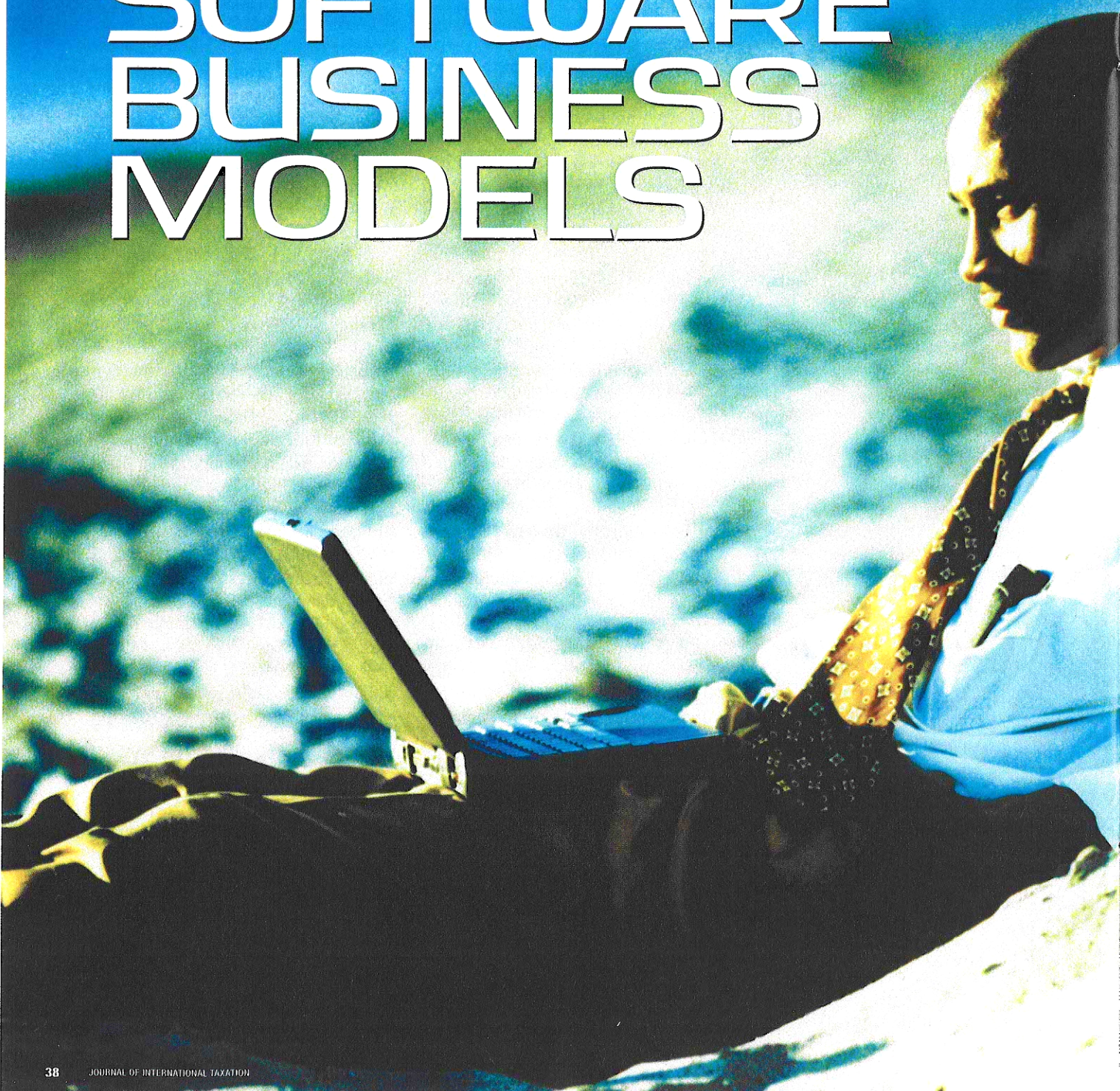


Favorable IRS Guidance on Tax Benefits for

U.S. POSSESS

SOFTWARE BUSINESS MODELS





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A concession of up to 90% of the regular possession corporate income tax rate is possible, but businesses seeking to locate will still need to scrutinize their own business models and operating activities to ensure that the tax benefits are achievable because Section 937(b), the Temporary Regulations thereunder, and Notice 2006-76 all involve a fairly complex interplay of various U.S. tax concepts and rules.

