

# Two's Company, Three's a Cloud: New Tax Guidance on IP, Digital Content and Cloud Transactions

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The recent judicial and legislative actions described below are the latest steps in modernizing the federal income tax system in the United States to make it compatible with today's digital economy. The changes provide taxpayers greater guidance towards treatment by the Internal Revenue Services ("IRS" or the "Service") when engaging in cross-border intellectual property ("IP") and digital content transfers and cloud transactions.

## Intellectual Property Licenses

The US Court of Appeals for the Ninth Circuit, covering most of the western United States, affirmed the US Tax Court's decision about a tax dispute between the online retail giant Amazon and the IRS. The question before the court was whether Amazon.com, Inc. ("Amazon US") US had received reasonable compensation for licensing a package of intangible assets, including IP, to its Luxemburg subsidiary, Amazon Europe Holding Technologies SCS ("Amazon Europe"), in 2005 and 2006. Amazon Europe had paid \$225 million in the deal with Amazon US. The IRS argued, however, that a different transfer pricing methodology should have been used by the taxpayer, resulting in Amazon Europe paying an additional \$3.4 billion and increasing Amazon US's income tax bill by \$234 million.

The argument was ultimately defined by what items Amazon US licensed as part of its package of intangible assets. Amazon isolated individual ownable assets and valued them individually. The IRS arrived at the adjusted value of the assets by valuing the tangible assets of Amazon Europe, and assuming any remainder in value was an intangible asset transferred in the transaction. It argued that the package included "more nebulous" assets such as Amazon's goodwill, employees and "culture of innovation."

The court ultimately concluded that the Service's reading of the statute and regulation was overly broad and that case law on the subject indicated "that intangibles were limited to independently transferable assets."

While relegated to a footnote in the court's opinion, it is worth highlighting that Congress has amended the definition on intangible property in the Tax Cuts and Jobs Act of 2017 ("TCJA"). Further, the court commented there was "no doubt" that the IRS position would have succeeded if it was argued post-TCJA.

This article was written by Alexis Maguina before joining Haynes and Boone.

## **Newly Proposed IRS Regulations**

The IRS has proposed the Regulations described below and will be accepting comments on them until November 12, 2019.

### **Computer Programs May Now Become Just Part of Digital Content**

Proposed Treasury Regulation Section (the “Proposed Regulation” or “Prop. Reg.”) 1.861-18 takes a step towards modernizing the current regulatory tax structure by building on previously written regulations for software transactions.

Traditionally, Treas. Reg. 1.861-18 (the “Computer Regulations”) provided parameters for classifying transactions involving computer programs. The Computer Regulations defined computer programs as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.” Transactions are placed in one of four categories: 1) as a sale or license of a “copyright right” in computer programs 2) transfer of computer programs (a “copyrighted article”), 3) services for developing or classifying computer programs, or 4) transferring of know-how relating to computer programming techniques.

Prop. Reg. 1.861-18 maintains the four categories but replaces the term “computer program” with “digital content.” Most important, “digital content” is set to include computer programs and “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.” The Computer Regulations’ categorization methodology will now cover products such as e-books, downloadable movies and music. Prop. Reg. 1.861-18 also provides three new examples related to the expanded scope of digital content. The examples highlight how the ability to replicate and access the content will distinguish a copyright right, a copyrighted article, and a “cloud transaction” (further discussed later in this article).

### **Income Sourcing**

Prop. Reg. 1.861-18 redefines how income from the sale of copyrighted articles will be sourced. Historically, said income was sourced to the location where the “rights, title and interest” were transferred from the seller to the buyer. The Proposed Regulations make it so the income is sourced to the “location of the download or installation onto the end-user’s device used to access the digital content.” However, “in the absence of information about the location of download or installation” the income will be sourced to the location of the customer based on the taxpayer’s “recorded sales date for business or financial reporting purposes.” However, the Proposed Regulations do not explicitly mandate that taxpayers track the location of the download or installation and does not define when said information will be considered “absent.” Without further guidance, this nebulous tracking standard may be nothing more than an invitation for taxpayers to collect data based on the tax implications.

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## Cloud Transactions

Prop. Reg. 1.861-19 tackles a new type of transaction in the economy: cloud transactions. The new regulation clarifies the treatment of software and cloud computing in relation to new provision enacted as part of the TCJA (Internal Revenue Code Sections 59A, 245A, 250 and 267A).

The Proposed Regulations define cloud transactions as “a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in § 1.861-18(a)(3)), or other similar resources.” As with any rule, there is an exception: the Proposed Regulation have an exemption when the on-demand network access is minimal in relation to the transaction, such as downloading digital content.

The Proposed Regulation also builds on services versus lease principles already established under IRC § 7701(e) to categorize cloud transactions. It lists the following (but not exclusive) factors that make a transaction a lease instead of a service:

1. the service recipient is in physical possession of the property,
2. the service recipient controls the property,
3. the service recipient has a significant economic or possessory interest in the property,
4. the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
5. the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
6. the total contract price does not substantially exceed the rental value of the property for the contract period.

The regulations provide eleven examples that use these factors to determine whether a transaction is a cloud transaction and whether it will be deemed a lease or a service. It is worth highlighting in every example where the activity is deemed to be a cloud transaction, it is categorized as a service. While no specific guidance is provided about the sourcing of income from cloud transactions, it is assumed that the transaction will follow the normal rules of sourcing income for leases and services.