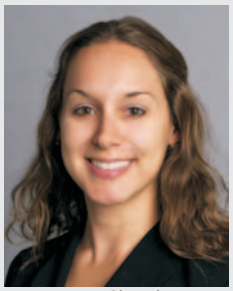
U.S. Tax Issues for Foreign Mobile Application Companies

By Lora Cicconi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This article explores the character and source of income earned by foreign companies developing mobile applications under federal tax law and whether the income earned by those companies would likely be taxable in the United States. The article also examines whether U.S. investors in those companies would likely be taxed under subpart F or the passive foreign investment company rules.

A. Introduction

The last few years have seen a dramatic rise in companies developing and marketing software applications (apps) for mobile computer platforms. Deal activity in this area has also grown, with 38 acquisitions recorded in the first four months of 2011, some valued at more than $100 million.[1] As transactions involving app companies become more common, concerns about their U.S. tax treatment, especially for those based in foreign countries, are inevitable.[2] These foreign companies must navigate a complicated set of rules to determine their U.S. tax liability, and their U.S. investors must determine their potential tax exposure as shareholders. Many of those critical tax matters depend on the type and source of the income earned by the foreign entity.

Accordingly, this article considers how income earned by foreign corporations engaged in the development and marketing of apps would likely be characterized and sourced under U.S. federal tax law. Based in part on this analysis, the article explores whether the income earned by a foreign app company would be taxable in the United States, and whether U.S. investors in a foreign app company would be taxable under subpart F or the passive foreign investment company rules.

B. Income Streams of App Companies

Companies that develop and market apps principally derive income from the sale of their apps and in-app products and from advertising displayed in the apps. Apps and in-app products are sold in online stores, such as Apple's App Store, Google's Android Market, and Amazon.com's Appstore for Android. Those transactions are structured so that the end-users directly pay the online stores, which in turn pay over the revenue to the companies, usually less a 30 percent commission.[3] The agreements governing the relationship between the app companies and the online stores generally require that the companies grant the stores a nonexclusive, royalty-free license to copy and use the apps for distribution purposes.[4]

Regarding the advertising income that app companies earn, the mobile advertising networks generally pay the companies a portion of the revenue generated from the advertisements placed in the apps.[5] As with the agreements governing the online sale transactions, some of the agreements governing

[1]Shayndi Raice and Yukari Iwatani Kane, "Mobile-App Firms Make More Deals," *The Wall Street Journal*, May 18, 2011 (most deals were for less than $100 million, but a few were valued at between $100 million and $500 million).

[2]*See, e.g.*, Kane, "Overseas Start-Ups Move In," *The Wall Street Journal*, May 26, 2011 (discussing foreign app developers establishing U.S. offices).

[3]*See, e.g.*, Apple iOS Developer Program License Agreement (Apple Agreement), Schedule 2, section 3.4, *available at* http://www.scribd.com/doc/41213383/iOS-Developer-Program-License-Agreement; Android Market Developer Distribution Agreement (Android Agreement), section 3.2, *available at* http://www.android.com/us/developer-distribution-agreement.html; Amazon Appstore Distribution Agreement (Amazon Agreement), section 2, *available at* http://www.slashgear.com/amazon-android-app-store-tcs-leak-29104993/.

[4]*See* Apple Agreement, Schedule 2, section 1.2(c), (d), (f), (g); Android Agreement, sections 5.1, 5.2; Amazon Agreement, section 4.1(a). The Apple Agreement does not describe a nonexclusive, royalty-free license, but requires that the app developer appoint Apple as its agent for delivery of the apps, which agency includes the right to copy and use the apps. Apple Agreement, Schedule 2, section 1.2(c), (d), (f), (g).

[5]*See, e.g.*, Casale Media Publisher Agreement, section 4, *available at* http://casalemedia.com/publishers/agreement/; Tapjoy Publisher Agreement (Tapjoy Agreement), section 3.1, *available at* https://www.tapjoy.com/tos-publisher.html.

advertising transactions require that the app companies grant the advertising distributors a nonexclusive, royalty-free license to copy and use the apps for advertising purposes.[6]

This article assumes a hypothetical app company (Appco), whose only income is derived from the sale of apps and in-app products and advertising placed in apps.[7] It further assumes that Appco is organized and based in a foreign country that is not a party to a tax treaty with the United States and develops its own apps exclusively in its country of residence. Appco conducts some minimal marketing activities in the United States through a U.S. office. Otherwise, its only contacts with the United States are the sale of its apps to end-users in the United States via online stores and the sale of in-app advertising to U.S. advertisers through mobile advertising networks.

