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Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven

*David R. Tillinghast**

I. INTRODUCTION 341
II. BASIC ISSUES THAT WILL RECUR 341
III. HYPOTHETICAL FACT PATTERN 343
IV. UNITED STATES TAXATION OF SOFTCO UNDER DOMESTIC LAW 344
A. *Is Softco Engaged In a U.S. Trade or Business?* 345
B. *Does Softco Derive Income Effectively Connected with a U.S. Business?* 348
1. *Sales Income* 348
2. *Income from the Production of Personal Property* 350
3. *Rental Income* 351
4. *Royalty Income* 353
5. *Services* 354
6. *Summary* 355
C. *Is the Income of Softco Subject to U.S. Withholding Tax?* 355
V. U.S. TAXATION OF SOFTCO UNDER THE IRISH TREATY . . . 358
A. *Qualification of Softco Under the Treaty* 358
B. *Taxation of Softco's Business Profits* 359
C. *Taxation of Softco's Royalty Income* 360
VI. TAXATION OF SOFTCO'S U.S. SHAREHOLDER(S) UNDER THE U.S. TAX HAVEN REGIMES 360
A. *Taxation of U.S. Parent on Income of Softco Under Subpart F* 360
1. *Sales Income* 361
2. *Rental and Royalty Income* 365
3. *Services Income* 367
4. *Passive Investment Income* 368
5. *Summary* 368

* Partner with Baker & McKenzie, New York, New York.

B. *Taxation of U.S. Individual Shareholders Controlling Softco* 369
C. *Taxation of U.S. Individual Owning 25% of Softco's Stock* 372
D. *Summary of the Application of the Tax Haven Regimes* 373
VIII. WHAT DOES ALL OF THIS PROVE? 374
A. *Income Characterization* 374
B. *What Constitutes the Production of Property?* 375
C. *The Cacophony of Tax Haven Rules* 376
IX. SOME MODEST SUGGESTIONS 376

I. INTRODUCTION

The advent of the Internet and other electronic means of conducting commercial transactions has created a new galaxy of ways to structure business operations and a concomitant range of novel tax issues.[1] It is commonly said that, because of the diminished need for a vendor to have a physical presence in the country of the customer, one of the likely effects of electronic commerce will be to shift revenues away from source jurisdictions and towards residence jurisdictions.[2] In fact, this may be only partially true. Income may be shifted away from the customers' countries all right, but into a tax haven jurisdiction rather than into the enterprise's home jurisdiction. A major issue for enterprises that use the Internet and their residence tax jurisdictions, therefore, will be whether controlled foreign corporation or similar legislation will operate to impose tax on any revenues that are shifted in this manner.

The purpose of this paper is to consider how a hypothetical business operation structured to operate in a tax haven might be treated under United States federal income tax law, both under provisions taxing income at the source and under provisions taxing U.S. persons on tax haven income of foreign corporations, and then to reflect on what, if anything, this tells us about the need for change. Because the Internal Revenue Service has issued a regulation discussed below, specifically characterizing income derived from transactions in computer software (and not other types of transactions in electronic commerce), the paper will focus on a company delivering software over the Internet; but many of the issues presented will arise in the case of other Internet providers.

II. BASIC ISSUES THAT WILL RECUR

Many of the federal income tax issues raised by electronic commerce depend upon the characterization of items of income or transactions giving rise to income under definitions and concepts born in the age of bricks and

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1. See generally William C. Benjamin & Michael J. Nathanson, Conducting Business Using the Internet: Gauging the Threat of Foreign Taxation, J. Int'l Tax'n, March 1998, at 29; Daniel J. Langin, The Economics of the Internet: Insurance and Risk Management, Advertising and Other Business Models, Valuation and Tax Issues, First Annual Internet Law Institute, at 447 (PLI Patents, Copyrights, Trademarks and Literary Property Course Handbook Series No. 482, 1997); Peter A. Glicklich et al., Internet Sales Pose International Tax Challenges, 84 J. Tax'n 325 (1996); Amy Hamilton, Former New York Revenue Chief Outlines Emerging Tax Issues in Electronic Commerce, 96 Tax Notes Today 213-14 (Oct. 31, 1996) (LEXIS, FEDTAX library, TNT file).

2. See, e.g., David R. Tillinghast, The Impact of the Internet on the Taxation of International Transactions, 50 Bull. Int'l. Fiscal Doc. Number 11/12 524, 525 (1996).

mortar. In some cases these do not readily adapt themselves to the world of electronic commerce. In addition, the same, or cognate, issues may arise in different contexts; and it is difficult in some cases to decide whether interpretations should vary according to context or whether they should be harmonized.

In our tax law, much depends upon the characterization of income. As relevant to this discussion, critical decisions include the differentiation of items of income as being derived from: (i) sales; (ii) rentals; (iii) royalties; or (iv) services. The Internal Revenue Service (IRS) has issued a regulation (the "Regulation") addressing these issues in the case of computer software;[3] but the scope and application of these rules is not yet well established.[4]

Additional distinctions may turn on whether, when an enterprise is deemed to transfer a product (a copy of a software program, for example) to a customer, the "thing" that it delivers is tangible or intangible property[5] and whether it is inventory.[6]

As another example, it may be critical to determine whether an enterprise which is deemed to make a sale of a product has "manufactured" or "produced" that product.[7] With respect to the ephemera in which electronic commerce deals, what does this mean? If an enterprise either creates or acquires a software program and then provides copies of that program to customers, it may deliver the final product in a variety of ways. It may encode the program on a CD or simply deliver it by downloading it onto the customer's computer.[8] Is the creation of the CD the "production" of the property sold? If so, has the enterprise also "produced" the copy of the software program which it delivers by downloading it onto the customer's computer? Or is it the creation of the original software program which constitutes the "production" of property?

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3. See Regs. § 1.861-18.

4. For comments made when the Regulation was in proposed form, see Ned Maguire et al., Deloitte & Touche L.L.P., Deloitte & Touche Offers Comments on Tax Policy Implications of Global Electronic Commerce, 15 Tax Notes Int'l 1483 (Nov. 3, 1997); Attorneys Offer Additional Input on Computer Classification Regs., Public Comments on Proposed Regs., 15 Tax Notes Int'l 1345 (Oct. 27, 1997) (Comments of Gary L. Sprague, Robin A. Chester, and John M. Peterson of Baker & McKenzie); Software Group Answers Questions on U.S. Computer Program Regs., Public Comments on Proposed Regs., 15 Tax Notes Int'l 1078 (Oct. 6, 1997) (comments of Kenneth A. Wasch of Software Publishers Association).

5. See infra text accompanying notes 42-44.

6. See infra text accompanying notes 39-40.

7. See infra text accompanying note 24.

8. Howard E. Abrams & Richard L. Doernberg, How Electronic Commerce Works, 14 Tax Notes Int'l 1573, 1585 (May 12, 1997).

III. HYPOTHETICAL FACT PATTERN

Softco is an Irish public limited company which is a corporation for U.S. tax purposes and which operates out of a branch in Bermuda. Softco enters into agreements with USco, a U.S. corporation, under which USco grants Softco rights to distribute software programs developed by USco.[9] In one category of such transactions, USco grants to Softco exclusive rights for the life of the subject copyrights, in consideration of a fixed payment. In a second category, USco grants to Softco nonexclusive rights in consideration of a periodic royalty based on its sales.

In addition, Softco enters into contracts with a number of individuals, some of whom are resident in the United States and some of whom are employees of USco, to develop additional software programs on its behalf, which they do as independent contractors on an ongoing basis. In some cases, these individuals modify programs previously created by USco either to improve them or to adapt them for foreign markets. Softco also acquires the rights to some programs from unrelated non-U.S. persons. The programs acquired by Softco are downloaded onto servers which Softco maintains in Bermuda. Softco owns the intellectual property rights for programs developed for it.

Softco licenses the software programs it acquires in various ways to unrelated customers, in the United States and in other countries. In most cases, Softco's customers are businesses which typically acquire the right to use Softco's programs at multiple locations and sometimes acquire the right to relicense to others. In all of these cases, Softco receives an up-front lump sum payment as the only consideration for the transfer.

In addition, Softco licenses programs to a Cyprus company, Russco, owned by the same shareholder(s) that own(s) Softco, for distribution in Eastern Europe. To the extent that Softco owns or has an exclusive license of rights to a software program, it grants to Russco exclusive rights in the countries in which it operates. In other cases, Softco grants Russco nonexclusive rights. In all of these transactions, Russco pays Softco royalties based on Russco's net sales.

Softco offers its customers (and the customers of Russco) a "hot line" service; a customer that experiences difficulties in operating a Softco program can telephone for assistance, which is provided either by employees of Softco located in Bermuda or by one or more of the independent contractors who create, modify or adapt programs for Softco. This service is provided without

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9. If, as we will hypothesize later, Softco and USco are related persons, the amount of the royalty receivable by USco is subject to adjustment by the IRS under the "commensurate with income" standard of § 482 of the Code. The very difficult problems which are encountered in making such a determination are beyond the scope of this article.

charge for the first year and thereafter at a specified hourly rate. In addition, if a customer's requirements indicate an adaptation of a standard program, Softco will undertake (through its independent contractors) to provide the necessary revision or addition. To facilitate analysis, we will first assume that none of the independent contractors providing the above services is located in the United States. We will then make the assumption that U.S. contractors are involved.

Softco employs six persons, all of whom are located in Bermuda. Two of them actively solicit customers by telephone and on the Internet; two are technicians who operate the "hot line," fielding questions or complaints received from customers and when necessary referring them to independent contractors; the last two perform administrative functions. Softco also advertises its programs on the Internet, on television and in magazines in the United States and other countries. All orders are placed by customers through the Internet, and deliveries of software, customer assistance and program adaptations are made by downloading the necessary codes from Softco's servers in Bermuda directly onto customers' computers. Customers make payments via the Internet to accounts maintained by Softco in Bermuda.

For purposes of analysis, it will be assumed sequentially that Softco is owned: (i) 100% by USco, which is wholly owned by U.S. persons; (ii) 100% by four U.S. individual shareholders who control USco; and (iii) 25% by a U.S. individual and 75% by non-U.S. persons.

IV. UNITED STATES TAXATION OF SOFTCO UNDER DOMESTIC LAW

Wholly apart from the U.S. rules taxing U.S. shareholders on their shares of the undistributed income of foreign corporations, to be considered below,[10] Softco itself may be subject to U.S. tax if it either: (i) is engaged in the conduct of a trade or business in the United States[11] (through a permanent establishment, if an income tax treaty applies)[12] and derives income which is effectively connected with that trade or business[13] (and attributable to the permanent establishment, if a treaty applies);[14] or (ii) derives income which constitutes fixed or determinable annual or periodical

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10. See infra, Part VI, text accompanying notes 106-65.

