS ARE THE SAME AS IN *EXAMPLE 10*, EXCEPT THAT CORP E, THE COUNTRY Z CORPORATION, ACQUIRES THE RIGHT TO MAKE PROGRAM X AVAILABLE TO WORKSTATION USERS WHO ARE CORP E EMPLOYEES BY WAY OF A LOCAL AREA NETWORK (LAN). THE NUMBER OF USERS THAT CAN USE PROGRAM X ON THE LAN AT ANY ONE TIME IS LIMITED 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.



“-18 REGS” – EXAMPLE 11

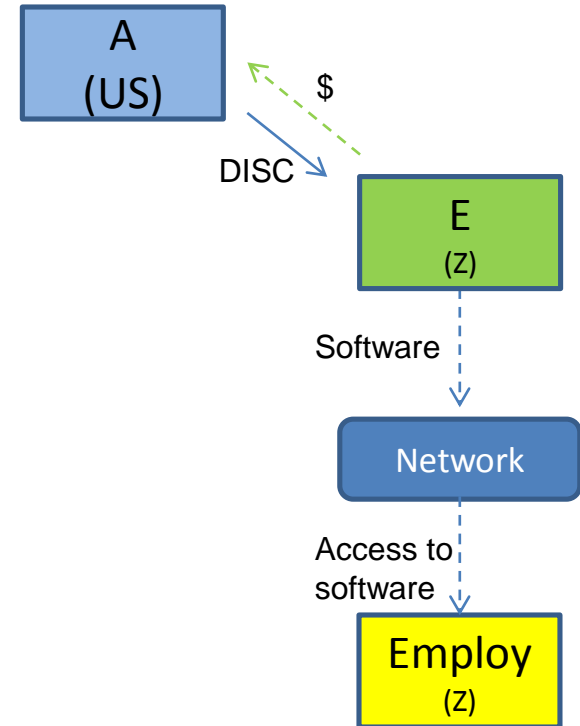
COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- (ii) *Analysis*. Under paragraph (g)(2) of this section the mode of utilization is irrelevant. Therefore, as in *Example 10*, under paragraph (c)(2) of this section, no copyright right has been transferred, and, thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a **copyrighted article**.
- 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 paragraph (g)(3) of this section.
- **Sale or Lease?**
 - Sale – same as example 10



“-18 REGS” – 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.



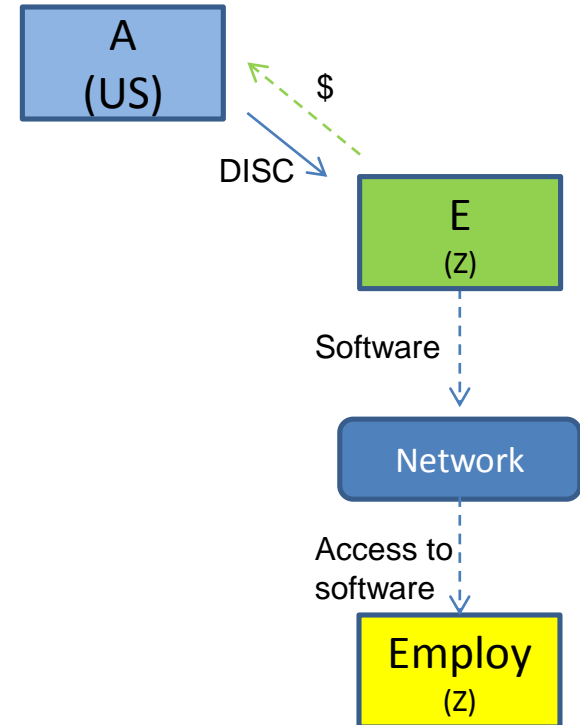
“-18 REGS” – EXAMPLE 12

COPYRIGHT RIGHT OR COPYRIGHT ARTICLE?

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

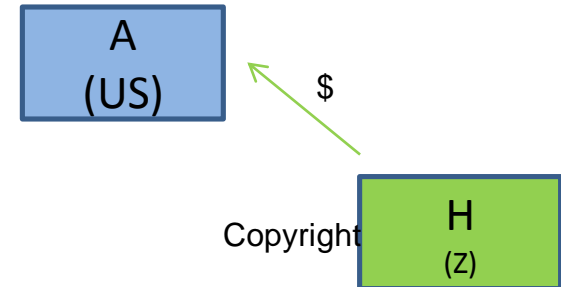
SALE OR LEASE?

- 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 paragraph (f)(2) of this section there has been a lease of a copyrighted article.



“-18 REGS” – EXAMPLE 15

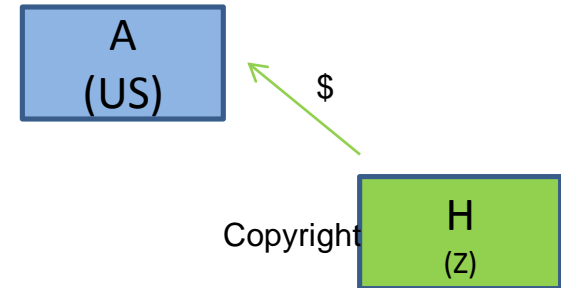
CORP H, A COUNTRY Z CORPORATION, ENTERS INTO A LICENSE AGREEMENT FOR A NEW COMPUTER PROGRAM. PROGRAM Q IS TO BE WRITTEN BY CORP A, A U.S. CORPORATION. CORP A AND CORP H AGREE THAT CORP A IS WRITING PROGRAM Q FOR CORP H AND THAT, WHEN PROGRAM Q IS COMPLETED, THE COPYRIGHT IN PROGRAM Q WILL BELONG TO CORP 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 LABELLED 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.



“-18 REGS” – EXAMPLE 15

COPYRIGHT RIGHT/ ARTICLE/ SERVICE/ KNOW HOW:

- Taking into account all of the facts and circumstances, Corp A is treated as providing **services** to Corp H. Under paragraph (d) of this section, 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 paragraph (g)(1) of this section, 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).



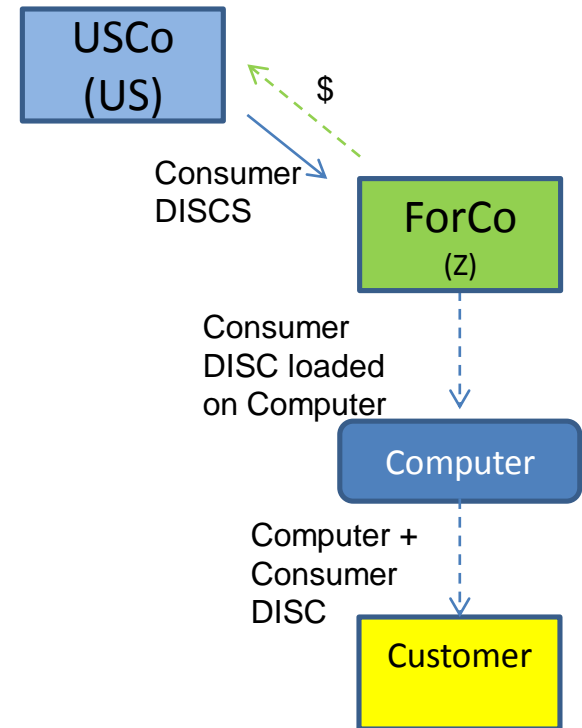


**COMPUTER
SOFTWARE**

**PROGRESSION OF
SOFTWARE**

SOFTWARE PROGRESSION – BASE CASE (PROBLEM 1)

USCO, A U.S. CORPORATION, DEVELOPED A SOFTWARE PROGRAM NAMED MIGHTY MIGHT. USCO TRANSFERS DISKS CONTAINING MIGHTY MIGHT TO FORCO, A FOREIGN CORPORATION ENGAGED IN THE MANUFACTURE AND SALE OF PERSONAL COMPUTERS IN COUNTRY Z. THE DISKS ARE SHIPPED IN BOXES COVERED BY WRAPPER ON WHICH IS PRINTED WHAT IS GENERALLY REFERRED TO AS A SHRINK-WRAP LICENSE. THE TERMS OF THESE LICENSES DO NOT PERMIT FORCO TO MAKE ADDITIONAL COPIES OF MIGHTY MIGHT. FORCO USES EACH INDIVIDUAL DISK ONLY ONCE TO LOAD A SINGLE COPY OF MIGHTY MIGHT ONTO EACH SEPARATE COMPUTER. FORCO THEN RE-PACKAGES THE DISK INTO THE PACKAGING, AND TRANSFERS THE DISK WITH THE COMPUTER WHEN IT IS SOLD.



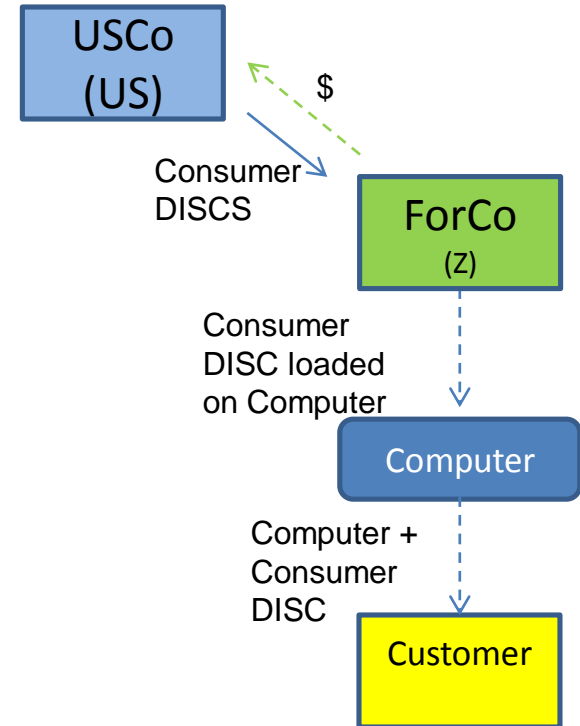
SOFTWARE PROGRESSION – PROBLEM 1

COPYRIGHT RIGHT OR COPYRIGHT ARTICLE? HAS A COPYRIGHT RIGHT BEEN TRANSFERRED?

