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CLOUD TRANSACTIONS

Are there Silver Linings in the New Cloud Regulations? How Clicks are Taxed

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The Final Regs. extend the scope of Treas. Reg. 1.861-18 to transactions involving "digital content."

The Department of Treasury and the Internal Revenue Service (IRS) recently issued proposed and final regulations for Treasury Regulation Section 1.861-18 and 19. These regulations will significantly change the way computer programs, movies, and music, in digital format, will be taxed in the United States. This article discusses recent changes based on the final regulations for taxing digital content and cloud transactions. This article also discusses the 2025 proposed regulation and the determination of the source of income from cloud transactions based on a taxpayer-by-taxpayer approach that looks to the location of the taxpayer's employees and assets. Since a significant portion of digital content and cloud transactions involves a cross-border element, we will begin this article with a discussion of how U.S. and foreign persons are taxed in the United States.

TAXATION OF U.S. PERSONS

The basic rule of the U.S. income tax system is that U.S. citizens, resident aliens and domestic corporations[1] are subject to tax on worldwide income regardless of the country from which the income derives, the country in which payment is made or the currency in which the income is received. For U.S. persons, the term "source of income" is typically only relevant for foreign tax credit purposes.[2]

TAXATION OF NON-RESIDENTS BY THE UNITED STATES: EFFECTIVELY CONNECTED AND NON-EFFECTIVELY CONNECTED INCOME, GAIN, OR LOSS

A non-resident individual or other non-resident entity of the U.S., including a foreign corporation, is subject to U.S. income tax only with respect to U.S. source income it derives from passive investment, as well as income or gain effectively connected, or treated as

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effectively connected with the carrying on of a U.S. trade or business (ECI) or through a permanent establishment in the U.S.

A foreign corporation or other non-U.S. resident carrying on a trade or business in the U.S. is taxed on a net basis, i.e., on ECI derived by the U.S. trade or business minus allowable deductions. The ECI rules apply U.S. trade or business characterization to income derived by indirect owners of the business through a flow-through entity, such as foreign beneficiaries of a trust or foreign partners in a partnership, for each owner's pro rata share or deemed allocation of ECI.[3]

ECI net income is subject to U.S. income tax at regular tax rates. The same outcome applies to a foreign corporation that is a resident of a treaty jurisdiction to the extent its business and associated profits are attributable to a permanent establishment situated in the U.S. For a foreign corporation, the current tax rate of U.S. federal income tax is 21%.

U.S. SOURCE INCOME: FOUNDATIONAL RULES

A foreign corporation not engaged in a U.S. trade or business is subject to a 30% flat rate (without deduction or credit) on its U.S. source income that is not ECI. Section 881(a)(1) of the Internal Revenue Code describes this category of U.S. source income, which is generally passive in nature, as "fixed or determinable or periodical income (FDAP). FDAP U.S. source income includes dividends, interest, rents, salaries, wages, premiums, annuities, and compensations. [4] Further, certain species of foreign source income that are attributable to a foreign corporation's office or fixed place of business in the United States may be deemed to be effectively connected with a U.S. trade or business.

ROYALTIES AND LICENSE PAYMENTS AS FDAP

Royalties and payments made by U.S. users for licenses and similar arrangements for the use of intangible property owned by a foreign corporation (or non-U.S. person) are treated as FDAP.[5] This includes payments for the use of patents, copyrights, secret processes and formulas, goodwill, franchises, trademarks, trade names, and brands. Accordingly, royalty payments for the use of intangibles within the U.S. that are not effectively connected with a U.S. trade or business (or permanent establishment) of a foreign corporation or non-resident licensor, are subject to the flat 30% withholding tax subject to treaty modification.[6] The governing standard is for royalty income to be sourced based on the country in which the licensed property is used and not the jurisdiction in which the licensor resides or maintains its principal place of business.

The dividing line between the licensing of intangible property and gains from the sale of intangible property is not always clear. This has been the subject of tax litigation. This is because gains from the sale of property, including intangible personal property, do not subject a foreign corporation to the 30% withholding tax unless otherwise provided by a contrary IRC provision.