11. See IRC § 882(a).

12. See, e.g., Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, July 28, 1997, arts. 5, 7 [hereinafter U.S.-Ir. Treaty] (Business Profits and Permanent Establishment).

13. See IRC § 882(a).

14. See, e.g., U.S.-Ir. Treaty, supra note 12, art. 7 (Business Profits).

income subject to withholding tax[15] (and not exempted by applicable treaty).[16] Since many tax haven companies are not entitled to the benefits of any U.S. income tax treaty, the discussion will first focus on U.S. domestic law and them turn to the impact of an applicable treaty.

A. *Is Softco Engaged In a U.S. Trade or Business?*

Whether a foreign corporation is engaged in trade or business in the United States under U.S. domestic law is always a difficult question. It is a factual question, and therefore one on which the Internal Revenue Service does not issue advance rulings.[17] Moreover, the available authority, while considerable, dates largely from the 1950s or earlier.[18] Therefore, it is difficult to reach a definitive conclusion in many cases, although in general a rather low level of activity seems to be required. All that is required is that the activity be "considerable, continuous and regular."[19]

On the assumption that U.S. independent contractors are not involved in performing "hot line" or other services offered by Softco to customers, there are two possible bases for finding Softco to be engaged in a U.S. trade or business: It advertises to and deals with U.S. customers, and it retains U.S. persons to create software programs for it.[20]

Although nothing in this area is clear, it seems likely that Softco's advertising and dealings with U.S. customers, without the intervention of any person or facility located in the United States, would not by itself be enough to cause Softco to be engaged in business in the United States. In the *Piedras Negras* case,[21] a Mexican company which broadcast radio programs from Mexico into the United States and collected advertising revenues from U.S. advertisers was held not to have U.S.-taxable income. Although the opinion intermixes the concept of "doing business" with the concept of what

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15. See IRC § 881(a).

16. See, e.g., U.S.-Ir. Treaty, supra note 12, art. 12 (Royalties).

17. See Rev. Proc. 98-7, 1998-1 I.R.B. 222.

18. See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941); Continental Trading, Inc. v. Commissioner, 265 F.2d 40 (9th Cir. 1959) cert. denied, 361 U.S. 827 (1959); Herbert v. Commissioner, 30 T.C. 26 (1958), acq., 1958-2 C.B. 6.

19. Moore v. Commissioner, 56 T.C. Memo (CCH) at 1150, 1155, T.C. Memo (P-H) ¶ 89,038, at 89-174 (1989).

20. Although the author has found no authority on the point, it seems doubtful that Softco's activities in acquiring rights to software from USco would be considered to constitute engaging in business in the United States. Cf. Regs. § 1.864-6(a)(2)(i) ex. 1 (income derived by foreign corporation from licensing outside the United States patent rights acquired through office in the United States is not attributable to that office for purposes of § 864(c)(4)(B)).

21. Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297 (1941), nonacq., 1941-1 C.B. 18, aff'd, 127 F.2d 260 (5th Cir. 1942).

constitutes U.S.-source income, the court basically held that the company was not engaged in business in the United States.[22]

Here, however, Softco has also entered into contracts with U.S. individuals, as well as others, for the creation of software programs. Presumably, at least, the U.S. persons will do most of their work in the United States, possibly in facilities maintained by USco. The fact that they are independent contractors rather than employees of Softco does not prevent their activities from being attributed to Softco in making the necessary determination.[23]

A threshold question is whether these U.S. activities are to be characterized as the "manufacturing" or "production" of property by Softco. If it is considered to be engaged in manufacturing in the United States, Softco will be considered to be engaged in business in the United States.[24] The answer is not clear but, as discussed below, under existing law the programmers' activities will apparently not be taken into account in determining whether Softco has any U.S.-taxable income; and this may mean that it should not be deemed engaged in trade or business on account of the activities.[25]

Assuming that the U.S. programming activities do not constitute "manufacturing," it is not clear whether Softco will be deemed to be engaged in a U.S. trade or business. Although it dealt with services performed in the United States on behalf of a foreign corporation, the leading modern case on the "doing business" question, the Tax Court's decision in *Inverworld Inc. v. Commissioner*,[26] is not particularly helpful in answering the question of whether the individuals' activities cause Softco to be engaged in business. Apart from the fact that *Inverworld* involved financial transactions which are the subject of specific regulatory rules,[27] the United States activities consisted of the execution of specific market transactions on behalf of the foreign corporation's customers, rather than the creation of an underlying capital asset to be used in the foreign corporation's business. Moreover, the

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22. See id. For a discussion of the case law addressing this issue, see Nancy H. Kaufman, Common Misconceptions: The Functions and Framework of "Trade or Business Within the United States," 25 Vand. J. Transnat'l L. 729, 782-786 (1993).

23. See, e.g., Lewenhaupt v. Commissioner, 20 T.C. 151, 162-63 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955); de Amodio v. Commissioner, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962).

24. The author has been unable to find any authority expressly so holding. This almost certainly reflects the fact that the proposition is considered self-evident. Ongoing manufacturing activity in the United States is certainly the type of "considerable, continuous and regular" activity that constitutes engaging in business. See Moore, 56 T.C. Memo (CCH) at 1155, T.C. Memo at 89-174; supra text accompanying note 19.

25. See infra text accompanying notes 50-51.

26. 71 T.C. Memo (CCH) at 3231, T.C. Memo (RIA) ¶ 96,301 (1996).

27. See *Inverworld*, 71 T.C. Memo (CCH) at 3237-5, T.C. Memo (RIA) at 96-2806 to 96-2807.

U.S. activities carried on in that case constituted essentially *all* of the business activities of the foreign corporation;[28] and while the point is unspoken in the rather turgid opinion rendered by Judge Wells, this circumstance could hardly have failed to influence the decision.

In Softco's case, although its business activities are rather limited, a substantial portion of them will be carried on outside the United States. From the facts stated above, we do not know what portion of the programming will be done in the United States and what portion will be done elsewhere. Let us suppose that it will vary, but that substantial amounts will be done both inside and outside the United States. In addition, of course, on the first assumption stated above, all of the marketing, delivery, "hot line," adaptation, financial and administrative functions of Softco will be performed outside the United States.

Perhaps the closest precedent is the *Balanovski* case.[29] There an Argentine partner in an Argentine partnership came to the United States and over a substantial period of time carried on extensive activities connected with procuring military equipment which the partnership resold to the Argentine government. Obviously, not all of the partnership's activities were carried on in the United States, since the partner who remained in Argentina was responsible for procuring the government's orders and arranging for payment. Nevertheless, the United States component seemed to be the more critical part of the partnership's total activities.[30] The partnership was held to be engaged in trade or business in the United States.[31] The case is analogous to the Softco case in the sense that the activity carried on in the United States was the procurement of goods which were to be marketed outside the United States, while in Softco's case it is the creation of programs to be marketed by Softco outside the United States (although in some instances to U.S. customers).

All of this does not lead to a firm conclusion. To this author it seems possible, however, that if the programming that is done for Softco in the United States continues on a regular basis and constitutes a substantial portion of the total, Softco could be considered to be engaged in business in the United States. Whether this conclusion leads to the imposition of tax depends on whether Softco would be deemed to derive income effectively connected with its U.S. business, an issue discussed below.

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28. See *Inverworld*, 71 T.C. Memo (CCH) at 3237-22, T.C. Memo (RIA) at 96-2110 (no fixed facility other than in the United States).

29. United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968 (1957).

30. See *Balanovski*, 236 F.2d at 305 (extensive purchasing activities in the United States; title to goods passed in the United States).

31. See id. at 306-07.

We now relax the initial assumption and consider that the individual U.S. programmers, in addition to creating software programs for Softco, participate in providing "hot line" and other services to customers of Softco. In this event, Softco will probably be considered to be engaged in trade or business in the United States, although a recent Tax Court case may cast some doubt on this conclusion.[32]

B. *Does Softco Derive Income Effectively Connected with a U.S. Business?*

The answer to this seemingly simple question is one of Byzantine complexity. We encounter here, as we shall encounter again, the fundamental need to determine the character of the income items we are talking about. In addition, based upon the income characterization, we must determine the source of each item.

1. *Sales Income.*—The Regulation provides that income derived from the provision of software will be considered income from the sale of personal property if it is derived from a permanent transfer of a "copyrighted article" as opposed to a transfer of a "copyright right."[33] In the most general terms, the distinction is between a case where a customer buys a copy—or a number of copies—of a software program for its own use and one where the transferee also gets the right to sublicense or otherwise provide the software to others.[34] The sale characterization rule applies whether the medium of delivery of the program is physical or electronic.[35] Given the nature of Softco's operations, it is likely that much of its income will be characterized as sales income under the Regulation.[36]

If this income had a U.S. source, it would always be considered effectively connected income.[37] If the sales income had a foreign source, it could also be effectively connected income, but only under very limited circumstances: among other things the foreign corporation would be required to have an office in the United States through which the sales are effected.[38] Although Softco retains U.S. individuals to create software programs (and

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32. See discussion of the *Miller* case at text accompanying notes 86-89.

33. Regs. § 1.861-18(c)(1).

34. See Regs. § 1.861-18(c)(2).

35. See Regs. § 1.861-18(g)(2).

36. Under the Regulation, a transaction in which a customer acquires the right to make even a large number of copies for its own internal use will be treated as a sale, so long as the customer does not obtain the right to retransfer rights to use to others. See Regs. § 1.861-18(h) ex. 10.

37. Income derived from the sale of property is not fixed or determinable annual or periodical income. See Regs. §§ 1.871-7(a)(1), 1.1441-2(a)(3). Therefore, the "per se" rule of § 864(c)(3) applies.

38. See IRC § 864(c)(4)(B).

possibly perform other services) for it, they play no part in the marketing of the programs, and Softco has no sales facilities in the United States. Therefore, it should not be taxable on foreign-source sales income.

It seems likely that sales income of Softco would be characterized as income from the sale of "inventory property."[39] If so, its source depends upon where title to the property sold passes.[40] If it passes outside the United States, the income is foreign-source income; if it passes in the United States, it is U.S.-source income. The passage of title in turn depends on when and where the risk of loss passes from seller to buyer.[41]

When one is dealing with the physical shipment of tangible goods—the situation contemplated when the passage of title rule was adopted, this distinction (whether or not sensible from a policy perspective) is not difficult to make. Well established commercial law rules (relating to such things as F.O.B. and C.I.F. contracts) specify where title and risk of loss pass.[42] In the case of transactions entered into by Softco, however, the passage of title rule is essentially meaningless. In fact, most software transactions are licenses for intellectual property purposes, so that title in fact does not pass to the customer.[43] Moreover, how can one say where "risk of loss" passes when Softco, having presumably received payment, transmits the code of a software program over the telephone line which connects its server in Bermuda with its customer's computer in the United States? Literally, the

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39. The Regulation declines to address this question directly. It implies, however, that copies of software programs will constitute inventory property in at least some cases by referring to determining the source of income from sales of program copies under § 861(a)(6). See Regs. § 1.861-18(f)(2).