- No copyright right identified in paragraph (c)(2) of this section has been transferred.
- ForCo acquires the disks without the right to reproduce and distribute publicly
- Have transfer of copyright article

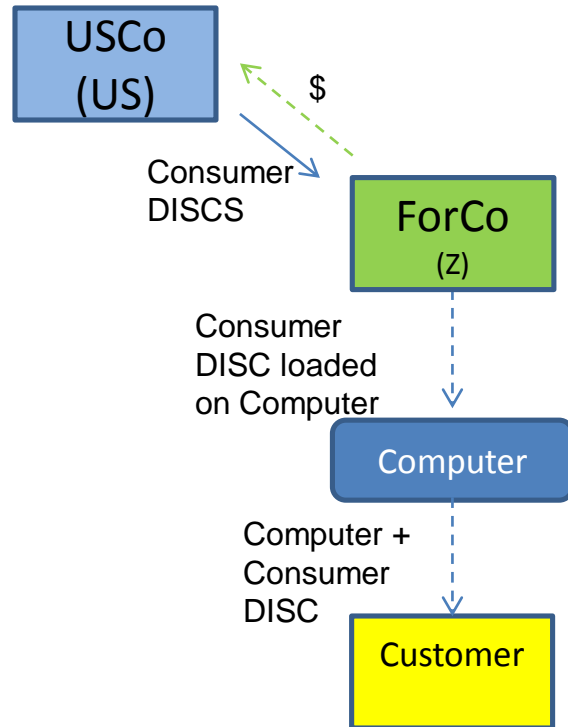
SALE OR LEASE?

- ForCo treated as the owner of copyrighted articles; classified as the sale of a copyrighted article.

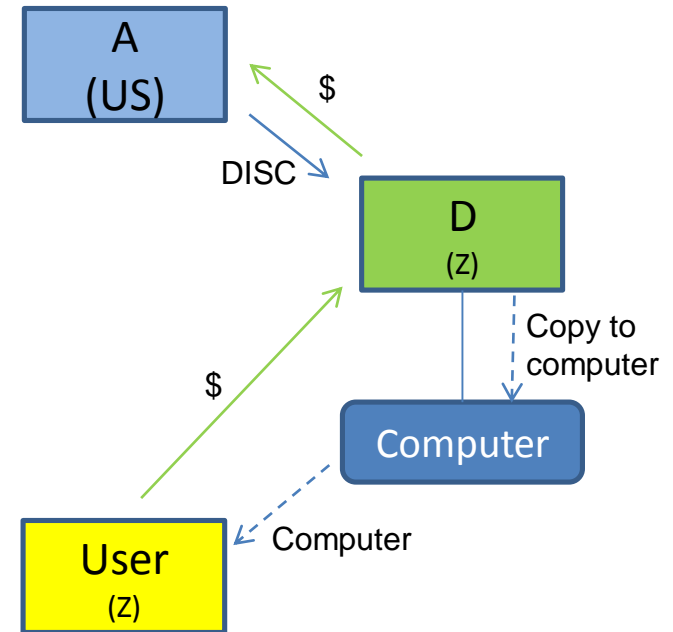


COMPARE EXAMPLE 8 & PROBLEM 1

Problem 1

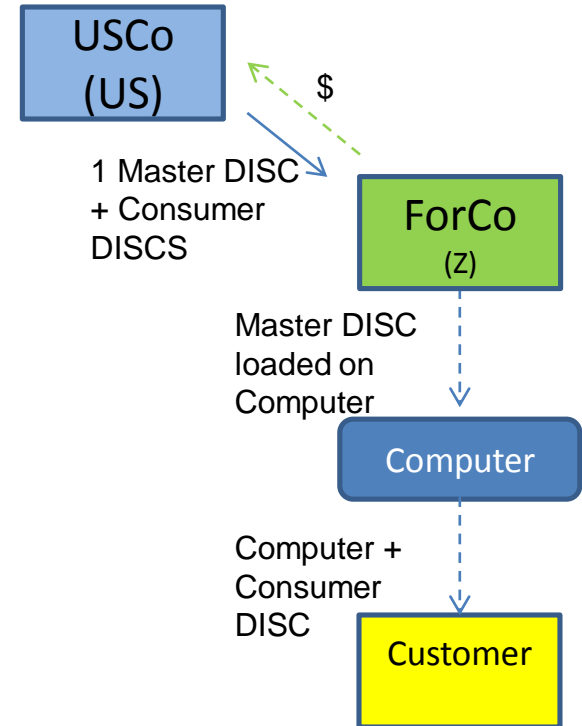


Example 8



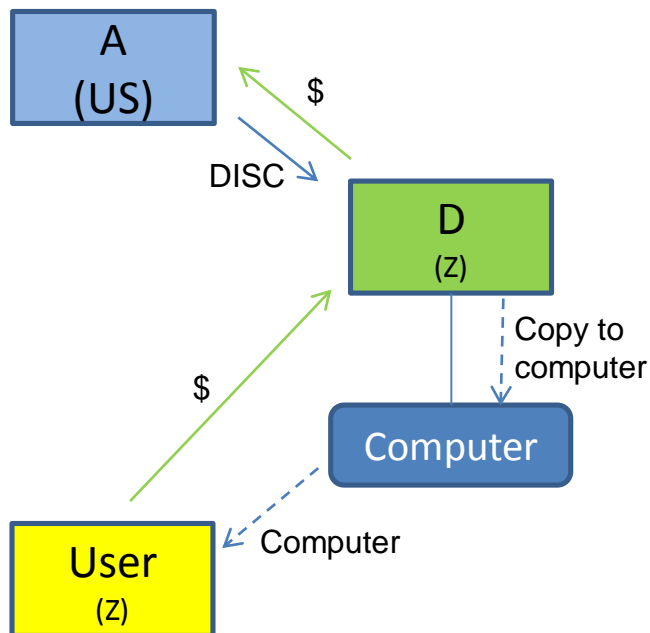
SOFTWARE PROGRESSION – PROBLEM 2

SAME FACTS AS PROBLEM 1 ABOVE,
EXCEPT USCO TRANSFERS ONE
“MASTER DISK” OF MIGHTY MIGHT
TO FORCO, ALONG WITH BOXED
COPIES OF THE PROGRAM. FORCO
USES THE MASTER COPY TO PLACE
THE MIGHTY MIGHT PROGRAM ON
EACH COMPUTER, AND SENDS A
COPY OF THE BOXED COMPUTER
PROGRAM ALONG WITH EACH
COMPUTER. WHAT IS THE
CHARACTER OF USCO’S INCOME?
WHAT IS THE CHARACTER OF
FORCO’S INCOME?