Generally, a sale results where the transfer is made of all substantial rights of ownership.[7] Even where there is a transfer of all or substantially all ownership rights to potentially qualify the transaction as a "sale" of intangible property, gains from such sale to the extent "contingent on the productivity, use or disposition of the property" are treated as FDAP and are taxed at a gross 30% rate. A payment that is indefinite in amount or as to time is generally not treated as "contingent" for purposes of this rule.[8]

SOURCE OF INCOME FROM LEASES, LICENSES, AND SERVICES

Sourcing rules determine whether income from payments of a particular transaction will be treated as U.S. source or foreign source income or partly both based on an allocation provision.[9] Compensation for personal services performed in the United States is U.S. source income, and compensation for personal services performed abroad is foreign-source income.[10] As noted, personal services are sourced under the "place of performance" standard.[11] In comparison, royalty and licensing income associated with intangible personal property is sourced according to where the intangibles are used, as well as the location where the licensee seeks legal protection.[12] For example, a licensee remits fees to the manufacturer of copyrighted software for use in the U.S. The manufacturer or developer of the software is a foreign corporation based in Brazil which does not have, at present, a tax treaty with the U.S. The payment is U.S. source FDAP income, assuming that the Brazilian corporation does not carry on a trade or business in the U.S.

In the Deficit Reduction Act of 1984, Congress enacted IRC § 7701(e) to distinguish between a lease and a service contract. Six factors are set forth in the statute: (1) the service recipient has physical possession of the property "leased;" (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 economic risk of loss by 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.

INCOME FROM COMPUTER PROGRAMS AND CLOUD TRANSACTIONS

As mentioned above, income from copyrights, patents, trademarks, or similar intangibles may be treated as "royalties" and therefore FDAP under a "license" arrangement, or alternatively, as gain from the sale of the property if substantially all rights are transferred, or as services income if the income is principally derived in the form of compensation for

the owner's services in developing the property. Where the foreign person or corporation receives payments but does not have ownership in the intangible property, the transaction is treated as compensation. Where less than substantially all of the foreign person's or corporation's rights are transferred, the transaction is characterized, in general, as a license.

Treas. Reg. 1.861-18 (Software Rules) provides rules for classifying income from computer programs as well as income from services and know-how. There are several rules involving the transfer of a computer program, service, or know-how including: (1) a transfer of a "copyright right" in the program, which is treated as a sale if "all substantial rights" in the copyright as to a particular country are transferred or a license producing royalty income if less than all substantial rights are transferred;[13] (2) a transfer of the program or intangible, which is treated as a sale where "the benefits and burdens" of ownership are transferred and, if not, then the transaction constitutes a lease yielding rental income;[14] (3) a contract for services with respect to the development or modification of the program;[15] or (4) for "know-how relating to computer programming techniques," which would, in general presumably be treated as licensing income unless the transferee acquires ownership rights with respect to the "know-how."[16]

The Software Rules did not appear to provide a complete basis for addressing characterization and sourcing issues related to "cloud computing" transactions, a more recent phenomenon. While computer software technology includes the purchase or lease of a license to install and run software on an individual's or corporation's computers, cloud computing permits consumers to access the internet or virtual space where the software is located through one or more provider's servers to run its data on the host company's software, hardware, and data storage. A developer may serve as an intermediate party between the consumer and the owner of the technology.

Therefore, it was unclear based on the Software Rules whether cloud computing income should be characterized as royalty, rental, or services income. Cloud computing transactions may, in general, be described as involving three models: (1) software as a service (SaaS); (2) platform as a service (PaaS); and (3) 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. It is generally understood that SaaS transactions are the predominant cloud computing transaction. 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 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 problem with issuing tax rules on cloud computing is that these transactions occur entirely in the virtual world, i.e., there is little connection between the revenue-generating activity and a particular geographic location. The potential incongruities between the source of revenue and geographic activity can yield no taxation at all or double taxation.[17] There is an associated problem of classification of payment for cloud services.

