Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200813041**
Release Date: 3/28/2008

CC:INTL:B06:
POSTU-136720-07

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 114.00-00

date: December 17, 2007

to:

(Large & Mid-Size Business)
Attn:

from: Christopher J. Bello
Senior Technical Reviewer, Branch 6
Associate Chief Counsel (International)

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subject:

This Chief Counsel Advice responds to your request for assistance dated August 14, 2007. This advice may not be used or cited as precedent.

LEGEND

USCorp =
Sub1 =
Sub2 =
Sub3 =
Sub4 =
Sub5 =
Sub6 =
Date1 =
Date2 =
Date3 =
SLA X =

ISSUE

Whether a software license agreement ("SLA") that grants copyright rights in computer software for a minimum term of one year and continuing thereafter until terminated in writing by either party or until modified in writing by both parties results in one license or multiple licenses for purposes of the foreign sales corporation ("FSC") provisions and the extraterritorial income ("ETI") exclusion provisions.

CONCLUSION

For purposes of the FSC and ETI exclusion provisions, such SLA reflects a single license with a minimum duration of one year that continues until termination or modification of the SLA.

FACTS

USCorp maintains a SLA with Sub1 ("SLA X").[1] USCorp and Sub1 originally entered into SLA X on Date1. Article 2 of SLA X provides:

Thus, under SLA X, USCorp licenses to Sub1 the right to use, copy, distribute, and sublicense USCorp's computer software.

In exchange for these rights, SLA X provides that Sub1 must pay USCorp a fee based on Sub1's use, copying, distribution, and sublicensing of USCorp software. Article 6 of SLA X[2] provides, in relevant part:

[1] USCorp maintains SLAs with many of its subsidiaries. USCorp provided Examination with copies of the SLAs that USCorp maintains with Sub1, Sub2, Sub3, Sub4, Sub5, and Sub6. The SLA with Sub1 is materially similar to the SLAs that USCorp maintains with Subs2 through 6. For purposes of simplicity, we discuss only the SLA between USCorp and Sub1. Our analysis of SLA X also applies to the SLAs that USCorp maintains with Subs2 through 6.

Thus, Sub1 must pay a royalty to USCorp with respect to each software copy that it sells, incorporates into hardware, or otherwise uses.

The duration terms of SLA X provide, in relevant part:

[2] The excerpted language is from SLA X as modified on Date3. Modifications of SLA X are discussed in some detail below.

SLA X, Article 8(a)-(c). Thus, SLA X describes a license with a minimum duration of one year and which remains in effect until it is (1) terminated in writing by either party at the end of a calendar month with six months notice; (2) modified by both parties in writing; or (3) otherwise terminated pursuant to paragraph (d) or (f) of Article 8 of SLA X. Paragraphs (d) and (f) of Article 8 address the right to terminate for violations of SLA X and in the event that Sub1 ceases to be a subsidiary of USCorp, respectively. Paragraphs (d) and (f) of Article 8 are not relevant to the issue in this case.

On Date2, USCorp and Sub1 signed a written agreement that amended SLA X. On Date3, USCorp and Sub1 signed a written agreement that amended SLA X again. Both amendments revised the amounts and terms of the fees payable by Sub1 to USCorp as well as other provisions of the original SLA not relevant to the present issue. Neither of the amendments revised the terms regarding the duration of the agreement.

For its 2004 and 2005 calendar taxable years, USCorp claims that SLA X (as amended on Date3) reflects a single license entered into on Date3 for purposes of applying the FSC and ETI exclusion provisions because the Date3 written amendment by USCorp and Sub1 constituted a "significant modification." See USCorp's Memorandum for Submission to the National Office of the Internal Revenue Service, pp. 6-11 ( ). Accordingly, USCorp claims that it is entitled to ETI exclusions – computed pursuant to the ETI exclusion provisions as in effect on Date3 – with respect to the income it recognized in 2004 and 2005 pursuant to SLA X. Therefore, USCorp argues that the ETI exclusions computed with respect to income in calendar year 2005 are not subject to the ETI phase-out rule (described below). As explained below, we agree with USCorp's assertions except to the extent that we think all modifications, not only "significant modifications," result in a new SLA as of the date of each modification.

