Corporate & Tax Alert

IRS Issues Proposed Regulations on the Classification of Cloud-based Transactions: Lease of Property or Provision of Services?

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As cloud computing continues to grow in popularity as a business model for the deployment of software services, understanding the tax treatment of revenues generated from cloud-based transactions becomes critical. **The IRS has issued proposed regulations (published in the Federal Register on August 14, 2019) that provide guidance on whether a cloud-based transaction should be treated as a lease of property or the provision of services.** Understanding the regulatory classification of these transactions is increasingly important for businesses, because rental income and income from rendering services may be subject to different tax treatment. The proposed regulations supplement existing regulations that provide rules for classifying transactions involving computer programs as a license of a computer program, a rental of a computer program, or a sale of a computer program.

The proposed regulations will apply to cloud-based transactions occurring pursuant to contracts entered into in taxable years beginning on or after the date of publication of a Treasury decision adopting the proposed regulations as final regulations in the Federal Register. The IRS is receiving public comments on the proposed regulations until November 12, 2019.

For non-tax purposes, cloud computing transactions typically are described as following one or more of three models: **Software as a Service (SaaS); Platform as a Service (PaaS); and Infrastructure as a Service (IaaS)**. SaaS allows customers to access applications on a provider's cloud infrastructure through an interface, such as a web browser. PaaS allows customers to deploy applications created by the customer onto a provider's cloud infrastructure using programming languages, libraries, services, and tools supported by the provider. IaaS allows customers to access processing, storage, networks, and other infrastructure resources on a provider's cloud infrastructure. A cloud computing transaction typically does not involve any transfer of a computer program; that is, a transfer of a copyright right or copyrighted article or any provision of development services or knowhow relating to computer programs or programming.

The proposed regulations **define a "cloud transaction" as a transaction through which a person obtains non-*de minimis** on-demand network access** to computer hardware, digital content, or other similar resources. This definition is not limited to computer hardware and software, or to the IaaS, PaaS, and SaaS models described above, because it is intended also to apply to other transactions that share characteristics of on-demand network access to technological resources, including access to streaming digital content and access to information in certain databases. Notwithstanding this broad definition, it does not encompass every Internet transaction. For example, the mere download (or other electronic transfer of digital content for storage and use on a person's computer hardware or other electronic

device) does not constitute on-demand network access to the digital content and so would not be considered a "cloud transaction."

"Digital content" is defined in the proposed regulations to mean **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. Examples include books in digital format, movies in digital format, and music in digital format.

Interestingly, as with the prior regulations addressing computer programs, the proposed regulations are issued under the section of the Internal Revenue Code of 1986 (Code) that provides rules for determining the "source" of income (i.e., in general, where the income is earned) for assessing tax in international transactions. Because the proposed regulations are issued in the context of international transactions, it is unclear what relevance they will have outside the international transaction context. The concepts applied and analysis provided would seem equally applicable in the context of domestic transactions.

There have been a few indications that the courts and Internal Revenue Service might look to definitions contained in the regulations classifying computer programs for purposes of international transactions (§ 1.861-18), which are issued under the same section of the Code as the proposed regulations, for non-international transaction purposes. In particular, IRS Notice 2005-14, 2005-1 CB 498, which addresses income attributable to domestic production activities under Section 199 of the Code (now repealed), cites § 1.861-18 for the determination of whether a transfer of computer software is a sale or exchange of property, a license generating royalty income, or a lease generating rental income. In addition, Private Letter Ruling 200843013 (10/24/2008) addresses whether royalties received by the taxpayer from the licensing of computer products are active business computer software royalties for purposes of the tax imposed on personal holding company income. The analysis in the private letter ruling cites § 1.861-18(a)(3)(i) for the definition of a computer program. Moreover, in *Norwest Corporation and Subsidiaries v. Commission of Internal Revenue*, 108 TC 358 (1997), the Tax Court, in a fully reviewed opinion, addressed whether the computer software acquired by the taxpayer was tangible personal property eligible for the investment tax credit. In its analysis, the Tax Court cites for comparison the provisions of § 1.861-18 that provide guidance on the distinction between copyrighted articles, on the one hand, and the underlying, exclusive copyright rights, on the other hand. While the extent to which the proposed regulations will be considered to apply outside the context of international transaction is yet to be seen, it is important to know that these rules exist when considering federal domestic income tax issues, as well as state and local income, sales, and use tax issues, for cloud-based transactions.

The proposed regulations take an **all or nothing approach in classifying a cloud-based transaction** as a lease of property (i.e., computer hardware, digital content, or other similar resources) or the provision of services. Thus, a cloud-based transaction that has elements of both lease and services generally will be classified in its entirety, taking into account all the relevant factors, as either a lease or a service, and not bifurcated into a lease transaction and a separate service transaction. The relevance of any factor varies depending on the circumstances, and no one factor is determinative.

The proposed regulations list the following factors as **demonstrating that a cloud-based transaction is classified as the provision of services**, rather than a lease of property:

(1) The customer is not in physical possession of the property;

(2) The customer does not control the property, beyond the customer's network access and use of the property;

(3) The provider has the right to determine the specific property used in the "cloud transaction" and replace such property with comparable property;

(4) The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated;

(5) The customer does not have a significant economic or possessory interest in the property;

(6) The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;

(7) The provider uses the property concurrently to provide significant services to entities unrelated to the customer;

(8) 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

(9) The total contract price substantially exceeds the rental value of the property for the contract period.

Although the proposed regulations take an all or nothing approach with respect to a single cloud-transaction, **an arrangement composed of multiple transactions generally requires separate classification for each transaction**. Any transaction that is *de minimis*, taking into account the overall arrangement and the surrounding facts and circumstances, will not be treated as a separate transaction, but as part of another transaction.

The proposed regulations contain **a number of helpful examples illustrating when a cloud-based transaction will be treated as a lease of property or the provision of services**. The examples are contained in paragraph (d) of § 1.861-19.

* *De minimis* is a latin term typically meaning "trivial"; however, the IRS does not define that term for application in the proposed regulations. Some examples contained within the regulations do provide guidance on when an item is considered "*de minimis*."

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