PROPOSED CLOUD COMPUTING REGULATIONS

Proposed Regulations (Prop. Regs.)[18] provide specific rules for cloud transactions. Treasury, in its proposed rulemaking, acknowledged that in general, a cloud transaction involves access to property or use of property, instead of the sale, exchange, or license of property, and therefore should be classified as either a lease of property or the provision of services. Treasury then looked to IRC § 7701(e) and relevant case law to delineate the factors to characterize a cloud computing transaction as either a lease of property or the rendition of services. In particular, IRC § 7701(e)(1) instructs that a contract that purports to be a service contract will be treated instead as a lease, if, based on all facts and circumstances: (1) the service recipient is in physical possession of the property; (2) the service recipient controls the property; (3) the service recipient has 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.

IRC § 7701(e)(2) provides that the factors described above apply to determine whether any arrangement, not just contracts which purport to be service contracts, is to be treated as a lease. The list of factors is neither weighted, nor all-inclusive. In general, cloud computing will involve payment for the rendition of services but again, must be examined under the filter of each specific transaction and "all relevant" factors tested.

The Prop. Regs. define a "cloud transaction" to be "a transaction through which a person obtains on-demand network access to computer hardware, digital content[19] or other similar resources, other than on-demand network access that is de minimis taking into account the overall arrangement and the surrounding facts and circumstances."[20] The preamble to the Prop. Regs. provides that examples include "streaming music and video, transactions involving mobile device applications, and access to data through remotely hosted software."[21] However, a cloud transaction does not include "network access to downloaded digital content for storage and use on a person's computer or other electronic device."[22]

PROPOSED REGULATIONS DEFINITION OF DIGITAL CONTENT

The Prop. Regs. define "digital content" as any content in digital format that is either protected by copyright law or is no longer protected by copyright law solely due to the passage of time, regardless

of whether it is transferred in a physical medium (e.g., books, movies, and music in digital format).[23] The transfer of the "mere right" to publicly perform or display digital content for the purpose of advertising the sale of the digital content should not constitute the transfer of a copyright right.[24] When copyrighted articles are sold and transferred through an electronic medium, the sale is deemed to occur at the location of download or installation onto the end user's device used to access the digital content.[25] If there is no information on the location of download or installation onto the user's device, then the sale is deemed to have occurred at the location of the customer based on the taxpayer's recorded sales data for business or financial reporting purposes.[26]

SOURCING RULES UNDER THE PROPOSED REGULATIONS FOR CLOUD COMPUTING TRANSACTIONS

In general, U.S. sourcing rules attempt to identify the geographic location of economic activity or financial arrangements. These rules play a more prominent role in the taxation of foreign persons and corporations, since they effectively define the boundaries of U.S. taxation. Traditionally, services have been performed by individuals located at easily identifiable physical locations. In today's internet-driven economy, digital commerce poses a challenge to the application of the traditional sourcing rules. The *Piedras Negras* case provides useful guidance in determining the source of income for high tech companies. The *Piedras Negras* case involved a foreign radio station located close to the U.S. border that broadcasted programing targeted primarily at U.S. listeners. The majority of the foreign radio station's income was derived from U.S. advertisers. The studio and broadcasting plant were located in a foreign country (Mexico) and the employment of capital and labor was outside of the U.S. The Fifth Circuit Court of Appeals stated that the source of income "is the situs of the income-producing service," that is, the "services required of the taxpayer under the contracts."[27] Under these facts, the court held that there was no U.S. source income because the principal place of business was outside the U.S. and the labor and activities that produced the income were outside the U.S.

Piedras Negras continues to be relevant to technology companies today because it addresses issues that arise when a foreign corporation provides services in multiple locations. Importantly, the case held that the location of the customer is not relevant in determining the source of income. The Fifth Circuit Court of Appeals in *Container Corp. v. Commissioner*[28] cited the *Piedras Negras* case in determining the source of income for guaranty fees and stated "[i]t is clear that the source of payments for services is where the services are performed, not where the benefit is inured."

The source rules for gross income are organized by categories of income, such as interest, dividends, personal services income, rentals, royalties, and gains from the disposition of property.[29] Since the source of income is determined according to the location where the income producing activity occurs (i.e., the location of the services required under the contract), the location of the employees that provide the service and the property used in the service are relevant. If all of a company's employees and property are located in a foreign country, it normally should be easy to conclude that the source of compensation for services should be outside the U.S. However, additional questions can arise when contributions to the services are provided by third parties. For example, if a dependent agent[30] conducts activities in the U.S. on behalf of the foreign principal, income earned by the principal that is generated in part by that agent's activities could be deemed U.S. source income. Conversely, if a dependent agent is located in a foreign jurisdiction, then the income potentially could be classified as foreign-source services income.

