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Article

Character and Source of Income from Internet Business Activities

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Introduction

With the increasing interconnectedness of the global economy, the rapid advance of technology, and the ease with which information and services can move around the world, a clear understanding of the U.S. tax rules is vital to the long term success of any global technology-centered company. One of the most important issues in the taxation of U.S.-based multinational companies, particularly those companies that operate primarily in the internet business space, is the character and source of income.

For internet companies, as well as for other taxpayers, determining the character of income often involves trying to distinguish between income from the provision of services and income from intangible property (*e.g.*, royalties). The determination of whether income should be treated as services income or income from intangible property will directly impact how such income will be taxed under the U.S. tax rules, including the application of the source of income rules. For U.S. companies, the source of income is particularly important in determining the extent to which a foreign tax credit can be claimed.[1] For foreign companies and for U.S. companies making payments to foreign companies, the source of income is important to determine whether certain income may be subject to U.S. withholding taxes or taxed as income that is effectively connected with a U.S. trade or business.[2]

[1] Section 904(a) of the Internal Revenue Code (the "*Code*") operates to limit a taxpayer's foreign tax credit to the amount of U.S. tax imposed against the taxpayer's foreign source taxable income. Due to the mechanics of the § 904 foreign tax credit limitation, U.S.-based taxpayers prefer receiving income that is characterized as foreign source income.

[2] Non-U.S. persons generally are subject to U.S. taxation on U.S. source income that is considered fixed or determinable annual or periodical gains, profits, and income (*e.g.*, interest, dividends, rents, royalties). §§ 871(a) and 881. Typically, taxation takes the form of a U.S. withholding tax. Thus, the U.S. payor of this income to a foreign person can become a withholding agent, with liability for a failure to withhold. Alternatively, a non-U.S. person's U.S.-source income, such as U.S.-source services income, could constitute effectively connected income. §§ 871(b) and 882. Non-U.S. persons generally are not subject to U.S. taxation on foreign source income unless the income is considered effectively connected with the conduct of a U.S. trade or business. §§ 871(b) and 882.

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Character of Internet-Related Income: Services Income or Royalties?

The rapid growth of internet-related businesses such as online advertising, cloud computing, data warehousing, and internet hosting, adds further significance to the question whether income generated from these activities should be treated as services income or income from the use of intangibles.[3] Among other significant consequences, the characterization of income as services income or royalty income may affect a company's ability to maximize its foreign tax credits, the amount of income to be immediately taxed under Subpart F of the Code, withholding tax rates, and the application of the § 482 transfer pricing rules.

Traditionally, the distinction between services income and income from the use of intangible property has hinged on whether the owner and the user of the intangible property are the same person. Income derived from permitting another person to use property with a share of the profits reserved by the owner generally results in royalty or rental income.[4] In contrast, property used in connection with the provision of services is considered to be owned and used by the service provider, not the service recipient. The service provider may use its intangible assets in rendering the services, but keeps the assets.

Note, however, that if assets are produced from the rendering of the services, the service provider typically will not own the newly created assets. In this regard, the rendition of services usually involves the employment of capital and labor for the benefit of another, without the retention by the service provider of ownership rights or interests in the fruits of the services.[5] R&D type services, for example, where it is the service recipient (not the service provider) that obtains

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[3] For this purpose, intangibles generally includes patents, copyrights, secret processes and formulas, goodwill, trademarks, trade names, franchises and other like property. §§ 861(a)(4), 862(a)(4).

[4] *See, e.g., Commissioner v. Wodehouse*, 337 U.S. 369 (1949) (amounts received by the taxpayer for an exclusive copyright to the American market for stories to be written were royalties); Rev. Rul. 74-555, 1974-2 C.B. 202 (payments received by the taxpayer for the use of, or for the privilege of using, copyrights in the U.S. are royalties, and not compensation for labor or personal services, because the taxpayer did not give away control over what the taxpayer was to write or when it was to be written, but merely the right to publish the books or stories that were written.).

