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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE:	February 26, 2001
MEMORANDUM FOR:	Douglas P. Kunze International Territory Manager LM:RFP
FROM:	Anne P. Shelburne Assistant to the Branch Chief CC:INTL:6
SUBJECT:	Source of Income from License of Computer Software

This Chief Counsel Advice responds to your memorandum dated August 21, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

USCorpA =
USCorpB =
FCorpY =
FCorpZ =
CountryX =
Year1 =
AmountA =
AmountB =
AmountC =
AmountD =
AmountE =

Tax Treaty X =

ParagraphA =
ParagraphB =

ISSUE

Whether, and to what extent, contingent royalties paid by a domestic licensee to a foreign corporation licensor for worldwide computer software rights constitute U.S. source income under section 861(a)(4) of the Internal Revenue Code ("Code") subject to a withholding tax under section 1442(a) where the licensee modifies, may reproduce, and sublicenses the software wholly within the United States to a domestic sublicensee for integration into the sublicensee's computers sold to customers both within and outside the United States.

CONCLUSION

The royalties paid by the domestic licensee to the foreign corporation licensor should be treated as 100% U.S. source income under section 861(a)(4) and, thus, subject to withholding tax under section 1442(a).

FACTS

FCorpY, a CountryX corporation and resident, created computer operating software in CountryX. FCorpY wholly-owned USCorpA, a domestic corporation formed in Year 1. FCorpZ, a CountryX corporation, and USCorpB, a domestic corporation, were the two largest shareholders of FCorpY, and each had an AmountA% ownership interest in the company.

On April 1, Year 1, FCorpY licensed to USCorpA the exclusive worldwide (except CountryX) rights to sell, use, copy, manufacture, or sublicense specified software that it created. On the same day, USCorpA sublicensed to USCorpB the exclusive worldwide (except CountryX) rights to sell, use, copy, manufacture, or sublicense the software that it licensed from FCorpY. The licensing and sublicensing agreements "remain in force for a period of one year from the effective date and shall be renewed for subsequent one (1) year terms annually, unless terminated by mutual agreement."

USCorpA modified the FCorpY software to render it compatible with U.S.-manufactured computers. FCorpY employees assisted USCorpA in these software modification activities in the United States. USCorpA asserts that such employees resided in the United States no longer than 183 days in a calendar year. USCorpA reimbursed FCorpY for the costs and wages associated with hiring the FCorpY employees that participated in the software modification activities in the United States. Examination was unable to determine whether USCorpA reproduced the modified software ("USCorpA software") in the United States and transferred the software copies to USCorpB or whether USCorpA downloaded or transferred a single software copy to USCorpB, which then reproduced copies in the United States as needed.

USCorpB manufactured computers in the United States and sold them to unrelated third party customers both within and outside the United States. USCorpB installed the sublicensed software into some of its computers. USCorpB provided royalty and sales summaries to USCorpA indicating that it sold approximately AmountB% of the computers with integrated USCorpA software to customers in the United States and AmountC% to customers outside the United States. USCorpB has not explained, and USCorpA does not know whether the breakdown of sales to customers inside and outside the United States listed in such summaries is determined with respect to title passage, customer location, place of ultimate use of the computers, or some other standard.

Pursuant to the licensing and sublicensing agreements, USCorpB paid a royalty to USCorpA, and USCorpA, in turn, paid a royalty to FCorpY, when a customer purchased a USCorpB computer that incorporated USCorpA software. Under the licensing agreement which included a fixed fee schedule for the software products covered by the license, the royalties that USCorpA paid to FCorpY for each copy of USCorpA software integrated into computers sold by USCorpB varied depending on the style of software and the model of the computer. Solely for purposes of this memorandum, we assume that the royalties earned by FCorpY under the licensing agreement did not constitute income effectively connected with the conduct of a trade or business within the United States within the meaning of sections 881(a) and 1441(c).