The Prop. Regs. propose a formula to determine the "place of performance" for sourcing income received from a cloud transaction which are categorized as the provision of services. They adopt a "taxpayer-by-taxpayer" approach for the sourcing with every regarded legal entity treated as an individual taxpayer. These rules focus on the economic contributions between parties and provide mathematical formulas to determine the source of income for U.S. tax. Income generated from cloud transactions is considered U.S. source and therefore subject to U.S. tax to the extent that non-U.S. business personnel, intangible property, and tangible property that contributed to income received from the transaction was located and/or performed in the U.S.

Different rules apply to determine the source of income for U.S. tax purposes.[31] Gross income that is U.S. source income includes compensation for labor or personal services performed in the United States.[32] Alternatively, if the services are performed outside the United States, then the income is foreign sourced.[33] If a portion of taxable income is attributable to sources within the U.S. and also to sources outside the U.S., the portion attributable to U.S. sources could be determined by general apportionment.

To determine where services are performed, the Prop. Regs. adopt a formula that uses three factors: (1) intangible property factor; (2) personnel factor; and (3) tangible property factor and in each case the U.S. source portion thereof. The factors would be specified expense items. For cloud transactions, the U.S. source portion of gross income would be determined by multiplying the gross income by a fraction known as the "apportionment fraction." The numerator is the sum of the U.S. source portions of each of the three actors and the denominator of which is the sum of the three factors.

U.S. source gross income = Gross Income x (Sum of the U.S. portion of each factor / Sum of the three factors)

The above three-factor test would apply to each cloud computing transaction.

In contrast to rules governing the source of services income, rules governing the source of rental income and royalty income[34] are sourced according to the place in which the property is located or used.[35] Case law and other authorities interpreting this standard as it applies to royalties do not provide

a clear framework.[36] Gain from the sale of personal property such as intangible property is sourced according to the residence of the seller.[37] On the other hand, sales of inventory property, such as the sale of a computer program at retail, are sourced where title passes.[38] Finally, foreign-source gain may be recharacterized as U.S. source if the sale is attributable to an office or fixed place of business in the U.S.[39]

THE INTANGIBLE FACTOR

The first factor in the apportionment fraction is the intangible property factor. The intangible property is the sum of the specified research and experimental (R&E) expenditures.[40] The U.S. portion of the R&E expenditures must be apportioned in each cloud transaction for gross income allocation.[41] The Prop. Regs. determine the U.S. source portion of the intangible property factor by multiplying the intangible property by a fraction. The numerator of the fraction would be the sum of the total compensation paid to R&E expenditures for services performed within the U.S. under the principles of the time basis rule. The denominator would be the total compensation paid for the R&E expenditures.[42]

U.S. sourced portion (intangible property factor) = Intangible property factor x (R&E Comp (within U.S.) / R&E Comp (Total))

THE PERSONNEL FACTOR

The second factor in the apportionment fraction is the personnel factor. The personnel factor is the sum of the total compensation paid to all the entities' employees whose direct service contributed to the cloud transaction.[43] Compensation paid for R&E is excluded from this allocation. The personnel factor would be considered the direct contribution to the provision of a cloud transaction to the extent the personnel "personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are managers who directly support or immediately supervise such technical or operational personnel.[44] The Prop. Regs. provide a comprehensive list of activities considered to contribute to a cloud transaction.

Activities that directly contribute to a cloud transaction:[45]

1. Conduct scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction;
2. Provision of monitoring, diagnostic, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security;
3. Management of cloud transaction's infrastructure;
4. Delivery of end-user support with respect to the cloud transaction; and
5. Similar function.

Activities that do not directly contribute to a cloud transaction:[46] (1) business strategy; (2) leadership; (3) legal or compliance; (4) marketing; (5) communications; (6) sales; (7) business development; (8) finance; (9) accounting; (10) clerical; (11) human resources or administration; (12) similar function.