ERIC D. RYAN

It is not often that the IRS tells you what you can do to obtain the benefits of a tax holiday,

but on September 18, 2006, the Service published favorable guidance for software and other e-commerce companies looking to establish operations in U.S. possessions that have low-tax regimes. Notice 2006-76, 2006-38 IRB 459, provides two common e-commerce business models—one a "seller" of software, and another an "application service provider"—as positive examples that will satisfy the requirements of new Section 937(b), which could otherwise limit tax benefits. The Notice is effective immediately.

This guidance should have an immediate impact on the attractiveness of U.S. possessions, such as the U.S. Virgin Islands (USVI), that have an active tax concession

regime. Based on various economic factors, a concession of up to 90% of the regular possession corporate income tax rate is possible.¹ That would make for a corporate tax rate of approximately 4%, rivaling those of Ireland, Singapore, and various Caribbean spots.

Although this guidance is particularly welcome by the possessions, businesses seeking to locate there will still need to scrutinize their own business models and operating activities to ensure that the tax benefits are achievable. This is because Section 937(b), the Temporary Regulations thereunder, and Notice 2006-76 all involve a fairly complex interplay of various U.S. tax concepts and rules.

Background of Section 937

Section 937 was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357, October 22, 2004). A few months earlier, the IRS expressed concern in Notice 2004-45, 2004-2 CB 33, over reports of abuse of the USVI tax concession regime, particularly whether certain U.S. citizens and residents had truly become bona fide residents of the possession.² That Notice also identified several “meritless” filing positions. Many viewed Notice 2004-45 as a warning that the entire USVI tax regime was under attack. Within this charged atmosphere, new Section 937, which includes rules on determining residency,³ the sourcing of income and determining effectively connected income,⁴ and reporting requirements,⁵ was added to the broader tax bill.

To understand the potency of Section 937(b), it is important to recognize that some U.S. possessions operate what is commonly referred to as a “mirror tax system.” Under this approach, the tax laws of the possession are identical to those of the United States, except that residents of these possessions remit their tax liabilities to the possession rather than to the United States.

Despite this mirror system, it is generally possible for the USVI to reduce possession taxes for certain taxpayers as an incentive to develop operations there. Section 934, which was added to the Code in 1960, specifically allows for this possibility. However, Section 934(b)(1) generally limits the tax reduction to “income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands.”

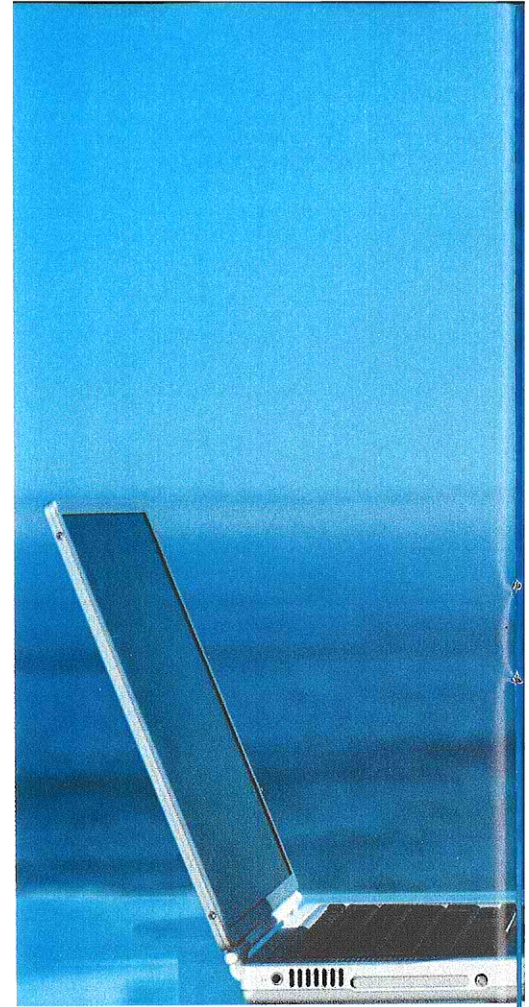
Prior to the enactment of Section 937(b), it was unclear how USVI-source income or effectively connected income should be defined. This might be a little