Under the sublicensing agreement, which included a fixed fee schedule for the software products covered by the sublicense, the royalties that USCorpB paid to USCorpA for each copy of USCorpA software integrated into computers sold by USCorpB varied depending on the style of software and the model of the computer.[1] Each royalty paid <u>to</u> USCorpA exceeded the corresponding royalty paid <u>by</u> USCorpA by approximately AmountD%.

USCorpA was also in the business of providing computer consulting services in the United States. These services are not at issue here.

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[1] The fixed fee schedules were updated annually in accordance with each license or sublicense renewal.

In determining the source of the royalties that USCorpA paid to FCorpY for withholding tax purposes, USCorpA looked to USCorpB's sales of computers that incorporated the USCorpA software. USCorpA treated the royalties attributable to software integrated into USCorpB computers sold to customers outside the United States as foreign source income and treated the royalties attributable to software integrated into computers sold to customers inside the United States as U.S. source income (although, as described above, the basis for determining U.S. and foreign computer sales is unclear). Applying this computer sales-based methodology for sourcing royalty payments, USCorpA withheld tax from the AmountB% portion of the royalties that it paid to FCorpY attributable to sales to customers in the United States and withheld no tax from the remaining AmountC% portion of the royalties that it paid to FCorpY attributable to sales to customers outside the United States. In sum, USCorpA subtracted and kept a portion of the royalty paid to it by USCorpB as compensation for its own developments. Then, USCorpA split the remaining portion of the royalty paid to it by USCorpB into AmountB% and AmountC% portions and paid a withholding tax on the AmountB% U.S. source portion.

LAW AND ANALYSIS

I. Withholding Tax on Certain Foreign Corporation Income

The issue in this case is whether FCorpY is subject to U.S. withholding tax on payments it received from USCorpA. Sections 881(a) and 1442(a) impose a 30% withholding tax on the amount received from sources within the United States by a foreign corporation as fixed or determinable annual or periodical gains, profits, or income if the amount received is not effectively connected with the conduct of a trade or business within the United States. For purposes of sections 881(a) and 1442(a), fixed or determinable annual or periodical income includes "royalties for the use of patents, copyrights, secret processes and formulas, and other like property." Treas. Reg. §§ 1.881-2(b)(1), 1.1441-2(a)(1), and 1.1442-1.[2] The withholding agent indicated in section 1442(a) is the person "who pays or causes to be paid an item of income" listed in Treas. Reg. § 1.1441-2. Treas. Reg. § 1.1441-7.

The 30% withholding tax rate required under section 1442(a) is reduced as provided by a treaty with any country. Treas. Reg. §§ 1.1441-6 and 1.1442-2. Tax Treaty X, a tax treaty between the United States and CountryX, was in effect at all relevant times. ParagraphA of Tax Treaty X provides that royalties derived from sources within the United States by a resident of CountryX may be taxed by the United

[2] All references to regulations under sections 1441 and 1442 are to the regulations contained in T.D. 6187, 1956-2 C.B. 567, that were in effect prior to January 1, 2001.

States at a rate not in excess of AmountE%. For purposes of Tax Treaty X, ParagraphB defines royalties as payment of any kind made as consideration for the use of, or the right to use, among other things, copyrights of literary, artistic, scientific works, broadcasting films or tapes, or other like property. The royalty payments made by USCorpA to FCorpY constitute royalties within the meaning of ParagraphB as payments for a copyright of a scientific work or other like property or right. See, e.g., Treas. Reg. § 1.861-18.

II. Source of Royalties

A. The Statutes

The amount of FCorpY's withholding tax liability depends on the source of the royalties paid by USCorpA to FCorpY because sections 881(a) and 1442(a) impose a withholding tax only on U.S. source income. Section 861(a) lists items of gross income that are treated as income from sources within the United States. Section 861(a)(4) provides:

> Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property

shall be treated as income from sources within the United States. Treas. Reg. § 1.861-5 provides further that "income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States."

