

Reproduced with permission from Tax Management International Journal, 44 TMIJ 251, 04/10/2015. Copyright © 2015 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Proposed New Subpart F Income Category: 'Foreign Base Company Digital Income'

By Lowell D. Yoder, Esq.
McDermott Will & Emery LLP, Chicago, Illinois

The Obama Administration's 2016 Budget proposes a new category of Subpart F income that would apply to certain "digital income," and be labeled "foreign base company digital income."¹ This category generally would include income from selling or licensing digital products or providing digital services where the controlled foreign corporation (CFC) uses intangible property developed by a related party to produce the digital income. The Administration's 2015 Budget contained the same proposal.²

The current Subpart F rules are applied by first classifying the income derived by a CFC from its business operations, e.g., sales, services, rents, or royalties. Then, a determination is made concerning whether an item of income falls within the relevant definition of Subpart F income, i.e., foreign base company sales income, foreign base company services in-

come, or foreign personal holding company income. There is no Subpart F rule that applies specifically to digital income.

Income from the sale of a product is foreign base company sales income if the product sold is purchased from a related person, the product is purchased from any person and sold to a related person, or the product is purchased or sold on behalf of a related person. This category applies only if the product is both manufactured outside, and sold for use outside, the CFC's country of organization.³ Income from selling products that are neither purchased from a related person nor sold to a related person is not foreign base company sales income. In addition, income derived by a CFC from selling products that it manufactures is not Subpart F income. A CFC qualifies for the manufacturing exception if it physically manufactures the products or substantially contributes to the physical manufacture of the products by a contract manufacturer.⁴

Services income is foreign base company services income if it is derived from performing services for, or on behalf of, a related person, and the services are performed outside the CFC's country of organization.⁵ Income from services performed for an unrelated person falls outside this Subpart F income category provided the services are not performed on behalf of a related person. Services are considered as

¹ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (2015) (hereinafter 2016 Green Book), at p. 32-34.

² Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* (2014) (hereinafter 2015 Green Book), at p. 58; see also Staff of the Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal*, JCS-2-14 (Dec. 2014), at p. 25.

³ §954(d).

⁴ Reg. §1.954-3(a)(4). Where a CFC engages in manufacturing, purchasing, or selling activities in a foreign branch, under certain circumstances a branch rule can apply to treat a portion of the CFC's income as foreign base company sales income. §954(d)(2).

⁵ §954(e).

performed on behalf of a related person if a related person subcontracts the services to a CFC, guarantees the services, and a related person performs any of the services, or 80% of the costs of providing the services are paid to related U.S. persons for assistance in providing the services.⁶ Income from services performed for or on behalf of a related person is not Subpart F income if the services are performed within the CFC's country of organization.

Rental or royalty income is foreign personal holding company income unless it is derived in the active conduct of a leasing or licensing business and received from unrelated persons.⁷ The active business requirement is met if the CFC manufactures or produces the property, acquires the property and adds substantial value thereto, or actively markets the property.⁸ Rents and royalties received from a related CFC are excluded from foreign personal holding company income provided the expense does not reduce Subpart F income of the CFC payor.⁹

An item of income is classified for purposes of applying the foreign base company income rules based on its substance.¹⁰ A single transaction may give rise to income that falls within more than one of the foreign base company income categories. As a general rule, the income must be apportioned among the various relevant categories or, if the portion falling within particular categories is indeterminate, then the income from the transaction is classified in accordance with the predominant character of the particular integrated transaction.¹¹ An item of income that is foreign personal holding company income is first tested under those rules, and if it qualifies for an exception and is also classified as sales or services income, such item is again tested under the foreign base company sales or services income rules.¹²

Therefore, under current law, any digital income that is sales income is not foreign base company income if the products sold are not purchased from or sold to related persons. Income from providing digital

services to unrelated persons generally does not give rise to foreign base company services income, provided a related U.S. person does not substantially assist in providing those services (the 80% cost test), and no related person guarantees the services and a related person performs a portion of the services (or significant related services). Income from licensing or leasing a digital product to unrelated persons is not foreign personal holding company income provided the CFC actively markets the property, or materially contributes to the development of the property. Whether intangibles are developed by a related person is not determinative of whether these foreign base company income definitions are met, and there is flexibility in structuring transactions to classify the income in a manner that minimizes the potential application of the foreign base company income rules under particular circumstances (e.g., to treat income as services income where provided to unrelated persons).

The Obama Administration expressed concern that taxpayers can choose different forms for substantially similar transactions involving digital goods and services (leases, sales, or services), and thereby avoid the application of the existing Subpart F rules. The 2016 Green Book provides the following example: “[A] transaction involving a transfer of a computer program (i.e., a copyrighted article) could be characterized as a sale or lease of the computer program, depending on the facts and circumstances concerning the benefits and burdens of ownership with respect to the computer program. A computer program hosted on a server also might be used in a transaction characterized as the provision of a service to a user who accesses the server from a remote location.”

