



International Tax ADVISORY ■

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Proposed Regulations Classifying Cloud Transactions and Digital Content Released

On August 9, 2019, Treasury and the IRS published [proposed regulations](#) regarding the classification of cloud transactions and transactions involving digital content for purposes of the international provisions of the tax code. The proposed regulations also modify the [existing rules](#) for classifying transactions involving computer programs, applying those rules to transfers of digital content. Determining the classification of cross-border transactions is key to determining whether income generated from such transactions is U.S. source or foreign source, and ultimately how such income will be taxed.

The existing regulations were finalized in 1998, which might as well have been a century ago given the amount of technological advancement that has occurred since then. While the existing regulations may have seemed sufficient given the state of technology in 1998, there is a serious need for a refresh. The proposed regulations are the first attempt by Treasury and the IRS to address the tax issues related to cloud computing and digital content.

The Existing Regulations

The existing regulations provide rules for classifying transactions involving computer programs. In the existing regulations, the term “computer program” is 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” and includes “any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.” Such transactions are categorized in one of four ways: (1) a transfer of a copyright right in a computer program; (2) a transfer of a copy of a computer program; (3) the provision of services for the development or modification of a computer program; or (4) the provision of know-how relating to computer programming techniques.

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A cloud computing transaction or similar transaction involving digital content typically does not involve any transfer of a computer program classified under the existing regulations as a transfer of a copyright right or copyrighted article or any provision of development services or know-how relating to computer programs or programming. The existing regulations do not provide any comprehensive guidance for categorizing many common transactions that involve cloud computing or digital content.

The Proposed Regulations

Definition of cloud transactions

Cloud transactions are defined in the proposed regulations as transactions through which a person obtains non-de-minimis, on-demand network access to computer hardware, digital content, or other similar resources. In the preamble to the proposed regulations, Treasury and the IRS explain that the definition is not limited to computer hardware and software or to the three cloud service models (software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS)) because the government intends for the rules to apply to other transactions that share characteristics of on-demand network access to technological resources. The preamble explains that although the definition is broad, it does not encompass every transaction executed or completed through the Internet. For example, the mere download or other electronic transfer of digital content for storage and use on a person's computer or other electronic device would not be considered a cloud transaction under the proposed regulations.

Classification

The proposed regulations provide that a cloud transaction should be classified solely as either a lease of property or the provision of services. The preamble to the proposed regulations states that, in general, "the application of the relevant factors to a cloud transaction will result in the transaction being treated as the provision of services rather than a lease of property." Consistent with that statement, none of the numerous examples in the proposed regulations of how the classification rules apply to cloud transactions illustrate a cloud transaction that would be classified as a lease of property rather than the provision of services. Treasury and the IRS have requested that taxpayers provide realistic examples of cloud transactions that would be treated as leases under proposed classification rules.

The preamble notes that although some cloud transactions may have characteristics of both a lease of property and the provision of services, such transactions are generally classified in their entirety and are not bifurcated into separate transactions. Some arrangements may involve multiple cloud transactions. In that case, the proposed regulations require a separate classification of each cloud transaction, not taking into account any transaction that is de minimis. In addition, some arrangements may involve multiple transactions, where one or more transactions would be classified as a cloud transaction and one or more transactions do not qualify as a cloud transaction. In that case, the classification rules in the proposed regulations only apply to the cloud transactions, and the non-cloud transactions will be classified based on other applicable tax-law provisions.

The proposed regulations provide that all relevant factors must be considered when determining whether a cloud transaction should be classified as a lease of property or the provision of services. The proposed

regulations provide the following non-exhaustive list of factors that would demonstrate that a cloud transaction should be classified as a rendition of services, rather than a lease of property:

- (i) The customer is not in physical possession of the property;
- (ii) The customer does not control the property, beyond the customer's network access and use of the property;
- (iii) The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property;
- (iv) The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated;
- (v) The customer does not have a significant economic or possessory interest in the property;
- (vi) The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;
- (vii) The provider uses the property concurrently to provide significant services to entities unrelated to the customer;
- (viii) 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; and
- (ix) The total contract price substantially exceeds the rental value of the property for the contract period.

The proposed regulations provide that not all factors may be relevant to a given transaction and so may be disregarded depending on the facts and circumstances.

Generally, income generated from a lease of property is sourced where the property is located, and income generated from the provision of services is sourced where the service is performed. However, the proposed regulations are silent on how the source of a cloud transaction should be determined based on its classification.

Modification of existing regulations

The proposed regulations also contain several modifications to the existing regulations. The proposed regulations broaden the scope of the existing regulations to apply to all transfers of "digital content," which 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 a physical medium." The intent of this change is to broaden the application of the existing regulations to include things like books, music, and videos in digital formats.

The proposed regulations also modify the existing regulations to 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. The preamble explains that this change is made in light of the government's experience in administering the existing regulations.

The proposed regulations also modify the existing regulations to clarify the sourcing rule for the sale of a copyrighted article through a digital medium. Pursuant to the proposed regulations, such sales are sourced to the location of download or installation onto the end-user's device. If the location of download or installation is not known, such sales are deemed to have occurred at the end user's location, which is determined based on recorded sales data for business or financial reporting purposes.

Key concerns about the proposed regulations

The proposed sourcing rule for the sale of a copyrighted article through a digital medium has proven to be quite controversial, and practitioners have raised several concerns. Some practitioners have noted that the proposed sourcing rule does not comport with existing tax-law principles. Practitioners have also noted that the proposed regulations do not provide any guidance on how to determine who the end user is, and they neglect to address situations where an intermediary is used. Additionally, practitioners have flagged that non-U.S. sellers that sell copyrighted articles through a digital medium to U.S. customers will want to pay close attention to the proposed sourcing rule since it is such a significant departure from the existing rule. If the proposed regulations go into effect as written, such non-U.S. sellers could find themselves generating U.S.-source income as a result of these sales, and they could be considered engaged in the conduct of a U.S. trade or business.

Practitioners have also been left wondering why Treasury and the IRS neglected to provide sourcing rules for cloud transactions in the proposed regulations. It is disappointing that the proposed regulations address cloud transactions and provide a non-exhaustive list for when they are treated as a lease or service, but then stop short of providing any guidance on how to determine the source of income generated by such transactions.

Looking Ahead

The proposed regulations would apply prospectively to taxable years beginning on or after the date of publication of the final regulations in the *Federal Register*. Thus, the proposed regulations would only apply to transactions occurring pursuant to contracts entered into in taxable years beginning on or after the date final regulations are published. Although far from final, taxpayers should consider if and how these proposed regulations will impact them. Treasury and the IRS have requested comments on all aspects of the proposed regulations, and comments and public hearing requests are due by November 12, 2019.

For more information, please contact [Edward Tanenbaum](#) at 212.210.9425 or [Stefanie Kavanagh](#) at 202.239.3914.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

International Tax Group

John F. Baron
Chair
704.444.1434
john.baron@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Sam K. Kaywood, Jr.
404.881.7481
sam.kaywood@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Edward Tanenbaum
212.210.9425
edward.tanenbaum@alston.com

Seth M. Buchwald
404.881.7836
seth.buchwald@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghai Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
SILICON VALLEY: 950 Page Mill Road ■ Palo Alto, California, USA, 94304-1012 ■ 650.838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333