C. U.S. Taxation of Foreign Corporations

In general, foreign corporations are subject to U.S. tax on two types of income: income that is effectively connected with the conduct of a trade or business in the United States, regardless of the source of the income; and fixed or determinable annual or periodic income from a U.S. source that is not effectively connected with a U.S. trade or business.[8]

The amount of a foreign company's effectively connected income and FDAP income depends in part on the source of its income, and the source of that income in turn partly depends on its character. For companies involved in software transactions, income character must be analyzed under computer software regulations promulgated under section 861 (the software regs).[9] Accordingly, this article begins with a discussion of the character of Appco's income under the software regs and then considers the source of Appco's income under the rules governing the sourcing of income. Drawing from those analyses, this article discusses whether Appco is likely to have effectively connected or FDAP income. Last, it discusses whether U.S. investors in Appco are likely to be taxable under subpart F or the PFIC rules.

D. Characterizing Appco's Income

Under the software regs, the character of payments received in transactions involving computer programs is based on the nature of the rights conveyed. The determination is made without regard to the transaction form adopted by the parties or the terms they apply.[10] In addition, the means of the transaction (that is, whether by purchase of physical disc or electronic download) is irrelevant.[11]

The software regs establish four basic categories of transactions: (1) the sale of a copyright right, (2) the license of a copyright right, (3) the sale of a copyrighted article, and (4) the lease of a copyrighted article.[12] The categories arise from two basic distinctions: the distinction between copyright rights and copyrighted articles, and the distinction between partial and complete transfers.

1. Copyright rights. A transfer involves copyright rights if the transferee acquires any of the following rights regarding the copyright: the right to make copies of the property, the right to prepare derivative property, the right to make public performances, or the right to publicly display the property.[13] A transfer of copyright rights is treated as a sale or exchange for income tax purposes if, taking into account all facts and circumstances, the transferee receives substantially all of the rights to the underlying copyright right. If there has not been a transfer of substantially all of the rights, the transfer will be treated as a license generating royalty income.[14]

The principles of sections 1222 and 1235, as well as relevant case law, may be applied in determining

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[6]*See* Tapjoy Agreement, sections 2.5, 5.

[7]The remainder of this article does not differentiate between the sale of apps and the sale of in-app products, because the sale of an app is essentially the same transaction as the sale of an in-app product (*i.e.*, a digital transfer of software to an end-user effected via an online store), and both types of transactions appear to be governed by the same agreements. *See* Apple Agreement, sections 3.3.23, 7.1, Attachment 2 (directly addressing in-app purchases); *see also* Amazon Agreement (broadly defining apps as ''software applications, games or other digital products . . . including any content, ads, services, technology, data and other digital materials included in or made available through such products, together with their enhancements, upgrades, updates, bug fixes, new versions and other modifications and amendments''); Android Agreement (broadly defining products as ''software, content, and digital materials distributed via the [Android] Market''). References to sales of apps are meant to be inclusive of sales of in-app products.

[8]Sections 881(a), 882(a).

[9]Although the software regs as drafted apply to traditional software, the same principles should apply equally to a broader set of products. *See* David Hardesty, Hardesty, *Electronic Commerce: Taxation and Planning* (1999 and Supp. 2011-2012), para. 11B.02[7]; commentary on Article 12 of the OCED model tax convention, paras. 12.2, 17.1 (providing that the principles applicable to software also apply to transactions concerning digital products).

(Footnote continued in next column.)

[10]Reg. section 1.861-18(g)(1).

[11]Reg. section 1.861-18(g)(2).

[12]Reg. section 1.861-18(b)(i)-(ii), 1.861-18(f). The regulations also address transactions involving services and know-how (see reg. section 1.861-18(d)-(e)), but those categories are not relevant here.

[13]Reg. section 1.861-18(c)(1)(i), 1.861-18(c)(2)(i)-(iv).

[14]Reg. section 1.861-18(f)(1).

whether all substantial rights have been transferred.[15] Generally, such a transfer will be deemed to occur if the transferee receives the exclusive right to use and sell the copyrighted work for an unlimited duration.[16]

2. Copyrighted articles. A transfer involves a copyrighted article if the transferee receives a copy of a software program but acquires no rights (or a de minimis grant of rights) that accompany a copyright right.[17] To qualify for sale treatment, the transferee of the copyrighted article must receive all the benefits and burdens of ownership. If there has not been a transfer of all the benefits and burdens of ownership, the transaction will be treated as a lease generating rental income.[18]

The burdens and benefits analysis is the same test that determines whether transfers of tangible personal property are sales or leases.[19] The Tax Court has applied this test to the transfer of software and found that the benefits and burdens passed when the transferee paid a fixed cost for the use of the software and had the right to use it for the rest of its useful life.[20]

3. Characterization of Appco's income streams.

a. Sale of apps. The end-users who purchase Appco's apps merely acquire the software for their own use. They do not acquire the rights to copy the apps, make derivative programs, make public performances, or publicly display the apps. Accordingly, under the software regs, Appco's transfer of its apps to end-users should be characterized as the transfer of a copyrighted article rather than a copyright right.