surprising, since for many years Section 934(b)(4) has given Treasury the express authority to write Regulations on the topic. In fact, no such Regulations were ever issued. Accordingly, some taxpayers have taken a general facts-and-circumstances approach to these determinations, rather than sticking with the “mirror code” tax approach. When the IRS got wind of these expansive interpretations, it expressed its shock in Notice 2004-45, calling such broad interpretations meritless.

Section 937(b)(1) now clearly requires the determination to be made on existing U.S. tax principles of source and effectively connected income determinations. Section 937(b)(2) further states that any income from U.S. sources or effectively connected with U.S. trade or business is not to be treated as possession source or connected. This “all or nothing rule” creates a bright-line test that can narrow the availability of the possession tax regime.

For example, even though a creator/licensor of intellectual property (IP) has operations solely in the USVI, and all of its activity is within the USVI, where the IP is used in the United States, income from licenses will be sourced to the United States. This result occurs due to the royalty sourcing rule of Section 861(a)(4), which requires a determination of where the IP is used. Since in this example the income is U.S. source, it cannot be USVI source, and it cannot qualify for possession tax concessions. That the income might be effectively connected with a USVI trade or business does not trump the U.S.-source determination.

Of course, under U.S. tax law, different types of income require an analysis of different underlying factors to determine source, such as where services are performed or title of goods passes on sales of inventory.⁶ Thus, a thorough understanding of U.S. tax law under Sections 861 through 865 is critical to understanding what types of income can



and cannot qualify for possession tax concessions for certain business models.

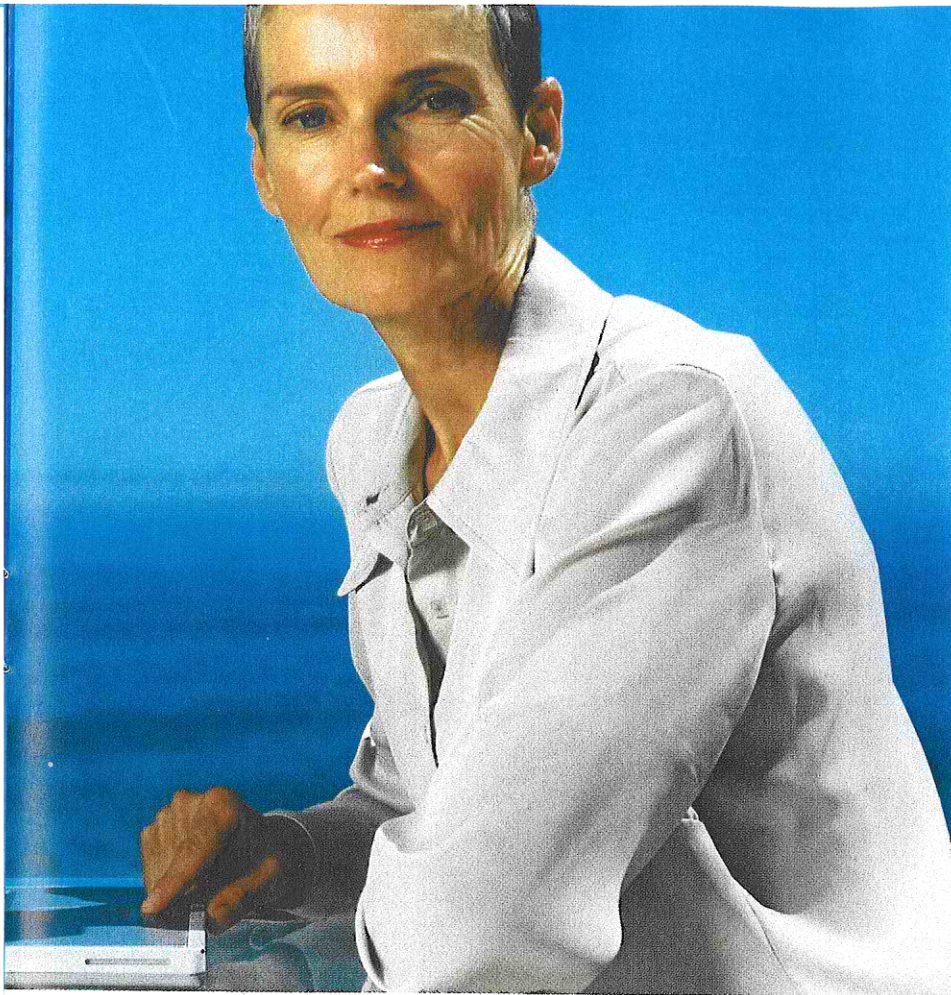
In recognition that the full panoply of the existing source rules in the Code and Regulations may not, in fact, be consistent with the policy of encouraging development in the possessions, the legislative history and the Code itself provide that Regulations can amend the existing rules to fit these circumstances.⁷ To date, Treasury has provided one exception, but interested parties are hoping for more.