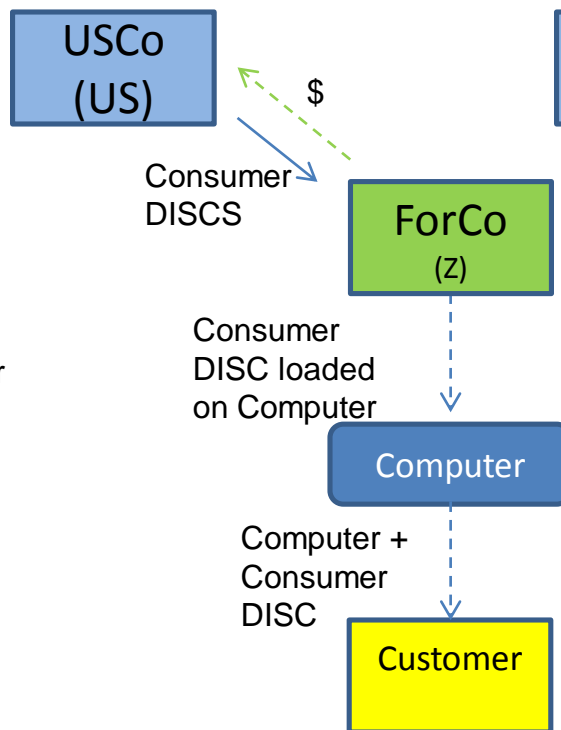


COMPARE – EXAMPLE 8, PROBLEM 1 AND PROBLEM 2

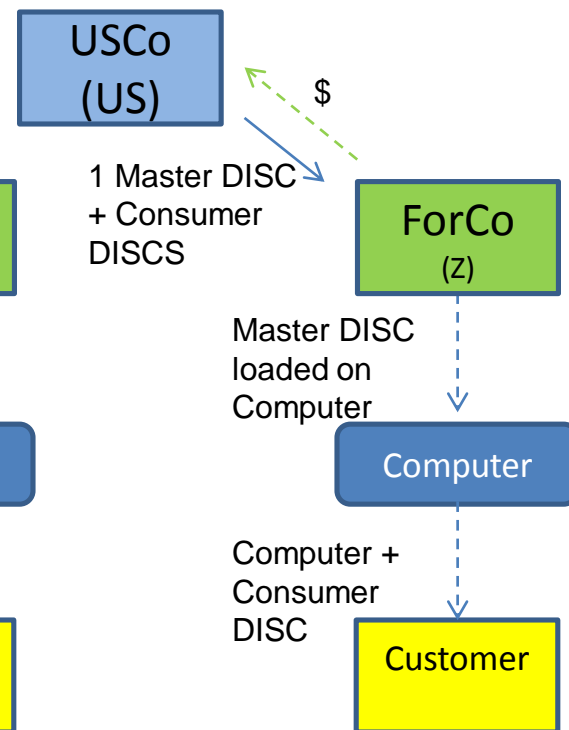
Example 8



Problem 1

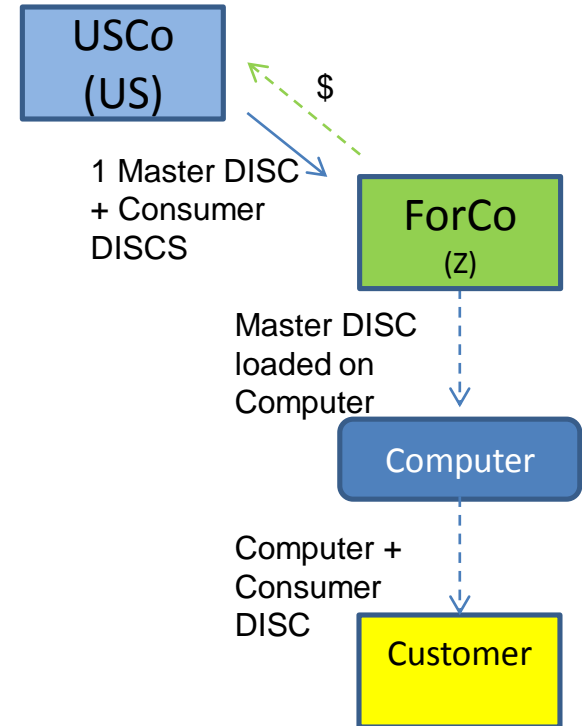


Problem 2



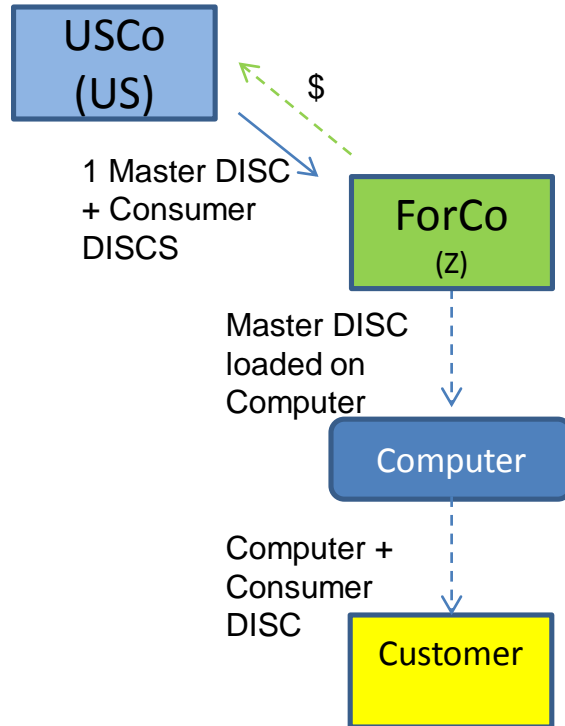
SOFTWARE PROGRESSION – PROBLEM 3

SAME FACTS AS PROBLEM 2 ABOVE,
EXCEPT FORCO **DOES NOT**
TRANSFER A PHYSICAL DISK TO THE
END CUSTOMER, BUT **INSTEAD**
PROVIDES A PRODUCT KEY ALONG
WITH EACH COMPUTER SOLD WHICH
THE END USER MUST ENTER IN
ORDER TO MAKE THE SOFTWARE
FUNCTIONAL. FORCO PAYS USCO \$X
FOR EACH PRODUCT KEY SOLD.
WHAT IS THE CHARACTER OF
USCO'S INCOME? WHAT IS THE
CHARACTER OF FORCO'S INCOME?

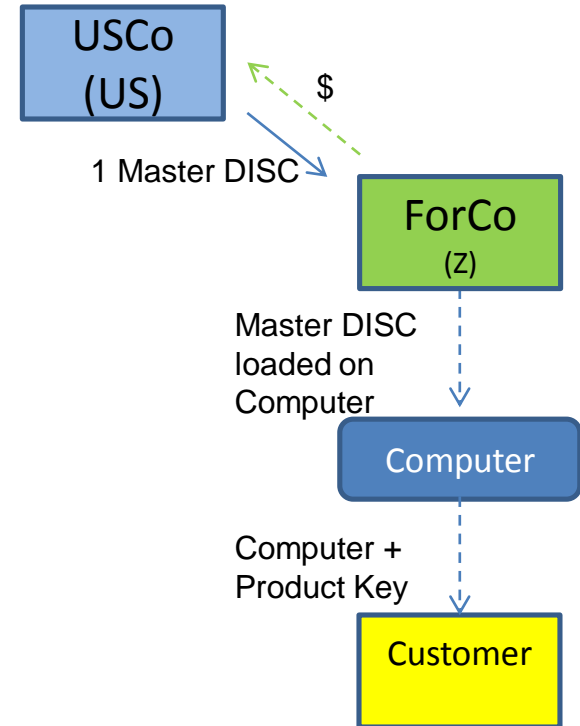


COMPARE – PROBLEM 2 & PROBLEM 3

Problem 2

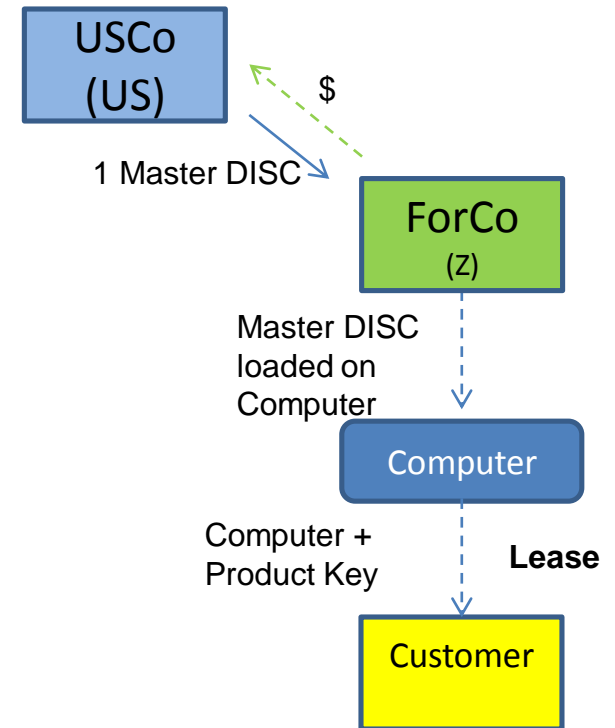


Problem 3



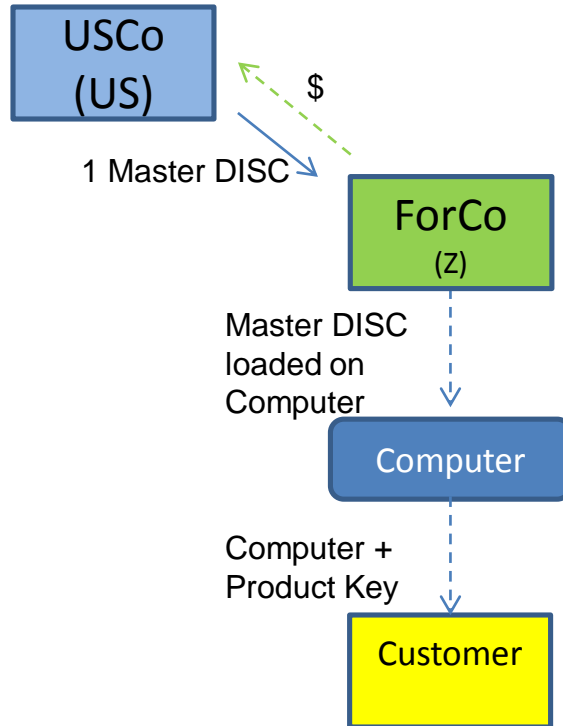
SOFTWARE PROGRESSION – PROBLEM 4

SAME FACTS AS PROBLEM 3 ABOVE, EXCEPT, INSTEAD OF SELLING COMPUTERS EMBEDDED WITH THE MIGHTY MIGHT PROGRAM, FORCO LEASES THE COMPUTERS TO END USERS. THE LEASE TERM WITH THE END USER IS FOR A TERM OF 1 YEAR. THE USEFUL LIFE OF THE MIGHTY MIGHT SOFTWARE PROGRAM IS FOR 5 YEARS. WHAT IS THE CHARACTER OF USCO'S INCOME? WHAT IS THE CHARACTER OF FORCO'S INCOME?

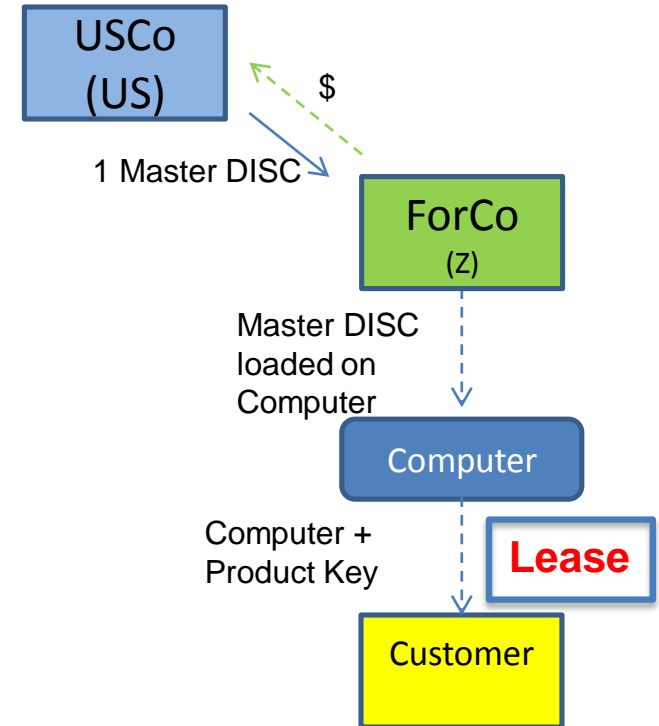


COMPARE – PROBLEM 3 & PROBLEM 4

Problem 3

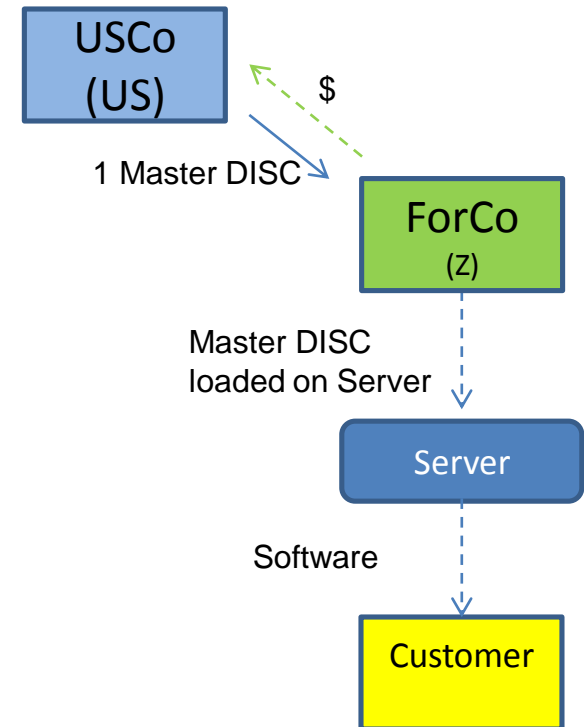


Problem 4



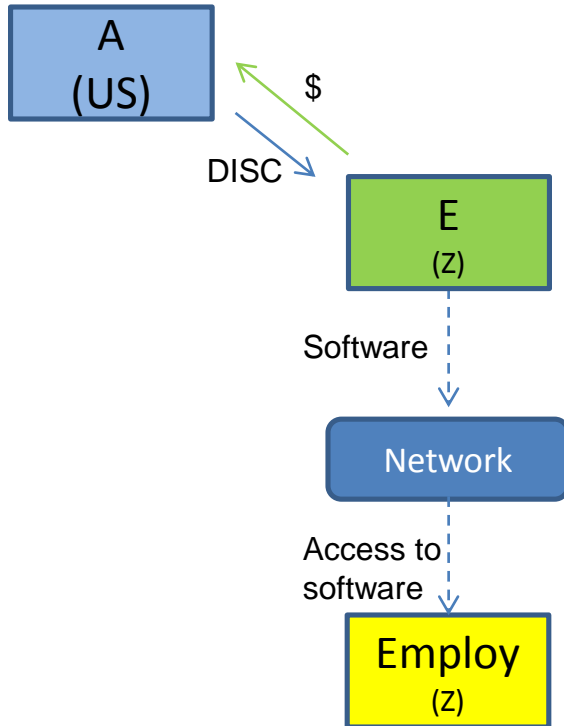
SOFTWARE PROGRESSION – PROBLEM 5

USCO, A U.S. CORPORATION, DEVELOPED A SOFTWARE PROGRAM NAMED MIGHTY MIGHT. USCO TRANSFERS A “MASTER DISK” CONTAINING MIGHTY MIGHT TO FORCO, A FOREIGN CORPORATION. FORCO STORES MIGHTY MIGHT ON FORCO SERVERS, AND OFFERS MIGHTY MIGHT TO CLIENTS ON A SUBSCRIPTION BASIS. CLIENTS PAY FORCO A MONTHLY FEE FOR EACH UNIQUE USER, WHICH IS LINKED TO A UNIQUE LOG IN NAME AND PASSWORD.