In terms of whether the transfer should be viewed as a sale or a lease, the software regs and attendant case law suggest that sale treatment is more appropriate. The end-users pay a fixed cost for the apps and their use is not limited by term or in any other way. Thus, using the standards articulated by the Tax Court, the benefits and burdens pass to the end-user, and any income generated from the online sale of apps should be treated as income from the sale or exchange of property under the software regs.

The reality of a sale should not be changed by the fact that Appco's agreements with online stores such as Apple, Google, and Amazon require it to grant a license to copy and use its apps. The agreements indicate that the grant of the license is for purposes of the stores' marketing and distribution of the apps.[21] Thus, the license appears merely incidental to the sale of apps to end-users.[22]

b. Advertising. The income that Appco earns from advertisements is derived from the placement of advertisements in its apps, not from the license or lease of the apps. Thus, Appco's income from advertisements should not be treated as royalty or rental income under the software regulations. For the reasons discussed above related to the sale of apps, that should not change because some of Appco's contracts with advertising networks require it to grant the network a nonexclusive license to copy and use its apps for advertising purposes.[23]

E. Sourcing Appco's Income

1. Source of income from sale and use of property. Under the sourcing rules, sales of personal property are usually sourced to the seller's country of residence.[24] However, in the case of inventory property (which includes "property held by the taxpayer primarily for sale to customers in the ordinary course of [its] trade or business"),[25] sales are sourced where title passes regardless of the seller's location, unless the sale is attributable to a U.S. office and other conditions are met.[26] Also, if the inventory is produced in a foreign country and sold in the United States or vice versa, it is sourced in part where title passes (again, unless the sale is attributable to a U.S. office), and in part where production takes place.[27]

Income is generally attributable to a U.S. office if the office is a material factor in the realization of the income.[28] Regarding income from inventory sales in particular, the material factor test is satisfied if (1) the office actively participates in soliciting the order, negotiating the contract of sale, or performing other

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[15]*Id.*; T.D. 8785, *Doc 98-29705*, *98 TNT 201-82*.

[16]*Pickren v. United States*, 378 U.S. 595, 599-601 (5th Cir. 1967) (transfer of secret formula treated as license when the transferee's right to use the formula was for a limited period of time); *Hooker Chemicals & Plastics Corp. v. United States*, 591 F.2d 652, 658-659 (Ct. Cl. 1979) (transfer of patent treated as sale because "the transferees received the exclusive rights to the patents in their respective territories for the remaining life of the patents"); *see also* reg. section 1.861-18(h), Example 5; *cf.* reg. section 1.861-18(h), Example 6.

[17]Reg. section 1.861-18(c)(1)(ii). There also may not be any more than a de minimis service or know-how component to the transfer. *Id.*

[18]Reg. section 1.861-18(f)(2).

[19]T.D. 8785; *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) (enumerating factors considered in the benefits and burdens test).

[20]*Sprint Corp. v. Commissioner*, 108 T.C. 384, 397-400 (1997), *Doc 97-12019*, *97 TNT 84-8*; *see also* reg. section 1.861-18(h), examples 1 through 4.

[21]*See supra* note 4.

[22]*See, e.g.*, T.D. 8785.

[23]*See supra* note 6.

[24]Section 865(a).

[25]Sections 865(a)(i) and 1221(a)(1).

[26]Sections 861(a)(6), 862(a)(6), 865(b), and 865(e)(2); reg. section 1.861-7(c).

[27]Sections 863(b) and 865(e)(2).