Section 937 Temporary Regulations

On April 6, 2005, Treasury and the IRS issued Temporary and Proposed Regulations (REG-159243-03, TD 9194), which were revised on January 30, 2006 (TD 9248). Temp. Regs. 1.937-2T and -3T include rules for source determinations and effectively connected income determinations, respectively.

The Regulations provide a direct link to the existing source rules of Sections 861 through 865 and grant one exception from the general source rules: the “manufacturing exception” relating to the sale of certain manufactured

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goods does not apply.⁸ Thus, it appears that for goods manufactured in the USVI that are sold with passage of title in the United States, the special exception would provide that the entire source of the income would be the USVI. This makes sense, since otherwise a significant portion of income from this type of substantial USVI operation would be adversely affected.

Unfortunately, the Temporary Regulations do not have many positive examples of operations in the USVI that continue to qualify as USVI source and effectively connected income, under either the general source and effectively connected tax rules or the special exception. Thus, commenters have noted that the existing Section 937(b) Regulations provide plenty of warning of what not to do, but do not give a road map of how the tax concessions can be obtained. Given the atmosphere in 2004, Treasury and the IRS no doubt had little enthusiasm for promoting tax concessions in the Regulations. But it is, after all, U.S. territories that stand to benefit from the incremental economic activity enticed to locate in the possessions, so why not help them a little?

