Microsoft Corp. v. Commissioner, 115 T. C. 263 (2000)

Copyrights in computer software masters do not qualify as export property for FSC benefits when accompanied by a right to reproduce abroad.

Summary

In Microsoft Corp. v. Commissioner, the Tax Court ruled that royalties from licensing computer software masters with reproduction rights abroad do not constitute foreign trading gross receipts (FTGRs) under the Foreign Sales Corporation (FSC) provisions. Microsoft argued that software masters should be treated as export property akin to films and sound recordings, but the court held that the statutory exception for export property only applies to specific content types, not to software. The decision was based on the temporary regulation's interpretation and the legislative history, which did not include software within the export property definition, aiming to prevent the export of jobs. This ruling has significant implications for the tax treatment of software exports and the application of FSC benefits.

Facts

Microsoft Corp. developed computer software and licensed it to foreign original equipment manufacturers (OEMs) and controlled foreign corporations (CFCs). These licenses allowed the licensees to reproduce and distribute Microsoft's software abroad. Microsoft paid commissions to its foreign sales corporation, MS-FSC, and claimed deductions for these commissions. The Internal Revenue Service (IRS) disallowed these deductions, asserting that the royalties from these licenses were not FTGRs because the software masters did not qualify as export property under section 927(a) of the Internal Revenue Code.

Procedural History

Microsoft filed a petition with the U. S. Tax Court challenging the IRS's determination of tax deficiencies and disallowed deductions for the years 1990 and 1991. The Tax Court, after reviewing the case, issued a decision upholding the IRS's position that royalties from software masters with reproduction rights did not qualify as FTGRs.

Issue(s)

1. Whether royalties attributable to the licensees' reproduction and distribution of Microsoft's computer software masters outside the United States constitute FTGRs under section 924 of the Internal Revenue Code?
2. Whether the temporary regulation excluding computer software with reproduction rights from export property is a valid interpretation of section 927(a)?

Holding

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1. No, because the court determined that computer software masters do not fall within the statutory exception for export property, which is limited to specific content types like films and sound recordings.
2. Yes, because the temporary regulation is a reasonable and permissible interpretation of the statute, harmonizing with its language, purpose, and legislative history.

Court’s Reasoning

The court applied the statutory and regulatory framework to determine that computer software masters do not qualify as export property when licensed with reproduction rights. It interpreted the parenthetical exception in section 927(a)(2)(B) as content-specific, applying only to motion pictures and sound recordings. The temporary regulation, which explicitly excludes software with reproduction rights from export property, was upheld as a valid interpretation. The court emphasized that the legislative history showed Congress’s intent not to include software in the export property definition, aiming to prevent the export of jobs. The court also rejected Microsoft’s argument that software should be treated similarly to films and sound recordings, citing fundamental differences in functionality and content. The court’s decision was further supported by the consistent application of the regulation by the IRS and Congress’s inaction to amend the statute in light of the temporary regulation.

Practical Implications

This decision clarifies that computer software masters licensed with reproduction rights abroad do not qualify for FSC benefits, impacting how software companies structure their international licensing agreements. Legal practitioners must advise clients on structuring software exports to comply with this ruling, potentially affecting tax planning strategies. The decision may discourage the export of software production jobs and could influence future legislative efforts to amend the FSC provisions. Subsequent cases have cited this ruling in similar contexts, reinforcing its significance in tax law related to software exports. Businesses in the software industry need to reassess their tax strategies and consider the implications of this ruling on their international operations.

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