Notice of Proposed Rulemaking and Notice of Public Hearing

Classification of Certain Transactions Involving Computer Programs

REG–251520–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the tax treatment of certain transactions involving the transfer of computer programs. The proposed regulations provide rules for classifying such transactions as sales, licenses, leases, or the provision of services or of know-how under certain provisions of the Internal Revenue Code and tax treaties. This document also provides notice of a public hearing on the proposed regulations.

DATES: Comments must be received by February 11, 1997. Requests to speak (with outlines of oral comments) at a public hearing scheduled for March 19, 1997, at 10 a.m. must be submitted by February 26, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–251520–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–251520–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternately, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http:\\www.irs.ustreas.gov\prod\tax_regs\comments.html. The public hearing will be held in the NYU Classroom, room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, William H. Morris, (202) 622–3880 or Carol P. Tello, (202) 622–3880; concerning submissions and the hearing, Christina Vasquez, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

These regulations are proposed to clarify the treatment under certain provisions of the Internal Revenue Code (Code) and tax treaties of income from transactions involving computer programs.

I. Introduction

Computer programs are generally protected by copyright law. Typically the protection afforded by copyright law is a principal source of the value of a computer program to the owner of the copyright. Conversely, the principal source of the value of a computer program to the purchaser of a copy of the program is not the protection afforded by copyright law, but the right to use or sell the copy. In this regard, computer programs are similar to other copyrighted works such as books, records, motion pictures, etc. For example, when a copy of a book is purchased, the purchaser does not thereby also acquire any copyright rights. Accordingly, the proposed regulations generally distinguish between transactions in a copyright and in the subject of the copyright.

In developing regulations addressing the treatment of computer programs, the IRS and Treasury generally have been guided by the following principles: (i) the rules should take into account the special features of computer programs, such as the ability to deliver copies electronically as well as physically, and to make perfect copies at little or no cost, and (ii) wherever possible, transactions that are functionally equivalent should be treated similarly. For example, a transaction that involves the transfer for internal use only of fifty copies of a computer program should generally be treated the same as a transfer of one copy (for internal use) with the right to make forty-nine other copies all for internal use. Similarly, if the right to use a computer program is limited in time, the transaction should generally be treated the same irrespective of whether, at the end of the period of permitted use, a disk containing the computer program must be returned, or the program automatically deactivates itself.

II. Copyright Law Principles

Distinguishing between transactions in a copyright and in the subject of the copyright requires an examination of U.S. and foreign copyright law (e.g. EC Directive on Legal Protection of Computer Programs, 1991 (91/250/EEC); and the Berne Convention (Paris Text, July 24, 1971)). An overview of U.S. copyright law as it relates to computer programs is set forth below. However, the IRS and the Treasury do not purport in these regulations to interpret U.S. copyright law and these proposed regulations should not be taken as an expression of the legal or policy views of the U.S. Copyright Office.

The Copyright Act of 1976, as amended (17 U.S.C. 101 et seq.), provides protection against infringement of the exclusive rights of the owner of a copyright in original works of authorship, fixed in any tangible medium of expression, including literary works. (17 U.S.C. 102.) The term *literary works* is defined to include: ''. . . numbers, or other verbal or numerical symbols or indicia, regardless of the nature of the material objects, such as books, periodicals, manuscripts, phonorecords, film, tapes, disks, or cards, in which they are embodied.'' (17 U.S.C. 101.) Thus, computer programs are literary works for purposes of the Copyright Act.

The Copyright Act grants five exclusive rights to a copyright owner. Of these, three are most relevant in the case of computer programs: the right to reproduce copies of the copyrighted work (17 U.S.C. 106(1)); the right to prepare derivative works, which may themselves be separately copyrighted, based upon the copyrighted work (17 U.S.C. 103 and 106(2)); and the right to distribute copies of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease or lending (17 U.S.C. 106(3)). Additionally, in certain circumstances, the right to publicly perform the copyrighted work (17 U.S.C. 106(4)) and the right to publicly display the copyrighted work may also be relevant (17 U.S.C. 106(5)).