LAW AND ANALYSIS

Both the FSC and ETI exclusion provisions provide tax benefits with respect to foreign trading gross receipts ("FTGR"). See generally I.R.C. §§ 114; 921-927; and 941-943. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("ETI Act") generally replaced the FSC provisions with the ETI exclusion provisions. Pub. L. No. 106-519, 114 Stat. 2423, §§ 2 and 3 (2000). Section 5(a) of the ETI Act provides that the ETI exclusion provisions generally apply to "transactions after September 30, 2000" ("ETI effective date"). The legislative history further clarifies that the ETI exclusion provisions are "effective for transactions entered into after September 30, 2000." (Emphasis added). S. Rep. No. 416, 106th Cong., 2d Sess. 20 (2000) ("ETI Report"); see also Rev. Proc. 2001-37, 2001-1 C.B. 1327, §§ 2.02 and 6.03. For purposes of the FSC and ETI exclusion provisions, "transaction" means any sale, exchange, or other

disposition; lease or rental; and furnishing of services. I.R.C. §§ 927(d)(2)(A) and 943(b)(1)(A). The term "lease" includes a license. ETI Report, p. 19; Temp. Treas. Reg. §1.924(a)-1T(a)(2).

The American Jobs Creation Act of 2004 ("AJCA") generally repealed the ETI exclusion provisions. Pub. L. No. 108-357, 118 Stat. 1418, 1423, § 101(a) and (b) (2004). Section 101(c) of the AJCA provides that the general repeal of the ETI exclusion provisions "shall apply to transactions after December 31, 2004" ("ETI repeal date"). Two transition rules apply. One provides:

> (d) TRANSITIONAL RULE FOR 2005 and 2006.--
> (1) IN GENERAL.--In the case of transactions during 2005 or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection.
> (2) APPLICABLE PERCENTAGE.--For purposes of paragraph (1), the applicable percentage shall be as follows:
> (A) For 2005, the applicable percentage shall be 20 percent.
> (B) For 2006, the applicable percentage shall be 40 percent.

AJCA, § 101(d). Thus, for transactions entered into during 2005 and 2006, taxpayers may claim 80% and 60%, respectively, of the ETI exclusions that would have been permitted prior to the ETI repeal date with respect to the income recognized from such transactions during those calendar years ("ETI phase-out rule").

The other transition rule provides:

> (f) BINDING CONTRACTS.--The amendments made by this section shall not apply to any transaction in the ordinary course of a trade or business which occurs pursuant to a binding contract--
> (1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of such Code, as in effect on the day before the date of the enactment of this Act), and
> (2) which is in effect on September 17, 2003, and at all times thereafter.
>
> For purposes of this subsection, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

AJCA, § 101(f). We refer to the section 101(f) transition rule as the "ETI binding contract rule." Section 101 of the AJCA does not apply to transactions that are described in the ETI binding contract rule. In other words, the ETI exclusion provisions are not repealed or phased out with respect to such transactions. The ETI binding contract rule applies on a transaction-by-transaction basis.

We interpret the ETI effective date such that (subject to various transition rules and repeal dates not all of which are discussed herein) the FSC provisions generally apply to transactions entered into before October 1, 2000, and the ETI exclusion provisions generally apply to transactions entered into after September 30, 2000. This interpretation of the ETI effective date is explicitly supported by the legislative history to the ETI Act. ETI Report, p. 20. The determination of when a transaction is entered into within the meaning of section 5(a) of the ETI Act requires an analysis of the surrounding facts and circumstances on a case-by-case basis.

We interpret the ETI repeal date consistently with the ETI effective date because the language of section 101(c) of the AJCA is materially similar to the language of section 5(a) of the ETI Act. Thus, the determination of when a transaction is entered into within the meaning of section 101(c) of the AJCA also requires an analysis of the surrounding facts and circumstances on a case-by-case basis. In contrast to the ETI effective date and ETI repeal date, both of which apply on a transaction-by-transaction basis, we interpret the ETI phase-out rule as applying to income recognized during the 2005 and 2006 calendar years from transactions entered into during those years.

