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Treasury Department Issues Proposed Rules on Cloud Transactions, Other Digital Content

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On August 9, the US Department of the Treasury released proposed regulations on the federal income tax treatment of "cloud transactions" and certain other transactions involving digital content (the "Proposed Regulations"). The Proposed Regulations, if finalized, would arguably represent the most significant US federal tax guidance on computing transactions in more than 20 years. A cloud transaction is generally defined as a transaction through which a person obtains non-de minimis on-demand network access to computer hardware, digital content or other similar resources, not including network access to download digital content for storage and use on the end user's computer or mobile device.

Although the Proposed Regulations were issued under a section of the Internal Revenue Code relating to the source of income, they do not include a sourcing rule for cloud transactions (but they do include a sourcing rule for digital downloads). Instead, the Proposed Regulations would provide rules for determining the overall characterization of cloud transactions, whose source would be determined under existing law. The characterization of cloud transactions under the Proposed Regulations is relevant not only for sourcing, but also for their treatment under a number of provisions of tax law, including the base erosion and anti-abuse tax (BEAT), related provisions on foreign derived intangible income (FDII) and global intangible low-tax income (GILTI), anti-hybrid rules, transfer pricing, certain anti-basis-importation provisions and more.

Background

The Proposed Regulations would update and modernize regulations issued on "computer program" transactions that were finalized in 1998 (the "Existing Regulations"). Under the Existing Regulations, a transaction involving a computer program is characterized, depending on a number of factors, in one of four possible ways: (i) a transfer of a copyright right in a computer program; (ii) a transfer of a copy of a computer program (a "copyrighted article"); (iii) the provision of services for the development or modification of a computer program; or (iv) the provision of know-how. A transfer of a copyright right can be further classified as either a sale or a license, depending on whether "all substantial rights" in the right have been transferred. Similarly, a transfer of a copyrighted article can be further classified as either a sale or a lease, based on whether the benefits and burdens of ownership of the article have been transferred.

As the Treasury Department acknowledges in the preamble to the Proposed Regulations, the Existing Regulations do not address "on-demand network access to computing resources, such as networks, servers, storage and software," which have become increasingly prevalent business models since 1998, when the Existing Regulations were promulgated. The Proposed Regulations attempt to fill this gap by addressing so-called "cloud computing transactions" such as Software as a Service (SaaS); Platform as a Service (PaaS); and Infrastructure as a Service (IaaS), as well as other cloud transactions such as streaming digital content, mobile device applications and access to certain databases, in each case, not involving the downloading of content on the end-user's equipment.

Further, the Proposed Regulations would clarify certain aspects of the Existing Regulations relating to transfers of copyright rights and copyrighted articles, including extending the regulations beyond computer programs to all digital content. Digital content is defined in the Proposed Regulations as "a computer program or any other content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time, whether or not the content is transferred in a physical medium."

Cloud transactions

For a cloud transaction, which typically involves access to or use of property rather than the sale, exchange or license of property, the Proposed Regulations narrow the Existing Regulations' four possible characterizations to

two: (i) a lease or (ii) the provision of services. Any cloud transaction would be subject to one or the other of these two characterizations; no bifurcation of a transaction would be permitted, although the Treasury Department allows for the possibility that one arrangement might include multiple cloud transactions to be classified separately.

The classification of a cloud transaction as a lease or services would be based on the facts and circumstances, taking into account all relevant factors. The Proposed Regulations enumerate a non-exclusive list of factors, which are based on Section 7701(e) of the Internal Revenue Code (an existing statute on services versus lease classification) as well as case law, demonstrating that a cloud transaction should be classified as the provision of services rather than a lease of property. An overarching theme of the factors in the Proposed Regulations is whether the provider or the recipient has a significant economic or possessory interest in, and control over, any underlying property relating to the cloud transaction. The Proposed Regulations note that not all factors will be relevant in all cases, and that other, non-enumerated factors can sometimes be relevant.

While the factors are derived from existing law (much of which was developed in a pre-Internet, brick-and-mortar economy), the preamble to the Proposed Regulations cautions that cloud transactions “may have significant differences from other lease and service transactions that involve direct physical access to property. Accordingly, the interpretation of factors and their application to cloud transactions require an analysis that is sensitive to the inherent differences between transactions involving physical access to property and transactions involving on-demand network access.”

Sales of copyrighted articles and copyright rights in electronic medium

As noted above, the Existing Regulations treat the transfer of a copyrighted article as either a sale or a lease, depending on whether all substantial rights in the article have been transferred. Existing law provides that income from the sale of personal property is sourced to the country where the rights, title and interest in the property are transferred, but does not state where that is for property sold through an electronic medium (i.e., digital downloads). The Proposed Regulations would resolve this ambiguity by specifying that a sale takes place at the location of the download or installation onto the end user’s device used to access the digital content, subject to an anti-avoidance rule. The Treasury Department expects that a vendor will normally be able to ascertain this information, but if it cannot, the sale would be deemed to occur at the customer’s presumed location based on recorded sales data for business or financial reporting purposes.

The Proposed Regulations also would clarify that “a transfer of the mere right to public performance or display of digital content for purposes of advertising the digital content does not by itself constitute a transfer of a copyright right.” As an example, the Proposed Regulations refer to a retailer that is allowed to display a screenshot of a video game on its own advertisements; such a retailer would not be treated as having acquired a copyright right.

Prospective effective date

The Proposed Regulations will become effective when final regulations are published. The Treasury Department cautions that no inference should be drawn from the proposed effective date (i.e., the lack of current effectiveness) regarding the treatment of transactions entered into before such date. Any change in the timing of income recognition will be treated as a change of accounting method, which means affected taxpayers must go through applicable administrative procedures before changing the treatment of an item.

Pending finalization, the Treasury Department has requested comments from the public on all aspects of the Proposed Regulations. In particular, comments were requested on administrable rules for sourcing income from cloud transaction in a manner consistent with existing provisions of the Internal Revenue Code and on whether the classification of cloud transaction as either a service or a lease is correct, or whether another classification (such as a license or sale) might be proper.

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