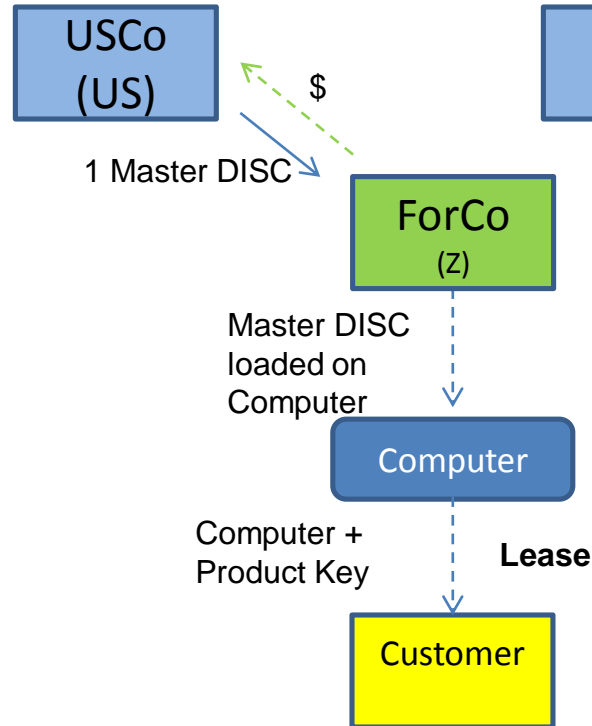


COMPARE – EXAMPLE 11/12, PROBLEM 4 & PROBLEM 5

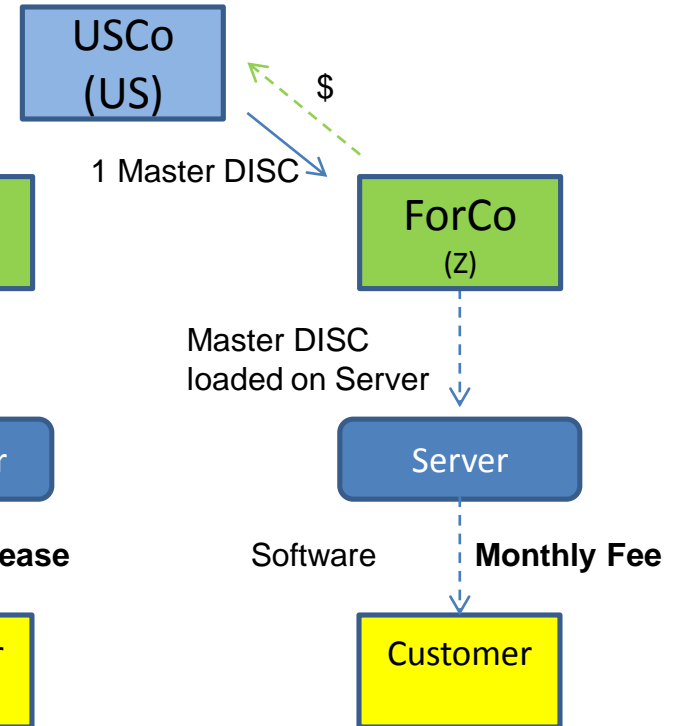
Example 11/ 12



Problem 4



Problem 5





CLOUD COMPUTING

WHAT IS CLOUD COMPUTING

CLOUD COMPUTING IS A MODEL FOR ENABLING UBIQUITOUS, CONVENIENT, ON-DEMAND NETWORK ACCESS TO A SHARED POOL OF CONFIGURABLE COMPUTING RESOURCES (E.G., NETWORKS, SERVERS, STORAGE, APPLICATIONS, AND SERVICES) THAT CAN BE RAPIDLY PROVISIONED AND RELEASED WITH MINIMAL MANAGEMENT EFFORT OR SERVICE PROVIDER INTERACTION. THIS CLOUD MODEL IS COMPOSED OF FIVE ESSENTIAL CHARACTERISTICS, THREE SERVICE MODELS, AND FOUR DEPLOYMENT MODELS. NATIONAL INSTITUTE OF STANDARDS AND TECHNOLOGY.

CLOUD COMPUTING CHARACTERISTICS

ON-DEMAND SELF-SERVICE. A CONSUMER CAN UNILATERALLY PROVISION COMPUTING CAPABILITIES, SUCH AS SERVER TIME AND NETWORK STORAGE, AS NEEDED AUTOMATICALLY WITHOUT REQUIRING HUMAN INTERACTION WITH EACH SERVICE PROVIDER.

BROAD NETWORK ACCESS. CAPABILITIES ARE AVAILABLE OVER THE NETWORK AND ACCESSED THROUGH STANDARD MECHANISMS THAT PROMOTE USE BY HETEROGENEOUS THIN OR THICK CLIENT PLATFORMS (E.G., MOBILE PHONES, TABLETS, LAPTOPS, AND WORKSTATIONS).

RESOURCE POOLING. THE PROVIDER'S COMPUTING RESOURCES ARE POOLED TO SERVE MULTIPLE CONSUMERS USING A MULTI-TENANT MODEL, WITH DIFFERENT PHYSICAL AND VIRTUAL RESOURCES DYNAMICALLY ASSIGNED AND REASSIGNED ACCORDING TO CONSUMER DEMAND. THERE IS A SENSE OF LOCATION INDEPENDENCE IN THAT THE CUSTOMER GENERALLY HAS NO CONTROL OR KNOWLEDGE OVER THE EXACT LOCATION OF THE PROVIDED RESOURCES BUT MAY BE ABLE TO SPECIFY LOCATION AT A HIGHER LEVEL OF ABSTRACTION (E.G., COUNTRY, STATE, OR DATACENTER). EXAMPLES OF RESOURCES INCLUDE STORAGE, PROCESSING, MEMORY, AND NETWORK BANDWIDTH.

CLOUD COMPUTING CHARACTERISTICS

RAPID ELASTICITY. CAPABILITIES CAN BE ELASTICALLY PROVISIONED AND RELEASED, IN SOME CASES AUTOMATICALLY, TO SCALE RAPIDLY OUTWARD AND INWARD COMMENSURATE WITH DEMAND. TO THE CONSUMER, THE CAPABILITIES AVAILABLE FOR PROVISIONING OFTEN APPEAR TO BE UNLIMITED AND CAN BE APPROPRIATED IN ANY QUANTITY AT ANY TIME.

MEASURED SERVICE. CLOUD SYSTEMS AUTOMATICALLY CONTROL AND OPTIMIZE RESOURCE USE BY LEVERAGING A METERING CAPABILITY¹ AT SOME LEVEL OF ABSTRACTION APPROPRIATE TO THE TYPE OF SERVICE (E.G., STORAGE, PROCESSING, BANDWIDTH, AND ACTIVE USER ACCOUNTS). RESOURCE USAGE CAN BE MONITORED, CONTROLLED, AND REPORTED, PROVIDING TRANSPARENCY FOR BOTH THE PROVIDER AND CONSUMER OF THE UTILIZED SERVICE.

CLOUD COMPUTING MODELS

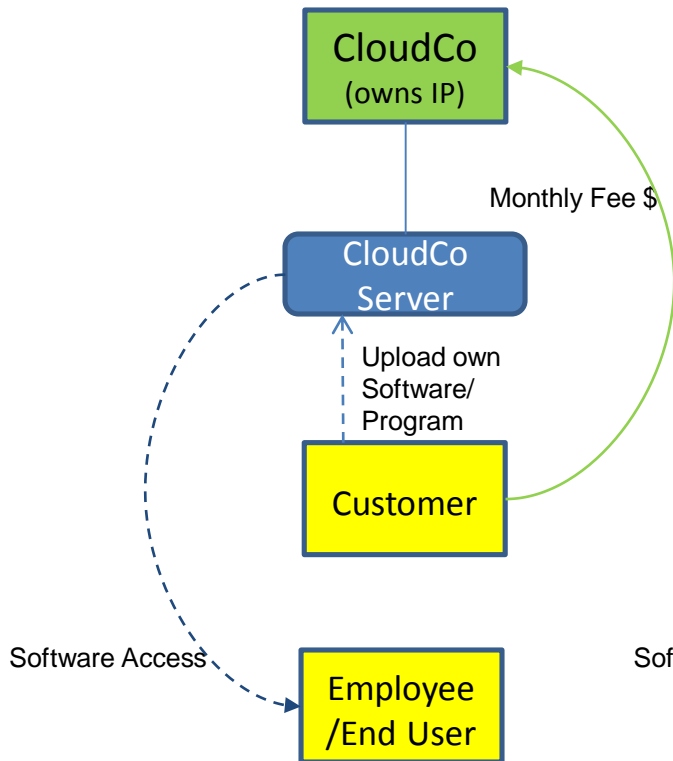
SOFTWARE AS A SERVICE (SAAS). THE CAPABILITY PROVIDED TO THE CONSUMER IS TO USE THE PROVIDER'S APPLICATIONS RUNNING ON A CLOUD INFRASTRUCTURE². THE APPLICATIONS ARE ACCESSIBLE FROM VARIOUS CLIENT DEVICES THROUGH EITHER A THIN CLIENT INTERFACE, SUCH AS A WEB BROWSER (E.G., WEB-BASED EMAIL), OR A PROGRAM INTERFACE. THE CONSUMER DOES NOT MANAGE OR CONTROL THE UNDERLYING CLOUD INFRASTRUCTURE INCLUDING NETWORK, SERVERS, OPERATING SYSTEMS, STORAGE, OR EVEN INDIVIDUAL APPLICATION CAPABILITIES, WITH THE POSSIBLE EXCEPTION OF LIMITED USER SPECIFIC APPLICATION CONFIGURATION SETTINGS.

