SULLIVAN & CROMWELL LLP

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Treasury and IRS Release Proposed Regulations on Cloud Computing and Digital Content Transactions

The Proposed Regulations Generally Would Extend Rules Applicable to Computer Programs to Other Digital Content, Provide Guidance for Classifying Cloud Transactions and Treat Sales of Downloaded Material Based on the User's Location for U.S. Tax Purposes

SUMMARY

On August 9, 2019, the Treasury Department and IRS released proposed regulations (the "Proposed Regulations") under the U.S. Internal Revenue Code (the "Code") that, if finalized, would provide guidance on the classification of cloud transactions and digital content transactions. The classification of cloud and digital content transactions is not entirely clear under current law, which does not comprehensively address transactions in digital media or cloud transactions where no or minimal content is "transferred" to a user. In general, the Proposed Regulations generally would confirm industry practice that cloud transactions are generally treated as the provision of services, and that current rules applicable to computer programs are extended to other digital media. Significantly, however, the Proposed Regulations would deem sales of downloaded content to occur based on the user's location, increasing the importance for non-U.S. taxpayers selling to U.S. customers to determine whether such non-U.S. taxpayers might be treated as "engaged in a U.S. trade or business."

BACKGROUND

Current regulations on digital transactions are generally limited to the treatment of transactions involving "computer programs," which are generally limited to electronic downloads of software.[1] The current regulations on computer programs generally categorize transfers involving computer programs as: (i) the transfer of a copyright, (ii) the transfer of a copy of a computer program, (iii) the provision of services for a computer program or (iv) the provision of know-how regarding computer programming techniques.[2]

The current regulations do not comprehensively address the treatment of "cloud transactions," which do not necessarily involve a download of software to a user's device. Such cloud transactions include Software as a Service ("SaaS"), Platform as a Service ("PaaS") and Infrastructure as a Service ("IaaS"), among other on-demand network access transactions, including streaming music and video, use of mobile apps and remotely-hosted software. In addition, the current regulations do not directly address downloads of "digital content" other than computer programs. In particular, the current regulations do not extend to downloads of music, video and e-books.

The classification of cloud and digital content transactions impacts a number of different provisions of the Code. More specifically, such classification may impact whether income is treated as U.S. or foreign source. For example, under general sourcing principles of the Code, rents and royalties are generally sourced where the leased or licensed property is used, services are generally sourced where the services are performed, and the source of sales of inventory may depend on where title passes. For non-U.S. taxpayers, the source and classification of cloud and digital content transactions may impact whether income from such transactions is treated as "effectively connected income" subject to U.S. taxation. For U.S. taxpayers, foreign source income generally increases the capacity for crediting foreign income tax against U.S. income tax liability. In addition, certain "U.S. shareholders" directly or indirectly holding interests in controlled foreign corporations ("CFCs") are subject to tax on a current basis (effectively, as a deemed dividend) on "subpart F income" earned by such CFCs.[3] The classification of cloud and digital content transactions of a CFC can affect whether such transactions give rise to subpart F income in the hands of U.S. shareholders.[4]

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1 *See* Treas. Reg. §1.861-18(a)(3).

2 Treas. Reg. §1.861-18(b)(1).

3 *See* Sections 951 and 952. References herein to a "Section" are to sections of the Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") unless otherwise stated.

4 Other provisions of the Code that are impacted by the classification of cloud and digital content transactions include the base erosion and anti-abuse tax ("BEAT") and the 37.5% deduction allowed in respect of foreign-derived intangible income ("FDII"). Characterizing a cloud transaction as a service may implicate the services cost exception for payments subject to BEAT. *See* Section 59A(d)(5). In addition, services treatment may affect eligibility and documentation requirements for treatment as FDII.

Cloud transactions generally have been classified as leases of property or the provision of services under general tax principles. In addition, taxpayers and practitioners generally have treated transfers of digital content (such as downloads of music, video and e-books) under principles similar to the regulations applicable to "computer programs." However, this treatment has been subject to some uncertainty. Accordingly, the Proposed Regulations would clarify the classification of cloud transactions and digital content transactions for purposes of the international provisions and certain other purposes of the Code. In the preamble to the Proposed Regulations, the Treasury and IRS note that they believe the Proposed Regulations are generally consistent with current industry practice, but request comments as to whether this characterization is accurate.