Compensation paid to an employee whose primary function is to directly contribute to a cloud transaction must be allocated. The allocation is based on the relative amount of time the employee spends contributing to the cloud transaction instead of the gross income generated by the cloud transaction. The U.S. source portion of the personnel factor is equal to the portion of services performed in the U.S. on a time basis rule.[47] In the context of a cloud transaction, the personnel factor is determined by multiplying the personnel factor by a fraction in which the numerator is the sum of the total compensation paid to personnel services performed within the U.S. and the denominator being the total sum of compensation paid to such personnel.[48]

U.S. Source Portion (personnel factor) = Personnel Factor x (Direct Services Personnel Compensation (Within U.S.) / Direct services Personnel Compensation (Total))

If the IRS finalizes the Prop. Regs., the personnel factor rule will necessitate rigorous tracking of employee time. Businesses will be required to determine whether and to what extent employees worked on cloud transactions and where that work occurred.

THE TANGIBLE FACTOR

The third factor in the apportionment fraction is the tangible factor. The tangible property factor would equal the sum of: (1) the depreciation expense for the taxable year[49] for tangible property; and (2) rental expenses for the year the tangible property is leased. Expenses are included in the tangible property factor to the extent directly provided to the cloud transaction.[50] Expenses relevant to more than one cloud transaction would be allocated among the cloud transactions based on a relative gross income portion that is received from each cloud transaction.[51] The U.S. source portion of the tangible property factor would equal the part of the factor attributable to the property located within the U.S.

U.S. source portion (tangible property factor) = Tangible property factor x (Depreciation and Rental Expense for Property Located Within the U.S. / Depreciation and Rental Expense (total))

ANTI-ABUSE RULE

The Prop. Regs. contain a general anti-abuse rule, which would permit the IRS to adjust the sourcing of an individual's or entity's income if transactions are structured with a principal purpose of reducing U.S. tax liability in a manner that is inconsistent with the regulation's intent.

FINAL CLOUD COMPUTING REGULATIONS

On January 14, 2025, the IRS and the Treasury finalized regulations (Final Regs.) for cloud transactions. The Final Regs. define "digital content transaction" as the transfer of digital content or the provision of modification or development services or of know-how with regard to digital content. The Final Regs. define a "cloud transaction" as a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources, other than on-demand network access that is de minimis, taking into account the overall arrangement and surrounding facts and circumstances. On-demand access may be distinguished from transactions

whose predominant character involves downloading a program to the user's own computer or transferring rights in the content that extend beyond online use. The Final Regs. modify Treas. Reg. 1.861-18 to include the transfer of all manner of digital content so that it is no longer limited to computer programs.

The Final Regs. introduced the following changes to the 2019 Prop. Regs.:

Cloud Transactions as Services

In a departure from the Prop. Regs., all cloud transactions will be classified solely as the provision of services. There will be no need to perform an analysis to distinguish between services and a lease to determine how a cloud transaction is taxed.

Definition of Digital Content

The Final Regs. extend the scope of Treas. Reg. 1.861-18 to transactions involving "digital content." The Final Regs. do not expand the definition of digital content; however, they expand the scope to include any content in digital format that is either protected by copyright law, no longer protected by copyright law solely due to the passage of time or because the content was dedicated (or passed) to the public domain.

The Final Regs. define "cloud transactions" as a transaction through which a person obtains on-demand network access to computer hardware, digital content or other similar resources, but does not include network access for the purpose of downloading digital content for storage and use on a person's computer or other electronic device.

The Final Regs introduce a new predominant character rule. Under this rule, a transaction that has multiple elements is classified in its entirety as a digital content or cloud transaction if the predominant character is a digital content or cloud transaction, respectively. The predominant character is generally determined by the primary benefit or value received by the customer in the transaction. If that is not reasonably determinable, the predominant character is determined based on the primary benefit or value received by a typical customer in a substantially similar transaction.

The prior de minimis standard set a relatively low floor (i.e., a minimal or insignificant level) above which a component element in a multi-element transaction may need to be treated as a separate transaction in its own right. By contrast, the new predominant character standard seeks to determine the primary benefit or value received by the customer in a multi-element transaction between two parties. When ascertained, such primary benefit or value to the customer will be the transaction's predominant character and, if such predominant character is a digital content or cloud transaction, the transaction "in its entirety" (including all its elements) will be characterized as such.

