U.S. TAXATION OF CLOUD TRANSACTIONS AND DIGITAL CONTENT TRANSFERS: 20-YEAR-OLD REGULATIONS FINALLY MOVE WITH THE TIMES

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BACKGROUND

Recently, the I.R.S. released proposed regulations for the classification of cloud computing transactions and proposed amendments to the existing computer software regulations of Treas. Reg. §1.861-18 (the "-18 Regulations").

Until now, when attempting to classify computer-based transactions, taxpayers only had the guidance of the -18 Regulations, which were proposed in 1996 and adopted in 1998 with minimal change. These rules have not kept pace with computer-based transactions, which are an ever-growing and evolving area. To put things in perspective, when the -18 Regulations were adopted, a typical internet connection could download 1GB in approximately 48 hours. Now, it takes less than 15 minutes. Oh, how times have changed.

The -18 Regulations, in their current state, provide rules for classifying transactions that involve "computer programs."[1] They apply to transfers of computer programs as well as to services relating to the development or modification of computer programs. As such, this does not have direct application to many of the internet-based transactions in which taxpayers engage daily (*e.g.*, streaming a movie on Netflix or storing data in Dropbox).

The proposed rulemaking addresses three aspects:

- It proposes amendments to the -18 Regulations that will extend the scope of the regulations to apply to transfers of digital content, which goes beyond computer programs.
- It proposes a new source rule for income from certain transactions covered under the -18 Regulations.
- It proposes to add Treas. Reg. §1.861-19 to address the classification of cloud computing transactions.

In the absence of I.R.S. guidance, and since the -18 Regulations did not apply, cloud computing transactions had previously been analyzed based on traditional characterization principles. With no transfer of property rights, cloud computing transactions have generally been treated as service transactions. The proposed regulations are consistent with such practical treatment, and thus, no economic impact is projected.

While the proposed regulations provide clarity as to the classification of cloud computing transactions as service transactions, they do not address the source rule for

[1] Computer programs are defined as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.

services in the cloud. Therefore, the existing uncertainty as to where income will be sourced continues. In the context of cloud computing, services can be deemed to take place where servers are located, where company personnel are located, or maybe where customers are located (or any combination of the above). Regrettably, the new proposed rulemaking does not offer clarity on that point.

PROPOSED CHANGES TO THE -18 REGULATIONS

Transfer of Digital Content

As mentioned above, the -18 Regulations currently apply only to transactions involving computer programs. The proposed amendment would replace all references to "computer programs" with "digital content" and thus broaden the scope of the existing regulations to apply to all transfers of "digital content." Digital content is generally defined as any content in digital format that is protected by copyright law and digital content that is not so protected solely due to the passage of time. The manner in which the content is transferred is immaterial to this determination.

As a result of the proposed amendment, transactions involving computer programs or content in digital format would generally be treated as one of the following:

- A sale transaction (which could be a sale of a copyrighted right or a sale of a copyrighted article)
- A licensing transaction (which could be a lease of a copyright right or a lease of a copyrighted article)
- The provision of services
- The provision of know-how

Under the -18 Regulations, when a transfer is involved and when most of the substantial copyrighted rights are transferred, the transaction is a sale of a copyright right. If most of the substantial rights are not transferred, the transfer is a lease. When no copyrighted right is transferred, the transfer is of a copyrighted article, and if the benefits and burdens of ownership are shifted, the transfer is a sale. Otherwise, the transfer is a lease. Generally, the copyrighted rights include three rights:

- The right to make copies
- The right to prepare a derivative
- The right to publicly preform or display

The proposed amendment clarifies that the mere transfer of the right to publicly perform or display digital content for the purpose of advertising the sale of the digital content, without transfers of other rights, does not constitute a transfer of a copyrighted right.

In the facts described in Example 19, one of the three new examples from the proposed regulations, the following transaction (which was probably written with Kindle in mind) describes a digital content transfer and would be classified as a sale of a copyrighted article under the existing -18 Regulations:

"When a copyrighted article is sold through an electronic medium, the sale will be deemed to occur at the location of download or installation onto the end-user's device."

Corp A operates a website that offers electronic books for download onto end-users' computers or other electronic devices. The books offered by Corp A are protected by copyright law. Under the agreements between content owners and Corp A, Corp A receives from the content owners a digital master copy of each book, which Corp A downloads onto its server, in addition to the non-exclusive right to distribute for sale to the public an unlimited number of copies in return for paying each content owner a specified amount for each copy sold. Corp A may not transfer any of the distribution rights it receives from the content owners. The term of each agreement Corp A has with a content owner is shorter than the remaining life of the copyright. Corp A charges each end-user a fixed fee for each book purchased. When purchasing a book on Corp A's website, the end-user must acknowledge the terms of a license agreement with the content owner that states that the end-user may view the electronic book but may not reproduce or distribute copies of it. In addition, the agreement provides that the end-user may download the book onto a limited number of its devices. Once the end-user downloads the book from Corp A's server onto a device, the end-user may access and view the book from that device, which does not need to be connected to the internet in order for the end-user to view the book. The end-user owes no additional payment to Corp A for the ability to view the book in the future.[2]

A Customer-Based Source Rule

The amendment to the -18 Regulations includes a new source rule. It is proposed that when a copyrighted article[3] is sold through an electronic medium, the sale will be deemed to occur at the location of download or installation onto the end-user's device. If this information is not available, the rule deems the location of the customer based on the taxpayer's recorded sales data for business or financial reporting purposes.