[5] *Boulez v. Commissioner*, 83 T.C. 584 (1984) (payments received by taxpayer for conducting an orchestra were payments for the performance of personal services because taxpayer has no property interest in the fruits of his work, *i.e.*, the recordings). Boulez highlights some of the problems in this area. Germany said the taxpayer received royalty income; the U.S. said the income he received was services income. He was taxed in both countries. The taxpayer unsuccessfully sought competent authority relief, but the countries' competent authorities couldn't agree. Thus, the taxpayer was forced to litigate, and lost again. Part of the taxpayer's problem was that his contract wasn't sufficiently clear as to the nature of his income. *Cf. Goosen v. Commissioner*, 136 T.C. No. 27 (2011) ("The characterization of petitioner's on-course endorsement fees and bonuses [as services income or royalties] depends on whether the sponsors primarily paid for petitioner's services, for the use of petitioner's name and likeness, or for both. We must divine the intent of the sponsors and of petitioner from the entire record, including the terms of the specific endorsement agreement.").

ownership of the intellectual property that is developed,[6] are more in the nature of building (developing) property for the service recipient, and thus constitutes the rendition of services.[7]

In determining whether income from internet related activities should be characterized as services income or income from the license of intangible property, it is helpful to consider § 7701(e), which sets forth a list of factors to consider in distinguishing between service contracts and leases. Section 7701(e), although enacted to provide guidance on the availability of certain investments credits, generally applies for all purposes of the income tax provisions of the Code.[8] A services contract can be treated as a lease if certain requirements are met.

Under § 7701(e)(1), factors indicating the existence of a lease (rather than a services contract) include: (A) the service recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant economic or possessory interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Applying these principles to internet related activities, it seems that income from activities such as cloud computing, data warehousing, database access, web-hosting transactions, and the like should be treated as income from services transactions rather than from the use of intangible property. In all of these activities, the operating company providing the service typically owns, controls, operates, and maintains the equipment on which the data or web site is stored. The operator provides customers with access to the equipment and software and the operator has the right to remove and replace equipment and software at will. Customers typically will not have possession of, control over, or any interest in, the equipment and software used. Moreover, customers use the equipment and software concurrently with other customers and pay a volume or time-based fee.

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6 *See, e.g., Karrer v. United States*, 138 Ct. Cl. 385 (1957) (taxpayer's compensation for products developed as a result of the taxpayer's research is compensation for personal services and not royalties because the taxpayer did not own any intellectual property rights in developed products).

7 In 1998, the Treasury promulgated Treas. Reg. § 1.861-18 in an attempt to deal with the characterization of income from software transactions involving computer programs as royalty or sales income. *See* T.D. 8785, 1998-2 C.B. 496. The key question in this regulation is whether substantially all the rights in the copyright, including the right to freely distribute the copyright, are transferred. The right to freely distribute the article resembles complete control and ownership of the article. If substantially all the rights are transferred, the transaction is a sale. However, Treas. Reg. § 1.861-18 generally does not distinguish between services, royalty, and sales income, since the only services that are covered by the regulation are software programming related services. *See* Treas. Reg. § 1.861-18(b).

8 *See* JCT Explanation of the Deficit Reduction Act of 1984, JCS-41-84, at 59. Section 7701(e)(1) reversed a prior case which the government had lost: *Xerox Corp. v. United States*, 656 F.2d 659 (Ct. Cl. 1981).

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The Organization for Economic Co-operation and Development (the "*OECD*") also regards income from such activities as services income.[9] The same conclusion can be reached with respect to targeted online advertising. Although targeted online advertising entails the use of intangible property (*e.g.*, search and matching algorithms, and valuable end-user data), the proper treatment of this income should be services income. A company that provides online internet advertising provides valuable sophisticated advertising services that allow advertisers to reach a particular audience. In this regard, an advertising customer generally pays for the dissemination of advertisements to particular users of a given web site, rather than for the customer's use of end-user data.