[28]Reg. section 1.864-6(b)(1).

significant services necessary for the consummation of the sale, which are not the subject of a separate agreement between the seller and the buyer; and (2) the income, gain, or loss is realized in the ordinary course of the foreign corporation's trade or business carried on through the U.S. office.[29]

Income from the use of property (such as rent or royalties) is generally sourced where the property is used. That rule also applies to income from the sale of intangible property when the gain from the sale is contingent on the use of the property.[30]

2. Source of income from services. Income from services is sourced where the services (including capital and labor) are performed.[31] For example, in *PiedrasNegras Broadcasting Co. v. Commissioner*, advertising revenues earned by a radio broadcasting company were sourced in Mexico where the company's personnel and equipment were, even though the radio programs were broadcast in the United States and the advertising revenue was derived from the United States.[32] If services giving rise to compensation income are performed partly in foreign countries and partly in the United States, the income must be allocated between those sources.[33]

3. Sourcing of Appco's income streams.

a. Sale of apps. As discussed above, the income that Appco earns from the sale of its apps likely would be characterized as income from the sale of property rather than as royalty income. The income likely would be further characterized as income from the sale of inventory property because it is "property held by the taxpayer primarily for sale to customers in the ordinary course of [its] trade or business."[34] Accordingly, whether Appco's sales income is from U.S. sources depends on where title to the apps passes, unless the income is attributable to a U.S. office.[35] Appco's income from its app sales should not be attributable to a U.S. office because its U.S. office only engages in marketing activities — it does not actively participate in soliciting orders or negotiating sales contracts for the apps, nor does it perform any development or programming work or any other significant services necessary for the consummation of the sale of apps.

Whether title passes within or outside the United States is a more difficult question. The title passage rules are not easily applied to transfers of intangible goods via electronic commerce because software transactions are governed by license agreements, which generally do not refer to a transfer of property.[36] Further, title passes when risk of loss passes, yet there is no true risk of loss when software is transmitted electronically.[37] The software regs recognize the limitations inherent in the title passage rules, but decline to address them, merely noting that "the parties in many cases can agree on where title passes," and suggesting that transactions in computer programs "will be sourced under similar principles."[38] Based on that language, in the case of foreign corporations that sell software via electronic download, title should arguably be treated as passing where the foreign company is located, as that is where title would pass if the transaction involved tangible goods.[39] Thus, income from Appco's sales of apps would likely be sourced outside the United States and in the country where Appco is based and where the product is electronically introduced into commerce, especially given that Appco has no U.S. office or facility creating the product being sold.

b. Advertising. Appco's income from the placement of advertisements would likely be considered compensation received for services, which, as noted above, is sourced where the services (including capital and labor) giving rise to the income are performed. Various services could be viewed as giving rise to the advertising income in Appco's case, including developing, marketing, and selling the apps; creating the software code that permits the advertisements to be embedded in the apps; and meeting and negotiating with advertising networks. In Appco's case, the capital and labor used for those services are primarily located offshore. Even though marketing activities are conducted in the United States, they are unlikely to be viewed as contributing in any material way to the advertising income because they are not a driver of the success of the advertising business. Similarly, while an argument could be made that a portion of the capital giving rise to the advertising income is located in the United States because Appco's apps are sold through online stores whose servers are

[29]Reg. section 1.864-6(b)(2)(iii).

[30]Sections 861(a)(4), 862(a)(4), and 865(d)(1).

[31]Sections 861(a)(3) and 862(a)(3).

[32]43 B.T.A. 297, 312 (1941); *see also* LTR 6203055590A (income from advertisements placed in a magazine published and distributed in foreign countries was foreign source because it arose from the capital and labor employed in the publishing and distribution centers in foreign countries).

[33]Reg. section 1.861-4(b)(1)(i).

[34]Section 865(a)(i), section 1221(a)(1); *see also* David R. Tillinghast, "Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven," 4 *Fla. Tax Rev.* 339, 349 (1999).

[35]Under section 863(b), Appco's income will be sourced in part to its country of organization because production takes place there, but whether there will be any U.S.-source income based on sales to U.S. customers depends on the title passage and U.S. office attribution rules.

[36]Tillinghast, *supra* note 34, at 349-350; *see also* T.D. 8785.

[37]Reg. section 1.861-7(c); Tillinghast, *supra* note 34, at 349-350.

[38]T.D. 8785.

[39]Tillinghast, *supra* note 34, at 350.

located in the United States, the servers are not owned by Appco.[40] Thus, it seems unlikely that Appco's advertising income would be treated as derived from U.S. sources.