PLATFORM AS A SERVICE (PAAS). THE CAPABILITY PROVIDED TO THE CONSUMER IS TO DEPLOY ONTO THE CLOUD INFRASTRUCTURE CONSUMER-CREATED OR ACQUIRED APPLICATIONS CREATED USING PROGRAMMING¹ TYPICALLY THIS IS DONE ON A PAY-PER-USE OR CHARGE-PER-USE BASIS. ² A CLOUD INFRASTRUCTURE IS THE COLLECTION OF HARDWARE AND SOFTWARE THAT ENABLES THE FIVE ESSENTIAL CHARACTERISTICS OF CLOUD COMPUTING. THE CLOUD INFRASTRUCTURE CAN BE VIEWED AS CONTAINING BOTH A PHYSICAL LAYER AND AN ABSTRACTION LAYER. THE PHYSICAL LAYER CONSISTS OF THE HARDWARE RESOURCES THAT ARE NECESSARY TO SUPPORT THE CLOUD SERVICES BEING PROVIDED, AND TYPICALLY INCLUDES SERVER, STORAGE AND NETWORK COMPONENTS. THE ABSTRACTION LAYER CONSISTS OF THE SOFTWARE DEPLOYED ACROSS THE PHYSICAL LAYER, WHICH MANIFESTS THE ESSENTIAL CLOUD CHARACTERISTICS. CONCEPTUALLY THE ABSTRACTION LAYER SITS ABOVE THE PHYSICAL LAYER. ³ LANGUAGES, LIBRARIES, SERVICES, AND TOOLS SUPPORTED BY THE PROVIDER.³ THE CONSUMER DOES NOT MANAGE OR CONTROL THE UNDERLYING CLOUD INFRASTRUCTURE INCLUDING NETWORK, SERVERS, OPERATING SYSTEMS, OR STORAGE, BUT HAS CONTROL OVER THE DEPLOYED APPLICATIONS AND POSSIBLY CONFIGURATION SETTINGS FOR THE APPLICATION-HOSTING ENVIRONMENT.

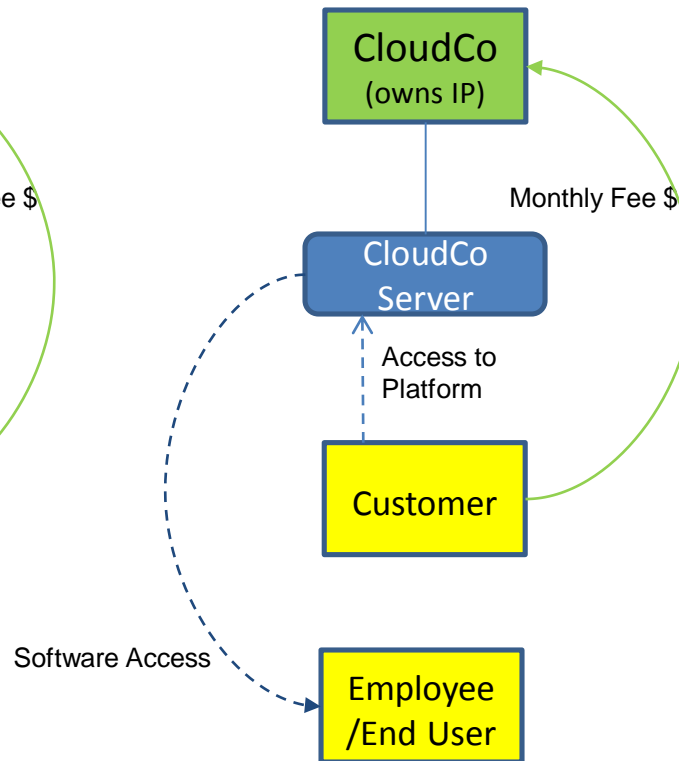
INFRASTRUCTURE AS A SERVICE (IAAS). THE CAPABILITY PROVIDED TO THE CONSUMER IS TO PROVISION PROCESSING, STORAGE, NETWORKS, AND OTHER FUNDAMENTAL COMPUTING RESOURCES WHERE THE CONSUMER IS ABLE TO DEPLOY AND RUN ARBITRARY SOFTWARE, WHICH CAN INCLUDE OPERATING SYSTEMS AND APPLICATIONS. THE CONSUMER DOES NOT MANAGE OR CONTROL THE UNDERLYING CLOUD INFRASTRUCTURE BUT HAS CONTROL OVER OPERATING SYSTEMS, STORAGE, AND DEPLOYED APPLICATIONS; AND POSSIBLY LIMITED CONTROL OF SELECT NETWORKING COMPONENTS (E.G., HOST FIREWALLS).

CLOUD COMPUTING MODELS

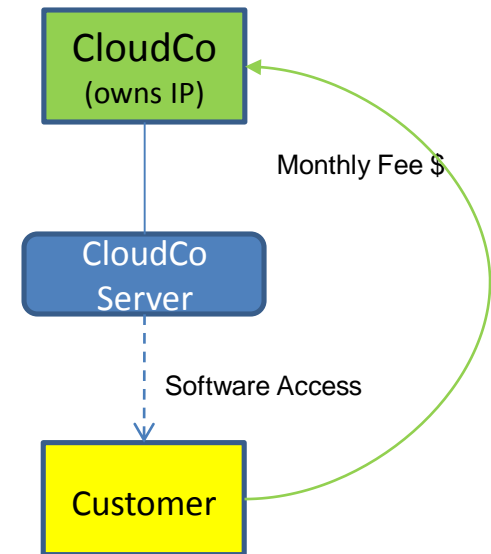
IaaS



PaaS



SaaS





CLASSIFICATION AND TAXATION OF CLOUD COMPUTING

CLOUD CASE STUDY

FORCO/ DEVELOPER IS A SOFTWARE DEVELOPER (DEVELOPER) AND CREATED SOFTWARE FOR WHICH IT CURRENTLY HOLDS ALL INTELLECTUAL PROPERTY RIGHTS.

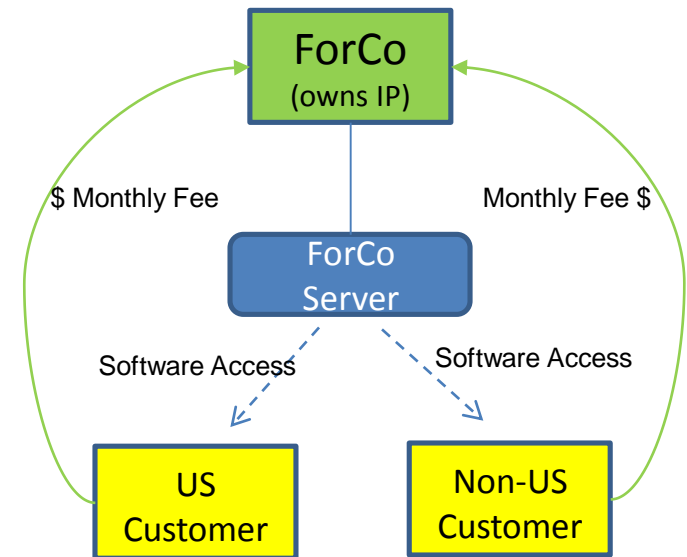
THE SOFTWARE ALLOWS USERS TO RECORD AND MANAGE THEIR BUSINESS TRANSACTIONS.

THE BUSINESS INFORMATION IS GENERATED AND ENTERED BY THE CUSTOMERS' EMPLOYEES.

ALL CUSTOMER DATA IS HELD IN A SINGLE DATABASE THAT PROVIDES THE ORGANIZATION WITH ACCESS TO ALL OF ITS PERFORMANCE METRICS IN A CUSTOMIZABLE, REAL-TIME DISPLAY.

THE BUSINESS APPLICATION SOFTWARE AND CUSTOM DATABASES ARE HOSTED ON DEVELOPER'S COMPUTER INFRASTRUCTURE.

DEVELOPER ALSO ENSURES THE SOFTWARE IS WORKING PROPERLY AND UNILATERALLY INSTALLS ANY NECESSARY UPGRADES.



CLOUD CASE STUDY

DEVELOPER HAS CUSTOMERS WORLDWIDE, COMPRISED OF BOTH U.S. BUSINESSES AND FOREIGN BUSINESSES.

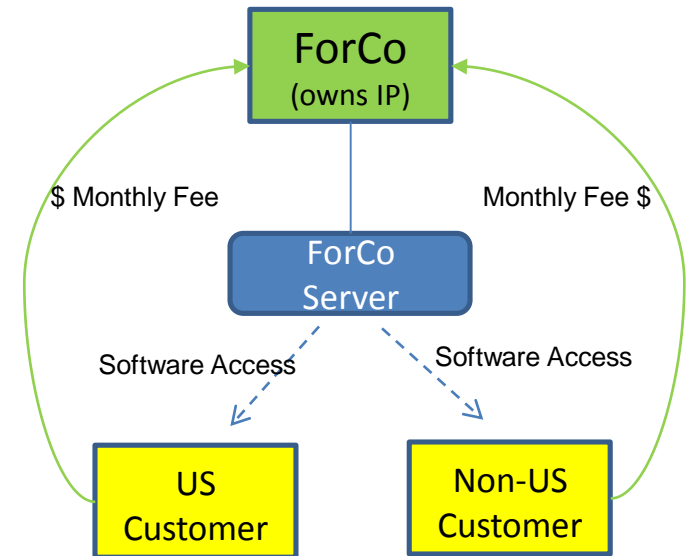
IN EXCHANGE FOR A MONTHLY SUBSCRIPTION FEE, CUSTOMERS RECEIVE ACCESS TO THE SOFTWARE'S WEB-BASED TOOLS.

MOREOVER, PURSUANT TO THE CONTRACT, THERE IS NEITHER A TRANSFER OF TITLE TO THE SOFTWARE, NOR A TRANSFER OF POSSESSION OF THE SOFTWARE TO THE CUSTOMER.

