Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Elizabeth S. Martini
(Large Business & International)

from: Jeffery G. Mitchell, Chief, Branch 2
(International)

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subject: Sale of software products by a CFC to U.S. Customers

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

LEGEND

Taxpayer =
Sub =

ISSUES

Whether the sale of software products by a controlled foreign corporation (CFC) to U.S. end-user customers gives rise to an investment in U.S. property for purposes of section 956(c)(1)(D) of the Internal Revenue Code.

CONCLUSIONS

The sale of software products by a CFC to U.S. end-user customers does not constitute an investment in U.S. property for purposes of section 956(c)(1)(D). However, other related transactions between the CFC and its U.S. parent may constitute an investment in U.S. property under section 956.

FACTS

Taxpayer, a U.S. entity, is a distributor of information technology products and services. Taxpayer develops software in the United States pursuant to a cost sharing agreement

(CSA) with its wholly-owned foreign subsidiary, Sub, a CFC as defined in section 957. This memorandum does not opine on whether the CSA constitutes a qualified cost sharing arrangement as defined in Treas. Reg. § 1.482-7(b) (1995). Pursuant to the CSA, Sub acquires the rights to exploit copyrights in the U.S. When Taxpayer has completed development of a software product intended for sale to end-user customers, a final version of the software code is transferred to a "gold master" disk and sent to Sub. Sub then reproduces and sells copies of the software to end-user customers in the United States.

LAW

The definition of "United States property" for purposes of section 956(c)(1)(D) includes any right to use intangible property in the U.S. that is acquired or developed by a CFC for use in the U.S. Under the statute, the relevant consideration is whether the intangible property acquired or developed by a CFC is a right to use property in the U.S. Whether such right has been acquired or developed for use in the U.S. is to be determined based on all the facts and circumstances of the case. Treas. Reg. § 1.956-2(a)(iv)(d). However, a right actually used principally in the U.S. will generally be considered to have been acquired or developed for use in the U.S. unless affirmative evidence shows the contrary. Id. Thus, both the statute and regulations define U.S. property in relation to whether a CFC develops intangible property intended for use in the U.S. or acquires the right to use intangible property in the U.S.—not in relation to whether such right is actually exercised. Accordingly, an investment in U.S. property arises upon the acquisition or development of rights to use intangible property in the U.S., not upon the actual use of that intangible property in the U.S.

ANALYSIS

Sub made an investment in U.S. property under section 956 when it acquired or developed the rights to use copyright rights in the U.S. pursuant to the CSA. However, the actual sales of the computer software copies from Sub to end-user customers in the U.S. do not in themselves give rise to an investment in U.S. property within the meaning of section 956(c)(1)(D). Furthermore, the actual transfer of copies of the software by Sub to the end-user U.S. customers does not affect the calculation of the inclusion amount, if any, under section 956 attributable to Sub's original investment in U.S. property, because Sub does not acquire or develop additional rights (or relinquish any rights) to use the software in the U.S. merely as a result of the sale of copies to a U.S. person.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

As noted, Sub made an investment in U.S. property under section 956(c)(1)(D) when it acquired or developed the rights to use copyright rights in the U.S. pursuant to the CSA. However, the amount of the investment in U.S. property under section 956 depends on Sub's adjusted basis in the copyright rights. If Sub's costs of acquiring and developing the copyright rights were deductible and in fact deducted, Sub may have a $0 basis in

the U.S. property. Further factual development is needed to determine whether and to what extent other aspects of Sub's activities with respect to the copyright rights constitute an investment in U.S. property within the meaning of section 956.

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Please call Susan E. Massey at (202) 622-3840 if you have any further questions.