F. Is Appco's Income Taxable in the U.S.?

1. Is Appco's income effectively connected with a trade or business?

a. U.S. trade or business.

i. U.S. trade or business generally. While the concept of a trade or business is not clearly defined in U.S. tax law, a foreign corporation generally will be considered engaged in a trade or business in the United States if it engages in a course of income-producing activity in the United States that is considerable, continuous, and regular.[41] The trade or business analysis is both qualitative and quantitative, but the character of the activities and the purpose for which the office is established are the main criteria for determining whether an activity rises to the level of trade or business.[42] Thus, courts have held that passive activities such as ownership of a single building or an occasional sale do not constitute a trade or business.[43] In addition, clerical tasks, such as collecting revenues and remitting sums to the home office, have been found merely incidental to the foreign corporation's primary business and therefore insufficient to constitute a U.S. trade or business.[44] Similarly, the receipt of advertising revenues from the United States has been held not to constitute a U.S. trade or business in the absence of a physical office.[45]

While no court has directly addressed the question, purely promotional activities are not generally viewed as doing business in the United States.[46] Further, it is unlikely that a foreign corporation making direct sales to U.S. customers would be considered engaged in a U.S. trade or business.[47]

A foreign person that does not directly engage in any activities in the United States may nonetheless be treated as engaged in a U.S. trade or business by virtue of its agent's actions. The actions of dependent agents, acting exclusively for and under the control of the foreign person, are generally imputed to foreign persons.[48] In contrast, the actions of independent agents, acting in their own course of business, are generally not imputed to foreign persons.[49]

ii. Application to Appco. Given that the law governing the existence of a U.S. trade or business has not caught up with e-commerce, determining whether Appco is engaged in a U.S. trade or business does not yield a definite answer. Nonetheless, given the assumptions above, Appco should not be treated as engaged in a U.S. trade or business. Appco develops its products exclusively offshore and its only direct activities in the United States are minimal marketing activities. Those activities would likely be considered promotional activities incidental to Appco's primary trade or business of developing and selling apps. Further, while Appco sells its apps to U.S. customers and receives advertising income from U.S. sources, authorities suggest that neither of those activities constitute a U.S. trade or business.[50]

That Appco sells its apps through online stores based in the United States should not change that result. Apple, Amazon, and Google are not controlled by Appco, nor are they acting as its exclusive distributor. Therefore, their actions are best characterized as those of independent agents and should not be attributed to Appco.

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[40]*Compare PiedrasNegras*, 49 B.T.A. at 312 (only looking to the capital and labor of the service provider).

[41]*De Amodio v. Commissioner*, 34 T.C. 894, 905 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960); *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940).

[42]*Scottish Am. Inv. Co v. Commissioner*, 12 T.C. 49, 59 (1949).

[43]*Linen Thread Co. v. Commissioner*, 14 T.C. 725, 735-737 (1950); *Neill v. Commissioner*, 46 B.T.A. 197, 198 (1942); *Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938).

[44]*Scottish Am.*, 12 T.C. at 56-59; *Linen Thread*, 14 T.C. at 736.

[45]*PiedrasNegras*, 43 B.T.A. at 304-307 (foreign radio broadcasting company selling advertising space to U.S. customers not engaged in U.S. trade or business); *see also* LTR 8147001 (similar facts and result).

[46]Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income*, Volume II (2011 and Supp. 2012), para. 35.10; Tax Management Portfolio 908-2nd, III.A.1.a.

[47]*Id.*; Isenbergh, *supra* note 46, at para. 35.10; *see also Linen Thread*, 14 T.C. at 737 (two sales in the United States not trade or business when U.S. office did not solicit the business).

[48]*Lewenhaupt v. Commissioner*, 20 T.C. 151, 153-154 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); *Adda v. Commissioner*, 10 T.C. 273, 277-278 (1948), *aff'd*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949).

[49]*Estate of Cadwallader v. Commissioner*, 13 T.C. 214, 219-220 (1949); *Amalgamated Dental Co. v. Commissioner*, 6 T.C. 1009, 115-116 (1946); *see also* section 864(c)(5) and reg. section 1.864-7(d) (distinguishing between dependent and independent agents for purposes of determining whether foreign person has U.S. office). Note, however, that some courts have broadly attributed to a foreign person the actions of a person engaging in U.S. activities even when the agency relationship appeared to be independent. *See De Amodio*, 34 T.C. at 904-906; *Handfield v. Commissioner*, 23 T.C. 633, 636-637 (1955).

