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IRS Hearing Likely Eases Cloud Tax Rules' Implementation

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On Feb. 11, a hearing was held in Washington, D.C., on the proposed regulations that were issued last summer[1] under Section 861 of the Internal Revenue Code[2] with regard to the classification for tax purposes of cloud transactions and transactions involving digital content.

There were five speakers at the hearing representing industry constituencies,[3] each followed by questions from a three-person Internal Revenue Service, U.S. Department of the Treasury government panel.

Coincidentally, on the same day as the hearing, the American Bar Association Section of Taxation released a letter sent to the IRS commenting on the proposed regulations. While I will not review the ABA letter in much detail, it is interesting to note that the ABA recommendations[4] did not always match those of the industry speakers at the hearing.

This article is not a primer on the proposed regulations but rather a summary and analysis of some of the comments made about it at the hearing.[5] In that regard, the proposed regulations are important (1) as a first step to provide guidance on the taxation of cloud transactions, and (2) as a clarification of taxation of transactions involving digital content.

By promoting a better understanding of the business processes involved in cloud and digital content transactions, the hearing between industry and government should help to minimize unforeseen problems when the regulations are put into final form.

Do the regulations create undue tax problems for real estate operators running cloud storage facilities?

A concern expressed early on at the hearing was that the use in the proposed regulations under IRC Section 7701(e),[6] rules for service/lease distinction for cloud transactions, would go beyond their intended scope in cases of real estate operators running cloud type computing facilities on their premises. To the extent the IRC Section 7701(e) rules would lead to the characterization of income from such operations as being income from services instead of rent for a lease, then tax benefits available under, for example, the real estate investment trust rules in Part II of Subchapter M of the code could be jeopardized.

The answer to this may already be in the proposed regulations which do not on their face apply to Subchapter M.[7] However, the concern raised at the hearing would illustrate the inadvisability of making the proposed regulations applicable to the entire code and the advisability of carefully reviewing the code sections to which the proposed regulations are to apply, in each case so as to try to root out unintended or illogical consequences.[8]

Is the classification system for cloud transactions workable?

Comments were made that Proposed Treasury Regulations Section 1.861-19(a)-(c)[9] as written constitutes a confusing structure for classification of cloud transactions.[10] It was felt that vague terms like "arrangement" and "de minimis" should be eliminated to simplify the classification analysis.

It was also advocated that such transactions should be classified based on all the facts and circumstances — such as availability of separate pricing, use of separate skews and the taxpayer's definition of a transaction for nontax purposes. It was also urged that the classification factors set forth in the proposed regulations should not be considered as all encompassing since many cloud businesses have, or may have in the future, operational fact patterns not covered by the factors.

There was also a consensus industry recommendation to use a predominant character test in cloud transaction classification. Under the proposed regulations, a complex cloud transaction is to be broken down into its constituent parts and then each part that is not de minimis is classified. Under the predominant character test, the predominant character of the transaction as a whole would be identified and used for the characterization of the entire transaction.

It was suggested that the classification rule should be flexible enough to account for the different types of transactions within scope of the proposed regulations. For example, streamed music, cloud services to enhance desktop applications and multiplayer gaming were cited as all being very different, such that classification rules should allow for these differences.

All in all, the classification rules present a good start. However, as pointed out by the ABA Section of Taxation, some cloud transactions might well be properly characterized as licenses — a possibility not covered in the proposed regulations nor advocated at the hearing.

Also, the ever-changing nature of computing makes rigid classification rules likely unworkable. A solution may be to make status under the new rules a rebuttable presumption that taxpayer may rely on as a safe harbor.

This would allow planning but also permit a challenge by a taxpayer if the taxpayer can prove under the facts and circumstances in a particular case that the rules would result in an unfair outcome. And perhaps the final regulations should make taxpayers think twice about frivolous challenges to the rules by imposing a penalty for same.

How should related-party transactions be treated?

Comment was made that, for example, cloud transactions under the proposed regulations could be interpreted to apply to data center services that allow purchasers to operate dedicated servers in remote locations, controlled by a related party without the purchaser controlling the physical data center. It was urged that the related-party aspects of the transaction should not change the characterization, which the commentators at the hearing generally thought should be categorized as a service rather than a lease.

This sort of example was noted in a prehearing comment letter as being tied to the broader implications of the service-lease characterization of cloud transactions under the proposed regulations.