It seems doubtful that the inventory rules of §§ 471-474 can be applied in this context. Softco does not produce or acquire individual items of property and then resell them. Nevertheless, what Softco sells would presumably be considered "property held by the taxpayer primarily for sale to customers in the ordinary course of [its] trade or business" within the meaning of § 1221(1), and as such constitutes "inventory property" under § 865(i)(1).

40. Under § 865(b), income from the sale of inventory property is sourced under the passage of title rules of §§ 861(a)(6), 862(a)(6), and 863.

In Softco's case, if the inventory property rule did not apply, the sales income would be foreign-source under § 865(a)(2). Since Softco would not seem to have an office or fixed place of business in the United States to which the sales income is attributable, the special rule of § 865(e)(2) should not apply in making either of these determinations.

If Softco entered into transactions which were sales under the Regulation but received payments which were contingent on the customer's use of the program transferred, it is possible that the "royalty" source rule of § 865(d) would apply even though the transaction was not characterized as a license.

41. See Regs. § 1.861-7(c).

42. See U.C.C. §§ 2-319, 2-323, and 2-401.

43. See, e.g., Ned McGuire et al., Deloitte & Touche LLP, Deloitte & Touche Offers Comments on Tax Policy Implications of Global Electronic Commerce, 15 Tax Notes Int'l 1483 (Nov. 3, 1997).

"goods" cannot be "lost." If there is a malfunction in the telephone transmission, Softco will simply transmit the program again. Even if there could be a "loss," it is impossible to say "where" this loss occurred; since the transmission is instantaneous, there is no period of time separating the "shipping of the goods" and their "delivery."

The Regulation declines to resolve this question. The Preamble refers to the issue of determining the place of sale under the passage of title rule, notes that "the parties in many cases [apparently referring to transactions in physical goods] can agree on where title passes" and concludes that transactions in computer programs "will be sourced under similar principles."[44]

This indicates that the sensible answer is to treat title as passing from Softco to the customer when Softco transmits the program in Bermuda. As the Treasury White Paper states,[45] it is undesirable to have transactions effected on the Internet treated differently from transactions effected by traditional means; and no doubt if Softco had delivered the program by shipping it on an encoded CD, for example, it would have specified that title would pass to the customer in Bermuda. If necessary, Softco can add to its transmission a blurb to the effect that for tax purposes, title is deemed to pass in Bermuda.

2. *Income from the Production of Personal Property.*—Income from the production and sale (as opposed to the purchase and resale) of personal property has a split source. A portion is considered to be sourced where the personal property is produced and a portion where the sales income is derived. Income attributable to the production of personal property in the United States is U.S.-source income,[46] and will be treated as effectively connected income.[47] The term "produced" in the United States is defined to include "created, fabricated, . . . processed . . . [or] manufactured. . . ."[48] This suggests the possibility that some portion of the income derived by Softco from sales—*to either U.S. or foreign customers*—of software created (or modified) on its behalf in the United States could be taxable as effectively connected income.

In the present context, it is interesting to note that this issue arises only with respect to income which is characterized as derived from sales, and

44. T.D. 8785, 1998-42 I.R.B. 5, 7.

45. U.S. Dep't of the Treasury, Office of Tax Policy, Selected Tax Policy Implications of Global Electronic Commerce (1996) (visited July 21, 1997) <http://www.treas.gov/taxpolicy/internet.html>.

46. See IRC § 863(b)(2).

47. Since manufacturing income is not fixed or determinable annual or periodical income, the "per se" rule of § 864(c)(3) applies.

48. Regs. § 1.864-1.

not income characterized as rental or royalty income, which is sourced without regard to where the leased or licensed property was produced.[49]

It appears, however, that Softco will not be considered to derive income from manufacturing or production in the United States. The applicable regulation provides that, in determining whether income is derived in part from production in the United States, "the only production activities that are taken into account . . . are those conducted directly by the taxpayer."[50] This is intended to preclude consideration of the activities of contract manufacturers.[51] If so, the activities of the U.S. programmers are not to be attributed to Softco; and the income of Softco is to be characterized in its entirety as income from the sale of personal property.

Based on the foregoing, one would at least tentatively conclude that Softco does not derive income from the production of personal property in the United States. (Of course, to the extent that Softco deals in software programs which it does not develop or develops outside the United States, there can be no U.S.-source production income.)

3. *Rental Income.*—Under the Regulation, income derived from transferring a "copyrighted article" (as opposed to a "copyright right") can be treated as rental income if the customer is granted the right to use the program for only a limited period of time.[52] Although the Regulation is not clear on this point, a transaction which is treated as a rental of a copyrighted article is apparently to be treated as the rental of tangible personal property. This is intuitively correct in the case of the delivery of a "shrink-wrap" product, embodied on a CD,[53] and the Regulation is crystal clear that the mode of delivery will not make a difference.[54] We will proceed on the assumption, therefore, that this type of income is characterized as income from the rental of tangible personal property; if this were not the case, the rules discussed below with respect to royalties would apply.[55]

Income from the rental of tangible personal property will be considered effectively connected income if it is U.S.-source income, and then only if either (i) it is derived from assets used or held for use in the conduct of the United States business (the "asset use" test) or (ii) the activities of the

49. For a discussion of this anomaly and the possible reason for it, see Proposals on United States Taxation of Foreign Persons and of Foreign Income of United States Persons, International Aspects of United States Income Taxation, 1986 A.L.I. Fed. Income Tax Project 34-37 (May 14, 1987) [hereinafter ALI Study].

50. Regs. § 1.863-3(a)(1)(i)(A).

51. See Rev. Rul. 97-48, 1997-2 C.B. 89.

52. See Regs. § 1.861-18(f)(2), (h) ex. 3-4.

53. See Regs. § 1.861-18(h) ex. 1.

54. See Regs. § 1.861-18(g)(3).

55. See infra text accompanying notes 64-69.

U.S. business were a "material factor" in the production of the income (the "business activities" test).[56] If the rental is foreign-source income, it is not effectively connected.[57]

Income from the rental of tangible property has a U.S. source if the property is located in the United States.[58] To the extent that the income is received for the use of property located outside the United States, the income is foreign-source income.[59] This source rule creates an almost insoluble problem.

In many transactions characterized under the Regulation as the transfer of a "copyrighted article"—as opposed to many typical licensing transactions—there is no geographical limitation on the customer's use of the program. Therefore, the use may occur either within or without the United States. Softco will have no way to determine at the time of the transaction (which, on the facts given, is when it receives the single payment made by the customer) where the customer will use the program. Indeed, the customer itself may not know the answer at that time, since its plans may change; even an individual customer is likely to take a laptop along whenever he or she works in another country.

There is some precedent of dubious provenance for presuming that a U.S. person uses property in the United States unless the taxpayer can prove otherwise;[60] and it may be tempting to presume a U.S. location if the customer is located in—i.e., the software is delivered to—the United States (and, presumably, a non-U.S. use when the customer is outside the United States). In fact, however, any such rule would be unworkable. The provider will often not know the geographical location of its customer; and any such rule could be avoided by arranging for delivery at one location followed by immediate retransmission to another.

Assuming that rental income derived by Softco is found to have a U.S. source, it will nevertheless be effectively connected only if it meets either the asset-use test or the business activities test. The asset-use test ordinarily applies to passive income arising not from the corporation's business activities as such but from investment of funds or deployment of

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56. U.S.-source rental income is fixed or determinable annual or periodical income. See IRC § 881(a)(1)(A). As such, it is effectively connected income only to the extent so determined by applying the factors set forth in § 864(c)(2), which embodies the "asset use" and "business activities" tests.

57. See § 864(c)(4)(B) (enumerating types of foreign-source income that may be effectively connected, does not refer to income from the rental of tangible property).

58. See IRC § 861(a)(4).

59. See IRC § 862(a)(4).

60. See Molnar v. Commissioner, 4 T.C. Memo (CCH) at 951, T.C. Memo (P-H) ¶ 45,317 (1945), aff'd, 156 F.2d 924 (2d Cir. 1946); Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946).

capital assets held for use in the business.[61] This would not seem to fit Softco's case.

The business activities test seems more likely to apply, since it is directed at, among other things, cases in which income which is generally considered passive (royalties are the example referred to in the regulations) are derived in the conduct of an active business.[62] The test seems to be focussed, however, on activities directly related to earning the particular items of income involved—principally marketing activities conducted in the United States.[63] In Softco's case, there are no such U.S. activities; and the efforts of the U.S. programmers retained by Softco seem too indirectly related to the earning of any particular item of income to count.

Tentatively, therefore, one would conclude that any rental income derived by Softco would not be subject to tax as effectively connected income.

4. *Royalty Income.*—Under the Regulation, income derived from the transfer to a customer of a "copyright right" (as opposed to a "copyrighted article") is considered royalty income.[64] This has a U.S. source to the extent that the payment is made for the use of, or the right to use, the intangible property in the United States;[65] otherwise the source is foreign. If the royalty has a U.S. source it will be effectively connected or not, based upon the same factors discussed above with respect to rental income.[66] Unlike rental income, however, in limited circumstances royalty income can be considered effectively connected income even if it is foreign-sourced. The income must be attributable to a U.S. office or fixed place of business of the foreign corporation and it must be derived in the "active conduct of [the U.S.] trade or business."[67]

It seems doubtful that Softco could be deemed to have a fixed place of business in the United States because of its retention of U.S. individuals to create programs.[68] Moreover, the regulations seem to contemplate that

61. See Regs. § 1.864-4(c)(2)(i).

62. See Regs. § 1.864-4(c)(3)(i)(*c*).

63. See Regs. § 1.864-4(c)(3)(ii) ex. 2.

64. See Regs. § 1.861-18(c)(1)(i), (f)(1). A transfer of substantially all of the rights in a copyright will be treated as a sale or exchange of that item of intangible property. Id. In this case, the rules discussed above with respect to sales would apply. As to the imposition of withholding tax in such cases, see the discussion in the text accompanying infra notes 76-89.

65. See IRC § 861(a)(4).

66. See supra text accompanying notes 52-63.

67. IRC § 864(c)(4)(B)(i). If income characterized as rental income under the Regulation were considered to be derived from the rental of intangible, rather than tangible, property, the rule described here would apply, since by its terms it applies to "*rents* or royalties for the use of . . . intangible property." Id. (emphasis added).

68. See supra text accompanying note 38.

income will be attributable to a U.S. place of business only if that office has some direct relationship to the earning of specific items of income—again, generally, marketing activities.[69] Softco certainly carries on no such activities in the United States. Therefore, foreign-source royalties should not be considered effectively connected income. As in the case of rentals, however, determining where the intangible property is used will be a major problem.