Thus, under U.S. copyright law, the user of a computer program who does not possess any of those five rights (or parts of them) has obtained only rights to use the copyrighted article it possesses. Generally, that user is treated only as having received a copy of the copyrighted work. Under U.S. copyright law, a copy is a material object in which a work is fixed by any method now known or later developed, and from which the work can be perceived, repro-

duced, or otherwise communicated, either directly or with the aid of a machine or device (17 U.S.C. 101.). In these proposed regulations a copy is also referred to as a ''copyrighted article.'' The distinction between copies and copyrights is made most clearly in section 202 of the Copyright Act which provides:

> Ownership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied. Transfer of ownership of any material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object; nor, in the absence of an agreement, does transfer of ownership of a copyright or of any exclusive rights under a copyright convey property rights in any material object.

Certain rights pass to the purchaser of a copy of a computer program. The most important of these is the right to sell (but not, without permission, to lease, rent or lend) the copy to another person. (17 U.S.C. 109.) Additionally, the owner of a copy of a computer program has the right to make a copy of that copy as an essential step in the utilization of the program (e.g., copying to the memory of the computer) and may also make a copy for archival purposes. (17 U.S.C. 117.) If, however, the owner of the copy sells that copy, all copies made pursuant to the 17 U.S.C. 117 right must be destroyed. III. The Proposed Regulations and Copyright Law Principles

Although the proposed regulations are guided by copyright law principles in determining whether a copyright right or copyrighted article has been transferred, the regulations depart in some cases from a strict reliance on copyright law in order to take into account the special nature of computer programs and to treat functionally equivalent transactions in the same way. For example, the proposed regulations do not treat the transfer of a right to copy as the transfer of a copyright right, unless it is accompanied by the right to distribute the copies to the public.

Thus, where a corporation obtains the right, under an agreement, to make fifty copies of a program for use by its employees at one location (a site license) the transaction is not, for all practical purposes, any different from a transaction in which fifty individual disks are purchased. Accordingly, the proposed regulations treat the transaction as the transfer of a copyrighted article, rather than of a copyright right, despite a copyright law requirement that the corporation receive a ''license'' to make those fifty copies. Similarly, under the proposed regulations, the transfer of a computer program in perpetuity for internal use only on a single disk or set of disks in return for a one-time payment, in a transaction styled as a license of copyright rights (a so-called shrink wrap license), is treated as the sale of a copyrighted article and not the transfer of a copyright right. Therefore, such a transfer is classified solely as the sale of a copyrighted article for the purposes of the proposed regulations.

IV. Explanation of Provisions

Section 1.861–18(a)(1) of the proposed regulations describes the scope of the proposed regulations. These proposed regulations provide rules for classifying transfers of computer programs for the purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1057, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

Section 1.861–18(a)(2) describes the categories of transactions relating to computer programs. In particular, a transfer of a copyright right may be either a sale or license of that right and a transfer of a copyrighted article may be either a sale or lease of that copyrighted article. Section 1.861– 18(a)(3) defines the term *computer program.*

Section 1.861–18(b)(1) provides that a transaction involving the transfer of a computer program will be classified as either the transfer of a copyright right, the transfer of a copyrighted article, the provision of services relating to the development of a computer program, or the provision of know-how.

Section 1.861–18(b)(2) provides that a transaction involving computer programs which consists of more than one of the categories in paragraph (b)(1), is treated as separate transactions. Any resulting transaction that is de minimis, however, taking into account all facts and circumstances, will not be treated as a separate transaction.

Section 1.861–18(c)(1)(i) provides that the transfer of a computer program will be classified as the transfer of a copyright right if the transferee acquires one or more of the rights set forth in paragraph (c)(2).

Section 1.861–18(c)(1)(ii) provides that if such rights are not transferred and the transaction does not involve, or involves to only a de minimis extent, the provision of services or know- how, then the transaction will be classified solely as the transfer of a copyrighted article.

Section 1.861–18(c)(2) identifies those rights that will be treated as copyright rights for purposes of the proposed regulations. This list differs from the list of rights set out in the Copyright Act to take into account the special nature of computer programs. Specifically, the copyright law right to copy will only be treated as a copyright right for the purposes of the proposed regulations if it is accompanied by the right to distribute such copies to the public. The copyright rights that apply for purposes of this section are, in addition to the right to copy and distribute to the public, the right to prepare derivative computer programs, the right to make a public performance of the computer program, and the right to publicly display the computer program. The list of rights contained in § 1.861–18(c)(2) rather than those contained in the Copyright Act will apply for the purposes of the proposed regulations.

Section 1.861–18(c)(3) defines a copyrighted article as a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated.