THE PROPOSED REGULATIONS

A. CLOUD TRANSACTIONS

The Proposed Regulations would define "cloud transactions" to include any "transaction through which a person obtains non-*de minimis* on-demand network access to computer hardware, digital content . . . or other similar resources."[5] Under the Proposed Regulations, each cloud transaction would be classified as either: (i) a lease of computer hardware, digital content or similar resources or (ii) a provision of services.[6]

The Proposed Regulations set forth a non-exclusive list of factors in determining whether a cloud transaction constitutes a lease of property or provision of services, generally favoring service treatment. Factors supporting service treatment include: (1) no physical possession of property by the customer, (2) no control of the property by the customer, beyond network access and use of the property, (3) the right to determine specific property used in the cloud transaction rests with the provider, (4) the property is a component of an integrated operation in which the provider has maintenance, updating and other responsibilities, (5) no significant economic or possessory interest in the property, (6) the risk of diminished revenue or increased expense in the case of nonperformance on the contract is on the provider, (7) the provider uses the property to concurrently provide significant services to persons unrelated to the customer, (8) the provider's fee is based on work performed or customer's use rather than the passage of time, and (9) the contract price substantially exceeds the rental value of the property.[7]

For example, different standards apply to sales of property and services in determining whether property or services are for a "foreign use" or "located outside the United States." *See* Section 250(b)(4)-(5).

5 Proposed Treas. Reg. §1.861-19(b).

6 Proposed Treas. Reg. §1.861-19(c). The Proposed Regulations classify each cloud transaction as either a lease of property or the provision of services without bifurcation. Some arrangements involve more than one cloud transaction, in which case each transaction is classified separately.

7 Proposed Treas. Reg. §1.861-19(c)(2).

Often an arrangement will consist of a cloud transaction in part and a non-cloud transaction in part (including digital content transactions, described further below). For example, cloud services may be provided together with downloaded software. In these cases, the Proposed Regulations would provide that the cloud transaction and non-cloud-transaction are to be characterized separately unless one or the other is *de minimis*.[8]

Several examples illustrate the classification of cloud transactions (generally as a provision of services) and the distinction between cloud transactions and digital content transactions:[9]

- ***Server Capacity.*** The Proposed Regulations provide an example in which a data center operator provides computer capacity on the operator's servers, which may be sourced from any of several servers maintained exclusively by the operator, in exchange for a monthly fee based on computer power used.[10] The Proposed Regulations conclude that this transaction is treated as a service, and that such treatment would not change if the customer were offered dedicated servers (such as for security reasons) where the operator retains physical possession of the servers and is responsible for maintenance.[11]
- ***Streaming Content.*** The Proposed Regulations provide an example where digital content, including videos and music, of a streaming provider may be streamed to end-users from servers located in data centers owned and operated by a data center operator. The end-users use a computer or other electronic device to access unlimited steaming content, which is continually updated, in exchange for a flat monthly fee. The Proposed Regulations conclude that the transactions: (i) between the data center operator and the streaming provider and (ii) between the streaming provider and the end-user, are services.[12] In contrast, where digital content in the form of videos and music is offered solely for download onto end-users' computers or other electronic devices, does not require an internet connection once downloaded and requires no additional payment for the ability to play the content in the future following the initial download fee, the Proposed Regulations conclude that the transaction is not a cloud transaction but a digital content transaction (as described below).[13]
- ***Web Development & Hosting Platforms.*** The Proposed Regulations provide an example of a platform for development and hosting of websites for a fee based on storage and website traffic supported. The platform includes access to graphics that may be used in the customer's website with copyright remaining with the provider. The platform is accessed almost entirely from the customer's browser, except that a small portion of scripting code is downloaded to the customer's computer to facilitate secure login and access. The Proposed Regulations conclude that the entire transaction is a cloud transaction characterized as a service. The small amount of downloaded scripting code is deemed to be *de minimis*.[14] The Proposed Regulations further conclude that this

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8 Proposed Treas. Reg. §1.861-19(c)(3).

9 None of the examples listed in the Proposed Regulations describe a cloud transaction that is classified as a lease under Proposed Treas. Reg. §1.861-19. Treasury and the IRS request comments on realistic examples of cloud transactions that would be classified as leases.

10 Proposed Treas. Reg. §1.861-19(d)(1).

11 Proposed Treas. Reg. §1.861-19(d)(2).

12 Proposed Treas. Reg. §1.861-19(d)(9).

13 Proposed Treas. Reg. §1.861-19(d)(10).

14 Proposed Treas. Reg. §1.861-19(d)(3).

transaction would not change if the customer were also provided access to customer relationship management software on a monthly subscription basis, because factors supporting service treatment outweigh the subscription fee being based solely on the passage of time.[15]