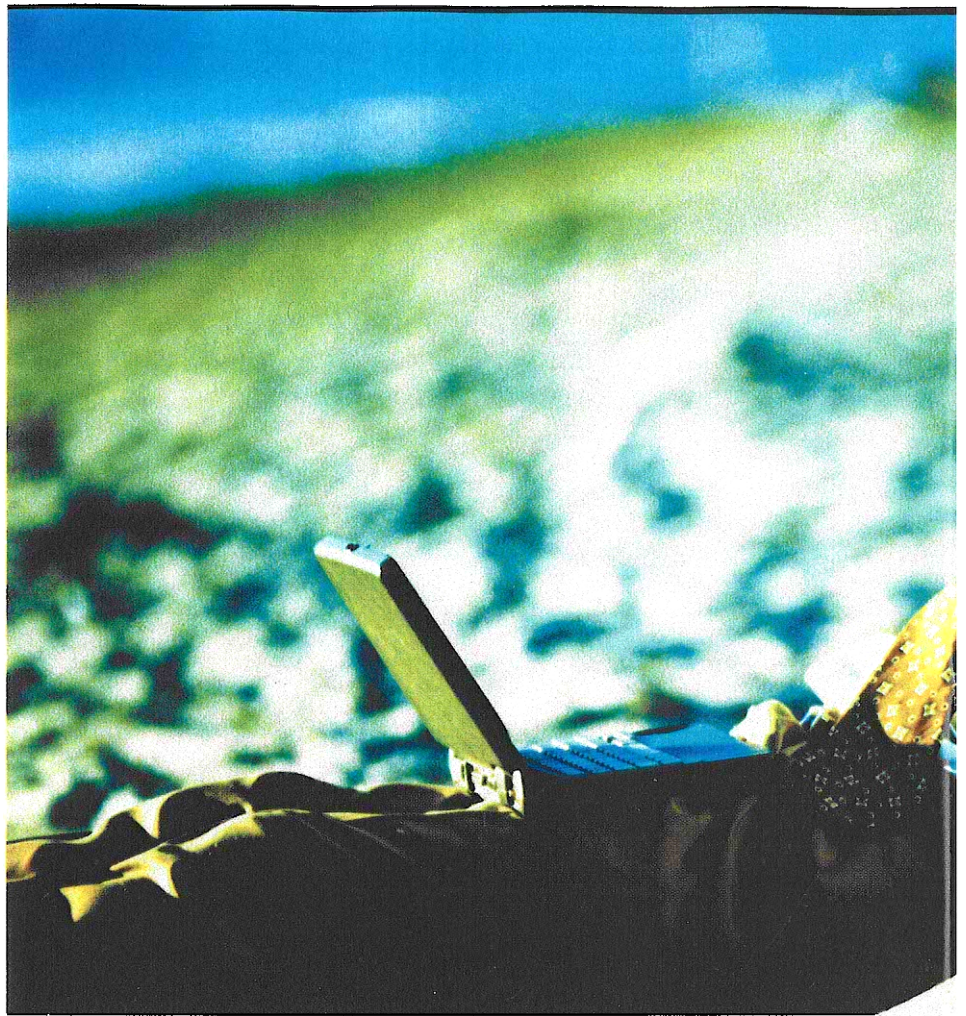
Notice 2006-76 Examples

To redress the perceived imbalance of overly pessimistic guidance, the IRS issued Notice 2006-76, which provides two helpful examples of software operations that continue to qualify for tax concessions in the possessions.

In the first example, software company A in Territory X develops software for sale. The taxpayer's software is either loaded onto CDs at the taxpayer's location in Territory X or downloaded from the Internet. In either instance, U.S. customers are involved. The taxpayer's contract provides that title passes to the customer in Territory X. The income from the transactions is therefore sourced to the possession, under the principles of Section 863(a).⁹ The income is also connected to the conduct of a trade or business in Territory X.

One key element in this example is that it incorporates the framework of Reg. 1.861-18 for determining the type of income involved. Thus, a taxpayer can be assured that if its contractual arrangement with its customer truly calls for the sale of a copyrighted article under tax principles, it is irrelevant that the contract is entitled "software license"—the income is not royalties despite the label.¹⁰

The **Section 937** "all or nothing rule" creates a bright-line test that can narrow the availability of the possession tax regime



Another critical element is that the taxpayer is able to designate the place of title passage, even for electronic transmissions. In practice, the actual location of title passage in a near-instantaneous electronic delivery arrangement might be hard to pinpoint. The Notice could have, but did not, explore how the "manufacturing exception" in the existing Temporary Regulations would be applied where the software was developed in the Territory and yet title was passed in the United States; arguably, in that situation, all of the income would still be sourced to the Territory. Nonetheless, Notice 2006-76 is a clear directive on how customer contracts, whether hard copy or electronic delivery, need to be crafted to receive the possession tax concessions.

In the second example, a company in Territory X has developed software that is provided to U.S. customers under an application server model. Here, the customer submits its own data to the company's servers in Territory X, where reports are generated and sent back to the customer. The customers pay a monthly fee under a subscription agreement and do not take possession of any of the company's software. The

example assumes that this is a "service." Since the services are performed within Possession X, and are connected with the company's trade or business in that possession, Temp. Regs. 1.937-2T and -3T will not operate to prevent the income from being Territory X source and effectively connected income.

By stating that the server and the activities are located in Territory X, the second example has some strong facts that make it easy to assume that the income should be sourced to Territory X. One can imagine other situations where the facts may not be quite so clear. However, the Notice provides a clear message about the importance of the location of the operations and the servers for the application service-provider model.

Of course, there is a wide variety of e-commerce services that can be delivered via an application service-provider business model. Online reference works, distance learning, community websites, multi-player real-time games, ticketing agencies, and webcasts are just some of the many businesses that deliver services via electronic means. There is no reason to believe that the logic of the second example would not apply to these business types as well.