In the seminal case of *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), *nonacq.*, 1941-1 C.B. 18, *aff'd,* 127 F.2d 260 (5th Cir. 1942), the court found that the situs of the taxpayer's advertising activities were at the location of its broadcasting facilities in Mexico. Although the court did not have to rule on the character of the income (since both rental income and services income would have been sourced in Mexico), both the Board of Tax Appeals and the Fifth Circuit looked to the broadcasting equipment (*i.e.*, capital) and efforts (*i.e.*, labor) for the determination of the situs of the taxpayer's income producing activities.

The court's focus on the location of the broadcasting equipment and labor indicate that these activities should be characterized as services.[10] The location of the broadcaster's audience (largely in the U.S.) was not a relevant consideration even though advertisers paid for access to that audience. The Fifth Circuit stated that "all services required of the taxpayer under the contracts were rendered in Mexico."[11] Certain incidental activities in the U.S. – employees crossing the border to collect mail and meet with advertisers to get paid – and the solicitation of business in the U.S. by dependent (an employee) and independent agents did not change this conclusion since the compensation under the contracts was for the services performed in Mexico.

The Service's holding in PLR 6203055590A (Mar. 05, 1962) provides further support for this conclusion. In PLR 6203055590A, the taxpayer sold advertising to U.S. advertisers for publication in a magazine to be distributed only outside of the United States. For purposes of determining the source of the taxpayer's advertising income, the Service only considered the sourcing rules under §§ 861 and 862 for compensation for labor or personal services. The Service characterized the payments to the taxpayer as "remuneration for its activities in disseminating their advertisements in its magazine published and distributed outside the United States." According to the Service, the "source of the advertising revenue to be received by [the taxpayer] from the U.S. advertisers, is the capital and labor employed in the publishing and distributing centers [outside the United States] with and through them, [the taxpayer] will carry on the activities to produce the advertising revenue." In other words, the taxpayer employed capital and labor for advertising, resulting in income from services.

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[9] *See* Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs by the Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments (February 1, 2001) (the "*OECD Report*").

[10] *See also Korfund Co. v. Commissioner*, 1 T.C. 1180, 1187 (1943) ("The *Piedras Negras Broadcasting Co*. case . . . involved employment of capital and labor in a foreign country in connection with the rendition of service . . . .").

[11] 127 F.2d at 260.

The OECD also regards income from online advertising activities as services income. As stated in the OECD Report, "All members of the Group agreed that the payments arising from [advertising] would constitute business profits falling under Article 7 [i.e., business profits] rather than royalties, even under alternative definitions of royalties that cover payments 'for the use, or the right to use, industrial, commercial or scientific equipment.'"[12]

Sourcing of Internet Services Income

In today's internet-driven business space, activities such as online advertising, cloud computing, data storage, internet hosting, and customer support often can cross multiple national boundaries and pose a challenge to the application of traditional sourcing rules. As discussed above, the income derived from the activities generally should be treated as income from services, rather than income from intangible property.[13]

General Sourcing Rule.

The general rule is that the source of income for services is the place of performance of those services. §§ 861(a)(3) and 862(a)(3). Traditionally, services have been performed by individuals located at easily identified physical locations. However, as services today increasingly involve multiple activities, personnel, locations, and technologies, determining the place of performance of services has become more challenging. Even with these added complexities, the basic source of income rules for services are still instructive in planning for today's more complex business transactions.

The *Piedras Negras* case provides useful guidance in determining the source of income for high tech companies. As discussed above, the *Piedras Negras* case involved a foreign radio station located close to the U.S. border that broadcasted programming targeted primarily at U.S. listeners. The majority of the foreign radio station's income was derived from U.S. advertisers. The studio and broadcasting plant were located in a foreign country (Mexico) and the employment of capital and labor was outside of the U.S. The Fifth Circuit stated that the source of income "is the situs of the income-producing service," that is, the "services required of the taxpayer under the contracts."[14] Under these facts, the court held that there was no U.S. source income because the principal place of business was outside the U.S. and the labor and activities that produced the income were outside the U.S.