- ***Online Software.*** The Proposed Regulations provide an example where word processing, spreadsheet and presentation software may be accessed through a web browser or mobile app for a monthly per-user fee. While a limited number of functions may be accessed offline, full functionality of the mobile app requires an internet connection. The Proposed Regulations conclude that the transaction is a cloud transaction classified as a service, with the downloaded mobile app being deemed *de minimis*.[16] In contrast, the Proposed Regulations conclude that access to downloaded software accessed offline with limited online functionality and with periodic updates as part of a monthly-fee arrangement is treated entirely as a digital content transaction that is classified as a lease of property.[17]
- ***Online Databases.*** The Proposed Regulations provide an example where an online database of industry-specific materials may be accessed through a website, but is also publicly available by other means. The end-users may download any of the materials to their own computers and keep such materials without further payment. The end-users pay a fee based on the number of searches or the amount of time spent on the website, which does not depend on the amount of materials downloaded and is substantially higher than the charge for accessing the same content outside of this database. The Proposed Regulations conclude that the transaction is a cloud transaction classified as a service, and the end-user's downloads of digital content are deemed to be *de minimis*.[18]
- ***Downloaded Software With Cloud Storage.*** Finally, the Proposed Regulations provide an example of a platform providing (i) access to downloaded software accessed offline with limited online functionality and with periodic updates as part of a monthly-fee arrangement and (ii) data storage in exchange for a monthly fee based on the amount of data storage used by the customer. The core functionality of the software does not depend on also purchasing the storage plan. The Proposed Regulations conclude that neither transaction is *de minimis*, and therefore the provision of software and the data storage capacity constitute separate transactions. The Proposed Regulations conclude that the provision of software does not constitute a cloud transaction, but rather a lease of a copyrighted article under the rules applicable to digital content transactions. However, the provision of data storage constitutes a cloud transaction classified as a service.[19]

B. DIGITAL CONTENT TRANSACTIONS

The Proposed Regulations also would modify the current regulations applicable to computer programs by generally extending the rules currently applicable to "computer programs" to all digital content.[20] Such "digital content" would include computer programs and any other copyrighted content, including books,

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15 Proposed Treas. Reg. §1.861-19(d)(4).

16 Proposed Treas. Reg. §1.861-19(d)(6).

17 Proposed Treas. Reg. §1.861-19(d)(7).

18 Proposed Treas. Reg. §1.861-19(d)(11).

19 Proposed Treas. Reg. §1.861-19(d)(8).

20 Proposed Treas. Reg. §1.861-18.

movies and music, in digital format (including content whose copyright has expired solely due to the passage of time).[21]

To address what the Treasury Department and IRS describe as uncertainty in determining the source of sales and the manipulability of location, the Proposed Regulations would provide that the sale of copyrighted articles through an electronic medium is deemed to occur at the location of download or installation. If this location is unknown, the sale would be deemed to occur at the location of the customer based on the taxpayer's recorded sales data.[22] This rule could represent a significant change for digital content providers whose contracts have treated title as passing at a prior point in the sales process. In particular, this rule could potentially increase the U.S. source income of non-U.S. taxpayers since the Code generally treats income from the resale of property "within the United States" as U.S. source.[23] Any sales treated as U.S. source under this rule generally could be taxable to non-U.S. taxpayers who are engaged in the conduct of a trade or business in the United States,[24] but generally would not impact non-U.S. taxpayers who are not otherwise engaged in the conduct of a U.S. trade or business. In addition, non-U.S. taxpayers entitled to benefits under an applicable tax treaty generally are entitled to exclude sales not attributable to a U.S. "permanent establishment." Accordingly, certain non-U.S. taxpayers may need to more closely analyze their particular facts and circumstances to determine whether they are engaged in a U.S. trade or business and whether they are eligible for the benefits of an applicable treaty. In the preamble to the Proposed Regulations, Treasury and the IRS note that they do not expect this rule to impact the application of tax treaties.

Finally, the Proposed Regulations would clarify the transfer of the right to perform or display digital content for advertising purposes as not constituting the transfer of a copyright right.[25] Accordingly, allowing a third party to advertise digital content (for example, with screenshots or clips) would not be treated as involving a license of the underlying content.

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21 Proposed Treas. Reg. §1.861-18(a)(3).

22 Proposed Treas. Reg. §1.861-18(f)(2)(ii).

23 *See* Section 861(a)(6). In addition, the Code generally treats inventory property produced outside the United States but "sold or exchanged within" the United States as potentially subject to apportionment between U.S. and non-U.S. sources. Prior to U.S. tax reform, income from the sale of inventory property acquired by production or manufacture, produced by the taxpayer in the United States and sold outside of the United States (or vice versa), would generally have been apportioned partly to the place of production and partly to the place of sale, pursuant to applicable apportionment formulas. Treas. Reg. §1.863-3(a)-(b). Following U.S. tax reform, however, such apportionment is done solely on the basis of "production activities." Section 863(b)(2).

24 Sections 871(b) and 882(a).

25 Proposed Treas. Reg. §1.861-18(c)(2)(iii) and (iv).

C. EFFECTIVE DATE AND REQUEST FOR COMMENTS

If finalized, the Proposed Regulations would apply to taxable years beginning on or after the date of publication of the Treasury decision adopting the Proposed Regulations as final regulations in the Federal Register. The preamble to the Proposed Regulations includes a request for comments by November 12, 2019.

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