Since the proposed regulations would apply to international provisions of the code — e.g. Sections 59A[11] (the tax on base erosion payments), 245A (deduction for the foreign-source portion of dividends received by domestic corporations from specified 10%-owned foreign corporations), [12]250 (foreign derived intangible income), and 267A (certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities),[13] all recently enacted under the 2017 Tax Cuts and Jobs Act — the determination of whether a

cloud transaction is a service or a lease of property could, in the view of the commentators at the hearing, have a significant impact.

One possible example of this impact might be under Code Section 59A, the new base erosion anti-abuse tax, or BEAT, which effectively limits the ability of larger U.S. corporations to deduct otherwise deductible payments made to related foreign affiliates.

However, there is an exception to the BEAT allowing deductibility under the services-cost method of Treasury Regulation Section 1.482-9(b), without the application of the business judgment rule therein.[14] At least some have suggested classification of a cloud transaction as a service would fit within this exception, whereas lease classification would very likely not.[15]

Should all cloud transactions simply be classified as services?

In the context of cloud transactions, the consensus at the hearing was that these should almost always be classified as services. In that regard, one idea discussed was making the service classification rise to the level of a presumption — albeit a rebuttable one. The point made early on about REITs and the like might well be an exception if the proposed regulations are to be read so as to apply to that part of the code dealing with REITs. In fact, "almost always" may understate the consensus as there was comment, seemingly endorsed by a super majority of the speakers, that all cloud transactions should be classified as services.

I think an a priori notion that all cloud transactions should be services would be too rigid. Almost surely there will be instances where cloud transactions are, at least in material part, leases. Also, it would make sense to broaden the proposed regulations to classify some cloud transactions as involving licenses where appropriate.

Do the income sourcing rules in the proposed regulations function properly?

There was discussion of the income sourcing rules for transactions involving the sale of copyrighted digital content through an electronic medium. While new Section 1.861-7(c) and Section 1.861-18(f)(2)(ii) of the proposed regulations deem such a sale occurs in the country of the download or installation onto the device used to access the content, there was support expressed for retaining the prior rule that income from sale of copyrighted features should be sourced to where the title to the digital content passed.

I would tend to agree with the knock on the prior rule. This, in short, is that it would be very easy to pass title by contract in a jurisdiction having no real economic connection to the transaction in order to game tax benefits.

As to the copyright-sale source rules, it was further thought they could frequently be difficult to administer such as where downloads of copyrighted articles were sold through unrelated distributors and that in any event the geolocation corresponding to the download device IP address might be unreliable as an indicator of a customer’s actual location.

To mitigate this, it was recommended a general rule be adopted that would source the income from a digital download of software to the billing location of the first unrelated purchasing entity of the download. But that being said, it was felt that taxpayers should be allowed to elect the download rule that has been proposed in the regulations. Moreover, it was suggested that in cases where Code Section 863(b)[16] applies (basically in cases of income derived from sources partly within and partly without the United States) that the

taxpayer should be allowed to apply exclusively the download rule.

This flexible approach makes sense. It would be very hard to track where downloads occur, but billing location information can be expected to be readily available. Still, where actual download location can be determined without undue difficulty, it would seem to be a reasonable standard to let the taxpayer source the income to that location.

It has been felt that the sourcing rules for digital content sales will raise effectively connected income (income from U.S. sources effectively connected to the conduct of a U.S. trade or business) issues for inbound sales from abroad. The theory is that sourcing to download location will result in a lot more U.S. tax nexus than the old title passage rule, presumably on account of downloads taking place within the U.S.

As to the sourcing of income from cloud transactions, there was a comment that current law was sufficient and indeed, consonant with that, the proposed regulations do not provide special sourcing rules for cloud transactions. But a recommendation was made at the hearing that if some official guidance was to be given, it should be based on sourcing of cloud transactions on an entity-by-entity basis as a provision of services, and with consideration of the facts and circumstances, including people's locations, functions and assets that directly relate to the production of the income.

This is pretty much the classic model for sourcing income from services. However, many are questioning if this model still works for digital commerce.

For example, there is a notion being asserted by some taxing jurisdictions that a mere sale to residents of a given jurisdiction creates income tax nexus. That seems a bit much for an income tax nexus as opposed to sales tax nexus or, in countries that have a value added tax, a VAT nexus.

