Office of Chief Counsel
Internal Revenue Service

Number: **200911005**
Release Date: 3/13/2009

memorandum

CC:INTL:B6
POSTF-129035-08

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 943.01-00

date: November 25, 2008

to: Joyce L. Sugawara
General Attorney (Los Angeles)
Large & Mid-Sized Business

from: Christopher J. Bello
Chief, Branch 6
Office of Associate Chief Counsel (International)

---

subject: Treatment of certain licenses of intangible property under the extraterritorial income exclusion provisions

This Chief Counsel Advice responds to your request for assistance dated August 26, 2008. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
=
Invention =
=
Contract A =
=
Contract B =
=
Product A =

=
Product B =

Amount X =

ISSUE

Whether certain intangible property licensed in Taxpayer's contracts constitutes qualifying foreign trade property (QFTP) under section 943 for purposes of determining whether gross receipts derived from royalties paid pursuant to the licenses constitute foreign trading gross receipts under section 942.

CONCLUSIONS

Section 943(a)(3)(B) excludes intangible property from the definition of QFTP except for copyrights on films, tapes, records, and computer software. The gross receipts at issue are royalties from the license of patent rights. Because patent rights are not QFTP, the gross receipts from these licenses cannot constitute foreign trading gross receipts.

FACTS

Taxpayer is a US corporation that developed Invention. Taxpayer owns intangibles related to Invention, including patent rights, copyright rights, trademarks, trade secrets, and know-how. Taxpayer characterizes Invention as software.

Taxpayer licenses this intangible property to unrelated companies under two types of contracts represented by Contracts A and B. Under Contract A, Taxpayer licenses copyright rights, patent rights, and various other intangible property related to Invention for use in producing Product A. The relevant contractual terms provide:

Contract A, Section 2.1. Contract A licensees make copies of Invention and install a copy in every Product A produced, pursuant to the copyright rights transferred by Contract A.

Under Contract B, Taxpayer licenses patent rights, trademarks, and know-how related to Invention for use in producing Product B. The relevant contractual terms provide:

Contract B, Section I.A. Contract B licensees purchase Product A from Contract A licensees and install Product A into Product B, a finished product that Contract B licensees manufacture and sell to consumers. Contract A restricts the sale of Product A by Contract A licensees to Contract B licensees:

Contract A, Section 4.2.

Contract A does not require licensees to pay royalties for the use of Taxpayer's intangible property, but each licensee must pay Taxpayer a one-time, nominal fee of $Amount X for the information necessary to incorporate Invention into Product A. The relevant contractual terms provide:

Contract A, Section 3.1.

Section I.A of Contract B provides that licensees will pay Taxpayer royalties for use of its patent rights. Section I.A of Contract B further provides that, as long as licensees pay Taxpayer royalties for the use of its patent rights, licensees are not required to pay Taxpayer royalties for the use of its know-how or trademarks. The relevant contractual terms provide:

Contract B, Section I.A. Section II.B of Contract B provides that the royalty for use of Taxpayer's patent rights varies depending on the licensee's Product B sales volume. Contract B contains no mention of copyright rights.

Taxpayer asserts that, because Invention is a type of computer software, and because computer software is mentioned in the parenthetical language of section 943(a)(3)(B), the intangible property licensed under Contract B qualifies as QFTP under section 943.[1] Furthermore, Taxpayer asserts that the decision in Microsoft Corp. v. Commissioner, 311 F.3d 1178 (9th Cir. 2002), rev'g Microsoft Corp. v. Commissioner, 115 T.C. 228 (2000) supports its position. Based on these assertions, Taxpayer believes that the gross receipts derived from Contract B licenses constitute foreign trading gross receipts under section 942, which generate extraterritorial income (ETI) exclusions under section 114.

LAW

Section 114 excludes certain amounts from gross income as ETI. Specifically, section 114(a), (b), and (e) provide:

> (a) Exclusion. Gross income does not include extraterritorial income.
>
> (b) Exception. Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart I of part III of subchapter N.

* * *

[1] As noted in more detail below, we cannot determine from Taxpayer's position paper whether Taxpayer's position is based generally on the fact that Invention comprises a software component or whether Taxpayer asserts more specifically that Contract B licenses patent and/or copyright rights in software. Our analysis reaches the same conclusion in either case.