What Notice 2006-76 Does Not Address

By its very terms, Notice 2006-76 states that the examples address only the rules under Section 937(b) and not circumstances where a taxpayer would be engaged in the conduct of a trade or business within the United States under Section 864. This is not overly surprising, since the determination of whether a U.S. trade or business exists is a facts-and-circumstances analysis, with not a great deal of regulatory guidance on the topic.¹¹

By positing that all activities of the software companies are located in the Territory, the examples unfortunately may give the impression that that is

required. But this would be a false conclusion. To the contrary, the Territory company's connections with the United States simply must not rise to the level of the conduct of a U.S. trade or business.

For instance, although the examples assume what appears to be a stand-alone corporation in the Territory, it should be permissible for the enterprise to be a subsidiary of a U.S. parent company. A mere ownership interest, without more, does not generate a taxable presence for the Territory subsidiary.

Also, it should be permissible for the Territory enterprise to have contractual relationships with its affiliates in the United States. Thus, the Territory enterprise should be able to enter into cost-sharing arrangements with its U.S. affiliate, and obtain an interest in intangible assets.¹² Similarly, the Territory affiliate should be allowed to apply a business model that sells goods to a U.S. affiliate for further distribution to consumers, as long as the title passage provisions are managed correctly, and the parties' transfer pricing follows the arm's-length principle of Section 482.

A final example of permissible activities relates to U.S. travel by Territory-company employees. Although it would not be a good idea for these traveling employees to conclude contracts with U.S. customers on these visits, there are a host of activities, such as visiting with

suppliers, that should not establish a U.S. trade or business.

Thus, it will be important for any enterprise seeking to claim the benefits of the tax concessions of possessions to identify the business model to establish the type of income generated, so that a precise analysis of the income source can be established. Moreover, the enterprise will need to further analyze its operations and connections with the United States so that it can have some assurance that it is not creating income that is effectively connected with a U.S. trade or business. These tax analyses are not common attachments to applications for tax holidays, but rather seem more the province of lawyers providing tax opinion letters. Perhaps, for operations in the possessions, these tax opinion letters will become common.

Conclusion

Notice 2004-76 has given some welcome examples of business models that will continue to qualify for tax concessions provided by U.S. possessions, but each taxpayer's own facts will need to be scrutinized for application to the rules. Treasury and the IRS plan to include the examples of Notice 2006-76 in the final Regulations under Section 937(b). Until the Regulations are issued in final form, taxpayers may rely on these examples as illustrative of the Temporary Regulations, so, as noted above, Notice 2006-76 applies immediately.

Treasury and the IRS also are considering other comments relating to exceptions or modifications of the Regulations. It is clear that the examples in Notice 2006-76 only confirm the current tax rules; no new exception is provided. Although there is clear legislative history and statutory authority for Treasury and the IRS to develop more taxpayer friendly exceptions, only time will tell whether they will be more generous. ☐

¹ Generally, the tax concessions are granted by the Economic Development Commission, a program under the Virgin Islands Economic Development Authority. As Notice 2006-76 deals with software and other e-commerce companies, it appears that one of the primary beneficiaries would be the University of the Virgin Islands' Research and Technology Park, which seeks to encourage high-tech investments with tax concessions. See www.uvirtpark.org/overview.html.

² See "IRS Warns About Virgin Islands Tax Scheme," 15 JOIT 6 (September 2004).

³ Section 937(a). In general, the new rules require 183 days of presence during the tax year in the possession, no tax home outside the possession, and no closer connection to the United States or other country than to the possession.

⁴ Section 937(b).

⁵ Section 937(c).

⁶ See Sections 861(a)(3) and (6).

⁷ The flush text of Section 937(b) (source rules) reads "Except as provided in regulations, for purposes of this title—" (emphasis added).

⁸ See Temp. Reg. 1.937-2T(d).

⁹ See also Section 861(a)(6).

¹⁰ See Reg. 1.861-18(g)(1).

¹¹ For example, see Reg. 1.864-2, which offers some exclusions for trading in stock, securities, or commodities, but little guidance on what actually constitutes a U.S. trade or business.

¹² See Reg. 1.482-7(a), which provides that a cost-sharing arrangement is not a partnership and does not, by itself, create effectively connected income.