5. *Services.*—To the extent that Softco adapts or modifies its programs to suit the needs of particular customers or performs "hot line" functions, it may derive income from the performance of services.[70] Under the first assumption set forth above, all of such services are performed outside the United States. Under these circumstances, the income will not be U.S.-source income;[71] and foreign-source services income is never effectively connected income.[72]

The alternative assumption set forth above is that some of these services are performed by programmers located in the United States. We concluded above that in that case Softco could be considered to be engaged in trade or business in the United States. Since the income attributable to such services would be sourced where the services are performed,[73] one would expect such income to be taxable effectively connected income. This conclusion may, however, be put in question by the opinion in the *Miller* case, discussed below in connection with the imposition of withholding taxes.

If tax is imposed, the basis of the tax must be ascertained. Presumably, Softco will maintain records documenting the occasions on which U.S. programmers have performed services.[74] In the absence of better information, the division of Softco's income between U.S. and foreign sources may be based on the amount of time spent by U.S. programmers compared to the amount of time spent by programmers located elsewhere.[75]

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69. See Regs. § 1.864-6(a)(2)(i).

70. See Regs. § 1.861-18(b)(1)(iii), (d).

71. See IRC § 862(a)(3).

72. Section 864(c)(4)(B) makes no reference to services income.

73. See IRC §§ 861(a)(3), 862(a)(3); cf. Rev. Rul. 70-424, 1970-2 C.B. 150 (activities of agent in U.S. attributed to principal).

74. Softco presumably pays its U.S. programmers according to how much they work and/or how much revenue it derives from the programs which they create.

75. See Regs. § 1.861-4(b); cf. Tipton & Kalmback, Inc. v. Commissioner, 480 F.2d 1118 (10th Cir. 1973) (income for services apportioned to within and without the United States on a time basis); Stemkowski v. Commissioner, 690 F.2d 40 (2d Cir. 1982) (determining time periods to be counted in apportioning to the United States income earned by Canadian hockey player).

6. *Summary.*—In summary, it appears that (i) Softco should not be deemed to derive effectively connected income from the production of property in the United States; (ii) sales income derived by Softco should be foreign-source and therefore not effectively connected; (iii) rental and royalty income will not be effectively connected because, as to rentals and U.S.-source royalties, the "asset use" and "business activities" tests are not met and, in the case of foreign-source royalties, Softco has no U.S. place of business to which royalties are attributable; and (iv) services income may be taxable but only to the extent that services are performed on behalf of Softco by programmers located in the United States. Accordingly, even in the absence of an applicable income tax treaty, Softco would appear to be exposed to U.S. corporate income tax only in this last situation.

C. *Is the Income of Softco Subject to U.S. Withholding Tax?*

Income which is not effectively connected with a U.S. business may nevertheless be subject to U.S. withholding tax at the statutory rate of 30% if (i) it is U.S.-source income and (ii) it constitutes "fixed or determinable annual or periodical" (FDAP) income.[76]

Income derived from the sale of personal property is not considered FDAP income,[77] and therefore is not subject to withholding tax regardless of its source.[78] Income from production of property will not be subject to withholding.[79] Rental or royalty income having a U.S. source is FDAP income subject to the withholding tax, however.[80] Thus, even if it is not engaged in business in the United States, Softco will be subject to withholding tax if it makes temporary transfers of "copyrighted articles," or transfers "copyright rights," to customers for use in the United States.

Even if Softco is liable to tax in principle, the tax may be uncollectible as a practical matter. Each customer that pays Softco for a software program or rights to a program is a withholding agent, technically

76. IRC §§ 871(a), 881.

77. See Regs. §§ 1.871-7(a)(1), 1.1441-2(a)(3).

78. There is one exception. Gain from the sale or exchange of intangible property is treated for withholding tax purposes as royalty income to the extent the consideration paid is contingent on the productivity, use or disposition of the property. See IRC § 871(a)(1)(D). A U.S.-source will also be established under the royalty rule. See IRC § 865(d)(1)(B).

79. If any portion of Softco's income is deemed to arise from the production of property in the United States, it will be deemed to be engaged in a U.S. trade or business, and the income will be considered effectively connected with that business. Income from production carried on outside the United States is not subject to withholding because it is not U.S.-source income. See IRC § 863(b)(2); Regs. § 1.863-3.

80. See IRC §§ 871(a)(1), 881(a)(1); Regs. § 1.871-7(b)(1).

liable to collect the tax owed by Softco.[81] Large business purchasers may know who Softco is and where it is located; they will presumably insist on withholding.[82] Other purchasers, however, will not be in a position to withhold. The customer may not even know where Softco is organized or where it operates. In addition, the practical difficulties of enforcing withholding obligations against a large number of persons making relatively small purchases are formidable.[83]

The application of withholding tax to amounts received by Softco attributable to services provided to customers is unsettled at the moment. To the extent that such services are performed, whether by Softco's own employees or by independent programmers, outside the United States the resulting income does not have a U.S. source and therefore is not subject to withholding.[84] If the income has a U.S. source, however, the statute and the regulations appear to subject it to the tax unless it is considered effectively connected income,[85] in which case the income would be subject to corporate tax in the hands of Softco.

In *Miller v. Commissioner*,[86] however, the Tax Court held in closely analogous circumstances that no tax needed to be withheld. In *Miller*, U.S. partnerships had paid fees to a related Hong Kong corporation for the performance of research services. The Hong Kong corporation in turn subcontracted with U.S. subsidiaries, among others, to perform a portion of the required services. The IRS asserted that the U.S. payors were liable to withhold tax from the payments they made to the Hong Kong corporation to the extent that these were attributable to the research conducted in the United States. The taxpayer pleaded that at the time of payment (which was in advance), it did not know to what extent the services it paid for would be performed in the United States. The IRS took the position that, when in doubt, the U.S. payor should withhold on the entire amount, and the Hong Kong corporation should apply for a refund if the withholding turned out to be excessive.

Noting that the U.S. subsidiaries were subject to tax on the income they earned and that, in the facts presented, the IRS could apply section 482 to adjust the amounts received by the U.S. subsidiaries if necessary to reflect

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81. See IRC § 1461.

82. As to possible exemption from withholding tax under an income tax treaty, see the discussion at text accompanying notes 103-05.

83. See, e.g., Tax and the Internet, discussion report of the Australian Taxation Office Electronic Commerce Project Team on the challenge of electronic commerce to tax administration §§ 7.2.8, 7.2.18 (1997). See Australian Taxation Office web page (visited August 3, 1999) <http://www.ato.gov.au/ecp/>.

84. See supra text accompanying note 76.

85. See Regs. § 1.1441-4(a)(1).

86. 73 T.C. Memo (CCH) 2319, T.C. Memo (RIA) ¶ 97,134 (1997).

their true income, the court held that the payments made to the Hong Kong corporation were not U.S.-source income subject to withholding because the Hong Kong corporation performed no services in the United States. The court stated: "In order for [the Hong Kong corporation] to be considered as having U.S. source income by virtue of the performance of services, [the corporation] itself would have to perform the services through agents or employees of its own."[87]

It is difficult to know exactly what to make of the quoted statement. Foreign corporations, like Softco, often retain U.S. persons, both individuals and entities, as subcontractors to assist them in performing their contract obligations. As surely would be true in Softco's case, the amount that the foreign corporation charges its customer for what is done in the United States will typically exceed the amount paid to the U.S. subcontractor(s), since the foreign corporation will be doing marketing, supplying working capital, taking risk, and performing administrative services and other functions. One would have thought that—passing for the moment the narrow question of withholding liability (an issue which the *Miller* court found it unnecessary to consider)[88]—what the foreign corporation earned would be treated as income from sources within the United States because the services provided were performed there. If not (contrary to the *Miller* court's footnoted suggestion),[89] the income could not constitute effectively connected income and would escape tax altogether.

One can sympathize with the hardship imposed on a taxpayer when, as in the *Miller* case and in Softco's circumstances, a payment is made at a time when the payor has no way of knowing what portion of the payment will turn out to represent U.S.-source income; but this seems an insufficient reason for holding that no tax is payable at all. Surely, the correct solution is to consider that all amounts paid to a Softco for services performed for a customer in the United States constitute U.S.-source, and therefore effectively connected, income in its hands. Softco must report it (and argue with the IRS about its proper amount), but the payor will be free of withholding responsibility. In this sense, services income is easier to deal with than rents and royalties, which will in most cases not give rise to effectively connected income regardless of source.

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87. *Miller*, 73 T.C. Memo (CCH) at 2323, T.C. Memo (RIA) at 97-854.

88. See *Miller*, 73 T.C. Memo (CCH) at 2324, T.C. Memo (RIA) at 97-855.

89. See *Miller*, 73 T.C. Memo (CCH) at 2323 n.11, T.C. Memo (RIA) at 97-854 n.11. ("If [the corporation] did perform services, it is possible that it could be considered as carrying on a trade or business in the United States.").

V. U.S. TAXATION OF SOFTCO UNDER THE IRISH TREATY

A. *Qualification of Softco Under the Treaty*

Softco will be entitled to claim the benefits of the Treaty only if (a) it is a resident of Ireland for Irish tax purposes and (b) it is a "qualified person" under Article 23, the limitation of benefits article.

Under Article 4 of the Treaty a company will be considered a resident of Ireland if it is subject to tax in Ireland by reason of its place of incorporation or management.[90] It is assumed in this discussion that Softco is both incorporated and managed and controlled in Ireland. It will therefore be treated as an Irish resident.

Under Article 23 of the Treaty, a company may be considered a "qualified person" under any one of several tests, only two of which are potentially applicable to Softco.

Under the "active business test," if Softco were engaged in the active conduct of a substantial trade or business in Ireland, it could claim benefits of the Treaty with respect to U.S.-source income items connected with that trade or business.[91] However, on the facts given it is not engaged in business in Ireland. If Softco did carry on business activities in Ireland—such as marketing activities—it might qualify under this rule if its business activities in Ireland were deemed substantial.[92]

Under the "ownership and base erosion" test, a company will be considered a qualified person if: (a) at least 50% of the voting power and value of its stock is owned by "qualified persons" or United States citizens or residents and (b) amounts deductible for Irish tax purposes which it pays to persons other than "qualified persons" or United States citizens or residents do not exceed 50% of its gross income.[93] Since Softco is owned by USco, a United States resident as defined in the Treaty,[94] it satisfies the "ownership" prong of this test. The question is whether it will satisfy the "base erosion" prong. This in turn depends on whether payments made by Softco are "deductible for income tax purposes . . . in [Softco's] State of residence."[95] In fact, no payments made by the Bermuda branch are

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90. See U.S.-Ir. Treaty, supra note 12, art. 4, para. 1(a).

