Proposed US Tax Rules for Cloud Computing Transactions and Digital Downloads - International Implications Are a Reason to Review

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Executive Summary

On August 9, 2019, the US Treasury Department published proposed regulations for the classification of “cloud transactions” and “transactions involving digital content” under the source of income rules of the Internal Revenue Code. The
proposed regulations would amend existing regulations that were introduced in 1998, at a time when retail digital downloads were virtually non-existent and the commercial use of cloud computer technology was still in its early stages.

The proposed regulations largely adapt the principles of income classification that taxpayers have been applying to date to transactions in the cloud. Those principles, which derive from statutory and case tax law, will typically treat cloud computing transactions as a provision of services rather than a lease of property.

In addition, the proposed regulations introduce an absolute rule that sources income from digital transactions at the place where the download of the digital content is deemed to occur. This new sourcing rule will of course have implications for cross-border transactions in the cloud, as described in more detail below. A planning and compliance review before the rules become final may have some merit.

Definition of Cloud Transactions

The proposed regulations include new definitions for classifying cloud computing transactions. The existing 1998 regulations provided rules for classifying transactions involving “computer programs” but did not specifically refer to cloud computing. Cloud technology existed at that time but was still in its infancy and commercially undeveloped. According to the background section accompanying the proposed regulations, cloud computing is characterized by on-demand network access to computing resources, such as networks, servers, storage and software. Cloud computing transactions typically involve what is known in the industry as: Software as a Service (SaaS), Platform as a Service (PaaS) and Infrastructure as a Service (IaaS). Today, these kinds of transactions typically do not involve the transfer of a copyright as was more common when the existing regulations were published. Cloud computing is characterized today by access to technology and not as a transfer of a property right in technology.

There are other transactions in the cloud that do not relate to computing but involve on-demand access to technological resources. Examples include streaming video, mobile device applications, and access to data through remotely hosted software. The proposed regulations refer to these transactions and the above cloud computing transactions collectively as “cloud transactions.” A cloud transaction is a transaction through which a person obtains non-de minimis, on-demand network access to computer hardware, digital content, or other similar resources.

Classification of Cloud Transactions as Provision of Services or as a Lease

The proposed regulations classify a cloud transaction as either a lease of property or a provision of services for US income tax purposes. Factors to consider when classifying a transaction as either a lease of property or a provision of services can be found in case law and in general statutory rules defining services contracts. A non-exclusive list of these factors is added under the proposed regulations.

Certain cloud transactions that have characteristics of both a lease and a service will be classified in their entirety as one or the other and the whole will not be
bifurcated into two proportionate transactions. If an arrangement includes a cloud transaction and a transaction that would be classified under other sections of the Internal Revenue Code and regulations, or under general tax law principles (i.e., a “non-cloud transaction”), then the classification rules in the proposed regulations apply only to classify the cloud transaction. A wrinkle to this general rule provides that neither the cloud transaction nor the noncloud transaction in a mixed arrangement will be classified separately if one of the transactions is de minimis.

The proposed classification rules extend to all transfers of digital content. Digital content is defined as “any content in digital format and that is either protected by copyright law or is no longer protected by copyright law solely due to the passage of time, whether or not the content is transferred in digital medium.”

**New Single Source of Income Rule for Downloads of Digital Content.**

The proposed regulations provide a new single source rule for transactions in the cloud involving the sale of digital content. There is no specific source rule in the current regulations. Sales of digital content typically include copyrighted features. Taxpayers have relied on the general principle that income from sales of copyrighted features was sourced where the title to those features passed. In practice, this has been considered problematical from a US Treasury perspective because taxpayers have been able to easily control the place of title passage through contractual language (if at all).

By adding a single source rule for the sale of digital content, the proposed regulations effectively eliminate the passage of title sourcing analysis for such sales. Under the proposed regulations, a sale of copyrighted features through an electronic medium is deemed to occur at the location of the download or installation onto the end-user’s device that is used to access the digital content. The income from the sale will be sourced at that location for US income tax purposes.

In order to determine the location of the end-user’s device or better said, the end user, the seller may rely on transaction data used for business or financial reporting purposes. US Treasury intended to avoid imposing on sellers a new, unique evidentiary approach to determine the source of the income.

**Implications for Cross-Border Sales – Actions to Consider**

A single source rule for the income from digital downloads will be welcome in place of the passage of title principle for its simplicity. Income from the direct sale of digital content by a US company to a non-US consumer will be foreign-sourced. This source rule will enhance for US companies the foreign derived intangible income opportunity (FDII) enacted under the Tax Cuts and Jobs Act of 2017. Generally, that benefit is an effective US corporate tax rate of 13.1% on the income from US to foreign sales of goods and services, including digital downloads.

In contrast, income earned from the sale of digital content from a foreign seller to a US consumer will be treated as US source income. The new sourcing rule can increase the risk for the foreign seller that such income will be treated as effectively
connected to a US trade or business of that seller. The foreign seller may not enjoy the protection from residence taxation under a US tax treaty permanent establishment clause. For example, the foreign seller may be based in a jurisdiction that does not have a US income tax treaty or such person fails to satisfy the relevant qualified resident test under the applicable US tax treaty with the base jurisdiction.

If no US tax treaty applies, the foreign seller could inadvertently become a US tax resident and be subject to IRS reporting and filing obligations. As a US tax resident, the foreign seller will be taxable on the income attributed to its US trade or business on a net basis and be subject to US withholding tax on the deemed transfer of the income from the US trade or business to the foreign person.

The foreign seller’s tax compliance analysis can become more complicated, with or without US tax treaty protection, by the fact that US tax treaties do not apply to state income tax rules. States have their own sourcing rules that can apply on top of the US source rules once a business is considered to have tax nexus in one or more states. Finally, state sales tax could apply to the foreign seller transaction if it is made to a retail consumer, without regard to whether a US tax treaty applies.

If a foreign seller of digital content into the US has any US tax risk as a result of this single source rule, it should take time now to review its US distribution structure and consider any cures to put in place before the proposed regulations become final.

US sellers to foreign consumers may have already considered the US corporate tax rate benefit for foreign derived intangible income but if not, they will want to use the still valid passage of title source rules to insure foreign source treatment for their direct cross border sales of digital content, at least until the proposed regulations become final.

**Taxpayer Comments and Effective Date of Final Regulations**

The US Treasury asks taxpayers to submit written comments by or before November 12, 2019. The analysis includes a non-exclusive list of specific issues for comment. The proposed regulations will go into effect for taxable years beginning on or after the date the final version of the regulations is published.

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