Distinction Between Temporary Downloads and Streaming

The Final Regs. distinguish between temporary downloads and streaming. Temporary downloads that involve a transfer of digital content could be classified as the transfer of a copyrighted article. In other words, a temporary download could result in a rental or lease income. However, when a customer streams digital content, the provider may merely be providing a service. In essence, the distinction between temporary downloads and streaming lies in the actual transfer and possession of the digital content. Temporary downloads will likely be treated as a transfer of copyrighted materials, while streaming will likely be considered a service providing access. The Final Regs. new predominant character rule will classify transactions that will include elements of both temporary downloads and streaming.

Sourcing Rules

The Final Regs. provide new sourcing rules so that when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of the purchasers' billing address.[52]

Treas. Reg. 1.861-19 generally classifies all cloud transactions as services income. A cloud transaction is defined as a transaction through which a person obtains on-demand network access to computer hardware, digital content,[53] or other similar resources. A cloud transaction does not include network access to download digital content for storage and use on a person's computer or other electronic device. Income from sales of downloads copyrighted articles will be sourced based on the billing address of the immediate purchaser of the article, rather than on where the ultimate end-user downloads or installs the article.

FINAL REGULATIONS APPLY PREDOMINANT CHARACTER STANDARD IN CROSS-BORDER DIGITAL TRANSACTION

The Final Regs. amend many of the illustrative examples in Treas. Reg. 1.861-18 and 19 and add several new ones. Example 20 in the Final Regs. discusses the application of the predominant character standard in a digital transaction.

> **Example 20:** Internet platform operator as agent for application developers
>
> (i) *Facts.* Corp A operates a platform on the internet that offers applications for download onto a customer's mobile phone. Under general tax principles, Corp A and an application developer establish an agency relationship whereby Corp A acts as the agent to offer the application for sale to customers on behalf of the application developer. The applications are protected by copyright law. Under the agreement between Corp A and the application developer, Corp A agrees to provide the application developer with platform and agency services to facilitate the sale of the application to customers. Corp A also provides the application developer with hosting services to host the application on Corp A's servers for download by customers. Corp A receives a digital master copy of the application along with a non-exclusive right to make copies of the application and allow customers to download copies of the application from Corp A's platform. Corp A has ascertained that the primary benefit or value from the transaction received by the application developer is the platform and agency services that Corp A provides. Corp A receives the right to make copies of the application merely to perform its activities as an agent on behalf of the application developer. When purchasing an application on Corp A's platform, the customer must acknowledge the terms of a license agreement with the application developer that states that the customer may use the application but may not reproduce

or distribute copies of it. In addition, the agreement provides that the customer may download the application onto only one mobile phone at a time. A customer does not need to be connected to the internet to access the application. The customer owes no additional payment to Corp A or the application developer for the ability to use the application in perpetuity. Corp A retains a fixed percentage of each purchase price of the application and remits the remaining balance to the application developer.

(ii) *Analysis.*

(A) The transaction *between Corp A and the application developer* has multiple elements. One element is the transfer of a master copy of an application by the application developer to Corp A[54], which would be considered a transfer of a copyrighted article if considered separately. The second element is the transfer of the right to make and distribute copies of the application by the application developer to Corp A, which would be described as a transfer of a copyright right if considered separately.[55] A third element is the hosting services provided by Corp A to the application developer.[56] Under the facts and circumstances, although Corp A receives a copy of the application and the right to make and distribute copies of the application, Corp A receives this copy and right merely to facilitate the sale of applications on behalf of the application developer.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, the transaction is classified within a single category if its predominant character is described in the Final Regs. The predominant character of the transaction is based on the primary benefit or value of the transaction to the customer (e.g., the application developer in this transaction) if it is reasonably ascertainable.

(C) The transfer of a copy of an application from the application developer to a customer (e.g., the end user in this transaction) is a digital content transaction with one element, which is the transfer of a copy of a digital program. Therefore, the transaction is treated solely as a transfer of a copyrighted article. Under the benefits and burdens test,[57] this transaction is a sale of a copyrighted article because a customer has the right to use the application in perpetuity.