Section 862(a) lists items of gross income that are treated as income from sources without the United States. Section 862(a)(4) provides that

> rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties

shall be treated as income from sources without the United States. See also Treas. Reg. § 1.862-1(a)(1)(iv).

Examination has established that USCorpA's rights in the software were used by USCorpA solely within the United States. USCorpA modified the FCorpY software in the United States. Pending future factual development, USCorpA may have reproduced the software in the United States. USCorpA sublicensed its software rights in the United States to a domestic licensee. Applying sections 861(a)(4) and 862(a)(4) to these facts, the royalties paid by USCorpA to FCorpY should be treated as U.S. source income.

B. Taxpayer's Allocation Method

Even if we had not determined above that the royalties paid by USCorpA to FCorpY were 100% U.S. source income on the face of section 861(a)(4), such royalties must, nevertheless, be sourced entirely within the United States as a result of Taxpayer's unreasonable allocation method. Taxpayer sourced royalties paid by USCorpA to FCorpY based on either the place of sale of computers with integrated USCorpA software by USCorpB or the location of the customers that purchased such computers from USCorpB. On the facts of this case, Taxpayer's method for allocating royalties between U.S. and foreign sources is unreasonable. Taxpayer's methodology disregards the activities of USCorpA in the United States as described above. Thus, Taxpayer's sale-based sourcing methodology disregards the fact that USCorpA performs no activities involving the software in any jurisdiction other than the United States.

As a result, although the amount of royalties USCorpA was required to pay FCorpY was determined by a percentage of computer sales, Taxpayer has not established a reasonable connection between USCorpB's computer sales and the place of use of USCorpA's software rights.

In addition, Taxpayer's proposed sourcing methodology cannot be verified by Examination and is, therefore, inappropriate. USCorpA's method for determining U.S. and foreign source royalty payments made to FCorpY is based solely on the summaries of royalties and computer sales submitted to USCorpA by USCorpB. Examination has been unable to determine whether Taxpayer's allocation method relies on the place of sale of USCorpB computers, the location of USCorpB's customers, or the place of ultimate use of the computers, or any other sale situs standard. Regardless of which of these standards is reflected in the summaries, the Service has been unable to ascertain whether the summaries accurately reflect the ratio of USCorpB's U.S. and foreign sales. Thus, even if such allocation method were considered reasonable, Taxpayer's sourcing methodology is inauditable and, therefore, unreasonable.

Therefore, Taxpayer has failed to provide a reasonable allocation method for sourcing AmountB% and AmountC% to U.S. and foreign sources, respectively. Courts have considered the issue of what qualifies as a reasonable allocation of royalty income between U.S. and foreign sources. Courts have held that the parties to the license have the information and are the best able to allocate income and, when a taxpayer does not demonstrate a reasonable basis for the allocation, all of the income is treated as U.S. source income. Although many of the cases address the sourcing of lump sum royalty payments, they make clear it is the taxpayer's burden to demonstrate that the taxpayer has used a reasonable method for splitting its income between U.S. and foreign sources.

For example, in Misbourne Pictures Ltd. v. Johnson, 189 F.2d 774, 775 (2d Cir. 1951), foreign corporations licensed to a domestic corporation the right to distribute and advertise throughout the world (except the British territories and Australasia) the original negative and soundtrack of a motion picture. In exchange, the licensors received a £50,000 advance payment followed by 55% of the profits from the motion picture. Misbourne, 189 F.2d at 775. The Second Circuit Court of Appeals held that the entire £50,000 advance constituted income from within the United States because "the appellants presented no basis for apportionment of the payment between the United States and other territory." Id. at 776.