91. See U.S.-Ir. Treaty, supra note 12, art. 23, para. 3.

92. The business in Ireland would have to be substantial in relation to the income derived from the United States for which Treaty benefits were claimed. This determination would be based on all of the facts and circumstances, but taking into account such factors as asset values, gross income and payroll expense. See U.S.-Ir. Treaty, supra note 12, art. 23, para. 3(b)(ii).

93. U.S.-Ir. Treaty, supra note 12, art. 23, para. 2(c).

94. See U.S.-Ir. Treaty, supra note 12, art. 4, para. 1(a).

95. U.S.-Ir. Treaty, supra note 12, art. 23, para. 2(c)(ii)(B).

deductible in Ireland because the income of the branch is not taxable there. Is the quoted phrase to be read in this context as meaning "deductible in Ireland if the income to which the payments related were taxable in Ireland?" If so, Softco's qualification might depend on the extent to which it made payments to U.S. or Irish persons, since these would not be counted as base eroding payments.

It is assumed in this discussion that Softco will not be taxable in Ireland on income attributable to its branch in Bermuda. This raises an important additional issue under paragraph 7 of Article 23, which embodies an "exempt branch" rule of the type first adopted in connection with the U.S.-Dutch treaty. Under this rule, if a resident of Ireland derives income from the United States which is (a) attributable to a permanent establishment which the company maintains in a third country and (b) exempt from tax in Ireland, the income will not qualify for benefits under the Treaty unless it is "income . . . connected with . . . the active conduct of a trade or business carried on by [a] permanent establishment [of Softco] in [a] third state." It appears that Softco has a "permanent establishment" in Bermuda; however, is that establishment engaged in an active trade or business? Despite the fact that it has few employees and relatively little in the way of capital equipment, it seems difficult to characterize Softco's activities in any other way.[96]

B. *Taxation of Softco's Business Profits*

Under the Treaty, business profits of Softco cannot be taxed in the United States unless Softco is deemed to have a U.S. permanent establishment to which such profits are attributable.[97] In brief, Softco could be deemed to have a permanent establishment in the United States if it had an agent in the United States (other than an independent agent) who had and habitually exercised authorized to enter into contracts on it s behalf.[98] On the facts given this is not the case. Softco could also be deemed to have a permanent establishment in the United States if it maintained an office or

96. Regulations section 1.355-3(b) contains an extensive discussion of what constitutes the active conduct of a trade or business for purposes of applying the § 355 rules relating to tax-free spin-offs and other corporate divisions. Softco would appear to qualify under these rules.

Specific rules apply in determining whether, for Subpart F purposes, rents and royalties received by Softco are derived in the active conduct of a trade or business. See infra text accompanying notes 127-32. Even if Softco did not qualify under these rules, it would seem strange to apply them here, among other things because the determination made here will potentially affect all categories of Softco's income, and these rules would not be relevant in determining the treaty status of a foreign corporation which is not a Controlled Foreign Corporation.

97. See U.S.-Ir. Treaty, supra note 12, art. 7.

98. See U.S.-Ir. Treaty, supra note 12, art. 5, para. 5.

other fixed place of business in the United States.[99] It is possible that the fixed places of business of individuals who write programs for Softco could be attributed to it. This seems unlikely, however. They are independent contractors using whatever facilities they normally use for their work, if any. Softco has neither control over those facilities nor the right to occupy them for its own use.[100] It therefore seems unlikely that, even if Softco were deemed to be engaged in trade or business in the United States, as discussed above, it would be deemed to have a permanent establishment.[101] Therefore, its business profits should be exempt from U.S. tax. The exempt profits should include sales, rental and services income.[102]

C. *Taxation of Softco's Royalty Income*

Royalty income would be differently treated, however. If exempt under the business profits article of the Treaty, as discussed above, it could still be subject to withholding tax under Article 12.[103] Article 12 generally provides that royalties received by a resident of Ireland will be exempt from U.S. withholding tax.[104] However, paragraph 7 of Article 23 (the "exempt branch" disqualification rule) must be taken into account here as well. If that rule applies, the United States is authorized to impose a 15% withholding tax. The application of the rule again depends on whether Softco is engaged in an active trade or business, which it appears to be.[105] If so, royalties will also be exempt.

VI. TAXATION OF SOFTCO'S U.S. SHAREHOLDER(S) UNDER THE U.S. TAX HAVEN REGIMES

A. *Taxation of U.S. Parent on Income of Softco Under Subpart F*

Assuming that Softco is wholly owned by USco, Softco is a controlled foreign corporation (CFC).[106] As a result, U.S. Parent can be

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99. See U.S.-Ir. Treaty, supra note 12, art. 5, para. 1.

100. See K. Vogel, Vogel on Double Taxation Conventions 286-87 (3d ed. 1997).

101. See Taisei Fire & Marine Ins. Co. v. Commissioner, 104 T.C. 535 (1995) (U.S. independent contractor did not cause taxpayer to have a permanent establishment).

102. Such income, unlike royalty income, is not covered by any other article of the Treaty.

103. Items of income dealt with in a specific article of the Treaty may be taxed under that article even if exempt under Article 7. See U.S.-Ir. Treaty, supra note 12, art. 7, para. 8.

104. See U.S.-Ir. Treaty, supra note 12, art. 12, para. 1.

105. See supra text accompanying note 94.

106. Under § 957(a), a foreign corporation is a controlled foreign corporation if more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of the stock is owned (or deemed to be owned under attribution rules) by United States shareholders.

subjected to tax on a current basis on Softco's "Subpart F income."[107] Whether Softco's income constitutes Subpart F income once again depends on how that income is characterized.

1. *Sales Income.*—Foreign base company sales income, which constitutes Subpart F income,[108] is defined, as relevant here, as income from the purchase of personal property from a related person and its sale to any person, or the purchase of such property from any person and its sale to a related person if: (i) the property is manufactured or produced outside the country in which the CFC is incorporated; and (ii) it is sold for use, consumption or disposition outside such country.[109] Since the rule applies only to the purchase and resale of property, it does not apply if the CFC acquires personal property, uses it to manufacture or produce a product and sells the manufactured product, regardless of the identity of the parties with which it deals or the geographical destination of the sales.[110]

At least some of the income derived by Softco will undoubtedly be characterized as sales income.[111] Although the issue is not entirely clear, it seems that the Regulation treats such income as resulting from the sale of tangible property. Thus, it may constitute foreign base company sales income.[112]

Except in the case of Russco (discussed below),[113] we are assuming that Softco's customers are unrelated persons. A threshold question, therefore, is whether Softco has "purchased" the personal property which it sells from a related person. The software programs which Softco delivers to its customers fall into four categories: (i) those which have been created for its own account; (ii) those which it has acquired from unrelated persons; (iii) those which it has acquired from USco; and (iv) those which it has acquired from USco and adopted or modified.

(a) **Programs not acquired from USco.** It seems clear that the programs which Softco has had created for its own account or acquired from unrelated persons have not been purchased from a related person, and

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107. IRC § 951(a)(1)(A). Subpart F income is defined in IRC § 952.

108. See IRC §§ 952(a)(2), 954(a)(2).

109. See IRC § 954(d)(1).

110. See Regs. § 1.954-3(a)(4)(i).

111. Sales made by Softco give rise to an element of services income, because the base price includes the right to "hot line" services for one year. Under the Regulation, this requires the transaction to be bifurcated into two elements unless the services element is de minimis. See Regs. § 1.861-18(b)(2).

112. It is not clear whether the foreign base company sales income rules, which were patently designed to apply to transactions in tangible goods, could be applied to the sale of exchange of intangible property.

113. See infra text accompanying note 126.

therefore sales of these should not give rise to foreign base company sales income.

(b) **Programs acquired from USco.** An issue arises, however, whether the acquisition of programs from USco is to be treated as a purchase of personal property from a related person. In some cases, Softco has not purchased software from USco but merely licensed it; these transactions are technically not "purchases." Moreover, the fact is that Softco has not purchased from anyone the copy of the software program which it delivers to its customer; it has generated this copy on its servers in Bermuda. Softco has acquired "copyright rights" from USco, a related person, but has not resold those rights as such.[114]

The situation is unlike the traditional case in which a large number of individual tangible objects are physically produced in the United States, shipped abroad and individually delivered to customers. One can think of a software program as a design which is used by Softco's servers in Bermuda to create replicas (in potentially infinite numbers); and it is the replicas that are sold to customers. A possible analogy would be the manuscript of a novel and the copies of the books which are sold.

On a technical reading of the statute, therefore, one could argue that income derived by Softco from sales of programs to unrelated persons is not foreign base company sales income, even if the programs have been acquired or licensed from USco. However, this conclusion seems too glib. The foreign base company sales income rules were adopted to deal with cases where a U.S. person artificially inserted a tax haven entity between the creator of a product and the customer for that product and thus insulated from both U.S. and foreign tax income which did not have its "natural business locus" in the tax haven.[115] Allowing for the very different circumstances under which software is created, acquired and delivered, as compared with tangible goods, by incorporating Softco USco could be said to be achieving exactly the proscribed result. The fact is that by transferring or licensing software to Softco and allowing Softco to sell it to customers, USco has avoided both U.S. and foreign tax on at least a portion of the resulting income. If, for example, USco shipped to Softco CDs encoded with the requisite programs and Softco sold these to its customers, the resulting income of Softco would constitute foreign base company sales income. It is doubtful that the differences in the mode of delivery should spell a difference in result here.

(c) **"Manufacture" or "Production" by Softco.** Even if, as this analysis suggests, Softco were deemed to have "purchased" the software which it sells to unrelated customers, its sales income would nevertheless not

114. Softco's transactions with Russco are an exception and are discussed below.

115. See ALI Study, supra note 49, at 257.

constitute foreign base company sales income if Softco were deemed to have "manufactured" or "produced" the personal property which it sells. The applicable regulation states that a CFC will be deemed to produce property if the property it sells "is in effect not the property which it purchased."[116] It also specifies that "[i]n no event will packaging, repackaging, labeling, or minor assembly operations" constitute production activities.[117]

None of the available precedents, which deal with tangible goods, is particularly helpful in determining how Softco would be treated under these regulatory rules.[118] The analogy to the packaging of goods is intriguing, however. If USco shipped CDs to Softco and Softco put them in packages and sold the packages to customers, Softco would derive foreign base company sales income. How different is the situation when Softco puts USco-generated software programs on its servers and thereafter delivers copies to its customers? One would think that the IRS might consider the two situations to be comparable and conclude that Softco derived foreign base company sales income.

The fourth category of software programs which Softco sells consists of programs acquired from USco which independent contractors then modify or adapt for Softco. As to these, the issue is whether Softco is deemed to have "manufactured" the property sold. A critical threshold question is whether the activities of the independent contractors are to be attributed to Softco.