THE CUSTOMER DOES NOT OWN THE SOFTWARE LICENSE, AND THE SOFTWARE IS NOT DOWNLOADED BY OR DELIVERED TO THE CUSTOMER OR INSTALLED ON THE CUSTOMER'S COMPUTERS.

INSTEAD, CUSTOMERS ACCESS THE SOFTWARE SOLELY THROUGH THE INTERNET; NO SPECIAL HARDWARE OR SOFTWARE IS NEEDED

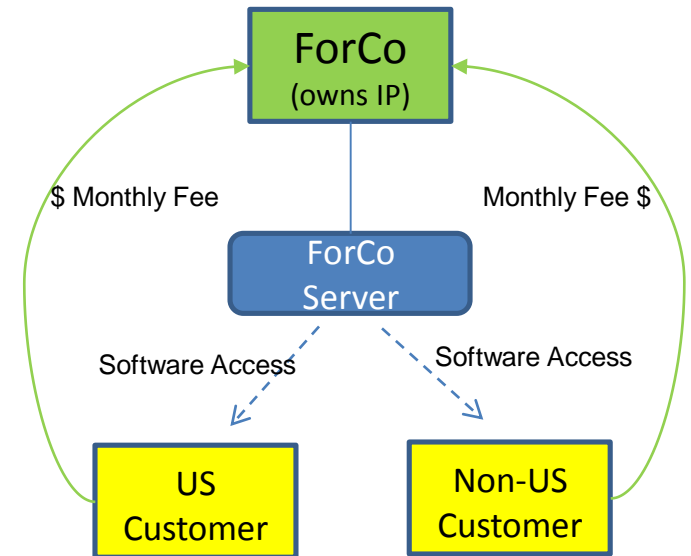
CUSTOMERS DO NOT EXERCISE ANY CONTROL, CUSTODY, OR POSSESSION OVER THE SOFTWARE OR THE HARDWARE ON WHICH THE SOFTWARE IS LOCATED.



CLOUD REVENUE CHARACTERIZATION

DO THE -18 REGS APPLY?

- Arguments for?
- Arguments Against?



CLOUD – REVENUE CHARACTERIZATION

(A) GENERAL—

- **SCOPE; -18(a)(1):** (1) *Scope*. This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.
- **DEFINITION OF COMPUTER PROGRAM; -18(a)(3):** (3) *Computer program*. For purposes of this section, 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....
- **CATEGORIES; SOLELY WITHIN; -18(a)(2) :** (2) *Categories of transactions*. This section generally **requires** that such transactions be **treated as being solely within one of four categories** (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

CLOUD – REVENUE CHARACTERIZATION

(B) CATEGORIES OF TRANSACTIONS—

- (1) **General.**a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—
 - (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.

CLOUD – REVENUE CHARACTERIZATION

(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 THIS SECTION **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.

CLOUD – REVENUE CHARACTERIZATION

(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 PARAGRAPH (B)(1) OF THIS SECTION 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.

CLOUD – REVENUE CHARACTERIZATION

(B) CATEGORIES OF TRANSACTIONS—

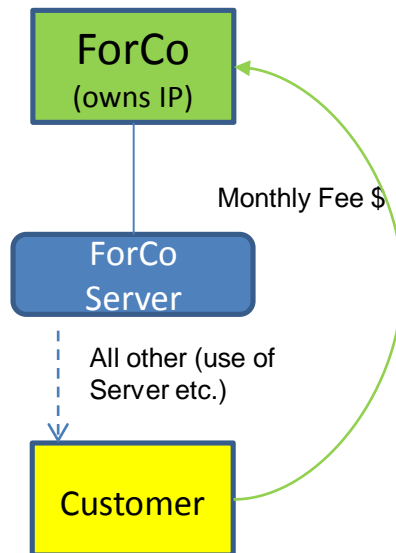
- (1) **General.** Except as provided in paragraph (b)(2) of this section, a **transaction involving the transfer** of a computer program, or the provision of services or of know-how with respect to a computer program (**collectively, a transfer of a computer program**) is treated as being **solely** one of the following—
 - (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.

CLOUD – REVENUE CHARACTERIZATION

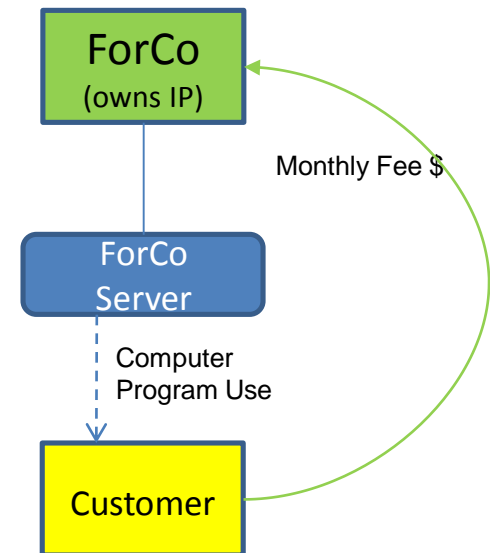


CLOUD REVENUE - BIFURCATION ALTERNATIVE

-18 Does Not Apply



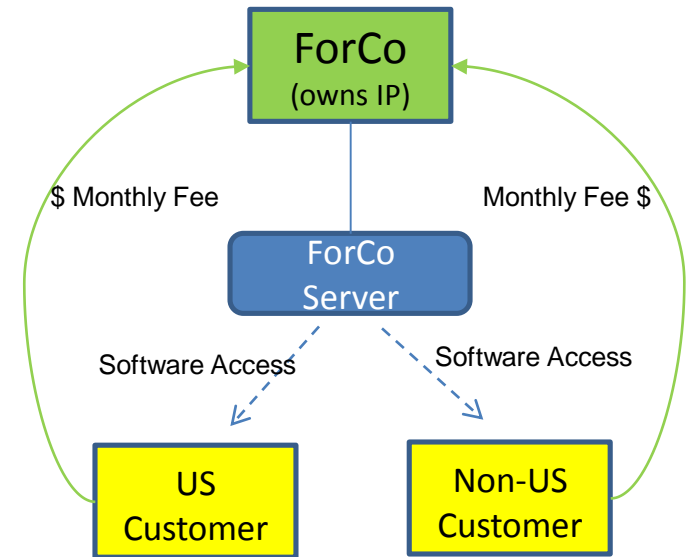
-18 Does Apply



REVENUE CHARACTERIZATION

IF COPYRIGHT RIGHTS, WHAT IS THE CHARACTER?

➤ Sale or Royalty?

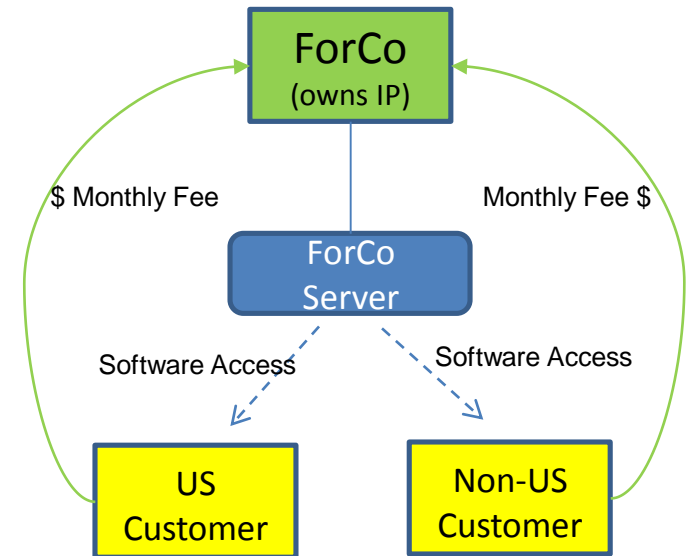


REVENUE CHARACTERIZATION

IF -18 DOESN'T APPLY, WHAT IS THE CHARACTER? LEASE OR SERVICE? 7701(E), TIDEWATER:

1. 7701(E) FACTORS

- (A) the service recipient is in physical possession of the property,
- (B) the service recipient controls the property.
- (C) the service recipient has a significant economic or possessory interest in the property.
- (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.
- (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and
- (F) the total contract price does not substantially exceed the rental value of the property for the contract period.



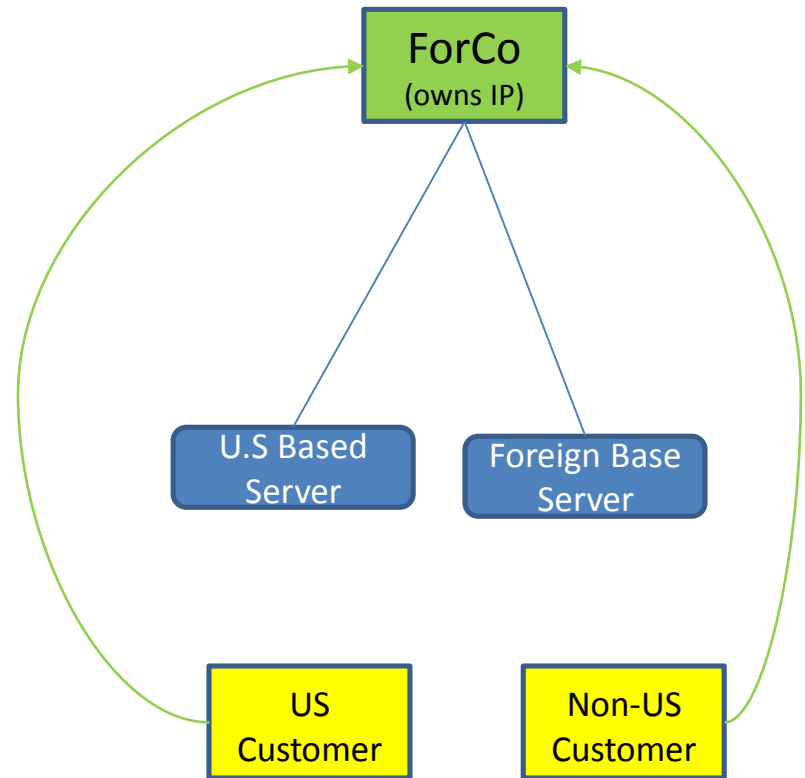
SOURCE

WHAT IS THE SOURCE OF THE INCOME?

