

# International Taxation

---

By *Eva Farkas-DiNardo and Kevin Rowe\**

## Recent Guidance Provides That a “Back-to-Back Computer Licensing Arrangement” Is Not Subject to Code Sec. 901(l)

In Notice 2005-90,<sup>1</sup> the IRS addressed fears that new Code Sec. 901(l) could prevent taxpayers from claiming foreign tax credits for foreign withholding taxes incurred on income derived through standard back-to-back computer program licensing arrangements in which the recipient of an item of income is required to make related payments with respect to positions in substantially similar or related property.

### Background

---

In general, Code Sec. 901(l) disallows a foreign tax credit for withholding taxes if the recipient of the income:

- has held the property that generated the income for less than 16 days during a 31-day testing period, beginning on the day that is 15 days before the right to receive the payments arises; or
- is under an obligation (e.g., a short sale or back-to-back payments) to make related payments with respect to positions in substantially similar or related property. Withholding taxes are defined as a tax imposed on the gross amount of a payment.

Code Sec. 901(l) is an extension of Code Sec. 901(k), which was enacted in 1997 and disallows foreign tax credits for foreign taxes paid with respect to dividends received on stock held for less than 16 days during the 30-day period that begins 15 days before the ex-dividend date for the stock. Code Sec. 901(k) was designed to combat transactions in which stock was transferred for a short period of time (one or two days in some cases) to a taxpayer who needed the foreign tax credit from the withholding tax imposed on the dividend paid on the stock during the time the taxpayer held the stock. For years not subject to Code Sec. 901(k), the IRS unsuccessfully challenged such schemes in *Compaq*

---

*Eva Farkas-DiNardo* and *Kevin Rowe* are with Alston & Bird in New York.

*Computer Corp.*,<sup>2</sup> and other cases on the grounds that the scheme involving a short holding period for the stock lacked economic substance.

Code Sec. 901(k)(4) excepts stock held in connection with an actively conducted "securities business" from the holding period requirement. Code Sec. 901(l)(2) contains a parallel provision excluding property held by a dealer in the active conduct of a trade or business in a foreign country from the holding period requirement and the back-to-back payments rule. Code Sec. 901(l)(3) also contains a general provision that authorizes regulations to exempt certain other property from the holding period requirement and the back-to-back payments rule where application of those rules is not necessary to achieve the purposes of Code Sec. 901(l): to prevent taxpayers from claiming foreign tax credits in inappropriate situations, involving the separation of the foreign tax credit benefit from the related income. Notice 2005-90 was issued under this authority.

## Notice 2005-90

The Treasury and the IRS have become aware of a pattern of business arrangements involving computer software licensing in which application of the foreign credit disallowance rule in Code Sec. 901(l) is not necessary to prevent abusive transactions. Notice 2005-90 provides that a "back-to-back computer licensing arrangement" entered in the ordinary course of the business of the licensor and the licensee is not subject to Code Sec. 901(l). The notice defines the "back-to-back computer licensing arrangement" as one or more transactions in which a U.S. corporation, as the licensor, licenses a computer program to another U.S. corporation. The licensee corporation (the "head licensee") in turn licenses the computer program in the ordinary course of its business to one or more of its foreign affiliates (the "sub-licensees") for use directly by the sub-licensee in its trade or business, or for use in computers or similar and related equipment it manufactures or markets.

The arrangement is considered entered in the ordinary course of business if the following apply:

- The arrangement is consistent with the "normal business practices" of the licensor and is motivated by sound business reasons (including reduction of administrative burdens associated with the license and minimizing exposure to credit and other risk).

- The licensor or any member of its affiliated group is engaged in the business of selling, leasing or licensing computer programs or software.
- Each copyright transferred by the head licensee to an affiliate is used in the affiliate's trade or business (as defined under the Code Sec. 367(a) regulations).

Under the arrangement described in the notice, the head licensee must pay royalties to the licensor when the head licensee or one of the sub-licensees uses the licensed software. The sub-licensee must in turn pay royalties to the head licensee when it uses the licensed software. The payment by the sub-licensee to the head licensee is covered by the plain language in Code Sec. 901(l)(1)(B) because the recipient of the payment is under an obligation to make related payments with respect to a license of the same property licensed to the sublicense. Thus, but for this notice, the head licensee would not be entitled to claim a foreign tax credit for any withholding tax paid by the sublicense with respect to royalties paid to the head licensee.

The notice is effective for amounts that are paid or accrued after November 21, 2004, the effective date of Code Sec. 901(l).

## Planning Considerations

Notice 2005-90 fixes one discrete case of overreach in Code Sec. 901(l), but it leaves many loose ends as evidenced by the request in the notice for comments on what should be addressed in regulations to be issued under Code Sec. 901(l). Specifically, the notice requests comments on the following:

- Whether the exception should apply where the sublicensees are not corporations
- Under what circumstances are the licensee and the sublicense considered related
- Whether the licensing exception should apply where the head licensee is a foreign corporation
- Other types of licensing arrangements that should be covered by an exception
- The parameters of the ordinary business requirement

The extent of this request for information should give pause to any taxpayer that is considering implementing a structure based on the notice.

### ENDNOTES

<sup>1</sup> For more information, please contact Eva Farkas-Dinardo at (212) 210-9592 and Kevin Rowe at (212) 210-9505 at Alston & Bird.

<sup>2</sup> Notice 2005-90, IRB 2005-51, 1163.

<sup>3</sup> *Compaq Computer Corp.*, CA-5, 2002-1 USTC ¶ 50,144, 277 F3d 778.