[50]If Appco were to begin to hire U.S.-based app developers, or even to engage in more substantial marketing or promotional activities here, the scales might tip in favor of a U.S. trade or business.

b. Effectively connected income.

i. Effectively connected rules. To the extent a foreign corporation is treated as conducting a U.S. trade or business, three types of income may be subject to U.S. tax as effectively connected with that trade or business. First, U.S.-source income other than FDAP income and capital gains will automatically be considered effectively connected income. This rule applies regardless of any relationship between the income and the trade or business, under the principle that U.S.-source non-investment income is ''attracted'' to the business.[51]

Second, U.S.-source FDAP income and capital gains may be treated as effectively connected with a U.S. trade or business if: (1) the income is derived from assets used or held for use in the conduct of the trade or business, or (2) the trade or business was a material factor in the realization of the income.[52]

Last, foreign-source income is only effectively connected with the U.S. trade or business under the following limited circumstances: (1) the foreign corporation maintains an office or fixed place of business in the United States, (2) the income is attributable to that office, and (3) the income is dividends, rents, royalties, or gains from the sale or exchange of inventory property.[53] Income is generally considered attributable to a U.S. office to the extent that the office is a material factor in its production and regularly carries on activities of the type from which the income is derived.[54] More specifically, income from inventory sales is considered attributable to a U.S. office under the same test described in Part E.1. — that is, if (a) the U.S. office actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale, which are not the subject of a separate agreement between the seller and the buyer; and (b) the income, gain, or loss is realized in the ordinary course of the foreign corporation's trade or business carried on through the U.S. office.[55]

ii. Application to Appco. If Appco were found to have a U.S. trade or business, it is not clear that any of its income should be treated as effectively connected with that business. As described above, the income that Appco earns from the sale of its apps likely would be characterized as inventory income derived from foreign sources. That foreign-source income would only be effectively connected to Appco's trade or business if it were attributable to its U.S. office. The attribution analysis here is the same as the analysis in Part E.3.a., which concluded that Appco's income from the sale of apps was not likely attributable to a U.S. office. Thus, the foreign-source income from app sales should not be effectively connected even if Appco were treated as engaged in a U.S. trade or business.[56]

Because foreign-source services income cannot be effectively connected with a U.S. trade or business, Appco's advertising income could only be effectively connected with its U.S. trade or business if it were from U.S. sources. As discussed above, it is unlikely that Appco's advertising income would be treated as coming from U.S. sources. Further, if any portion of the advertising income were derived from U.S. sources, it only would be effectively connected if it were derived from assets used or held for use in the conduct of the U.S. trade or business, or if the U.S. trade or business were a material factor in the realization of the income. Assuming that a U.S. trade or business existed, it seems unlikely that the advertising income could be derived from assets used in that trade or business or that such trade or business would be a material factor in the income, because the U.S. trade or business is limited to the marketing activities in the United States, which do not hold any assets, and is distinct from the business that brings in Appco's income.

2. Is Appco's income FDAP income?

a. FDAP income. As noted above, some income originating from sources in the United States may be subject to U.S. taxation, even if not effectively connected to a U.S. trade or business. The income covered by this provision includes interest, dividends, rents, royalties, salaries, and annuities, as well as other FDAP income.[57] FDAP income is broad enough to cover most types of U.S.-source income, including compensation for services earned by corporations.[58] Gains from the sale or exchange

[51]Section 864(c)(3). This income category includes U.S.-source gain from the sale of inventory property. Reg. section 1.864-4(b), examples 1-3.

[52]Section 864(c)(2)(A)-(B). The material factor test may not be satisfied if the foreign corporation's primary business is different from the business engaged in by the U.S. office. Reg. section 1.864-4(c)(3)(ii), Example 2.

[53]Section 864(c)(4).

[54]Section 864(c)(5)(B); reg. section 1.864-6(b)(1).

[55]Reg. section 1.864-6(b)(2)(iii).

[56]Note that if Appco's income from the sale of apps were derived from U.S. instead of foreign sources (for example, because it shifted its development operations to the United States, or restructured its contracts so that the sale of apps gave rise to rental income, which is sourced based on where the apps are used), then automatically it would be effectively connected to any U.S. trade or business based on the force of attraction rule described in Part F.1.b.i.

[57]Section 881(a).

[58]Reg. section 1.1441-2(b)(1)(i).

of property are typically excluded from FDAP income, subject to various exceptions.[59]

b. Application to Appco. Because of the character of the income involved, Appco's income from the sales of apps does not come within the meaning of FDAP income. As discussed above, sales of apps likely will be characterized as sales of copyrighted articles, which give rise to income from sales or exchanges of property rather than rental income. Income from sales of these properties is excluded from FDAP income, even if it is from U.S. sources. Thus, Appco's income from sales of apps would not be taxable as FDAP income under the exclusion for income from property sales.[60]

Appco's advertising income would likely be viewed as compensation received for services, which is within the scope of FDAP income. As discussed above, however, it is unlikely that the advertising income will be treated as derived from U.S. sources. Thus, Appco's advertising income likely would not be taxable as FDAP income.