Section 1.861–18(d) of the proposed regulations provides rules for determining whether a transaction involving a newly- developed or modified computer program will be treated as the provision of services or another transaction described in paragraph (b)(1) of this section. The determination is based on all facts and circumstances, including how risk of loss is allocated and the intent of the parties as to ownership of the copyright. See, e.g., *Boulez v. Commissioner*, 83 T.C. 584 (1984); Rev. Rul. 74–555 (1974–2 C.B. 202); Rev. Rul. 84–78 (1984–1 C.B. 173).

Section 1.861–18(e) provides rules for determining whether a transfer of information related to a computer program will be considered the provision of know-how. A provision of know-how will not be considered to occur unless a party transfers information that (i) relates to computer programming techniques, (ii) is not capable of being copyrighted, and (iii) is protected by trade secret protection.

Under § 1.861–18(f)(1), if a transfer involves copyright rights, it will be further classified as either a sale or a

license of copyright rights. This classification will be made by examining whether, taking into account all facts and circumstances, all substantial rights, under the principles of sections 1222 and 1235, have passed to the transferee.

Under § 1.861–18(f)(2), if a transfer involves a copyrighted article, it will be further classified as either a sale or a lease of a copyrighted article. This classification will be made by examining whether the benefits and burdens of ownership have passed to the transferee. See, e.g., *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237–38 (1981); *Torres v. Commissioner*, 88 T.C. 702, 720–27 (1987); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 431–40 (1985).

Under § 1.861–18(f)(3), the determination of the classification of a transfer involving a copyright right or copyrighted article must appropriately consider the special nature of computer programs in transactions that take advantage of those characteristics. For example, a transaction in which a person acquires a copyrighted article on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period may also be treated as the equivalent of returning the copy.

Section 1.861–18(g) of the proposed regulations provides certain additional rules of operation. Section 1.861–18(g)(1) provides that neither the form adopted by the parties to a transaction nor the classification of a transaction under copyright law are determinative for tax purposes. Therefore, as illustrated in Example 1, a transfer of a computer program on a disk subject to a shrink-wrap license will generally be a sale of a copyrighted article.

Section 1.861–18(g)(2) provides that the method of transferring the computer program, for example by disk or electronically, shall not be relevant in determining whether a copyright right or a copyrighted article has been transferred.

The foregoing rules are illustrated by a number of examples contained in § 1.861–18(h).

Under § 1.861–18(i), these regulations are proposed to apply to all transactions occurring on or after the date that is 60 days after the date the final regulations are published in the **Federal Register**. No inference should be drawn from the proposed effective date concerning the treatment of transactions involving computer programs entered into before the regulations are applicable.

The application of these rules for purposes of the affected Internal Revenue Code sections may result in a change in the method of accounting for certain transactions involving computer programs by certain taxpayers. If the final regulations are adopted, the IRS will consider issuing an automatic change revenue procedure to address the situation where the taxpayer is required to change its method of accounting to comport with the new regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described in the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 19, 1997, at 10 a.m. in the NYU Classroom, room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments by February 11, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (in the manner described in the ADDRESSES caption) by February 26, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are William H. Morris and Carol P. Tello, of the Office of Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.861–18 is added to read as follows:

§ 1.861–18 Classification of transactions involving computer programs.

(a) *General*—(1) *Scope*. This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1057, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions*. This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be

classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any data base or similar item if the data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of, or the provision of services or of know-how with respect to, a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—

(i) A transfer of a copyright right in the computer program;

(ii) A transfer of a copy of the computer program (a copyrighted article);

(iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving both a copyright right and a copyrighted article*—(1) *Classification*—(i) *Transfers treated as transfers of copyright rights.* A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows—

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article is a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk or in the main memory or hard drive of a computer.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will not be treated as the provision of know-how for the purposes of this section unless the information is—

(1) Information relating to computer programming techniques;

(2) Not capable itself of being copyrighted; and

(3) Subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles*—(1) *Transfers of copyright rights.* The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 shall apply.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation*—(1) *Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer pro-

gram on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (generally referred to as a shrink-wrap license), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account*. The rules of this section shall be applied irrespective of the physical or electronic medium used to effectuate a transfer of a computer program.