The 2015 Green Book explains, “In this regard, the subpart F rules, which are generally intended to require current U.S. taxation of passive and highly mobile income, have not kept pace with advances in technology. This shortcoming enables CFCs to shift income related to digital goods and services to low-tax jurisdictions, in many cases eroding the U.S. tax base. For example, a CFC may be able to conduct business with remotely-located customers through the ‘cloud’ using intangible property acquired from a related party and without conducting any substantial business activities of its own.”

The Obama Administration's new foreign base company digital income category would apply to income arising from the lease or sale of a “digital copyrighted article,” or the provision of a “digital service.” No definition is provided of the term “digital.” As mentioned above, a digital copyrighted article would include a computer program. This category might also apply to income from transferring goods digitally (e.g., movies, books, music, games), and pro-

⁶ Reg. §1.954-4(b)(1); Notice 2007-13, 2007-5 I.R.B. 410.

⁷ §954(c)(1)(A), §954(c)(2)(A).

⁸ See Reg. §1.954-2(c), §1.954-2(d).

⁹ §954(c)(6); Notice 2007-9, 2007-5 I.R.B. 401. See also §954(c)(3)(A)(ii); Reg. §1.954-2(b)(5) (same-country exception).

¹⁰ Reg. §1.954-1(e)(1). See Reg. §1.861-18 (rules for classifying income derived from computer programs).

¹¹ Reg. §1.954-1(e)(2) and §1.954-1(e)(3). If an item is classified as either sales or services income and qualifies for an exception, it should not be retested under the other category. See Rev. Rul. 86-155, 1986-2 C.B. 134.

¹² Reg. §1.954-1(e)(4). Income that is initially classified within a particular category of foreign personal holding company income but qualifies for an exception is not retested under another category of foreign personal holding company income. Reg. §1.954-2(a)(2)(i).

viding services remotely (e.g., hosting computer software).¹³

The new rule would apply only in cases where the CFC uses intangible property developed by a related party to produce the income. It apparently would not be relevant how the CFC obtains the rights to use the intangibles, e.g., it may purchase or license the property. The 2015 Green Book expressly states that property developed pursuant to a cost sharing arrangement satisfies this requirement. Digital income earned from using intangible property developed by the CFC or by an unrelated party would not be subject to the new Subpart F income category.

Foreign base company digital income would not include digital income if the CFC, though its own employees, makes a “substantial contribution” to the development of the property or services that give rise to the income (e.g., a computer program). No guidance is given concerning the application of this definitional limitation. The Administration may have in mind concepts similar to those provided in regulations treating a CFC that substantially contributes to the manufacture of property as not subject to the foreign base company sales income rules.¹⁴ In any event, there appears to be an intention to not apply this new category of Subpart F income if a CFC makes an important contribution to the development of the property or service giving rise to the digital income. Nevertheless, this is likely to be complex and unclear in application (e.g., digital income should not be subject to the new Subpart F income category if the CFC substantially contributes to version three of a computer program but not to prior versions).¹⁵

An exception is provided where the CFC earns income directly from customers located in the CFC’s

¹³ See OECD Report, *Addressing the Tax Challenges of the Digital Economy, Action 1* (Sept. 16, 2014).

¹⁴ See Reg. §1.954-1(e)(4)(iv) (substantial contribution activities for purposes of the manufacturing exception include oversight and direction, quality control, and developing or directing the development of trade secrets, technology, or other intellectual property); Yoder, *Subpart F: ‘Indicia of Manufacturing,’* 38 Tax Mgmt. Int’l J. 642 (Oct. 9, 2009).

¹⁵ Cf. Reg. §1.954-2(d) (exception for royalties received from

country of organization that use or consume the digital copyrighted article or digital service in such country. Again, this exception raises complexities in application. Where does a customer use an item? In the country where it is downloaded, or where the customer is resident? And, how would the relevant facts be determined?

The proposal does not contain a priority rule relative to the other categories of foreign base company income. Presumably, if an item falls within the definition of foreign base company digital income, it will be Subpart F income, even if it qualifies for an exception to another category of foreign base company income. On the other hand, if an item of digital income qualifies for an exception to foreign base company digital income, it would seem appropriate that such income should not be Subpart F income under another definitional category of foreign base company income.

Thus, the proposed new Subpart F income category potentially applies to any item of digital income regardless of whether the income is classified as sales, services, or rental income — it would remove the flexibility of applying different rules to different types of income.¹⁶ In addition, such income would be foreign base company income where a related person developed the intangibles used to generate the digital income without meaningful involvement of the CFC in developing the property or services (subject to a limited same-country exception). This new rule would not apply to a CFC that develops the relevant intangibles or obtains them from unrelated persons.

This proposal is counterproductive. It is complex in application and inconsistent with the taxation of similar income by other industrialized countries. The digital business sector is America’s jewel — our best interests are not served by undermining its global competitiveness with increased tax costs.

an unrelated person for licensing property the CFC developed, created, or produced, or acquired and added substantial value thereto); Reg. §1.954-2(c) (similar exception for rents).

¹⁶ Royalty income from licensing digital products would not be subject to the new rule.