

US IRS issues proposed regulations addressing cloud-based and other digital transactions

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Executive summary

On 9 August 2019, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released proposed regulations ([REG-130700-14](#), Prop. Treas. Reg. Section 1.861-19) addressing cloud-based transactions and other transactions involving digital content, such as gaming and social media. Treasury also proposed regulations that would amend current Treas. Reg. Section 1.861-18, which provides rules governing transactions involving computer programs. These proposed rules represent Treasury's first significant attempt to grapple with cloud computing and related digital tax issues. The proposed regulations apply for purposes of determining the treatment of software and cloud transactions under certain provisions enacted as part of the *Tax Cut and Jobs Act* (TCJA) (e.g., Internal Revenue Code¹ Sections 59A, 245A, 250 and 267A).

As expected, the proposed regulations reflect an incremental approach by Treasury to create a flexible and coherent framework to resolve a host of complex and dynamic tax issues raised by cloud computing transactions and the digital economy. The proposed regulations identify several critical gating issues regarding the classification of cloud computing and other digital transactions, such as characterizing cloud transactions as either a service or a lease.

The proposed regulations would modernize and expand the software regulations under Treas. Reg. Section 1.861-18 to cover “digital content.” They would also clarify certain open questions, such as the source of income for transactions involving sales of copyrighted articles and the scope of the rights to publicly display or make a public performance. However, the proposed regulations also would reserve on other important issues, principally, the source of income generated by cloud computing transactions and other digital activities.

Effective date

Prop. Treas. Reg. Section 1.861-19 would apply to cloud transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final. Prop. Treas. Reg. Section 1.861-18 would similarly be effective for transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final.

Detailed discussion

Overview of the proposed cloud computing regulations

In drafting the proposed regulations addressing the classification of cloud transactions, Treasury drew inspiration from a variety of sources – statutory (e.g., Section 7701(e)), regulatory (e.g., the software regulations under Treas. Reg. Section 1.861-18), and case law.

The unique nature of cloud transactions and the manner in which end users access cloud-based services, however, required Treasury to merge various elements of these sources into a new analytical framework – one that is largely based on the facts and circumstances of each particular cloud transaction and that requires taxpayers to weigh these facts and circumstances against a set of non-exhaustive factors.

Although the software regulations under Treas. Reg. Section 1.861-18 offered Treasury a plausible foundation upon which to construct rules governing cloud transactions, the antiquated approach adopted in the software regulations fails to adequately capture many commonplace cloud and digital transactions. As Treasury recognized in the preamble to the proposed cloud computing regulations (preamble), the software regulations generally do “not provide a comprehensive basis for categorizing many common” cloud computing and digital transactions.

Unlike the more limited scope of the software regulations, cloud computing transactions are typically characterized by on-demand network access to computing resources, such as networks, servers, storage and software.

Significantly, cloud computing transactions ordinarily do not involve a transfer of a copyright right or copyrighted article, as required under Treas. Reg. Section 1.861-18. And, the software regulations do not provide rules addressing online access to various software programs, servers or web-based applications, the hallmarks of cloud computing and other digital transactions.

As such, cloud computing transactions do not fit neatly within any specific provision of existing law, including the software regulations, although they will be housed adjacent to the software regulations, in newly-proposed Treas. Reg. Section 1.861-19.

Classifying cloud computing transactions

The proposed regulations effectively function to bifurcate cloud-based transactions into one of two categories: the rendition of services or a lease of property. Notably, for cloud transactions that are not service-oriented, the proposed regulations would default to treatment as a lease generating rental income, not a license giving rise to royalties for the use of intangible property (although the proposed regulations do request comments on this issue as, interestingly, there are no instances or examples of leases of cloud or digital content in the proposed regulations).

For these purposes, a “cloud transaction” would be broadly defined as a “transaction through which a person obtains non-de minimis on-demand network access to computer hardware, digital content (as defined in [Prop. Treas. Reg. Section] 1.861-18(a)(3)), or other similar resources.”

As noted in the preamble, Treasury intends that the proposed regulations would apply to a wide variety of cloud-based transactions, not only the traditional service models embraced by industry (e.g., infrastructure as a service, platform as a service, and software as a service), but also streaming media, web-based applications, and access to databases, servers, storage and software.

However, the proposed cloud computing regulations would not apply to transactions otherwise covered by the software regulations (e.g., downloading of software or other media, transfers of other digital content that is locally stored and available for use on a computer). In these cases, the software regulations (including proposed revisions herein) would continue to apply, not the proposed cloud computing rules.

Singular treatment as a service or lease

Following the Fifth Circuit's lead in *Tidewater v. United States*, 565 F.3d 299 (5th Cir. 2009), AOD, 2010-01 (1 June 2010), which adopted an "all or nothing" approach in applying the Section 7701(e) factors to determine whether a time charter for a sea vessel should be considered a "lease" or a "service agreement," the proposed regulations would likewise provide for singular treatment of a cloud transaction as solely a lease of property or the provision of services.

Where, however, a cloud-based arrangement comprises "multiple transactions," the proposed regulations would require taxpayers to separately analyze each component under the framework set out in Prop. Treas. Reg. Section 1.861-19. Helpfully, this proposed rule would not apply to any "de minimis" transaction, although the proposed regulations do not define "de minimis," and would avoid requiring taxpayers to unbundle and separately classify each component of a cloud transaction, no matter how immaterial.