> (e) Extraterritorial Income. For purposes of this section, the term ‘extraterritorial income’ means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.

Thus, section 114 excludes qualifying foreign trade income from gross income. Qualifying foreign trade income is defined in section 941(a).

In order to determine qualifying foreign trade income under section 941(a)(1)(B) or (C), taxpayers must first determine foreign trading gross receipts. See I.R.C. §§ 941(a)(1), (b)(1), and (c)(1) and (2)(A). Section 942(a)(1)(B) provides:

> (1) In general. Except as otherwise provided in this section, for purposes of this subpart, the term ‘foreign trading gross receipts’ means the gross receipts of the taxpayer which are—
>
> * * *
>
> (B) from the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States. . . .

Section 942(a)(1)(B) also applies to gross receipts from licensing QFTP. Treas. Reg. § 1.924(a)-1T(a)(2) provides: “All rules under this section applicable to leases of export property apply in the same manner to licenses of export property.” <u>See</u> <u>also</u> S. Rep. No. 416, 106th Cong., 2d Sess., p.19 (September 20, 2000) (standing for the proposition that the FSC regulations regarding licenses apply for purposes of the ETI exclusion). QFTP is defined generally in section 943(a)(1). However, even if property satisfies the general definition of QFTP in section 943(a)(1), it may nonetheless constitute excluded property under one of the exceptions in section 943(a)(3) and, therefore, not constitute QFTP. Section 943(a)(3)(B) excludes certain intangible property from the definition of QFTP:

> (3) Excluded property. The term ‘qualifying foreign trade property’ shall not include–
>
> * * *
>
> (B) patents, inventions, models, designs, formulas, or processes whether or not patented, <u>copyrights</u> (other than films, tapes, records, or other similar reproductions, and <u>other than computer software (whether or not patented)</u>, for

> commercial or home use), goodwill, trademark, trade brands, franchises, or other like property. . . (Emphasis added.)

Thus, section 943(a)(3)(B) describes two categories of intangible property for ETI exclusion purposes. In general, intangible property is excluded from the definition of QFTP and therefore is ineligible for ETI exclusions. However, the parenthetical phrase in section 943(a)(3)(B) provides a narrow exception to this rule for copyrights on films, tapes, records, and computer software. We refer to this limited category of intangible property as the "Copyright Exception." Accordingly, copyrights in computer software are not precluded by section 943(a)(3)(B) from constituting QFTP for purposes of section 943(a)(1), and gross receipts derived from licensing copyrights in computer software, therefore, may constitute foreign trading gross receipts that generate ETI exclusions, provided that all other ETI exclusion rules are satisfied.

Treas. Reg. § 1.861-18 provides rules for classifying a transaction involving a computer program as a sale or license of a copyright right in the program, a sale or lease of the program copy, performance of programming services, or provision of programming know-how. These rules apply in classifying such transactions for purposes of subchapter N of Chapter 1 of the Internal Revenue Code and for certain other listed Code sections. Treas. Reg. § 1.861-18(a)(1). Section 943, which defines both QFTP and excluded property including the Copyright Exception, is within subchapter N. Therefore, the rules of Treas. Reg. § 1.861-18 apply in determining whether a transfer involving a computer program constitutes a license of a copyright right that generates foreign trading gross receipts for purposes of section 942.

The transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the following:

> (i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
> (ii) The right to prepare derivative computer programs based upon the copyrighted computer program;
> (iii) The right to make a public performance of the computer program; and
> (iv) The right to publicly display the computer program.

Treas. Reg. §§ 1.861-18(c)(1) and (2).[2]

The definition of excluded property in the foreign sales corporation (FSC) rules under section 927(a)(2)(B) (repealed) is relevant for purposes of analyzing section 943(a)(3)(B) because section 943(a)(3)(B) is modeled on the language of section

[2] Treas. Reg. § 1.861-18(f)(1) further classifies transfers involving copyrights to determine whether the transfer of a copyright right is either a sale or exchange of the copyright right, or is instead a license of the copyright right.

927(a)(2)(B). The Copyright Exception in section 927(a)(2)(B), as originally enacted by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat 494, § 801(a), did not reference computer software:

> patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or other similar reproductions, for commercial or home use), goodwill, trademark, trade brands, franchises, or other like property . . .