Piedras Negras continues to be relevant to high tech companies today because it addresses issues that arise when a multinational corporation provides complex services in multiple locations. Importantly, the case held that the location of the customer is not relevant in determining the source of income. Just recently, the Fifth Circuit in *Container Corporation v. Commissioner,* 2011 U.S. App. LEXIS 8961, at *4, 107 AFTR 2d 2011-1831 (May 2, 2011), cited the *Piedras Negras* case in determining the source of income for guaranty fees and stated that "[i]t is clear

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12 OECD Report, *supra* note 9, at 28.

13 Section 861 sets forth significantly different source rules for services income from those from royalty income. *Cf.* §§ 861(a)(3) and 861(a)(4). Whereas the source of services income is generally the place of performance of the services (§§ 861(a)(3), 862(a)(3)), income from the use of intangibles, such as royalty income, is generally sourced to the place where the licensee uses or is entitled to use the property (§§ 861(a)(4), 862(a)(4)).

14 127 F.2d at 260-61.

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that the source of payments for services is where the services are performed, not where the benefit is inured."

Many internet companies, like search engines and social networking sites, earn a significant portion of their revenue from online advertisements. An interesting issue with advertisements is that the ad content is usually created by third party advertisers. Advertisers pay for access to potential customers, and they are willing to pay more money if they can be assured that an ad will reach either a large number of people or a selected target audience. To determine the situs of the income producing activity, the IRS or a court generally would apply a facts and circumstances test.

While the location of the servers could be one factor the IRS or a court would consider, the server location alone should not be a determinative factor for sourcing advertising income. Servers often can be located in different locations and are not necessarily the situs of the income producing activity. Server capacity also can be obtained from third parties and can be viewed as a commodity service that arguably does not add a significant amount of relative value. Further, server utilization can switch from one server to another based on capacity, possibly involving servers in different countries. Although one might equate servers to the broadcasting equipment used in the *Piedras Negras* case, the location of the broadcasting equipment was only one factor that was considered in the court's analysis.

An OECD discussion paper states that in the context of stand-alone computer servers, the functional and factual analysis is likely to show that the server is "performing only routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions."[15] Accordingly, the OECD Paper states the activities of the servers are very unlikely to warrant being attributed a substantial share of the profit. The OECD Paper also notes that where personnel are present "to perform maintenance and online services tasks, the quantum of the profit attributable to the permanent establishment would be commensurate with what independent service providers would be expected to earn in a similar situation."[16]

Since source of income is determined according to the location where the income producing activity occurs (*i.e.*, the location of the services required under the contract), the location of the employees that provide the service and the property used in the service are relevant. If all of a company's employees and property are located in a foreign country, it normally should be easy to conclude that the source of compensation for services should be outside the U.S. However, additional questions can arise when contributions to the service are provided by third parties.

Contributions to Services from Third Parties.

Complexities can arise when a service provider contracts with related and unrelated parties to perform some or all of the activities necessary to provide the service. Since multinational corporations contract with various related and unrelated entities in various locations, taxpayers should be mindful of situations in which the activities of certain agents could be attributed to the principal for purposes of applying the source of income rules.

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[15] Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transaction, OECD, at 4 (February 2001) ("*OECD Paper*"). *See also* Report on the Attribution of Profits to Permanent Establishments, OECD (December 2006).

[16] OECD Paper, *supra* note 15, at 4-5.

If a dependent agent conducts activities in the U.S. on behalf of the principal, income earned by the principal but which is generated in part by that agent's activities could be deemed U.S. source income to that extent. Conversely, if a dependent agent is located in a foreign jurisdiction, then the income potentially could be classified as foreign source services income. However, the activities of independent agents and entities otherwise dealing with the principal at arm's length generally should not be attributable to the principal and should not affect the source of the income. Further, the fact that a parent and its subsidiary, or two subsidiaries, contract with each other for the provision of services should not automatically create a relationship that would affect the source of income.