This rule will create more effectively connected income ("E.C.I.") for foreign taxpayers selling into the U.S. and who, until now, were confident they would not have E.C.I. as long as title did not pass in the U.S. and the income was not attributed to a U.S. fixed place of business or a permanent establishment. It is interesting to consider how this rule correlates to independent digital tax initiatives around the world, specifically France. These initiatives look to impose tax on revenues from digital services based on the location of the user and have been criticized for targeting U.S. multinationals. Now, the U.S. is itself imposing tax based on the location of the customer.

CLOUD COMPUTING TRANSACTIONS

New Prop. Treas. Reg. §1.861-19 governs the classification of "cloud transactions." A cloud transaction is defined as a transaction through which a person obtains a non-*de minimis*, on-demand, network access to computer hardware, digital content, or other similar resources.

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2 Prop. Treas. Reg. §1.861-18.

3 When no copyrighted right is transferred, the transfer is of a copyrighted article.

Under the proposed regulations, a cloud transaction can only be classified as either the provision of services or as lease of the resource to which access was granted (the "property"). A transaction may have the characteristics of both a lease and a service but should not be classified as two separate transactions when both aspects are part of an integrated transaction. When an arrangement involves multiple transactions, each should be viewed as a separate transaction and be analyzed independently, provided that it is not *de minimis*. The analysis of each separate transaction in the arrangement should be made under the appropriate set of rules, including the -18 Regulations and general tax law principles.

A cloud computing transaction would be treated as a provision of services under the proposed regulations when the factors relevant to the transaction, of the nine factors listed in the proposed regulations, are met.

This list of factors is non-exhaustive, and some may be irrelevant to a given transaction. The relevance of any factor depends on the factual situation. The list includes the following factors:

- The customer is not in physical possession of the property.
- The customer does not control the property, beyond the customer's network access and use of the property.
- The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property.
- The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated.
- The customer does not have a significant economic or possessory interest in the property.
- The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.
- The provider uses the property concurrently to provide significant services to entities unrelated to the customer.
- The provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time.
- The total contract price substantially exceeds the rental value of the property for the contract period.[4]

The proposed regulations demonstrate in several elaborate examples the analysis of the listed factors.

Example 6 addresses a transaction that has more than one component; however, the second component is *de minimis* and thus does not require a separate analysis. The facts describe a cloud computing transaction (*i.e.*, on-demand network access to the computer hardware of a provider) that is treated as the provision of services. In the facts of the example:

[4] Prop. Treas. Reg. §1.861-19.

> Corp A provides Corp B word processing, spreadsheet, and presentation software and allows employees of Corp B to access the software over the internet through a web browser or an application ("app"). In order to access the software from a mobile device, Corp B's employees usually download Corp A's app onto their devices. To access the full functionality of the app, the device must be connected to the internet. Only a limited number of features on the app are available without an internet connection. Corp B has no ability to alter the software code. The software is hosted on servers owned by Corp A and located at Corp A's facilities and is used concurrently by other Corp A customers. Corp A is solely responsible for maintaining and repairing the servers and software, and ensuring continued functionality and compatibility with Corp B's employees' devices and providing updates and fixes to the software (including the app) for the duration of the contract with Corp B. Corp B pays a monthly fee based on the number of employees with access to the software. Upon termination of the arrangement, Corp A activates an electronic lock preventing Corp B's employees from further utilizing the app, and Corp B's employees are no longer able to access the software via a web browser.[5]

Because (i) Corp B is not in physical possession of the property (the word processing, spreadsheet, presentation software, and servers), (ii) Corp B does not control the word processing, spreadsheet, presentation software, or servers, and (iii) the word processing, spreadsheet, presentation software, and servers are a component of an integrated operation in which the provider has other responsibilities, including sole responsibility for maintenance, repairs, software updates, and ensuring continued functionality and compatibility with Corp B's devices. Additionally, because (i) Corp A uses the servers concurrently to provide services to other customers and (ii) Corp A's fees are based not only on the passage of time but also on the level of use in connection to the number of employees with access to the software, (iii) the transaction is a service transaction. While the employees of Corp B download an app onto their devices, the app's main functions are only accessible when connected to Corp A's servers through the internet, and therefore, the download component of the transaction is considered *de minimis* and part of an integrated transaction that does not need to be separately analyzed.

No example is given in the proposed regulation to demonstrate when a cloud transaction is treated as a lease of property. It seems that in most cases, cloud computing transactions are anticipated to result in a provision of services categorization. Because services are sourced where the services are performed, this may create U.S.-source income where there was none before. Although one must wonder whether services would be deemed to take place where the servers are located (easily placed outside the U.S.), where company personnel is located (movable), or where customers are located (or any combination of the above).

CONCLUSION

The proposed regulations offer purported clarity. They formally apply the -18 Regulations to transfers of digital content. They propose a new source rule for transfers

[5] *Id.*

of copyrighted articles that will deem the customer's location as the source. They generally provide that most cloud computing transactions are service transactions.

Yet, questions remain. Where are services deemed performed? Will the location of the servers be a factor? Or will European countries newest digital tax legislation influence the analysis and deem at least some of the services to be performed where the customers are located? How does the work location of company employees affect cloud transactions?