Congress amended the Copyright Exception in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 1171 (TRA 1997), by adding the reference to computer software in the parenthetical following the word "copyrights":

> patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or other similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademark, trade brands, franchises, or other like property . . . (Emphasis added.)

Thus, section 927(a)(2)(B), as amended, provides that copyrights of computer software do not constitute excluded property under section 927(a)(2)(B). The legislative history to the amendment explains:

> For purposes of the FSC provisions, films, tapes, records and similar reproductions explicitly were included within the definition of export property. In light of technological developments, the Committee believes that computer software is virtually indistinguishable from the enumerated films, tapes and records . . . . The Act provides that computer software licensed for reproduction abroad is not excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with the right to reproduce is eligible for the benefits of the FSC provisions.

S. Rep. No. 33, 105th Cong., 1st Sess., p. 85 (June 20, 1997).

When Congress enacted the ETI exclusion provisions in the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (ETI Act), Pub. L. No. 106-519, 114 Stat 2423, § 3(a) (2000), including section 943(a)(3)(B) and a Copyright Exception identical to the post-TRA 1997 amendment version contained in section 927(a)(2)(B), it reaffirmed its intent to carve out copyright rights in software from the general rule for excluded property in section 943(a)(3)(B):

> Consistent with the policy adopted in [TRA 1997], computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for sale, sublicense, lease, or rental to an unrelated person for use outside the United States is not treated as excluded property by reason of the license to the related person.

S. Rep. No. 416, 106th Cong., 2d Sess., p. 19 (September 20, 2000).

The issue of whether copyright rights on software are excluded property under the pre-TRA 1997 version of section 927(a)(2)(B) was addressed in Microsoft, 311 F.3d 1178. The Court of Appeals for the Ninth Circuit held that copyrights on software are not excluded property within the meaning of the pre-TRA 1997 version of section 927(a)(2)(B). Microsoft, 311 F.3d at 1188-1189.

ANALYSIS

I. IRS Position

The issue in this case is whether Taxpayer's gross receipts from licensing intangible property pursuant to Contract B constitute foreign trading gross receipts under section 942, and, thus, qualify for ETI exclusions under section 114. The Field analyzed the rights licensed and other terms in Contract B, and determined that Contract B licensees pay Taxpayer royalties for the use of Taxpayer's patent rights, which are excluded property under section 943(a)(3)(B). Because excluded property cannot be QFTP, the gross receipts from licensing such patents do not constitute foreign trading gross receipts, and therefore do not qualify for ETI exclusions. We agree with the Field.

Generally, section 114 provides an exclusion from gross income to the extent of qualifying foreign trade income, which is derived from foreign trading gross receipts. Foreign trading gross receipts include gross receipts from the license of QFTP. Section 943(a) defines QFTP. Section 943(a)(3)(B) provides a list of intangible property that is automatically excluded from the definition of QFTP because of its intangible property status. The Copyright Exception within section 943(a)(3)(B) identifies certain intangible property that is carved out from the list of excluded property and, therefore, is not automatically excluded from the definition of QFTP. The carved-out property is limited to copyright rights in films, tapes, records, and computer software. Thus, the determination of whether Taxpayer's gross receipts from Contract B licenses are foreign trading gross receipts subject to ETI exclusions turns on whether the licensed property is copyright rights in computer software.

On its face, Contract B licenses patent rights, know-how, and trademarks; there is no license of copyright rights in Contract B. Contract B does not mention or even hint at any of the copyright rights in computer programs listed in Treas. Reg. § 1.861-18(c)(2). This is not surprising considering that, in the business strategy chosen by Taxpayer, only the Contract A licensees have any need for such rights. Also on its face, Contract B requires royalty payments only with respect to the patent rights. Thus, the gross receipts at issue are received with respect to a license of patent rights. Because patents are excluded property under section 943(a)(3)(B), gross receipts derived from licensing such property do not constitute foreign trading gross receipts under section 942 and do not generate ETI exclusions.