In *Miller v. Commissioner*, 73 T.C.M. (CCH) 2319 (1997), *aff'd,* 166 F.3d 1218 (9th Cir. 1998), the Tax Court held, and the Ninth Circuit affirmed, that services performed by a subsidiary did not create U.S. source income for the foreign parent company in that the relationship between the subsidiary and the parent was essentially no different from that of an unrelated independent contractor. In *Miller,* a foreign corporation was paid by U.S. entities to perform research and development. The foreign corporation subcontracted all of the research and development work to certain related and unrelated entities, including its wholly owned U.S. subsidiary. Since the foreign corporation did not itself perform services in the United States, the court held that there could not be any U.S. source income attributable to the foreign corporation.

In reaching its conclusion in *Miller*, the court found that there was no evidence requiring the court to disregard the corporate form of the U.S. entity. The court treated all transactions between the parent and the subsidiary as being conducted at arm's length. Even though the U.S. company was a wholly-owned subsidiary of the foreign corporation, it was doing business under its own name as a separate distinct entity and thus the activities of the U.S. subsidiary did not cause the foreign parent corporation to have U.S. source services income.[17] The court stated that in order for the foreign parent corporation to be considered as having U.S. source income by virtue of the performance of services, the foreign corporation itself would have to perform the services through agents or employees of its own. Even here, however, the relevant services should be limited to those services that are required of the taxpayer under the contract, as noted by the Fifth Circuit in *Piedras Negras*.

Based on the principles established in *Miller,* a subsidiary's provision of services should not be attributed to a different entity in the group in determining the source of that entity's services income provided that the corporate identity of the subsidiary is respected, the activities are conducted on an arm's length basis, and the relationship is no different from that of unrelated independent contractors. Both entities

[17] 73 T.C.M. (CCH) at 2323 ("The fact that a lower tier corporation performs some services in the United States is insufficient to support a conclusion that its higher tier parent corporation also performs services in the United States. The two corporations are and should be treated as separate persons unless one corporate form is a sham.").

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should have real operations and exercise a measure of autonomy.[18]

The Supreme Court in *Commissioner v. Bollinger*, 485 U.S. 340 (1988), established a clear bright line test for when the tax consequences of property held by an agent will be attributed to a principal. This same test could be useful in identifying situations in which the activities of a genuine agent may be attributed to a principal for income sourcing purposes. In *Bollinger*, the Court held that losses generated by apartment complexes that were registered in the name of certain corporations were attributable to the principal because the corporations owned the apartment complexes merely as agents of the principal. The Court held that the activities (in this case, ownership of the apartment complexes) of one corporation should be attributed to another: (1) when the fact that the corporation is acting as an agent is set forth in a written agreement, (2) the corporation functions as an agent and not a principal, and (3) the corporation is held out as an agent to third parties.

The Court reconciled its holding in *Bollinger* with an earlier case, *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949),[19] stating that the parent's control over its subsidiaries does not establish the existence of an agency relationship and that agreements to pay the parent all profits above a nominal amount are not determinative since income must be taxed to those who actually earn it without regard to assignment.[20]

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[18] The Supreme Court has maintained that the corporate entity doctrine serves a useful purpose in business life, and that a corporation will remain a separate taxable entity as long as the corporation carries on a business purpose. In *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), the Supreme Court held that a corporation is a separate entity and not an agent of its stockholders. However, the Court noted that the corporate form may be disregarded when it is a mere sham or unreal. In *Moline Properties* the Supreme Court held that there was neither an agency contract, nor the usual incidents of an agency relationship, and that the mere existence of a corporation with one or several stockholders did not make the corporation the agent of its stockholders.