G. The Anti-Deferral Rules

In general, U.S. investors in a foreign corporation are not subject to U.S. income tax on the corporation's earnings unless the corporation distributes the earnings. However, the United States has enacted anti-deferral rules, including the subpart F rules and the rules applicable to PFICs, each of which may have the effect of taxing U.S. investors currently on the income earned by the foreign corporation.[61] This section briefly discusses the anti-deferral rules and the likelihood that they would apply to U.S. investors in Appco.

1. Subpart F income and earnings in U.S. property. Under the subpart F rules, a U.S. shareholder of a controlled foreign corporation is taxed directly on its pro rata portion of some corporate earnings, even if the corporation does not distribute the earnings.[62] A U.S. shareholder is a U.S. person who owns at least 10 percent of the foreign corporation's voting stock.[63] A foreign corporation is a CFC if more than 50 percent of its stock, by voting power or value, is owned by U.S. shareholders.[64]

U.S. shareholders of CFCs generally are taxed on two categories of CFC income: (1) subpart F income and (2) earnings invested in U.S. property.[65]

a. Subpart F income. Subpart F income covers income earned by specific types of business operations and investment activities.[66] One relevant category of subpart F income for Appco's purposes is foreign personal holding company income, which includes several types of passive income. Of the passive income included in that category, royalty and rental income and gains from the sale or exchange of property that give rise to royalties and rents, are potentially implicated by Appco's business. As described above, Appco's transfer of its apps to end-users via online stores should be characterized as the sale or exchange of a copyrighted article under the software regulations. Thus, its income from app sales should not be treated as royalty or rental income. Similarly, Appco's advertising income should be viewed as income from services, not from the use of property. As a result, none of Appco's income should be at risk for treatment as royalty or rental income. Further, to the extent that Appco sells the underlying assets giving rise to its income, no passive income should result because the assets themselves do not give rise to royalties or rents. Thus, Appco should not have any foreign personal holding company income.[67]

Foreign base company sales and services income are other subpart F categories that could be relevant to Appco. Foreign base company sales income consists of income earned from the sale of property for use, consumption, or disposition outside a CFC's country of organization to the extent that property is sold to or on behalf of a related person, or purchased from or on behalf of a related person.[68] Similarly, foreign base company services income means income derived from services performed outside the CFC's country of organization for or on behalf of a related person.[69] Appco sells its apps for use outside its country of origin, but does not sell those products to any related person; rather, it sells its apps to a diverse group of end-users via unrelated third parties such as Apple, Google, and Amazon. Similarly, the advertisements placed in

[59]Reg. section 1.1441-2(b)(2)(i).

[60]Note that if Appco were to restructure its agreements with online stores or end-users so that the sale of its apps gave rise to rental income, that income would likely be subject to U.S. tax as FDAP income, because rental income is sourced where the product is used, and the United States is a large market for apps.

[61]Sections 951 et seq. and 1291 et seq.

[62]Section 951(a)(1).

[63]Section 951(b).

[64]Section 957(a).

[65]Sections 951(a)(1), 956.

[66]Sections 952(a)(1)-(5), 953, 954, 955, 999, and 901(j).

[67]Further, even if Appco's sale of apps was viewed as the transfer of less than all of a copyrighted article and therefore treated as a lease resulting in rental income, its income still might not be characterized as foreign personal holding company income. *See* section 954(c)(2) (rental and royalty income not treated as passive income if derived from an active trade or business and received by an unrelated party); *see also* reg. section 1.954-2(c) and (d).

[68]Section 954(d)(1).

[69]Section 954(e).

Appco's apps are said via unrelated third-party mobile advertising networks. Accordingly, Appco should not be treated as earning any foreign base company sales income or foreign base company services income.

b. Earnings from U.S. property. In addition to subpart F income, the U.S. shareholders of a CFC must include in their income their pro rata share of the CFC's earnings invested in U.S. property under section 956, regardless of the nature of the underlying income.[70] This rule is based on the theory that the income invested in U.S. property has been effectively repatriated.[71]

For purposes of section 956, the term ''U.S. property'' is broadly defined to include a right to use in the United States intangible property (such as patents, copyrights, inventions, designs, and secret processes) acquired or developed by the CFC for use in the United States.[72] The relevant consideration in determining whether an investment in U.S. property has been made is whether the intangible property acquired or developed by the CFC is a right to use property in the United States.[73] That inquiry is based on all the facts and circumstances, but a right used principally in the United States will generally be considered to have been acquired or developed for use in the United States unless affirmative evidence shows the contrary.[74] If a property right is acquired or developed for use in the United States, the amount taken into account by the U.S. shareholder is the property's adjusted basis reduced by liabilities to which the property is subject.[75]