In Example 20's analysis, there are only two transactions. The first is the 3-element transaction between the app developer and Corp A, analyzed in clauses (A) and (B). The second is the single-element transaction between the app developer and the end user, analyzed in clause (C).We have made the following preliminary observations:

First, by finding that the grant of a license by the app developer to Corp A is a transfer of a copyright, within the meaning of Treasury Regulation 1.861-18(b)(1)(i) and (c)(2)(i), Example 20 perhaps reads the definition too narrowly. It fails to take into account that transfers of a copyright right to make and distribute copies are typically for the purpose of allowing the licensee to commercially exploit the license for its own account (i.e., for its own profit). Without this purpose, it should not be possible for such a copyright right to be transferred.

Second, with respect to the second transaction in which the app (i.e., copyrighted article) is transferred to the purchaser of the app, Example 20 looks through Corp A due to its agency relationship with the app developer. Example 20 assumes the existence of this relationship under general tax principles without analysis. The final regulations explain that the assumption is made because such an analysis is outside the scope of the final regulations.

Third, under general tax principles, an agent's activities are generally imputed to its principal. If the agent conducts its activities in the U.S. on behalf of a nonresident principal who otherwise lacks a physical presence in the U.S., the foreign principal may be deemed to be engaged in the conduct of a U.S. trade or business through the agent, provided that the agent's activities in the U.S. are considerable, continuous, and regular.[58] If a U.S. trade or business is found, the ECI would be subject to U.S. income tax on a net basis at a rate of 21% if the principal is a foreign corporation.

CONCLUSION

The foregoing is intended to provide the reader with a basic understanding how digital content and cloud transactions are taxed under the newly released Final Regs. and proposed sourcing regulations to determine the source of income from a cloud transaction. It should be evident from this article that this is a complex area of tax law that is subject to constantly new developments and changes. Consequently, it is crucial that U.S. and foreign digital content creators review their particular circumstances with a qualified U.S. international tax attorney.

End Notes

[1] A domestic corporation is a corporation created or organized in the United States or under the laws of the United States, the District of Columbia, or one of the 50 states. *See* IRC §§ 7701(a)(4), 7701(a)(10). A dual-resident corporation is one that is organized in one jurisdiction but managed and controlled in a second country. When this dual-resident status exists, the presence or absence of a tax treaty is important. Where there is a tax treaty, the tie-breaker provision will, in general, result in the corporation's residence for tax purposes existing in the place of "effective management." Where there is no treaty involved, the dual-resident corporation may be subject to tax in both countries. *See* Treas. Reg. 301.7701-2(b)(9).

[2] The foreign tax credit provisions contained in IRC §§ 901 through 909 permit a foreign tax credit to reduce U.S. taxation on foreign source income.

[3] *See* IRC §§ 875(1) and 875(2), which provide that a foreign corporation (or nonresident alien individual) is engaged in a U.S. trade or business if the partnership, estate, or trust is engaged in a U.S. trade or business.

[4] *See* Treas. Reg. 1.1441-2(b)(1)(i); 1.1441-2(b)(1)(ii).

[5] *See* Treas. Reg. 1.871-7(b); 1.881-2(b).

[6] *See*, e.g., U.S. Model Tax Treaty (2016), Article 12.

[7] *See* IRC §§ 861, 862, 865(d)(1)(B); 865(a); 865(d); Rev. Rul. 69-156, 1969-1 CB 101, modifying Rev. Rul. 57-317, 1957-2 CB 909.

[8] *See* Treas. Reg. 1.871-11(a).

[9] *See* IRC §§ 861(a)(3) and 862(a)(3).

[10] *See* IRC §§ 861(a)(3) and 862(a)(3).

[11] *See* IRC § 861(a)(3).

[12] *See* IRC §§ 861(a)(4) and 862(a)(4).