[19] The Court in *National Carbide* held that certain subsidiary corporations were not acting as genuine agents of the parent corporation, and therefore the subsidiaries were required to recognize the full income earned from their respective operations (rather than treating the income as directly belonging to the parent corporation).

[20] The Second Circuit in *Le Beau Tours Inter-America, Inc. v. United States*, 547 F.2d 9 (2nd Cir. 1976), *aff'g* 415 F. Supp. 48 (S.D.N.Y. 1976), attributed the activities of a parent corporation to its subsidiary for purposes of determining the source of the subsidiary's services income. This decision is of questionable validity. The taxpayer in *Le Beau Tours* organized vacations in Latin America for U.S. tourists and claimed that all of its income was from foreign sources because it received its income by making these arrangements in foreign countries for oversea travelers. The U.S. parent corporation performed activities in the U.S. such as advertising and other administrative functions. The taxpayer asserted that its activities only generated foreign source income because the activities performed by the U.S. parent generated U.S. source income only for the U.S. parent. The court recognized that a corporation may divide its business by forming a separate subsidiary. However, the court stated that the U.S. corporation was created for the sole benefit of the Latin America operations. The Second Circuit's decision in *Le Beau Tours* cannot easily be reconciled with the Supreme Court's decisions in *Moline Properties* and *Bollinger*. Based on the Supreme Court's decision in *Moline Properties*, the court in *Le Beau Tours* should have treated the U.S. corporation as a separate distinct entity unless it was a sham operation. According to *Bollinger*, decided after *Le Beau Tours*, the court in *Le Beau Tours* should not have disregarded the separate corporate entity for tax purposes unless the corporation was an agent and held itself out as an agent to third parties. *Miller*, also, is contrary to *Le Beau Tours*.

Although issued prior to *Bollinger,* a technical advice memorandum issued by the Service also is relevant. With facts very similar to those in *Piedras Negras,* the Service held in TAM 8147001 (Jan. 3, 1979), that no agency relationship existed between a foreign corporation, which owned a radio station in a foreign country, and its owner, a U.S. corporation. The U.S. corporation was not the foreign corporation's exclusive agent and the foreign corporation did not exercise any control over the U.S. corporation's activities. Further, the foreign corporation did not require that the U.S. corporation only sell radio time on behalf of the foreign corporation's radio station. Based on these facts, the Service concluded that the source of income was from sources outside the U.S.

In light of this authority, multinational internet businesses should be mindful of how they contract with related and unrelated parties to provide any activities that are necessary to generate the principal's profits. The characterization of agency relationships, the corporate form, and the agreements are critical to effective international tax planning generally, and the sourcing of income in particular.

Conclusion

The character and source of income are important components of any multinational tax planning effort. However, identifying the proper character and source of income for companies that operate in today's high tech business environment, including internet-related businesses, can be especially important given the ease with which technology and services seemingly can cross national boundaries.

To minimize the likelihood of disputes with both U.S. and foreign tax authorities concerning the character and sourcing of services income, taxpayers are well-advised to clearly specify not only the scope of any rights that are being provided (or not provided) as part of the services, but also the location(s) in which the services are to be performed. Provided that the contract terms reasonably reflect the actual rights and services being provided, having such contract terms in place may go a long way towards avoiding unnecessary surprises and disputes concerning the tax treatment of services income.[21]

About the authors

Andy Kim and Jim Fuller are partners, and Larissa Neumann and Idan Netser are associates in the Mountain View office of Fenwick & West, LLP. Jim Fuller is also a member of the San José State University MST Program's Tax Advisory Board and a frequent speaker at the TEI-SJSU High Tech Tax Institute. For more information about the authors and Fenwick & West, visit http://www.fenwick.com.

[21] *Cf. Goosen v. Commissioner,* 136 T.C. No. 27 (2011) ("The contracting parties to the transaction have the burden of making a reasonable allocation of the royalty income between the U.S. and foreign sources.).

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