USCorp and Sub1 originally executed SLA X on Date1, amended it in writing on Date2, and amended it in writing again on Date3. Each amendment constituted a modification of SLA X pursuant to Article 8(a) and (c) because the amendments changed the terms of SLA X in writing and were signed by both parties. Whether any of the amendments resulted in a "significant" modification as claimed by USCorp is irrelevant to the issue in this case because Article 8(a) and (c) refer to <u>all</u> modifications, not "significant" modifications only.

Pursuant to Article 8(a) of SLA X (as originally executed and as amended on Date2 and Date3), each modification resulted in a new license for purposes of the FSC and ETI exclusion provisions because the language "

" indicates that the existing SLA X shall not continue in full force in the event of a modification. Thus, during taxable years 2004 and 2005, USCorp licensed to Sub1 copyright rights in USCorp's computer software pursuant to a new single license that was entered into on Date3 (which was after the ETI effective date and before the ETI repeal date) and continued thereafter pending termination or modification. To our knowledge, no termination or modification occurred after Date3 and before the end of USCorp's 2005 taxable year. Because USCorp entered into that new license after the ETI effective date and before the ETI repeal date, the ETI exclusion provisions as in effect prior to the ETI repeal date apply to all licensing income

earned by USCorp under such license. Therefore, USCorp's income from SLA X (as amended on Date3) in taxable year 2005 is not subject to the ETI phase-out rule.

We are aware of some views regarding the relevant transaction(s) and potential relevance of the ETI binding contract rule that are fundamentally at odds with our reasoning and conclusions explained herein. We address those misconceptions here. One such view incorrectly finds that the follow-on sales and sublicenses from Sub1 to its customers are the relevant transactions for purposes of determining USCorp's ETI exclusions. This position advocates that, but for the use of the software by Sub1 and the sales and sublicenses from Sub1 to its customers, no income would flow back to USCorp and, therefore, USCorp would have no FTGR in the first place. Alternatively, this position wrongly assumes that the FTGR used to compute USCorp's ETI exclusions are the gross receipts earned by Sub1 from its sales and sublicenses of USCorp software to third parties.

This position is erroneous in several respects. First, the position implicitly disregards the licensing, distribution, and marketing arrangement chosen by USCorp without any evidence that such arrangement lacks substance or otherwise should be disregarded. Second, this position is supported by neither Federal income tax principles nor the terms of SLA X. A license that allows a person to engage in a sublicense, use, or sale in the first place cannot be understood properly as arising only if such sublicense, use, or sale occurs. On the contrary, the license must exist independently of (and prior to) the subsequent sublicense, use, or sale. Third, this position conflates the definition of "transaction" with the form of payment chosen with respect to a transaction. To put it another way, form of payment (for example, fixed versus contingent) does not determine the number of transactions or when those transactions are entered into. This Office has made similar observations regarding methods of accounting in the long-term sale context – a long-term contract method of accounting dictates the timing of income inclusion with respect to sales, not the timing and number of such sales. In this case, the license exists regardless of whether it ultimately generates any income. The fact that the contingent payment terms contained in Article 6 of SLA X allow USCorp to recognize a return (and therefore FTGR) only if Sub1 uses the software or enters into follow-on sales and sublicenses does not support the conclusion that USCorp entered into multiple transactions where only a single license (that generated multiple royalty payments) is present.

Another misconception is that the binding contract rule limits the amount of the ETI exclusions that USCorp may claim with respect to its SLA X licensing income for 2005 to the 80% phase-out amount. This view is incorrect in several respects. First, if the ETI binding contract rule <u>did</u> apply to the license (which it does not), the effect of such application would be to enable USCorp to claim the full pre-AJCA amount of ETI exclusions regardless of when the licensing income was recognized. Second, because USCorp and Sub1 are related persons as defined in section 101(f)(1) of the AJCA, the ETI binding contract rule does <u>not</u> apply to the license (which means the ETI binding contract rule is irrelevant to determining USCorp's ETI exclusions in the first place).

Third, because USCorp and Sub1 entered into the new license after the ETI effective date and before the ETI repeal date, USCorp qualified to claim the pre-AJCA amount of ETI exclusions for the income from the new license even assuming the ETI binding contract rule applied.

[redacted]

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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Please call the branch at if you have any further questions.

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