Several other cases also hold that the taxpayer bears the burden of demonstrating a proper apportionment of royalties between U.S. and foreign sources and show that courts have required a strict connection between a taxpayer's use of property and the taxpayer's basis or method for allocating income between U.S. and foreign sources. For example, in Rohmer v. Commissioner, 153 F.2d 61, 65 (2d Cir. 1946), aff'g 5 T.C. 183 (1945), the Second Circuit held that the United States Tax Court was not unreasonable in finding that the entire lump sum royalty for U.S. and Canadian serial rights in literary works was U.S. source income where the taxpayer provided data comparing magazine circulation and profits in the two countries. The Second Circuit stated that evidence of U.S. and Canadian circulation of magazines in which a literary work was published "did not 'furnish a sufficient basis upon which' [the Tax Court] could 'determine that any income was derived from sources outside the United States.'" Id.

In Estate of Marton v. Commissioner, 47 B.T.A. 184 (1942), MGM paid a lump sum royalty for the worldwide rights to a motion picture but did not exploit the rights. The parties agreed that the underlying contract did not segregate the lump sum into amounts paid for U.S. and foreign rights or otherwise specify the source of the payment. Marton, 47 B.T.A. at 186. MGM argued that

> a reasonable segregation may be made, based on the percentage of the total income of the Metro-Goldwyn-Mayer Corporation from its activities, derived from sources within the United States and sources without the United States, for the four years following the acquisition of such rights by that corporation.

Id. The Board of Tax Appeals held that

> a segregation of the purchase price upon the basis of income derived by the corporation from its production and exhibition of other pictures in this and foreign countries would be wholly unjustified. . . . For all we know, the foreign rights to this picture were of little or no value.

Id.

In Molnar v. Commissioner, 156 F.2d 924, 926 (2d Cir. 1946), the Second Circuit applied a similar analysis as the Marton court when it rejected evidence of receipts from motion pictures (other than the movie at issue) as a basis for apportioning the taxpayer's royalty income from the movie between U.S. and foreign sources. The Molnar court cited Marton favorably for the proposition that proof based on production and exhibition of pictures other than the one in question is not an appropriate basis for sourcing royalty income. Molnar, 156 F.2d at 925-926. Molnar also addressed a second issue. The taxpayer licensed the motion picture rights in a short story, "The Marshal," to a movie producer who made a movie, "Tales of Manhattan," that incorporated the short story as a portion of the movie. Id. at 925. The taxpayer used the movie sales as the standard for apportioning his lump sum royalty payment between U.S. and foreign uses. Id. The Second Circuit held:

> It is impossible even to surmise what portion of the earnings of 'Tales from Manhattan' was derived from the incorporation of 'The Marshal' in the [former], still less to determine what portion of the lump sum paid by [the producer] to the taxpayer was paid for the privilege of showing the play outside the United States. Such statistics afforded no basis for any fact-finding tribunal to make an estimate of what was paid for the privilege of using the rights in foreign countries.

Id. at 926. Thus, courts have required taxpayers to demonstrate a reasonable method for allocating royalties from property used within and without the United States and, if they do not satisfy such requirement, all of the royalties should be treated as from U.S. sources.

III. Conclusions

USCorpA's activities with respect to the software occurred wholly within the United States. Thus, the royalty payments are U.S. source income. Moreover, Taxpayer's computer sales-based methodology for sourcing FCorpY's royalty income to U.S. and foreign sources was not reasonable. Examination cannot verify Taxpayer's methodology. Thus, Taxpayer has not demonstrated that its method of splitting royalty income between U.S. and foreign sources is a reasonable method. Unless Taxpayer can establish a reasonable basis for allocating the licensing royalties, under the case law described above all the royalties paid by USCorpA to FCorpY should be treated as income from U.S. sources.

Because FCorpY's royalties are fixed and determinable periodic income that was not effectively connected with the conduct of a trade or business within the United States under section 881(a), a withholding tax applies under section 1442(a). Tax Treaty X applies to reduce the withholding tax amount from 30% to AmountE%. As the withholding agent with respect to the royalties paid to FCorpY, USCorpA was required to withhold and deduct a AmountE% tax on 100% of the royalties paid by USCorpA to FCorpY with respect to FCorpY software.

Please call the branch at 202-874-1490 if you have any further questions.

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