The IRS has held that ''an investment in U.S. property arises upon the acquisition or development of the right to use intangible property in the United States, not upon the actual use of that intangible property in the United States.''[76] Thus, Appco should not be treated as investing in U.S. property solely as a result of the sale of its apps to end-users in the United States. Its development activities could result in an investment in U.S. property to the extent the rights associated with the apps were developed for use in the United States[77]; however, even then, Appco's U.S. shareholders may not be required to take any income into account since Appco's adjusted basis in the rights associated with its apps will be zero if its development costs were properly and fully deducted.[78]

2. PFIC status. The PFIC rules provide several alternative methods of taxation, all of which seek to approximate the economic result if a U.S. person were taxed on a current basis on its share of the earnings of the foreign company, regardless of whether the PFIC distributes the income.[79] Unlike the subpart F rules, which only apply to U.S. shareholders who own 10 percent of a CFC, the PFIC rules apply to all U.S. shareholders, regardless of their ownership level.

Whether a company is treated as a PFIC depends on the proportional amount of its passive versus active income and assets. There are two alternative tests for determining whether a foreign corporation is a PFIC — an income test and an asset test. Under the income test, a company is a PFIC if 75 percent or more of its gross income is passive. Under the asset test, a company is a PFIC if 50 percent or more of its assets are passive.[80]

a. Income test. For purposes of the income test, passive income is defined by reference to the subpart F definition in section 954(c).[81] Accordingly, the same analysis that applies to subpart F applies here, and Appco should not be treated as earning passive income because neither income from the sale of its apps nor advertising placed in its apps should give rise to royalty or rental income. Accordingly, Appco should not qualify as a PFIC under the income test.

b. Asset test. For purposes of the asset test, passive assets are those that produce passive income and active assets are those that produce active income. Similarly, assets that produce some active and some passive income are viewed as partly passive and partly non-passive in proportion to the relative amounts of income generated by those assets in the tax year. Intangible assets that produce

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[70]Section 956(a).

[71]H.R. Rep. No. 94-658, at 216-218 (1976).

[72]Section 956(c)(1)(D).

[73]ILM 201106007, *Doc 2011-3013*, *2011 TNT 30-20*.

[74]Reg. section 1.956-2(a)(1)(iv)(d).

[75]Reg. section 1.956-1(e)(1).

[76]ILM 201106007.

[77]As noted above, if the rights are principally used in the United States, then they will be considered to have been developed for use in the United States, absent a contrary showing. By its nature, a U.S. copyright would likely be considered to be principally used in the United States. Ned Maguire and Stuart Anolik, ''Subpart F and Source of Income

(Footnote continued in next column.)

Issues in E-Commerce,'' *Tax Notes*, Dec. 25, 2000, p. 1767, *Doc 2001-177*, *2000 TNT 248-93*; *compare* LTR 200229030, *Doc 2002-16790*, *2002 TNT 140-48* (the license of computer software to customers in the United States did not constitute a right to use a copyright in the United States because the taxpayer transferred copyrighted articles rather than copyright rights), *revoked by* LTR 200411016, *Doc 2004-5216*, *2004 TNT 50-55*.

[78]*Id.*; ILM 201106007. On the other hand, if Appco's development costs were capitalized rather than deducted, or if Appco purchased the rights to its intangible property from another party, there would be basis and an exposure to section 956 inclusion for Appco's U.S. shareholders. Maguire and Anolik, *supra* note 77.

[79]Sections 1291, 1293, 1295, and 1296.

[80]Section 1297(a)(1)-(2).

[81]Section 1297(b)(1).

identifiable items of income, such as patents and licenses, are included for testing purposes and are characterized on the basis of the income derived therefrom.[82]

Because intangible assets that generate active income are treated as active assets and intangible assets that generate passive income are treated as passive assets, the analysis under the PFIC asset test is similar to the analysis under the income test, except with a 50 percent rather than 75 percent permitted passive threshold. Thus, as long as the income from Appco's sale of apps is viewed as sale or exchange income based on the above analysis, Appco's assets should be viewed as entirely active.

H. Conclusion

Foreign app companies are likely to be popular investments and acquisition targets in the coming years. Assuming that they develop their software offshore and engage only in minimal activities in the United States, it is unlikely that they would be viewed as being engaged in a U.S. trade or business, or that they would have more than minimal FDAP income. Similarly, there should not be any significant risk of the anti-deferral rules applying to investors in foreign app companies based on the characterization of the income from the sale of apps as income from the sale or exchange or property.

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[82]Section 1297(a)(2); Notice 88-22, 1988-1 C.B. 489.