Rendition of service vs. lease of property: weighing the factors

The classification of a cloud transaction as either the provision of a service or a lease of property is a fact-intensive inquiry, taking into account a series of nine factors set forth in the proposed regulations. Although none of the factors is dispositive, and each factor is given equal weight, the proposed regulations would provide that not all factors may be relevant to a given transaction and thus may be disregarded. Notably, six of the nine factors are representative of those outlined within Section 7701(e), which has been the prevailing statutory reference for discerning license and services characterization of cloud transactions.

As set forth in the proposed regulations, the following factors would bear on the classification of a cloud transaction as a rendition of services, rather than a lease of property:

- ▶ 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.

Application of these factors, as well as the proposed cloud computing rules, are largely illustrated through a series of examples. As the examples demonstrate, application of the relevant factors to a cloud transaction would generally result in the transaction being treated as a rendition of services, not a lease of property, particularly where the end user may only access – but not possess, alter or control – the database, software or the servers that host the database or software.²

Modernization of software regulations

The proposed regulations would also make three changes to the existing software regulations in Treas. Reg. Section 1.861-18.

First, and most significantly, the proposed regulations would provide a sourcing rule for the sale of a copyrighted article through a digital medium. The proposed regulations would source such sales to the location of download or installation onto the end-user's device. In the absence of information on the location of download or installation, sales would be deemed to have occurred at the customer's location (determined based on recorded sales data for business or financial reporting purposes). The preamble notes that this change is necessary because applying the existing rules, under which the source of income was determined by the location where rights, title and interest passed to the buyer, can be easily manipulated and "bear little connection to reality" in the digital context. The proposed regulations provide no guidance on what constitutes an end user. Nor do the proposed regulations address situations involving an intermediary (for example, if Corp A sells software to Corp B for further resale). Thus, some uncertainty exists as to how to source such sales transactions. This may result in significant changes for many taxpayers, who previously relied on title passage under the existing law.

Second, the proposed regulations would clarify that the regulations apply to transfers of all “digital content” – not just “computer programs.” The proposed regulations would define “digital content” 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.” This change is intended to bring books, movies and music that are in digital format within the purview of the software regulations. Given the lack of other guidance, many taxpayers may have already been applying the software regulations to transactions covering these types of digital property by analogy. Thus, this change is not likely to have a significant impact on taxpayers. Treasury has specifically requested comments on the definition of digital content and whether any special considerations related to digital content should be taken into account.

Finally, the proposed regulations would provide that the right to public display or the right to public performance of digital content for the purpose of advertising the sale of digital content is not the transfer of a copyright right representing a proposed change to current guidance.

Scope of proposed regulations

The proposed regulations would apply to the international provisions of the Code, including certain provisions enacted as part of the TCJA (e.g., Sections 59A, 245A, 250 and 267A). Application of the proposed regulations to certain TCJA provisions would depend, in part, on the determination of a cloud transaction as a service or lease of property.

For example, under Section 59A, the new base erosion anti-abuse tax (BEAT), which effectively limits the ability of US corporations to deduct deductible related-party payments to foreign affiliates, treatment of a cloud transaction as a service could potentially result in deductible payments qualifying for the services cost method exemption. By contrast, deductible rental payments would generally be subject to the BEAT minimum tax.³

Similarly, treatment as a lease or a service would impact the transaction’s eligibility for the new Section 250 deduction for foreign-derived intangible income (FDII), specifically, whether the transaction satisfies the various requirements for “foreign use” and documentation because the FDII rules differ for service and lease transactions.

Request for comments

Comments are requested on all aspects of the proposed regulations. Among other topics, Treasury and the IRS seek comments on (1) whether digital content should be defined more narrowly, (2) realistic (actual) examples of cloud transactions that would be treated as leases, (3) sourcing income from cloud transactions, and (4) treatment of transactions involving the ability of customers to both download digital content and consume that same content on-demand over the internet. If a public hearing is scheduled, the date and time will be posted in the Federal Register.

Implications

With respect to characterization issues, the approach in the proposed regulations is generally consistent with how most taxpayers already analyze transactions involving digital content and cloud computing transactions. Thus, the proposed regulations, if finalized in current form, are unlikely to cause significant disruption or rethinking of reporting positions on income characterization. One notable exception is the new sourcing rule for sales of digital content through an electronic medium (copyrighted article transaction), which is a departure from the existing rules for sourcing of inventory products (generally where right, title and interest transfer from seller to buyer). The proposed primary approach for sourcing such income – looking to where users download the digital content – is going to be burdensome and difficult for taxpayers to track, forcing some taxpayers to effectively rely on the secondary rule (customer location based on sales data) to determine source. This proposed change may also raise effectively connected income (ECI) tensions for taxpayers selling inbound into the United States since the change likely will result in more US source income. Finally, Treasury’s reservation on providing guidance for sourcing income from cloud computing transactions perpetuates lingering questions and uncertainty, which will continue to trouble many taxpayers. Recent changes in the international tax landscape precipitated by the TCJA, as well as the OECD’s⁴ BEPS⁵ initiative, may only serve to exacerbate the need for additional guidance.

Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Example 6 in Prop. Treas. Reg. Section 1.861-19-(d) treats the provision of productivity software through an online app as a services transaction notwithstanding that some core functionality is usable by the customer even when the customer is offline. This characterization might be at odds with the treatment certain taxpayers apply to similar transactions.
3. Presumably the classification of a cloud transaction as a service or lease would be irrelevant with respect to Section 267A, the new anti-hybrid rules enacted as part of the TCJA, because Section 267A only disallows a deduction for certain related-party payments (or accruals) of interest or royalties.
4. Organisation for Economic Co-operation and Development.
5. Base Erosion and Profit Shifting.

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