In Revenue Ruling 75-7,[119] the IRS originally ruled that if a CFC retained a contract manufacturer to process property which the CFC owned, the activities of the manufacturer would be attributed to the CFC; if those activities constituted manufacturing, the CFC was deemed to manufacture the property for purposes of applying the foreign base company sales income rules. Some years later, in the *Ashland Oil* case,[120] the IRS sought to blunt the impact of this rule by arguing that when the contract manufacturer was located in a country other than the country in which the CFC was organized, it constituted a "manufacturing branch" of the CFC under section 954(d)(2); the result would have been that the CFC would be deemed to have purchased the property it resold from a separate, related manufacturing corporation, thus "restoring" its profit to the status of foreign base company sales income.

116. Regs. § 1.954-3(a)(4)(i).

117. Regs. § 1.954-3(a)(4)(iii).

118. See Dave Fishbein Mfg. Co. v. Commissioner, 59 T.C. 338 (1972), acq., 1973-1 C.B. 1 (manufacturing portable bag closing machines); Bausch & Lomb Inc. v. Commissioner, 71 T.C. Memo (CCH) 2031, T.C. Memo (RIA) ¶ 96,057 (1996) (manufacturing sunglasses).

119. 1975-1 C.B. 244.

120. Ashland Oil, Inc. v. Commissioner, 95 T.C. 348 (1990).

The government lost the *Ashland Oil* case; and rather than litigate the issue further, the IRS published Revenue Ruling 97-48.[121] This ruling accepts the holding of *Ashland Oil* but reverses the conclusion of Revenue Ruling 75-7, holding that manufacturing activities of a contract manufacturer located in another country are not to be attributed to a CFC for purposes of determining whether it has derived foreign base company sales income. The Treasury has recently proposed a regulation confirming this rule by specifying that a CFC will be considered to have manufactured or produced property only if, "as a result of operations conducted by such selling corporation in connection with the property that it purchased and sold," the property it sold is in effect not the property it purchased.[122]

The *Ashland Oil* transactions and similar arrangements involve contracts between two business organizations, each with its own facilities and staff of employees. The arrangements in Softco's case are different in that Softco separately contracts with a number of individuals for personal services. Does this distinction make a difference? Does the requirement of the proposed regulation that the "operations" be "conducted by such selling corporation" require that they be carried out by employees? Elsewhere in the regulations under section 954, the conduct of business by employees is expressly required.[123]

The thrust of Revenue Ruling 97-48 and the proposed regulation seems aimed at cases in which a CFC claims exemption from the foreign base company sales income rule on the basis of activities carried on by other persons in non-tax haven countries in which the CFC is not taxable. If the relationship which Softco entered into with the programmers who develop its programs were deemed an employer-employee relationship, the contract manufacturer rule would not seem to apply; but there are any number of reasons why it might be unacceptable for Softco to enter into such employment arrangements. Among other things, the CFC might well be considered to be engaged in trade or business in the United States (as well as other countries) and therefore subject to tax.[124]

Since it is not clear that the activities of the independent contractors retained by Softco are to be disregarded, it may be useful to consider whether Softco would be deemed to have "produced" the modified programs if those activities are taken into account.

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121. 1997-2 C.B. 304.

122. Prop. Regs. § 1.954-3(a)(4)(i) (effective for taxable years beginning on or after the date the final regulations are published in the Federal Register).

123. See, e.g., Regs. § 1.954-2(c)(1)(ii), (d)(1)(ii) (marketing activities relating to rents and royalties).

124. Rev. Rul. 70-424, 1970-2 C.B. 150 (principal-agent relationship causes foreign principal to be engaged in U.S. trade or business).

The applicable regulation sets forth two tests. Property will be deemed to be produced by the CFC if what is purchased is "substantially transformed" or if it is a component of the property sold and the processes performed by the CFC with respect to it "are substantial in nature and are generally considered to constitute the manufacture, production or construction of property."[125] The regulations illustrate these rules by examples relating to such physical objects as paper, screws and bolts, fish, engines and automobiles; these are again not of much help. One is left to speculate on the extent to which Softco would be required to modify or adapt programs it has acquired from USco before it would escape the foreign base company income category. Presumably, extensive modification should be deemed sufficient; but what this means would depend on an analysis of a highly technical nature.

(d) **Softco's Transactions with Russco.** In addition to its dealings with the public, Softco enters into transactions with Russco. In some of these transactions, Softco grants to Russco substantially all of the rights to its software programs in Eastern Europe. Even though the consideration paid by Russco is in the form of royalty-like contingent payments, for U.S. tax purposes these transactions are characterized as sales of the underlying "copyright rights."[126] Since Russco is a related person, such sales will give rise to Subpart F income (regardless of whether Softco has acquired the programs from USco) unless, under the analysis presented above, Softco is treated as having "produced" the programs.

2. *Rental and Royalty Income.*—Whether rental and royalty income of Softco constitutes Subpart F income depends on a different set of statutory and regulatory rules.

Rents and royalties generally constitute Subpart F income.[127] There is an exclusion, however, for rents and royalties derived in the active conduct of a trade or business and received from unrelated persons.[128] Amounts received by Softco from Russco which are not characterized as sales income will be characterized as royalties; and since Russco is a related person, the "active business" exclusion cannot apply. Royalty income received by Softco from Russco will therefore constitute Subpart F income. To the extent that income which Softco derives from transactions with unrelated persons is characterized as rental or royalty income, however, the "active business" exclusion may be available.

125. Regs. § 1.954-3(a)(4)(i)-(iii).

126. See, e.g., Rev. Rul. 54-409, 1954-2 C.B. 174; Rev. Rul. 75-202, 1975-1 C.B. 170; Rev. Rul. 84-78, 1984-1 C.B. 173.

127. See IRC § 954(c)(1)(A).

128. See IRC § 954(c)(2)(A).

At the outset, it is important to note that nothing in the ensuing analysis turns on whether the programs licensed by Softco were acquired from USco or from an unrelated person. The inquiry involves solely the business activities of Softco.

Under the applicable regulations, Softco could be considered to derive "active business" rents or royalties if it regularly performed marketing functions through a staff of its own employees which is "substantial in relation to the amount of royalties derived . . . ."[129] This determination is based on all of the facts and circumstances, but under a "safe harbor" rule a marketing organization will be deemed to be "substantial" if "active licensing expenses" equal or exceed 25% of "adjusted licensing profit." "Active licensing expenses" include amounts deductible under section 162 as ordinary and necessary business expenses, other than compensation to shareholders, persons related to them or agents or independent contractors. "Adjusted licensing profit" refers to a gross profit figure—the rents or royalties received less royalties paid, amounts of deductible deprecation or amortization and payments made to agents or independent contractors.[130] We do not have sufficient facts to know whether Softco could meet this test, but since it employs only two persons in its marketing function, it would have to incur rather substantial advertising expenses in order to satisfy this "safe harbor" rule. We will assume that the test is not met.

Softco could also qualify for the "active business" exclusion of rents and royalties if the property leased or licensed is property that it has manufactured or produced, or has acquired and added substantial value to, so long as if it regularly engages in these activities.[131] We will assume that Softco will meet the "regularly engaged" criterion, so that the question is whether it has "manufactured or produced" or "acquired and added substantial value to" the property leased or licensed.

In the case of programs acquired from USco or from unrelated persons (and not modified and adopted), Softco would not be considered to have produced the programs, and it seems unlikely that Softco would be deemed to "add substantial value" by reason of its marketing activities alone. With respect to the computer programs that Softco has contracted to have created for it, it would be deemed to have produced the property which it licenses if the activities of independent contractors located in countries other than Bermuda are not to be disregarded. The rules relating to contract manufacturing, discussed above, apply by their terms only to transactions

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129. Regs. § 1.954-2(c)(1)(ii), (d)(1)(ii).
130. Regs. § 1.954-2(c)(2)(ii)-(iv), (d)(2)(ii)-(iv).
131. See Regs. § 1.954-2(c)(1)(i), (d)(1)(i).

analyzed under the foreign base company sales income rules. It is unclear whether they should be applied here.

It is noteworthy that to qualify royalties as "active business" royalties under the marketing activities rule, the marketing organization must consist of employees, and payments made to independent contractors are disregarded in applying the "safe harbor" rule. There is no such express provision in the rule relating to the production of intangibles. Should this be implied, or is the omission to be taken as an intended difference?

In cases where Softco has retained independent contractors to modify or adopt programs originally acquired from USco or unrelated persons, the same questions arise; but in such cases, the additional question is whether these activities have "added substantial value" to the acquired programs. This seems to call for an analysis similar to the analysis of whether Softco has "produced" programs for purposes of applying the foreign base company sales income rules.[132]

3. *Services Income.*—If a CFC performs services "for or on behalf of" a related person and these are performed outside the country in which the CFC is organized, the resulting income can constitute foreign base company services income,[133] which constitutes Subpart F income.[134] Except to the extent that any of the independent contractors retained by Softco are located in Ireland, the services supplied by Softco to customers (in the form of "hot line" services or customer-requested adaptations or modifications) are performed outside its country of organization. In general, however, these services will be supplied to unrelated customers. The services nevertheless could be considered to constitute services performed on behalf of a related party if USco were deemed to provide "substantial assistance" to Softco in connection with their performance.[135] On the facts given, USco is not itself participating in the supply of services. At least tacitly, however, it is supplying assistance to Softco by permitting individuals who are its employees to create software programs and perform "hot line" and other services for Softco. In economic substance, this represents a diversion of USco's resources for the benefit of Softco.[136] An example in the applicable regulation deems a U.S. parent to provide substantial assistance to its CFC

132. See supra text accompanying notes 116-25.

133. IRC § 954(e).

134. See IRC § 954(a)(3).

135. See Regs. § 1.954-4(b)(1)(iv).

136. To the extent that individuals perform services for and are compensated by Softco, this is presumably with the consent of USco, and an alternative would be for USco to contract with Softco for the services of Softco's employees.

subsidiary when persons who are "regular employees" of the parent are "temporarily employed" by the subsidiary.[137]

To the extent that Softco performs services for customers of Russco, these may be considered to be performed for or on behalf of Russco to the extent that Russco pays Softco to perform them or Softco's performance fulfills an obligation of Russco.[138] This might be true with respect to any "hot line" services which Russco has included in the price it charges to its customers. On the other hand, if Russco customers separately contract and pay for services to be supplied by Softco, such services should not be deemed to be performed on behalf of Russco.