There is no other basis upon which Taxpayer could assert that its Contract B royalties derive from the license of copyright rights. Contract B licensees manufacture Product B subject to the patent, know-how, and trademark license governed by Contract B. Contract A prohibits the sublicense Taxpayer's copyright rights. The fact that Contract B licensees install Product A (a copyrighted article) into Product B, and thereby install Invention into Product B, is not a basis for classifying the licensing transaction contained in Contract B as a transfer of copyright rights. In addition, under the Copyright Act's first sale doctrine, Taxpayer's copyright rights to distribute copies of Invention do not survive the sale of Product A by Contract A licensees.[3] Thus, Taxpayer cannot claim that subsequent sales of Product A (which incorporates Invention) through the sales of Product B give rise to copyright royalties.

Because Taxpayer licenses excluded property to Contract B licensees, the gross receipts derived from such licenses do not qualify as foreign trading gross receipts, and, therefore, cannot generate ETI exclusions. Moreover, even if Contract B did include a license of copyright rights, our conclusion would remain the same because Contract B unambiguously provides that royalties are required only with respect to patent rights.

II. Taxpayer Position

Taxpayer has provided only a limited amount of information explaining its position. We believe Taxpayer can be understood as making one or more of three arguments. Consequently, the remainder of the discussion addresses those three arguments.

1. Because the licenses under Contract B involve certain rights related to software (i.e., patents, trademarks, and know-how), the compensation for those rights must qualify for ETI exclusions.

This argument disregards the plain language of section 943(a)(3)(B), which treats intangible property as excluded property except for certain copyright rights. Taxpayer

[3] 17 U.S.C. §§ 109(a) and 106(3). Section 109(a) provides, in relevant part, that "the owner of a particular copy . . . lawfully made under this title . . . is entitled, without the authority of the copyright owner, to sell, or otherwise dispose of the possession of that copy. . . ."

asserts that the Copyright Exception generally stands for the proposition that any transaction that has some discernable nexus to software must be determined to involve QFTP. But the Copyright Exception is very specific. It only modifies the word “copyright” in section 943(a)(3)(B), not the other items of intangible property that are also listed therein. Thus, the Copyright Exception cannot be interpreted generally to apply to any and all intangible property no matter how tangentially related to software. Taxpayer also asserts that Microsoft supports its interpretation of the Copyright Exception. However, there is no support for Taxpayer’s position in the Microsoft opinion, which explicitly addresses only copyright rights in software.

2. Because the licenses under Contract B convey patent rights, and because the Copyright Exception applies to software copyrights “whether or not patented,” the Copyright Exception applies to those patent rights, which are therefore not excluded property.

The Copyright Exception applies to copyrights on software whether or not such software is also protected by a patent; in other words, “even if” such software is also protected by a patent. The “even if” provision clarifies that, even though patent rights in software are explicitly treated as excluded property under section 943(a)(3)(B), copyright rights in that same software are not treated as excluded property by virtue of the presence of the patents. Thus, only gross receipts from the license of copyright rights in computer software qualify as foreign trading gross receipts, even though that software may be protected by both patent and copyright rights.

Taxpayer reads the “even if” provision as expanding the Copyright Exception to apply not only to copyrights on films, records, tapes and software, but also to patents on software. Taxpayer’s interpretation disregards the plain language of the Copyright Exception. The “even if” provision is premised on the fact, as reflected in the plain language of the statute, that patent rights are excluded property. But for that fact, the drafters would not have seen a need to clarify that a software patent (which is excluded property on the face of the statute) does not prevent copyright rights in the same software from being carved out of section 943(a)(3)(B) by the Copyright Exception.

3. The licenses under Contract B convey copyright rights in software, which are not excluded property because of the Copyright Exception.

This argument requires us to disregard the terms of Taxpayer's own contract for tax purposes, a practice we are loathe to adopt. See Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967). As explained above, Contract B by its terms licenses patent rights, not copyright rights. Furthermore, there is no transfer of copyright rights in Contract B as defined in Treas. Reg. § 1.861-18(c)(2). Taxpayer licenses its copyright rights under Contract A, but such licenses are royalty-free, and any income that may be derived from Contract A is not an issue in this case. Furthermore, under the Copyright Act's first sale rule, Taxpayer cannot claim that subsequent sales of Product A (which incorporates Invention) through the sales of Product B give rise to copyright royalties. Finally, and as already noted above, Contract B explicitly provides that royalties are required only with respect to patent rights.

Thus, we see no merit in Taxpayer's position.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 435-5265 if you have any further questions.

____
Christopher J. Bello
Chief, Branch 6
Associate Chief Counsel (International)