However, for example, given the amount of data that can be collected about customers in a given jurisdiction and the economic value of that information, the argument can certainly be made that those customers have created an asset for the taxpayer in that jurisdiction and that location of that asset should be a basis for finding income tax nexus there.

Ideally too, the proposed regulations might have addressed the sourcing rules for cloud transactions. But there may be something to be said for waiting and seeing how the cloud shakes out in future years, albeit at the expense of some continued uncertainty, before trying to impose more rigid sourcing rules that might be unsuited to developments in the industry.

Another issue discussed at the hearing was whether the income of the entity recognizing the customer revenue should be sourced according to the location of its own personnel and assets, or whether the source rule should be applied on some broader basis so as to include the personnel and assets of other related or unrelated entities that may be participating in the overall enterprise.

The recommendation made was to source cloud transaction income by reference only to the employees and assets of the entity recognizing the revenue. Other important source-of-income issues included whether the relevant personnel of the entity should be all the entity’s personnel, or instead only those directly involved in the delivery of the cloud services, and of what role assets, rather than personnel, should play into the source determination.

Do the proposed regulations fail to consider common business models used by industry?

There was a discussion of the situation where a video game developer sold digital content through a third-party platform operator. The basic recommendation was that the transaction between the developer and end user should be classified as the sale of a copyrighted article, and the transaction between the platform operator and the developer should be classified as a provision of services by the operator to the game developer.

A speaker recommended the addition of a platform distribution example, to supplement the licensed reseller example already in the proposed regulations. While the existence of a new example 19 as part of Section 1.861-18 of the proposed regulations, describing a licensed content reseller distribution model, was favorably noted, it was also noted that the reseller model is only one of two predominant cloud based distribution models for digital content.

Under a second model, a cloud-based platform provider facilitates the sale of digital content through its platform, but the user purchases the content directly from the content supplier. In that case, the platform provider acts as an agent, not a principal. The platform intermediary normally invoices and collects the purchase price, and then remits a portion to the content provider, but that intermediary is acting as an agent. So, it was recommended that character of the remitted revenue should be based on the transaction between the content provider and the user.

This would seem to be a fair comment but, in my opinion, there does need to be a limit on the examples. The regulations certainly can't give examples of all present supply chains and distribution methods — let alone unknown ones that inevitably will arise as the cloud industry evolves. Which is why the regulations should not be thought of as, nor try to be, exhaustive.

What comes next?

Well, the future is inherently a bit, ahem, cloudy. But the fact that industry and government have been talking to each other with a view to rationalizing the proposed regulations for finalization is encouraging.

The emphasis on clarity and better enabling taxpayer tax planning, as well as the need for the flexibility to allow for future cloud and digital transaction business models, should lead to a better collective regulatory outcome for all stakeholders. In that regard, these regulations, in final form, will apply to taxable years beginning on or after the date of publication of the Treasury decision adopting final regulations in the Federal Register.

However, the final regulations will almost surely not be the end of the story concerning U.S. taxation of cloud and digital content transactions. And, on a global level, a sea change in international taxation of these transactions by taxing jurisdictions outside the U.S. can be expected.

Stay tuned.

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[1] REG-130700-14.

[2] IRC Section 861 .

[3] The speakers at the hearing were Ameek Ashok Ponda of Sullivan & Worcester LLP; Thomas Roesser of Microsoft Inc.; Rafic Barrage of Baker & McKenzie LLP, on behalf of Entertainment Software Association; Gary D. Sprague of Baker & McKenzie LLP, on behalf of Software Coalition; and Sarah Shive of Information Technology Industry Council.

[4] Here are the recommendations included in the ABA's letter:
1. We recommend that the definition of the term "digital content," in Prop. Treas. Reg. § 1.861-18(a)(3), be expanded to include content that exists in the form of digital data and that is available for download, distribution, or access on electronic media, and that is not otherwise protected by U.S. copyright law. Transactions involving such digital data occur frequently and Prop. Treas. Reg. Section 1.861-18 should apply to classify the income generated from such transactions regardless of whether such digital data is protected by copyright law. This expanded definition of the term "digital content" should include consumer or user data and similar types of data files.

2. We recommend that the potential characterization of cloud transactions in Prop. Treas. Reg. § 1.861-19 be expanded to include transactions that are more properly characterized as licenses when the facts and circumstances suggest that non-de minimis copyright rights have been transferred as part of the same transaction involving what would otherwise be classified as a cloud computing transaction under Prop. Treas. Reg. § 1.861-19. In the alternative, Prop. Treas. Reg. § 1.861-19 should permit bifurcation of cloud computing transactions into digital content and cloud computing components.