(h) *Examples*. The provisions of this section may be illustrated by the following examples. All of the following examples assume that all parties are unrelated to each other:

Example 1. (i) *Facts*. Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It copies Program X on to disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis*. (A) Under paragraph (g)(1) of this section, the label license is not determinative. None of the copyright rights described in paragraph (c)(2) of this section have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under paragraph (c)(1)(ii) of this section, P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 2. (i) *Facts*. The facts are the same as those in Example 1, except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in Example 1, except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis*. (A) None of the copyright rights described in paragraph (c)(2) of this section have passed to P. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in *Example 1*, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 3. (i) *Facts*. The facts are the same as those in Example 1, except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis*. (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result would be the same if P were required to destroy the disk at the end of the one week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

Example 4. (i) *Facts*. The facts are the same as those in Example 2, where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis*. (A) As in *Example 3*, under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant, P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

(B) As in *Example 3*, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P''s computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3*, P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3*.

Example 5. (i) *Facts*. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of $y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) *Analysis*. (A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under paragraph (c)(1)(i) of this section because this transfer is accompanied by a copyright right identified in paragraph (c)(2)(i) of this section, this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of paragraph (b)(2) of this section, the disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within a geographic area, and has received the rights for the remaining life of the copyright in Program X. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty). (This would also be the case if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

Example 6. (i) *Facts*. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) *Analysis*. (A) As in *Example 5*, the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under paragraph (c)(1) of this section because Corp B has also acquired a copyright right under paragraph (c)(2)(i) of this section. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

Example 7. (i) *Facts*. Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time- to-time request. Corp C will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the license described in *Example 1*).

(ii) *Analysis*. (A) Corp C has not acquired any copyright rights under paragraph (c)(2) of this section with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under paragraph (g)(1) of this section. Under paragraph (c)(1)(ii) of this section, Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

Example 8. (i) *Facts*. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of computers which it manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) *Analysis*. The analysis is the same as in *Example 6*. Under paragraph (c)(2)(i) of this section, Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under paragraph (f)(1) of this section, this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties.

Example 9. (i) *Facts*. The facts are the same as in Example 8, except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in *Example 1*). Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis*. (A) As in *Example 7* (unlike *Example 8*) no copyright right identified in paragraph (c)(2) of this section has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article.

Example 10. (i) *Facts*. Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license). If additional workstations are subsequently introduced, Program X may be loaded on to those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis*. (A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

Example 11. (i) *Facts*. The facts are the same as in Example 10, except that Corp E, the Country Z corporation, acquires the right to make Program X available to workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis*. Under paragraph (g)(2) of this section the mode of transmission is irrelevant. Therefore, as in *Example 10*, under paragraph (c)(2) of this section, no copyright right has been transferred and thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles.

Example 12. (i) *Facts*. The facts are the same as in *Example 11*, except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp C receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, or if the contract is terminated, Corp E must return the disk containing the earlier version of Program X to Corp A, and delete (or otherwise destroy) any copies made of the current version of Program X. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis*. (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Under paragraph (d) of this section, based on all the facts and circumstances of the transaction, Corp A has not provided services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts*. The facts are the same as in *Example 12*, except that while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis*. For the reasons stated in *Example 10*, the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts*. Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards. The services required to perform this task are de minimis taking into account the facts and circumstances of this transaction. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10*.

(ii) *Analysis*. (A) As in *Example 10*, no copyright rights are being transferred under paragraph (c)(2) of this section. Under paragraph (b)(2) of this section, the services provided are de minimis. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts*. Corp H, a Country Z corporation, enters into a license agreement for a modified version of Program X only if Corp A, a U.S. corporation, makes substantial modifications to the program. Only the core idea of Program X will be used and a considerable amount of labor will be expended in rewriting Program X, which under applicable copyright law as a derivative work will be a separate, new program. Corp A and Corp H agree that Corp A is modifying Program X for Corp H and that, when modified Program X is completed, the copyright in the modified program will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis*. Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of modified Program X and is the owner of all copyright rights in modified Program X. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts*. Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques which are not generally known to computer programmers which will enable Corp I to more efficiently create computer

programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects. Such information is not capable of being copyrighted, but it is subject to trade secret protection.

(ii) *Analysis*. This transaction contains the elements of know-how specified in paragraph (e) of this section. Therefore, this transaction will be classified as the provision of know-how.

(i) *Effective date*. This section applies to transactions occurring on or after the date that is sixty days after the date final regulations are published in the **Federal Register.**

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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