4. *Passive Investment Income.*—Since Softco is a CFC, USco remains potentially subject to tax on any other types of Subpart F income which Softco earns. For example, if Softco reinvested its earnings in assets producing passive income, such as dividends and interest, those income items could result in a current tax on USco under Subpart F.[139]

5. *Summary.*—To summarize how Softco would be likely to be treated under Subpart F with respect to its software operations, it is useful to distinguish between its transactions with the public and its transactions with Russco. With respect to its transactions with the public:

1. As to programs which Softco acquires from USco and does not modify, income from *sales*, *rents* and *royalties will* constitute Subpart F income.
2. As to income from programs which Softco itself develops:
   (a) income from *sales* will *not* constitute Subpart F income;
   (b) income from *rents* and *royalties will* constitute Subpart F income if the activities of the independent contractor programmers are disregarded; otherwise it will *not.*
3. As to programs which Softco acquires from USco and modifies, income from *sales*, *rents* and *royalties will* produce Subpart F income if the activities of the independent contractor programmers are disregarded; if not, the outcome would depend upon whether the modification is sufficient to result in a "transformation" of the property.

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137. See Regs. § 1.954-4(b)(3) ex. 2.
138. See Regs. § 1.954-4(b)(1)(i)-(ii).
139. See IRC § 954(a)(1).

4. *Services* income will constitute Subpart F income only if USco is deemed to be providing "substantial assistance" to Softco by permitting its programmers to work for Softco and then only in cases where USco personnel have actually assisted in performing the services.

With respect to transactions with Russco:

1. Exclusive licenses of programs, characterized as *sales, will* constitute Subpart F income unless Softco is deemed to have "produced" the programs.
2. Nonexclusive licenses of programs, giving rise to income characterized as *royalties, will* constitute Subpart F income.
3. Income from the performance of *services* for customers of Russco *will* constitute Subpart F income if the services are paid for, or discharge a warranty or other obligation of, Russco; otherwise it will not.

B. *Taxation of U.S. Individual Shareholders Controlling Softco*

In the second scenario set forth at the beginning of this paper, Softco is wholly-owned by four U.S. individuals. Under these circumstances, Softco will not only be a CFC, but potentially a Foreign Personal Holding Company (FPHC) as well.[140] If Softco were a FPHC, its U.S. shareholders would be required to include currently in taxable income their respective shares of Softco's entire undistributed income.[141] Softco would still be a CFC; USco and Russco would remain related persons with respect to it;[142] and Subpart F would apply in essentially the same way as discussed above. Amounts taxable to the individuals as Subpart F income will be includible by them under the CFC rules and not under the FPHC rules,[143] but amounts which are not Subpart F income may be includible under the FPHC rules even if not includible under the CFC rules.

Softco will be a FPHC only if more than 60% (in the first applicable year, and 50% thereafter) of its gross income consists of foreign personal holding company income.[144] Income from sales or the performance of

140. A foreign corporation may be a FPHC if more than 50% of the voting power or value of its stock is owned directly or indirectly by five or fewer U.S. individuals. See IRC § 552(a)(2).

141. See IRC § 551.

142. Under § 954(d)(3), a person or entity is a related person with respect to a CFC if it owns, directly or indirectly, more than 50% of the voting power or value of the CFC's stock, or both it and the CFC are controlled by the same person or entity.

143. See IRC § 951(d).

144. See IRC § 552(a)(1).

services does not constitute FPHC income under any circumstances.[145] Accordingly, if the gross income derived by Softco from transactions which are characterized as sales or services constitutes more than 40% of Softco's gross income, Softco will not be a FPHC without regard to any "active business" or "production" tests. If this is not true, the status of Softco as a FPHC will depend upon the characterization of its royalty income. (Rental income constitutes FPHC income unless it constitutes 50% or more of total gross income,[146] which seems at least highly unlikely in the Softco case.) Royalties generally constitute FPHC income, but there is an exception for "active business computer software royalties."[147]

It would be too much to hope that this "active business" royalty exception would bear some resemblance to the similar exception from Subpart F income, and it does not. The rule was added by the Tax Reform Act of 1986[148] to apply in a domestic context and was extended to foreign corporations without any apparent thought. The bounds of the rule are hardly clear. No implementing regulations have been proposed or adopted. There are, however, four statutory requirements.[149]

First, active business computer software royalties must constitute at least 50% of the corporation's gross income for the year.[150] If Softco's gross income includes substantial income from sales and services (although this constitutes 40% or less of gross income), it is likely that this condition will be satisfied if—but only if—all or most of the royalties received by Softco qualify as active business computer royalties, an issue discussed below. If rental income and/or nonqualifying royalties constituted more than 10% of gross income, Softco might find itself with gross income of less than 40% from sales and services and less than 50% from either rents or qualifying royalties, in which case this condition would not be satisfied and Softco would be a FPHC.

The second condition is twofold. The royalties taken into account must first be received by a corporation which is "engaged in the active trade or business of developing, manufacturing, or producing computer software."[151] In the absence of regulatory guidance, one would think that Softco would meet this test as long as it continues to have software programs

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145. See IRC § 553 (defining foreign personal holding company income).

146. See IRC § 553(a)(7).

147. See IRC § 553(a)(1).

148. See Staff of the Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986 371-74 (Comm. Print 1987).

149. These are set forth in § 543(d), relating to domestic personal holding companies, and incorporated in § 551(a)(1) by cross-reference.

150. See IRC § 543(d)(3).

151. IRC § 543(d)(2)(A).

created for it by contractors on an ongoing basis—although it is not clear why activities of independent contractors should be taken into account in this context if they are to be disregarded in the Subpart F contexts discussed above.[152]

The second prong of the test requires that the royalties be attributable to software which is either (i) developed, manufactured, or produced by the corporation "in connection with" that trade or business; or (ii) "directly related to" that trade or business.[153] The additional question posed by (ii) is whether royalties attributable to software which Softco has acquired from USco qualify as "directly related," and it is not clear how that question is to be answered. Perhaps it makes a difference whether the software developed by Softco accounts for most of the royalty income and the software provided by USco is less important and merely fills out a line of products offered by Softco or whether, on the contrary, the royalties from USco-developed software are the dog and the royalties from Softco-developed software are the tail. The extent to which Softco modifies USco software programs may be relevant. There does not appear to be a clear answer.

The third condition is that certain deductions allowable to the corporation under sections 162, 174 and 195 (generally speaking, ordinary and necessary business expenses other than items such as depreciation and amortization, interest and compensation paid to shareholders) which relate to the royalties must equal at least 25% of the royalties. On the facts given, there is no way of knowing whether Softco would meet this test.

Finally, if Softco derives foreign personal holding company income other than the royalties (e.g., rents or dividends and interest derived from investing earnings) and such income exceeds 10% of total gross income, it must pay out an amount equal to the excess as dividends.

Notably, in determining whether royalties derived by Softco constitute "active business computer software royalties," nothing turns on whether the royalties are received from a related person, so that royalties received by Softco from Russco are counted.

As in the case of a CFC, if, by reinvesting its earnings in passive assets, Softco earned dividends, interest or other passive income, the resulting amounts would have to be taken into account in determining whether Softco is a FPHC.

C. *Taxation of U.S. Individual Owning 25% of Softco's Stock*

In the third scenario set forth at the beginning of this paper, Softco is owned 25% by a U.S. individual and 75% by non-U.S. persons. Under

152. See supra text accompanying notes 119-24, 129-32.

153. IRC § 543(d)(2)(B).

these circumstances, neither the Controlled Foreign Corporation nor the Foreign Personal Holding Company rules will apply.[154] The U.S. individual will, however, be subject to the Passive Foreign Investment Company (PFIC) rules. If a foreign corporation is a PFIC, a U.S. shareholder will be subject to a special tax regime under which the shareholder pays income tax plus an onerous interest charge upon receipt of an "excess distribution" from the corporation or upon gain realized upon disposition of the corporation's shares[155] unless the shareholder elects, under certain conditions, to include in income currently the shareholder's pro rata share of the corporation's entire income.[156] A foreign corporation is a PFIC if either: (i) 75% or more of its gross income consists of passive income; or (ii) 50% or more of its assets produce or are held for the production of passive income.[157] The asset test is based, in general, on the fair market value of the assets and is based on the average of quarter-end values.[158]

Passive income is defined by cross-reference to the definitions of foreign personal holding company income set forth in the CFC provisions.[159] In general, therefore, whether income derived by Softco is passive will depend upon the analysis set forth in the prior discussion. Sales income will not be passive income, and the treatment of rental and royalties would depend upon whether they constitute "active business" rents or royalties.

The PFIC rules modify the CFC rules in certain ways. Among others, rents or royalties received by the foreign corporation are not considered to be passive income if they are: (i) received from a related person; and (ii) are attributable to income of that person which is not passive income.[160] Softco will receive royalties from Russco which may not be active business royalties. Such royalties will not be considered passive income for PFIC purposes if they are attributable to active business income of Russco. This could be case if, for example, Russco's income consisted of income from sales, rather than rents or royalties.

If Softco derived a significant portion of its total income in the form of sales income, it is unlikely that 75% or more of its total gross income will be passive income, so it is unlikely to be a PFIC on this ground. It is more likely to fall afoul of the rule which makes it a PFIC if 50% or more of its assets are held for the production of passive income. It does not appear that Softco will own substantial tangible assets. Receivables from customers will

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154. See supra text accompanying notes 106 and 140.
155. IRC § 1291.
156. See IRC § 1295.
157. See IRC § 1297.
158. See IRC § 1297(a)(2).
159. See IRC § 1297(b)(1) (referring to § 954(c)).
160. See IRC § 1297(b)(2).

constitute assets producing active income to the extent that they are generated by sales or the performance of services but not, apparently, if they represent royalty receipts.[161] Cash and other amounts representing working capital are treated by the IRS as assets which produce passive income.[162] Whether the 50% test is met is likely to depend, therefore, not only on how the software assets which it holds are valued—not an easy task—but also how they are characterized. Assets are characterized by reference to whether they produce or are held for the production of passive income.[163] In Softco's case it appears that the same assets (the computer programs and the rights protecting them) are held to produce both active and passive income; in this case, the assets will be treated as partly active and partly passive in proportion to the amounts of income (presumably gross income) generated by them.[164]

Again, as when Softco is a CFC or a FPHC, investment of retained earnings of Softco in passive assets may turn Softco into a PFIC even if it would not be one based upon its operating assets.

D. *Summary of the Application of the Tax Haven Regimes*

The CFC rules are fundamentally different in their application from the FPHC and PFIC rules. The former are aimed at an operating company, presumably generating active business income in the main, that attempts to "sliver" its income into discrete segments that can be shifted into tax havens. Thus, under Subpart F, even if the CFC's Subpart F income is only a fraction of total income it will be counted; but (subject to *de minimis* and "*de maximis*" rules),[165] only the portion of the CFC's income which constitutes Subpart F income is taxed through to the U.S. shareholder(s) on a current basis. This may produce a tax even if the Subpart F income is only a fraction of the CFC's total income. Moreover, sales and services income can give rise to tax.