3. We recommend that examples be added to Prop. Treas. Reg. § 1.861-18 illustrating that transactions involving the purchase of streaming digital content be treated as sales of copyrighted articles despite the fact that there is no delivery of the copyrighted article to the consumer for storage on the customer's personal device

4. We recommend that the final regulations clarify that the "end user" sourcing rule for income from sales of copyrighted articles contained in Prop. Treas. Reg. § 1.861-18(f)(2)(ii) is intended to create symmetry among the source of income rules for all transactions involving transfers or assignments of digital content; namely, that the source of income from sales, leasing, and licensing of digital content is intended to be the same under Treas. Reg. § 1.861-18. Further, the "end user" rule should be clarified, or examples should be provided that demonstrate how to apply the rule where it may be difficult to ascertain one single location of download or installation where the "end user" has more than one way to access the digital content.

5. We also recommend that the final regulations extend the business records safe harbor rule contained in Prop. Treas. Reg. § 1.861-18(f)(2)(ii) to apply to licenses and leases of digital content.

[5] This article reflects the author's understanding of the gist of the hearing and may not in all instances be a fully accurate summary of each speaker's remarks.

[6] IRC Section 7701(e).

[7] See Prop. Treas. Reg. Section 1.861-19, classification of cloud transactions:
(a) In general. This section provides rules for classifying a cloud transaction (as defined in paragraph (b) of this section) either as a provision of services or as a lease of property. The rules of this section apply for purposes of Internal Revenue Code § 59A [the BEAT tax], § 245A [deduction for foreign source-portion of dividends received by domestic corporations from specified 10% owned foreign corporations], § 250 [FDII], § 267A [hybrids], § 367 [outbound transactions], § 404A [foreign deferred compensation plans], § 482 [transfer pricing], § 679 [foreign trusts having one or more United States beneficiaries], and § 1059A [limitation on taxpayer's basis or inventory cost in property imported from related persons]; Subchapter N of Chapter 1 [tax based on income from sources within or without the United States]; Chapters 3 [withholding of tax on nonresident aliens and foreign corporations] and 4 [FATCA withholding]; and § 842 [foreign companies carrying on insurance business] and § 845 [certain reinsurance agreements] (to the extent involving a foreign person), and apply with respect to transfers to foreign trusts not covered by § 679.

That being said, comment has been made that the proposed regulations reference IRC Section 7701(e) which could, in the view of the commentators, apply to the whole code, including Subchapter M.

[8] A recent example of the problems that can be created when code sections or treasury regulations are created to which a rule or law are applicable or incorporated by reference are the recent global intangible low taxed income rules (Code Section 951A) which created havoc when they did not work as expected with other sections of the code involving, for example, (1) Subpart F of the Code (controlled foreign corporations) and (2) the foreign tax credit rules at Subpart A of the Code.

[9] Prop. Treas. Reg. Section 1.861-19(a)-(c).

[10] Perhaps clearer is that it seems that content downloaded to the user's device is to be deemed to be a lease under the existing parts of Treas. Reg. Section 1.861-18. In contrast, on demand digital content which is provided online or otherwise streamed to the user is generally considered a cloud transaction and therefore, in the view of many, if not all, likely a service under the classification rules of Prop. Treas. Reg. Section1.861-19. However, despite the perceived clarity of the rule, one comment was made that this was not a sensible distinction and that content downloaded to a user device on a temporary basis should be treated, likely as a service, under Prop. Treas. Reg. Section1.861-19.

[11] IRC Section 59A.

[12] IRC 245A.

[13] IRC 267A.

[14] Treas. Reg. Section 1.482-9(b).

[15] This seems to be a good example of a possible unintended effect of the type discussed in endnote [8]. Concerns of this sort of result may well be what is driving the industry toward a consensus, if not unanimity, that all cloud transactions should be categorized as services. However, this "all services all the time" notion might be a rather blunt instrument and the solution may well be not to apply the service/lease dichotomy of the cloud transaction regulations to, for example, IRC Section 59A and more broadly perhaps to IRC

Section 482. Really, the implication of the regulations for each code section to which they could become applicable should be carefully thought through.

[16] IRC Section 863(b).