- Rent/Royalty
- Service

POTENTIAL JURISDICTIONS:

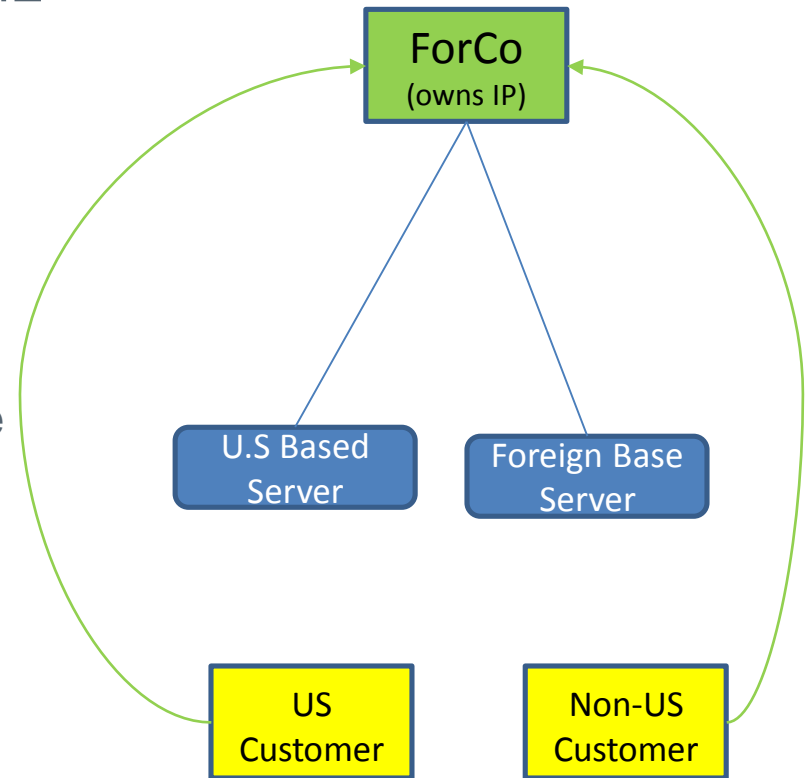
- Location of Server;
- Location of Customers;
- Location of ForCo's employees;
- Location of Agents.



SOURCE

WHAT IS THE SOURCE OF THE INCOME IF RENT/ ROYALTY?

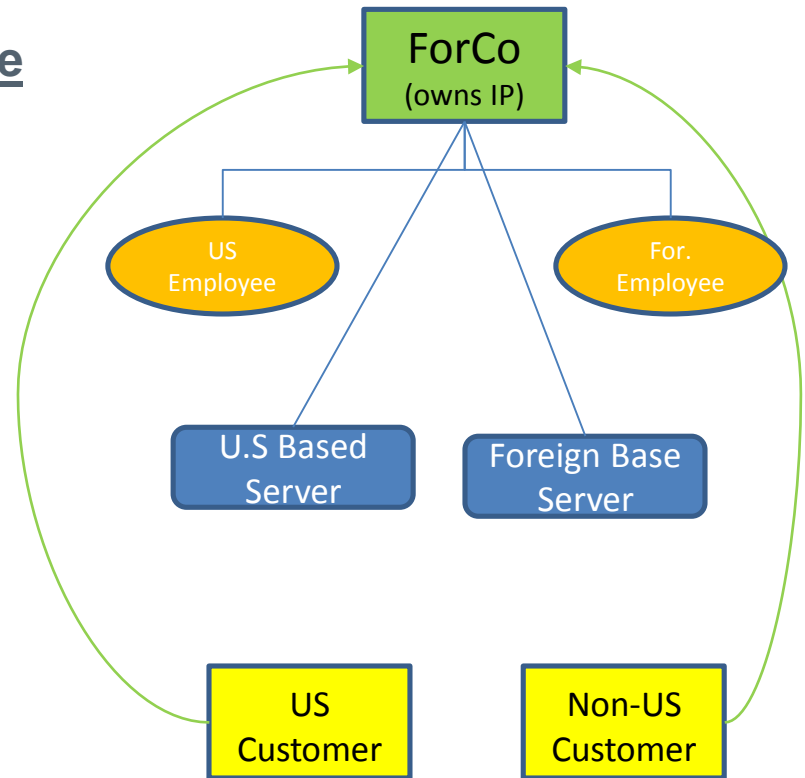
- Location of Customers?
- Location of Server?
- Location of IP Protection?
- Allocation Between Multiple Locations? See Garcia, Goosen Cases.



SOURCE

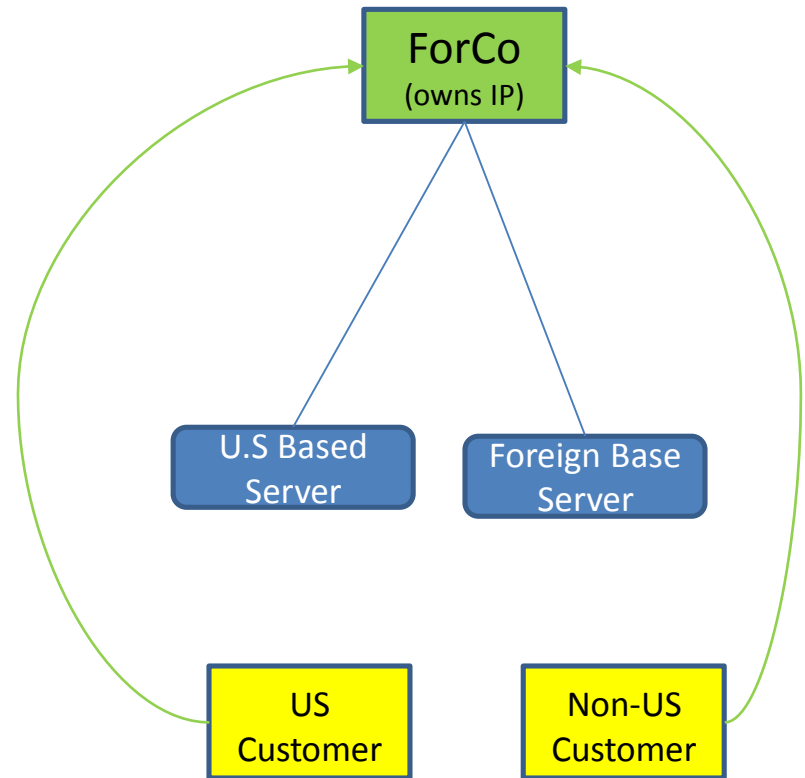
IF SERVICE INCOME?

- Location of capital and labor where income producing services are performed.
- Consider Piedres Negras v. Commissioner;



US TRADE OR BUSINESS; ECI

DOES FORCO HAVE US TB/ ECI?



US TRADE OR BUSINESS

- **U.S. TRADE OR BUSINESS. SEC. 864(B).**
 - Facts & Circumstances Test. § 1.864-2(e).; Case law – “regular, substantial, continuous”.
- **Effectively Connected Income. Sec. 864(c)**
- U.S. source FDAP income and capital gains. Sec. 864(c)(2).
- *Assets Test*: if income is derived from assets used in, the conduct of US trade or business - §864(c)(2)(A); Reg. Sec. 1.864-4(c).
 - (a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or
 - (b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or
 - (c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.
- *Business Activity Test*: activity of US business was material factor in realization of income - §864(c)(2)(B); Reg. Sec. 1.864-4(c).
- All other US source income: anything not FDAP or capital gains (“force of attraction rules”) - §864(c)(3), §1.864-4(b).
- Foreign Source Income – can be US ECI if: - §864(c)(4)(B)
 - US office/ or fixed place of business;
 - US office is material factor in producing income; and
 - One of following:
 - Rents or royalty from IP used outside the US, but have active US trade or business;
 - Certain dividend or interest if from active banking or financing business; or
 - Inventory sales that are sold through a US office unless sold for use outside the US and foreign office materially participated.

PERMANENT ESTABLISHMENT (“PE”)

OECD:

- The OECD Model Commentary distinguishes between automated equipment and the data and software stored on that equipment (such as a website). (paragraph 42.2)
- Ownership of automated equipment in a jurisdiction may constitute a permanent establishment; but
- A website and the server where the website is stored (or the use of an Internet Service Provider) do not generally arise to the level of a permanent establishment since such activities do not constitute a physical presence. (paragraph 42.3)

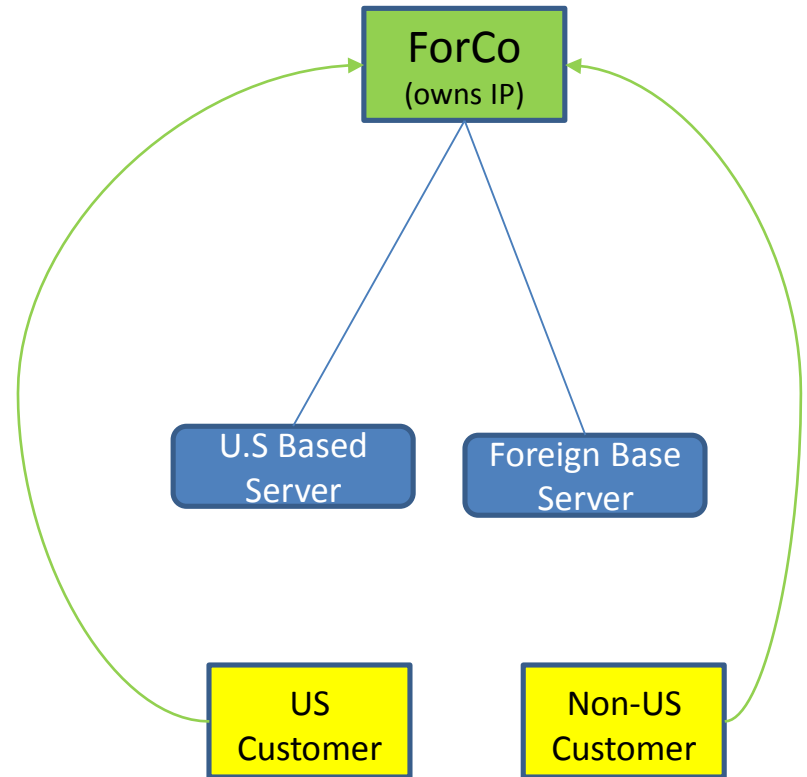
PERMANENT ESTABLISHMENT (“PE”)

And, even if there is physical presence, the electronic equipment must be engaged in something more than “preparatory or auxiliary” activities. (paragraph 42.7) An example of a preparatory or auxiliary activity is where a server hosts a website that is used (i) exclusively for advertising, (ii) for displaying products or (iii) for providing product information to customers. (paragraph 42.9)

- However, electronic equipment may constitute a PE if such functions form an essential and significant part of a company’s business activity. (paragraph 42.8) For example, if electronic equipment automatically processes (i) payment for the products, (ii) delivery of the products and (iii) the conclusion of customer contracts. (paragraph 42.9)

FDAP CONSIDERATIONS

Is Cloud payment FDAP?