By contrast, the FPHC and PFIC rules were addressed to offshore investment companies and others deriving predominantly passive investment income. Therefore, whether a foreign corporation is a FPHC or a PFIC is an "all or nothing" proposition; if the foreign corporation rings the definitional

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161. See Notice 88-22, 1988-1 C.B. 489.

162. See id.

163. See IRC § 1297(a)(2).

164. See id. Gross income, rather than net income, should presumably be used because the 75% passive income test is based on gross income.

165. Under § 954(b)(3)(A), if the sum of foreign base company income (without regard to deductions) and gross insurance income for a taxable year is less than the lesser of 5% of gross income or $1,000,000, then no part of such income will be treated as foreign base company income or insurance income. If this sum exceeds 70% of gross income, then the entire gross income will be treated as either foreign base company income or insurance income under § 954(b)(3)(B).

bell, the U.S. shareholder must account for his pro rata share of *all* of the foreign corporation's income; otherwise, none of it is taken into account. Moreover, only passive income is "bad," and this does not include sales and services income.

Under both types of regimes, rents or royalties may constitute active or passive income based upon a determination whether they are derived in the conduct of an active business, although the determination is based, in the case of the FPHC, on rules wholly different from those which apply under the CFC and PFIC regimes.

Not surprisingly, if the bulk of Softco's income consists of sales and services income, its income will be taxable, if at all, only under the CFC rules. On the other hand, if Softco's income were derived predominantly in the form of royalty income, it might become subject to tax under the FPHC and/or PFIC rules depending upon how much of the income failed to qualify under the applicable "active business" rule.

VIII. What Does All of this Prove?

Surely the reader has long since been numbed into oblivion by the bewildering array of rules that have to be considered in analyzing the U.S. tax treatment of a very simple business operation. Beyond this, it must have become obvious that current law requires the making of a large number of distinctions that: (i) are difficult if not impossible to make when dealing with electronic "goods" such as software programs; and/or (ii) just don't make much sense in this context.

A. *Income Characterization*

To begin at the beginning, one must question whether the Treasury Department is correct in believing that existing law, and particularly the existing income characterization rules, can adequately deal with the new environment of nonphysical commerce. When Softco transfers a "copyrighted article" to a customer, should the taxability of its income—either direct taxation at the source or the indirect taxation of its U.S. shareholders—really depend upon whether the customer's right to use the software program is limited in time? What is the policy which supports this distinction? One supposes that the original distinction struck between sales and rental income was based on the idea that the sale was a final transaction in which property was permanently transferred to the buyer, with the seller retaining no interest, while the lease was a temporary arrangement under which the lessor would:(i) "retain an interest" in the property; (ii) receive an ongoing stream of income; and (iii) at some point retake possession of the property, perhaps then redelivering it to another lessee. In the case of transfers of electronic "goods"

none or few of these suppositions are true: the "property" is infinitely replicable (and therefore the "lessor" has no particular "interest" in any individual copy), payment is often made in a lump-sum, and the "leased" item is seldom if ever returned or used by another (although the copy which the lessee has may be destroyed). In addition, the product life of software programs or many other types of electronic "goods" may be short enough that "permanence" is not a very meaningful reference.

Similarly, when Softco receives payments from Russco for the transfer of "copyright rights," why should the taxability of those that relate to the grant of substantially all of the rights in a program be tested under one set of rules (for sales and exchanges) while those that relate to nonexclusive transfers are tested under another (for royalties)? In the case of withholding tax, we have partially recognized this anomaly by treating contingent payments, at least, the same way in both cases.[166] Should not the same considerations dictate that, for purposes of the CFC, FPHC and PFIC regimes, the same rules should apply in both cases?

B. *What Constitutes the Production of Property?*

In determining when to apply the tax haven regimes (and in making the related determination of when U.S.-source production income arises) we really need a complete re-assessment of what constitutes the production of property and what the significance of that activity is. As long as any portion of the income derived by a company like Softco is treated as sales income it is necessary under existing law to determine whether Softco has "produced" the property it has sold, both to determine whether there is U.S.-source income taxable directly to the company and whether the company (if a CFC) has generated foreign base company sales income. By contrast, if the income is characterized as rental or royalty income, it does not matter for purposes of taxation at the source whether, where or by whom the property giving rise to the income was produced, while under the Subpart F rules, it matters whether the corporation involved "produced" or "added value" to the property. (Under the "active business computer royalty" rules applicable for FPHC purposes, the analogous "active business" tests are "overall," rather than "item specific" tests.)

Generally speaking, but also specifically in the case of nonphysical goods, there is a companion need to re-think the significance of activities that are carried on behalf of the enterprise by independent contractors. The "contract manufacturing" ruckus has arisen in the context of the foreign base company sales income rules, but from a policy perspective the same or analogous issues arise in other contexts.

166. See IRC §§ 871(a)(1)(D), 865(d)(1)(B).

C. *The Cacophony of Tax Haven Rules*

Although the problem is not unique to the present context, the overlapping, inconsistent and often impenetrable rules which apply to CFCs, FPHCs and PFICs are in desperate need of rationalization and simplification. Surely the "active business software royalty" rule, for example, applies to FPHCs and not to CFCs or PFICs simply through the historical accident that the rule was originally written for domestic companies that would otherwise be personal holding companies and, probably without thought, mirrored in the foreign personal holding company rules.

In addition, it is not clear why the PFIC rules, which—like the FPHC rules—are designed to define a corporation which derives predominantly passive income, treat rents and royalties under the CFC rules rather than the FPHC rules—and then also with a carve-out for rents and royalties received from related persons, which seems to have much more to do with CFC relationships (and foreign tax credit baskets) than with passive income determinations.

IX. SOME MODEST SUGGESTIONS

It is easier to identify the problems of existing law than it is to figure out whether or how the law ought to be changed. At a minimum, however, there are areas which are clear candidates for clarification or possible change.

The fundamental problem is that, when we deal with computer programs or other kinds of information that can be transmitted by electronic means, the traditional distinctions among tangible personal property (a machine) and intangible personal property (a patent) and services breaks down. We should surely spare the Tax Court the need to dance on the head of a pin all of the angels that were danced in the *Norwest* and *Sprint* cases,[167] in which the court struggled to apply a pre-electronic commerce "tangible property" rule to computer software. In polar cases, one can still distinguish among, say, the sale of a widget, the license of a patent and the provision of a legal opinion. More and more transactions, however, will fall into the muddled middle ground; and the best response to this is to make the characterization of the resulting income matter as little as possible.

This means that, with all due respect for my colleagues at the Treasury Department, a good place to start would be in eliminating major distinctions which flow from applying traditional income characterization rules. To begin with—and this is a recommendation which predates the age

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167. Norwest Corp. v. Commissioner, 108 T.C. 358 (1997); Sprint Corp. v. Commissioner, 108 T.C. 384 (1997).

of electronic commerce[168]—the distinction between the sale and the license of intangible property should be eliminated, regardless of whether the consideration received is contingent or fixed. In addition, while there may (or may not) be a continuing role for a distinction between income derived from the sale and the lease of tangible property, this is not a useful distinction when applied to any kind of property which can be delivered by downloading information on to the customer's computer. It is unlikely that in the real world deliveries of electronic information characterized as "sales" will be taxed at the source, and therefore, the attempt to impose tax on "temporary" transfers should be abandoned. There is also room for clarifying the meaning of "services" in characterizing income from the provision of "goods" over the Internet.[169]

Another fundamental characterization rule that needs rethinking is the rule that decrees that income derived from the production and sale of tangible property is to be split, with a portion of the resulting income attributed to the production activity and a portion to the sales activity, whereas this is not done in the case of income derived in the form of rents of tangible property or royalties or other amounts derived from the disposition of intangible property. There are some very real problems in applying a split characterization rule in circumstances in which contingent payments will be received over a substantial period of time,[170] but in transactions of a similar nature (for example, the delivery of a copy of a computer program for either a temporary period or for use forever in consideration of a one-time charge), it is difficult to justify the critically different tax consequences which may ensue from the characterization.

A parallel, but equally important, task is to clarify and rationalize the rules that make the current taxability of U.S. shareholders of a tax haven corporation depend upon whether the corporation has "manufactured" or "produced" property which it markets—whether through sales, rentals, royalties or dispositions. The underlying policy seems to be that if the foreign corporation derives the income in an active business—defined by referring to whether the corporation has "produced" the property involved, there is no current tax, while the opposite is true if there has been no "production." In the case of software programs and similar information delivered to customers, there is a major ambiguity as to whether the "production" which makes the difference is the creation of the copy—of a software program, a book or a series of data—delivered to a customer or the creation of the program, book or data itself. Since rather little investment in facilities or personnel is

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168. See ALI Study, supra note 49, at 43-50.

169. See Glicklich et al, supra note 1.

170. See ALI Study, supra note 49, at 34-36, 48.

involved in reproducing on a server copies of information downloaded into it, the "active business" policy represented by the requirement that property be "produced" by the foreign corporation might be most appropriately implemented by requiring that the corporation itself generate for its own account the software program, the book or the compilation of data.

Once the required "production" process has been determined, the test should be uniformly applied to sales, rental and royalty income of a CFC. In order to eliminate anomalies based on income characterization, consideration should be given to excluding income derived from transactions involving "produced" property regardless of whether the customer is a related person; this is now the rule for foreign based company sales income but not for rents and royalties.

As has been noted many times before, there is a seemingly needless overlap between the FPHC and PFIC regimes. This of course involves a variety of rules; but in the current context the issue is whether there is any possible reason for applying a completely separate (and hardly simple) test—the "active business computer software royalty" rules—for FPHC purposes, instead of adopting for that purpose as well as for PFIC purposes the CFC "active business" tests.

Finally, we should come to closure on the extent to which the activities of independent contractors, whether contract manufacturers or others performing services or carrying on other activities for the account of a corporation (or other entity), are taken into account in characterizing its income. For purposes of determining whether rents and royalties should be considered to be derived from the conduct of an active business and therefore not Subpart F income, marketing activities of independent contractors are not taken into account. This reflects the view, evident in other provisions of the tax law,[171] that the active conduct of a business implies having officers and employees that do the business. The issue is simply whether the answer is to be different when it is not marketing but production activities (including the performance of services) which form the asserted business activity—or whether the rents and royalties rule should be changed.

While the task is probably less urgent, the same questions need to be answered in determining when a foreign corporation or entity will be deemed to be deriving U.S.-source income from production (and services) activities. The regulatory rule which disregards the activities of nonemployees in apportioning income from the manufacture and sale of personal property may well have been influenced by the apportionment formula it seeks to apply, which involves the extent to which manufacturing assets are located in and outside the United States. It is not clear to this author, at least, that the

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171. See, e.g., Regs. § 1.355-3(b)(2)(iii).

draftsman was consciously excluding from U.S. tax altogether foreign entities which supply the services of, or have production activities carried out by, independent contractors in the United States.