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International Tax ADVISORY ■

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Controlled Foreign Corporation's Software Leasing Income Was Foreign Personal Holding Company Income

The IRS, in recent field attorney advice (FAA 20132702F), determined that a controlled foreign corporation's (CFC) income from software transfers to customers was foreign personal holding company income (FPHCI) under the subpart F rules. Specifically, the income was rental income from the leasing of a copyrighted article and did not qualify for the "active marketing exception" under the Code's "active leasing exception" in subpart F. The FAA offers taxpayers a good look at the IRS' analysis of the active marketing exception under the CFC regulations and offers practical guidance on qualifying for (and substantiating) the exception.

Facts

The taxpayer, a CFC, transferred software to customers under perpetual, non-exclusive and transferable (though only to affiliates of the customer) licenses. Under a license agreement, a customer paid a one-time fee for each user and annual maintenance and support fees based on the total number of users. After one year, a customer could terminate the agreement and the maintenance and support fees, provided the customer certified in writing that it no longer used the software. The taxpayer had seven customers during the years in issue; two of those customers were assumed by the taxpayer when one of its affiliates closed.

During some of the years at issue, the taxpayer had two employees, a financial controller ("accounting manager") and a software media production assistant ("production assistant"), as well as three directors, one of whom (the "executive director") the FAA treated as an employee based on his duties. During other years at issue, the taxpayer did not employ the production assistant. The employees' backgrounds were in accounting, finance and technology, and their job functions were largely administrative—e.g., bookkeeping, tracking payments, ordering the "software keys" to transfer to customers and filing tax returns. While there was some indication that the executive director assisted with marketing and worked with an affiliate company to

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promote sales, the employees did not track time spent on specific activities. The maintenance and support services provided to customers under the license agreements are contracted out to affiliates of the CFC.

Characterization of the Income

The FAA first concludes that income under the CFC's license agreements is rental income from the lease of copyrighted articles under Section 1.861-18 of the regulations. The taxpayer agreed with this characterization, which reflects that neither (i) copyright rights in the software nor (ii) benefits and burdens of owning the software are transferred under the agreements. Unless an exception applies, rents generally constitute FPHCI, which is taxable to "U.S. shareholders" of a CFC, as defined under the Code.

Under Section 954(c)(2), rents derived in the active conduct of a business and received from unrelated persons are excluded from the definition of FPHCI (the "active leasing exception"). The regulations further provide that rents are considered derived in an active business if the CFC leases one of four types of property, only one of which (the "active marketing exception") is relevant to the taxpayer in the FAA. The active marketing exception applies if property is leased as a result of a CFC lessor's marketing function if the lessor, through its own officers and employees in a foreign country, maintains and operates an organization in that country that (1) is regularly engaged in the business of marketing (or marketing and servicing) the leased property and (2) is substantial in relation to the amount of rents from leasing the property. The exception also extends to leases acquired by the CFC if the CFC performs active and substantial management, operational and remarketing functions with respect to the leased property.

The IRS found little evidence that the taxpayer regularly engaged in a marketing business. The taxpayer did not employ anyone with marketing expertise, compensate employees for marketing activity or success, or document the time its personnel spent on marketing. In contrast, related entities produced nearly all of the press releases for the parent's website and had even won international marketing awards. The agreement between the taxpayer and its parent company indicated that the taxpayer was not a marketing company, and the taxpayer had signed only one of its customers in the years at issue. The IRS concluded that the taxpayer mainly collected passive rents, especially considering that a "huge" proportion of its income was funneled to the parent company. Consequently, the taxpayer's rents constituted FPHCI because no active business was conducted.

Conclusion

CFCs deriving rental income and hoping to qualify for the active leasing and marketing exceptions to FPHCI treatment must be able to substantiate their qualification for the exceptions, including having employees with marketing expertise and job functions and documenting specific marketing activities and time spent on marketing. The CFC should operate a real and substantial leasing business, not appear as a "passive financial intermediary" that simply collects rents.

Payments for American Depository Receipts Programs Are U.S. Source Income, "Other Income" Under Treaties

In a legal advice memorandum (AM 2013-003) released July 12, 2013, the IRS Associate Chief Counsel (International) analyzes the character, source and treatment of payments by a domestic depositary institution in consideration for a foreign corporation's grant of the exclusive right to offer American Depositary Receipts (ADR). The memorandum concludes that the payments represent compensation for the transfer of a property interest in the United States, constitute U.S. source income and are subject to 30-percent withholding tax under Code Section 1442, unless the rate is reduced by a treaty. Moreover, the payments are likely "other income" under U.S. and OECD model treaties—not "royalties" or "business profits"—which means U.S. (source state) taxation could be eliminated entirely.

Background

In an ADR program, a foreign issuer places its stock with a U.S. financial institution (a "Depositary Institution" or DI) to make the stock more accessible to investors in the United States. The DI, which maintains and controls the stock, offers interests in the stock in the form of ADRs and makes dividend equivalent payments in U.S. dollars based on dividends paid by the issuer to the DI in foreign currency. Investors can trade ADRs on U.S. exchanges and OTC markets. ADR programs are subject to oversight by the SEC. In sponsored ADR programs, the subject of the AM, the foreign issuer enters an agreement with a specific bank to be its exclusive DI for a specified period of time. Unsponsored programs, in contrast, allow any DI to acquire the issuer's stock and offer ADRs to investors. The DI charges certain fees for administering the ADR programs to investors (and sometimes the issuer).

Issuers incur significant expenses to establish ADR programs, including accounting and legal fees, SEC registration costs, marketing expenses, exchange and listing fees, and other costs. To induce an issuer to enter an exclusive, sponsored ADR program, DIs commonly offer to pay a portion of these expenses. A DI may pay an issuer directly or to third-party vendors on behalf of the issuer.

AM 2013-003 Analysis

The character of particular ADR program-related payments depends on the facts and circumstances. In the case of inducement payments for sponsored ADR programs, the IRS concludes that the payments represent consideration for the transfer from the issuer to the DI of exclusive rights to establish a sponsored program for the issuer's stock. Citing *Sabatini v. Commissioner,* 98 F.2d 753 (2d Cir. 1938), a case where a nonresident alien author granted exclusive U.S. publishing rights, the memorandum determines that the exclusive ADR program rights constitute property interests located in the United States. Furthermore, payments for the transfer of those rights are U.S. source fixed or determinable annual or periodic (FDAP) income and subject to 30-percent withholding under Section 1442, unless the rate is reduced by a treaty (or the income is effectively connected with a U.S. business).

The IRS next considers the application of treaties to the payments. According to the memorandum, the payments are not "royalties": although the exclusive ADR program rights are property interests, the U.S. and OECD model treaties define royalties more narrowly than the Code. Nor do the payments constitute

"business profits" under the treaties, because the payments do not relate to the issuer's business. (The IRS clarifies that issuing stock and contracting with DIs to conduct ADR programs do not constitute businesses in themselves.) Because the payments are not described in specific treaty provisions, the payments fall under the models' "other income" articles, which generally permit taxation by the country of residence only.

Conclusion

For foreign issuers establishing sponsored ADR programs that are eligible for U.S. tax treaty benefits—and the domestic DIs running the programs—AM 2013-003 seems like good news. The memorandum clearly contemplates the elimination of U.S. tax on payments foreign issuers receive from DIs for exclusive ADR program rights under a treaty. Of course, the specific provisions of the operative treaty must be considered to determine whether and to what extent U.S. tax applies.

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