FDAP

a. Foreign persons taxable on U.S. source FDAP income.

b. Imposition of tax

- Section 871(individuals), Section 881(corporations).
- 30 percent of the amount received from sources within the United States by a nonresident alien individual/ corporation as—
 - interest
 - dividends,
 - rents,
 - salaries,
 - wages,
 - other fixed or determinable annual or periodical gains, profits, and income.

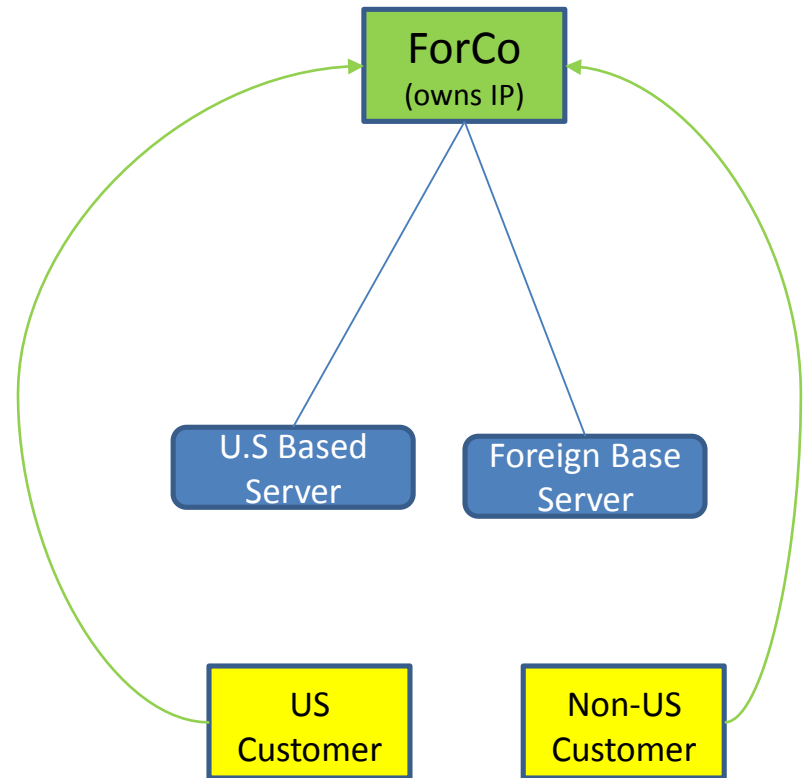
c. Tax collection mechanism – withholding at source

- Section 1441 (individuals), Section 1442 (corporations).

FDAP

Is Cloud payment FDAP?

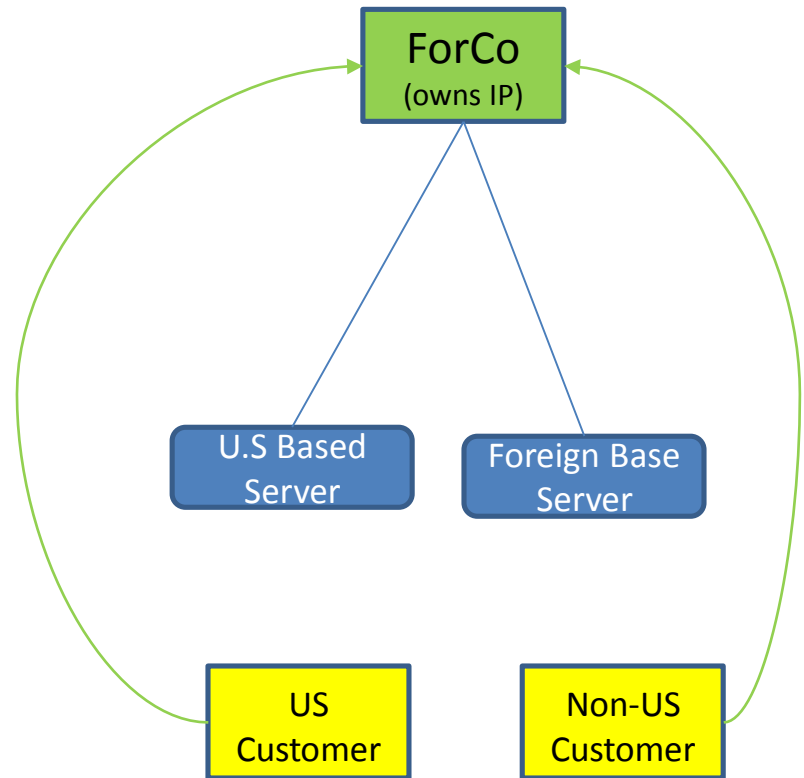
- If characterized as Rent/ Royalty; and
- U.S. Source;



SUBPART F

SUBPART F INCOME

- Foreign Personal Holding Company. Sec. 954(c).
 - Passive income such as dividends, interest, royalties, etc.
- Foreign Base Company Sales Income. Sec. 954(d).
 - Purchase or sale of property that is: (1) manufactured, produced, extracted outside the country where the CFC is incorporated, and (2) sold outside the country where CFC incorporated.
- Foreign Base Company Services Income. Sec. 954(e).
 - Services performed: (1) for or on behalf of related party; (2) outside of CFC country of incorporation.

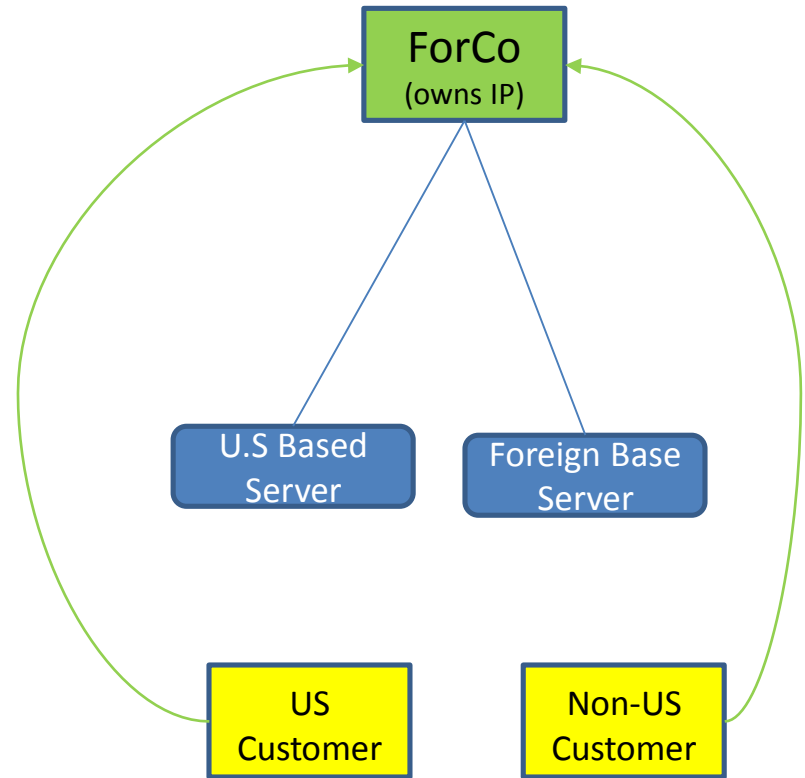


SUBPART F

Foreign Personal Holding Company Income.

Active Rents/ Royalty?

- What if USCo employees actively develop; ForCo owns rights and pays fee to USCo?



SUBPART F – ACTIVE RENT/ROYALTY

SEC. 954(C)(2)(A).

FOREIGN PERSONAL HOLDING COMPANY
INCOME SHALL NOT INCLUDE RENTS AND
ROYALTIES WHICH ARE DERIVED IN THE
ACTIVE CONDUCT OF A TRADE OR
BUSINESS AND WHICH ARE RECEIVED FROM
A PERSON OTHER THAN A RELATED
PERSON (WITHIN THE MEANING OF
SUBSECTION (D)(3)).

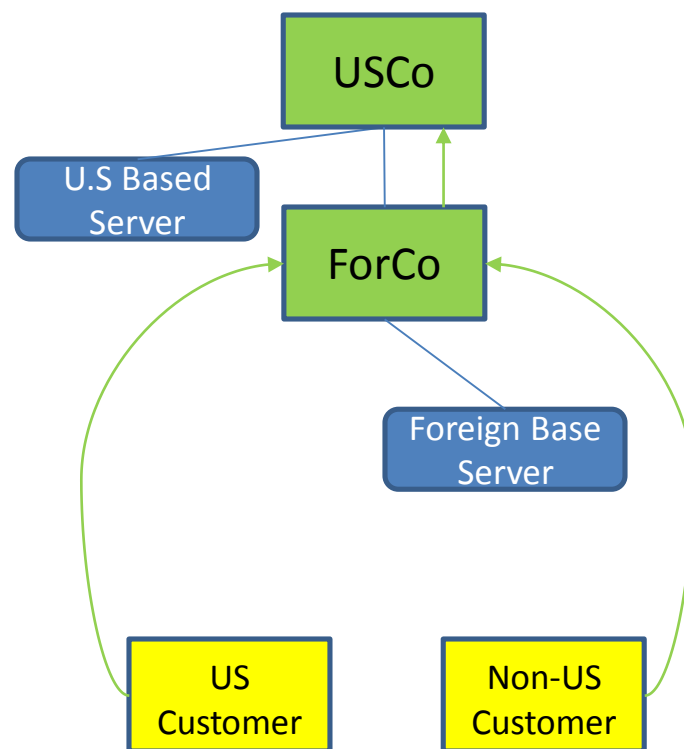
SUBPART F – SERVICES

Foreign Base Company Services Income?

* Services performed: (1) for or on behalf of related party; (2) outside of CFC country of incorporation.

TREAS. REG. 1.954-4(B) SERVICES PERFORMED FOR, OR ON BEHALF OF, A RELATED PERSON—

- **(1) Specific cases.** For purposes of paragraph (a)(1) of this section, “services which are performed for, or on behalf of, a related person” include (but are not limited to) services performed by a controlled foreign corporation in a case where—
 - **(i)** The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;
 - **(ii)** The controlled foreign corporation performs services (whether or not with respect to property sold by a related person) which a related person is, or has been, obligated to perform;
 - **(iii)** The controlled foreign corporation performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale; or
 - **(iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons**
- **Notice 2007-13: limits application of “substantial assistance” rule to where a U.S. person provides assistance to CFC, and the arm’s length cost of assistance exceeds 80% of the CFC’s total cost of performing services.**



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