November 14, 2003

MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

FROM: Thomas W. Wilson, Jr. /s/Thomas W. Wilson, Jr.
Industry Director
Communications, Technology, and Media

SUBJECT: Industry Directive on Foreign Sales Corporation (FSC)
I.R.C. § 921-927 Bundle of Rights in Software Issue

The opinion in Microsoft Corp. v. Commissioner, 311 F.3d 1178 (9th Cir. 2002), rev'g 115 T.C. 228 (2001), T.C. Dkt. No. 16878-96, and subsequent events require clarification as to use of resources on the issue of "bundle of rights" (*ie*. that royalties for the license of computer software are paid for a bundle of rights, including patents, trademarks, trade secrets, and other like intangible property.)

During Microsoft's tax years at issue (FYE June 30, 1990 and 1991), § 927(a)(2)(B) excluded from the definition of export property, "patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property".[1]

In the Tax Court in Microsoft, the Commissioner's principal argument was that Microsoft's computer software masters did not qualify as "films, tapes records, or similar reproductions" within the meaning of the parenthetical and therefore do not qualify as "export property". As an alternative, the Commissioner argued that the royalties were consideration for a "bundle of rights" including patents, trademarks, trade secrets, and other like intangible property that likewise do not qualify as "export property". The Tax Court ruled in the Commissioner's favor based upon the principal argument.

[1] For years 1998 through 2000, the statute was amended to change the parenthetical exception and exclude from the definition of export property, "patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), good will, trademarks, trade brands, franchises, or other like property." For years after 2000, the Extraterritorial Income (ETI) rules at § 114 and § 941 through § 943 replace the FSC rules (which were repealed.) The ETI rules relating to excluded export property at § 943(a)(3)(B) are essentially the same as § 927(a)(2)(B), as amended.

The 9th Circuit Court of Appeals in Microsoft reversed the Tax Court and held in Microsoft's favor that master copies of computer software licensed for adaptation, reproduction, and distribution abroad are included in "similar reproductions" within the parenthetical in § 927(a)(2)(B) and therefore qualify as export property for FSC purposes. The Court did not address the alternative "bundle of rights" argument and suggested in footnote 6 that the issue may be remanded to the Tax Court for further consideration.

At this time, litigation in Microsoft as to the "bundle of rights" issue is pending. However, considering the change in statute for years after 1997, as well as the Service's limited resources and intensity of resources necessary to litigate this issue, the Service should generally not assert the "bundle of rights" issue in any open tax year in an attempt to disqualify from the definition of "export property" under 927(a)(2)(B) master copies of computer software licensed solely for the purpose of adaptation, reproduction, and distribution to foreign customers abroad.

I believe this should clarify our approach for the future and allocate resources to those issues that will be sustainable in the post-audit process. This LMSB Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such.