[13] *See* Treas. Regs. 1.861-18(b)(1)(i); 1.861-18(f)(1); 1.8861-18(h), Ex. Treas. Reg. 1.861-18(c) provides that a transfer of a computer program is classified as the transfer of a copyright right if there is a non-de minimis grant of any of the following four rights: (1) the right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending; (2) the right to prepare derivative computer programs based upon the copyrighted computer program; (3) the right to make a public performance of the computer program; or (4) the right to publicly display the computer program. Treas. Reg. 1.861-18(f) further

categorizes a transfer of a copyright right as either the sale or license of the copyright right and a transfer of a copyrighted article as either the sale or lease of the copyrighted article.

[14] *See* Treas. Reg. 1.861-18(f)(2); Treas. Reg. 1.861-18(h), Ex. 3, Ex. 7, Ex. 12, and Ex. 13.

[15] *See* Treas. Reg. 1.861-18(b)(1)(iii).

[16] *See* Treas. Reg. 1.861-18(b)(1)(iv).

[17] SaaS cloud transactions should generally be viewed as the payment for services since the user or consumer will not receive copyright rights or ownership rights in the software and program. The question therefore is: What is the source of the services income? In general, services income is sourced to the place where the services are performed. *See Piedras Negras Broadcasting Co.*, 127 F.2d 260 (5th Cir. 1942).

[18] Prop. Reg. 1.861-19, REG-130700-14, 84 Fed. Reg. 40,317, 40,318 (8/14/2019).

[19] *See* Treas. Reg. 1.861-18(a)(3).

[20] *See* Prop. Reg. 1.861-19(b).

[21] *See* REG-130700-14.

[22] *See* Prop. Reg. 1.861-19(b).

[23] *See* Prop. Reg. 1.861-18(a)(3).

[24] *See* Prop. Reg. 1.861-18(c)(2)(iii) and (iv).

[25] *See* Treas. Reg. 1.861-7(c), Prop. Reg. 1.861-18(f)(2)(ii).

[26] *See* Prop. Reg. 1.861-18(f)(2)(ii).

[27] *See Piedras Negras*, 127 F.2d at 260-61.

[28] No. 10-60515 (5th Cir. May 2, 2011).

[29] *See* IRC §§ 861 and 862.

[30] A dependent agent is a person, whether or not an employee of the foreign enterprise, who is not an independent agent.

[31] IRC §§ 861-865.

[32] IRC § 861(a)(3).

[33] IRC § 862(a)(3).

[34] The term "royalties" is often referred to as "amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property."

[35] *See* IRC §§ 861(a)(4) and 862(a)(4).

[36] *Compare, e.g.*, Rev. Rul. 84-78, 1984-1 C.B. 173 (finding that a payment by a foreign corporation to a domestic corporation for the right to broadcast prize boxing fights was foreign-sourced income because it was entitled to broadcast the fight in the country of the foreign corporation); *with Sanchez v. Commissioner*, 6 T.C. 1141 (1946), *aff'd*, 162 F.2d 58 (2d Cir. 1947) (finding that royalties paid by a domestic corporation licensee to a non-resident individual were U.S. sourced even though goods were to be used abroad).

[37] IRC § 865(a).

[38] *See* IRC §§ 861(a)(6) and 862(a)(6); Treas. Reg. 1.861-18(f)(2).

[39] IRC § 865(e)(2).

[40] IRC § 174(b).

[41] Prop. Reg. 1.861-19(d)(2)(i).

[42] Treas. Reg. 1.861-4(b)(2)(ii)(F).

[43] Prop. Reg. 1.861-19(d)(3)(i).

[44] *Id.*

[45] Prop. Reg. 1.861-19(d)(3)(i).

[46] Prop. Reg. 1.861-19(d)(3)(iv).

[47] Prop. Reg. 1.861-19(d)(3)(ii).

[48] Treas. Reg. 1.861-4(b)(2)(ii)(E).

[49] IRC § 168(g)(2); Prop. Reg. 1.861-19(d)(4)(iii).

[50] Prop. Reg. 1.861-19(d)(4)(i).

[51] *Id.*

[52] Treas. Reg. 1.861-7(c).

[53] *See* Treas. Reg. 1.861-18(a)(2).

[54] Treas. Reg. 1.861-18(b)(1)(ii).

[55] Treas. Reg. 1.861-18(b)(1)(i) and (c)(2).

[56] Treas. Reg. 1.861-19.

[57] Treas. Reg. 1.861-18(f)(2)(i).

[58] https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci