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FEDERAL EXCISE TAX AND SUPPLY CHAIN PLANNING

Navigating New Norms: Adapting Supply Chain Strategies to Post-Pandemic Tax Realities and Compliance Demands

Robert Khachatryan

The landscape of supply chain management is in a pivotal state of transformation, catalyzed by the shifting sands of international tax regulations and the aftereffects of a global pandemic.

INTRODUCTION

In the wake of a global pandemic, the landscape of supply chain management has undergone a seismic shift. As industries worldwide scramble to adapt to the new normal, a critical aspect has emerged at the forefront of strategic planning: the intricate web of international tax regulations. This article delves into the complexities of supply chain planning in the post-COVID-19 era, where a nuanced understanding of changing tax laws, including digital taxation and emerging economic incentives, is no longer a luxury but a necessity to ensure compliance and cost efficiency.

At the heart of this discourse lies the Federal Excise Tax (FET)—a levy that, while often overshadowed by more prominent tax counterparts, plays a pivotal role in the international supply chain. A recent report from the Alcohol and Tobacco Tax and Trade Bureau (TTB) has highlighted the collection of an unprecedented $20 billion in FET in the fiscal year 2021, underscoring the magnitude of this fiscal instrument. The process, however, is not without its challenges.

Excise taxes, as a cornerstone of global tax policy, serve dual functions: generating government revenue and steering market behaviors towards lesser harm. Their strategic imposition on select consumables and activities is integral to fostering a healthier society and mitigating the fiscal burdens of negative externalities. However, the efficacy of excise taxes hinges on judicious design and application; otherwise, the resulting market distortions could prove more detrimental than the absence of any policy.

The average annual Transportation Federal Excise Tax Revenue from 1957 to 2022 was $19,923.71 million (source: The White House - Table 2.4 - COMPOSITION OF SOCIAL INSURANCE AND RETIREMENT RECEIPTS AND OF EXCISE TAXES: 1940 - 2028).

Particularly in the importation of heavy duty truck and bus tires, a dichotomy presents

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Foreign Cloud Computing Transactions: U.S. Taxation of Service, Intangible, Copyright, and Royalty Income

Anthony Diosdi

Cloud computing transactions differ from the traditional provisions of traditional software transactions.

New technology and new transactions often raise difficult issues of tax policy and administration in part because existing rules were developed to deal with other situations. The dramatic expansion in electronic commerce facilitated by the use of the Internet and other technology is subjecting existing tax principles to new pressures. One area of concern is the application of source rules to electronic commerce transactions. Suppose, for example, that a corporation delivers software or a digital product to a customer on the Internet. The customer can download the product and use it commercially. Depending upon the nature of the transaction and the property interests involved, the income to the corporation might appropriately be characterized as a rent or royalty for the use of technology, profit from the sale of a product, or a payment for services that it has rendered.

A complex set of regulations provides guidance with respect to the U.S. taxation of transactions involving digitized transactions. The software regulations enumerated in Treasury Regulation Section 1.861-18 (the "Software Rules") establish the framework for U.S. taxation of cross-border digital transactions. This article discusses the U.S. tax framework applicable to foreign digitized information.

TAXATION OF FOREIGN PERSONS AND FOREIGN CORPORATIONS BY THE UNITED STATES: EFFECTIVELY CONNECTED AND NON-EFFECTIVELY CONNECTED INCOME, GAIN, OR LOSS; AND BRANCH PROFITS TAX

In order to establish the framework applicable to U.S. taxation of foreign digitized information, it is important to discuss how foreign persons, foreign entities, and foreign corporations are taxed in the United States. The U.S. taxes a non-resident individual, a non-resident entity, and foreign corporations on the net amount of income effectively connected with the conduct of a trade or business within the U.S.[1] Therefore, under the U.S. Internal Revenue Code, the existence of a U.S. trade or business is the touchstone of U.S. taxation of a foreign corporation's profits. Despite its importance, there is no comprehensive definition of the term "trade or business" in the Internal Revenue Code or its regulations. The relevant case law suggests that a U.S. trade or business exists only if the activities within the U.S. are considerable, continuous, and regular and are engaged in for profit.

A non-resident individual, non-resident entity, and foreign corporation engaged in a U.S. trade or business is subject to U.S. taxation on the income effectively connected with the conduct of that U.S. trade or business.[2] Effectively connected income includes the following three categories of income:

1. Certain types of U.S.-source income;
2. Certain types of foreign-source income attributable to a U.S. office; and
3. Certain types of deferred income that is recognized in a year that the foreign person is not engaged in a trade or business, but which would have been effectively connected income if the recognition of the income had not been deferred;

A non-resident alien, non-resident entity, and foreign corporation engaged in the conduct of a U.S. trade or business can take deductions against its effectively connected gross income. These deductions include those for expenses, losses, and other deductions that are directly related to the effectively connected gross income (e.g., cost of goods sold), as well as a ratable portion of any deductions that are definitely related to any specific item of gross income.

In addition to the regular U.S. corporate income tax, foreign corporations engaged in a U.S. trade or business may become subject to the branch profits tax. The branch profits tax equals 30 percent of a foreign corporation's dividend equivalent amount. This tax attempts to mirror the 30 percent withholding tax imposed on U.S. subsidiary corporations that repatriate earnings to their foreign owners. The dividend equivalent amount of a foreign corporation is reduced by annual increases in such corporation's net equity, and is increased by annual reductions in its net equity.

INCOME NOT EFFECTIVELY CONNECTED WITH A U.S. TRADE OR BUSINESS

A non-resident individual, foreign entity, and foreign corporations not engaged in a trade or business in the U.S. are subject to a flat 30 percent withholding tax (without deduction or credit) on its U.S.-source income that is not effectively connected income. Internal Revenue Code Section 881(a)(1) describes this category of U.S. source income, which is generally passive in nature, as "fixed or determinable annual or periodic gains, profits, and income" ("FDAP income").

A foreign corporation's U.S.-source FDAP income is taxed on a gross basis without offsetting deductions. This is in contrast with the tax on income effectively connected with a U.S. trade or business, which is assessed on a net basis. In any event, the

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flat 30 percent withholding may be reduced or eliminated by applicable tax treaties.

The passive income categories subject to the flat 30 percent withholding tax include:

1. FDAP income such as interest, dividends, rents, salaries, wages, premiums, annuities, compensation, and other remunerations; and
2. Variable or contingent gains from the sale or exchange of intangible property such as patents, copyrights, secret process and formulas, goodwill, trademarks, trade brands, franchises, and other "like" property.

U.S. source royalty income may be classified as FDAP income subject to the 30 percent withholding tax. The rules governing U.S. taxation of royalty income are complicated. Rents and royalties are U.S. -source if the property is located or used in

SOURCE OF INCOME FROM LEASES, LICENSES, AND SERVICES DISTINGUISHED

The answer to many questions about the income taxation of international transactions depends upon the identification of the country in which the income is properly deemed to have been generated. It is therefore very important to consider the source rules. Most of the source rules are specified in Sections 861 through 865 of the Internal Revenue Code. The source rules play a prominent role in the taxation of foreign persons since they effectively define the boundaries of U.S. taxation. The sourcing rules under Internal Revenue Code Sections 861 and 862 instruct 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. Thus, the United States generally taxes the U.S.-source income of foreign persons and generally exempts their foreign-source income. The source rules for income are organized by categories of income, such as interest, dividends, personal services income, rentals, royalties, and gains from the disposition of property.[3]

Once an individual or business has determined the appropriate category of income, the next step is to apply the applicable source rule to classify the item of income as either U.S. or foreign source.

Compensation for services performed in the United States is U.S.-source income and compensation for personal services performed abroad is foreign-source income. The source of rental and royalty income is determined by the place where the property is located or used.[4] Accordingly, the source of rental income for tangible property will depend on the place where the property is physically located. The source of royalty income for intangible properties, such as patents, copyrights, trade secrets, trademarks, and goodwill depends on where the rights are used, which is generally the country in which the intangible property derives its legal protection.

For example, assume that a licensee remits fees to the manufacturer of copyrighted software for the use in the United States. The manufacturer or developer of the software is a foreign corporation based in Singapore, which does not have a tax treaty with the United States. The fees paid by the licensee are U.S.-source FDAP income and will not be subject to the 30 percent withholding tax.

INTRODUCTION TO THE SOFTWARE RULES

Probably the most important rules governing the taxation of digital transactions are the so-called "Software Rules" set forth in Treasury Regulation Section 1.861-18.

Treasury Regulation Section 1.861-18 provides rules for classifying income from the transfer of computer programs as well as income from the provision of services or know-how with respect to computer programs. Under these rules, transactions involving computer programs are categorized as one of the following four transaction types:

1. A transfer of a "copyright right" in the program, which is treated as a sale if "all substantial rights" in copyright as to a particular country are transferred and, if less than all substantial rights are transferred, a license generating royalty income;
2. A transfer of a copy of the program, which is treated as a sale of the copy if "the benefits and burdens" of ownership in the copy are transferred and, if not, a lease generating rental income;
3. The provision of services with respect to the development or modification of the program; or
4. The provision of "know-how" relating to computer programing techniques where such know-how consists of information subject to trade secret protection and is furnished under conditions preventing unauthorized disclosure.

According to the Treasury Department these rules "establish a framework applicable to any type of digitized information, at least to the extent it is protectable by copyright."

The Software Rules provide guidance as to how to characterize and source income received from transactions involving "computer programs." The regulations have defined the term "computer program" to mean:

> "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. For this paragraph, a computer program 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."[5]

The Software Rules state that a transaction must be based on substance rather than form. In other words, a transaction will not be classified on how it is described in an agreement. Conversely, an agreement stating that software is a "license" will not necessarily be treated as a "license" for tax purposes. Rather, the Software Rules provide that each transaction must be carefully analyzed. The taxable income relating to a computer program, the services related to the program, or the know-how of the program can be classified as either: 1) the sale of property (inventory or non-inventory; 2) license; 3) lease; or 4) service.

For the purposes of the "sale of property" in the context of the Software Rules, the Treasury Regulations provides after taking into consideration "all facts and circumstances," there must be either: 1) a transfer of "all substantial rights" in the copyright to the software; or 2) a transfer of a copyrighted article.[6] Below is a discussion of these two elements in more detail.

TRANSFER OF ALL SUBSTANTIAL RIGHTS IN A COPYRIGHT

A transfer of a copyright right will result for federal income tax purposes if an individual acquires any of the following: 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.[7]

If there has been a transfer of copyrights rights, the issue is whether the transfer is a sale, generating taxable gain, or a license, generating royalty income. The transaction will be a taxable sale if, taking into account all of the facts and circumstances, all substantial rights in the copyright have been transferred. The principles under Section 1222 relating to capital gains and losses and Section 1235 relating to the sale or exchange of patents may be applied when determining whether all substantial rights have been transferred.[8]

If the transferee acquires a copy of a computer program, but does not acquire any of the rights discussed above, the transaction is characterized as a transfer of a copyrighted article. A copyrighted article is a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated. [9] Further, the electronic transfer of software can constitute the transfer of copyrighted articles. Once it has been determined that there has been a transfer of a copyrighted article, an analysis of the facts and circumstances, including the intent of the parties as evidenced by their agreement and conduct, may lead to the conclusion that the transaction involves the provision of services.[10] If not, the issue then becomes whether there has been a sale of the copyrighted article. The transaction will be a sale if, taking into account all of the facts and circumstances, the benefits and burdens of ownership have been transferred.[11]

Specific source rules apply to the income derived from transactions in computer programs. Income from the sale of a copyright right will be sourced under the rules that apply to personal property sales discussed in Section 865 and Treasury Regulation Section 1.861-18(f)(2). Income from the sale of copyrighted articles where the computer program constitutes purchased inventory property will be U.S.- or foreign-source income, depending upon where title passes.[12] On the other hand, income from the sale of copyrighted articles where the computer program constitutes non-inventory personal property will be U.S.- or foreign-source income, depending upon where the property is located in the case of rents and the place where the property is used in the case of royalties.[13]

Below, see Example 1 which provides an example discussed in the regulations of a transfer of all the substantial rights in a copyright.

Example 1

The regulations provide the following example of a transfer of all substantial rights in a copyright: Corp A owns the copyright in a computer program, Program X, and Corp A transfers a disk for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X to Corp B, a Country Z corporation, and grants Corp B "an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country X, prepare derivative works based upon Program X, make public performance of Program X and publicly display Program X. Corp B will pay Corp A royalty of $y a year for three years which is the expected period during which Program X will have commercially exploitable value." The example concludes that the transfer should be treated as a sale by Corp A because Corp A transferred to Corp B all substantial rights in the copyright to Program X. This example also illustrates that just because an agreement is classified as a license, it is not controlling for federal income tax purposes. The fact that Corp A is supposed to receive payment classified as a royalty is also not controlling.[14]

As indicated above, a transfer of a "copyrighted article" takes place if a transferee obtains a copy of a computer program but the transferee does not acquire any of the copyright, rights or acquires only a de minimis right grant of such copyrights.[15] To be treated as a sale of a copyrighted article, there must be a transfer of the benefits and burdens of ownership in the copyrighted article.

Below, see Example 2 and Example 3, which are taken from the regulations and provide examples of a transfer of a copyrighted article as a sale.

Example 2

Corp A owns the copyright in a computer program "Program X" and copies Program X onto a disk. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a "shrink wrap license." The license is stated to be perpetual. The transferee receives the right to use the program on two of its own computers, the right to make one copy of the program on each machine as an essential step in using the program, and the right to resell the copy of the program so long as it destroys any other copies it had made. P, a resident of Country X receives a disk. The example indicates that the label in the contract "license" is not determinative and that since none of the copyrights rights have been transferred to P, P has acquired a copyrighted article. The same conclusion applies where the software is made available through a website rather than as a disk.[16]

Example 3

Corp A transfers a disk containing Program Y to Corp E, a Country Z corporation, in exchange for a lump sum payment. Program Y is a computer program development program, which is used to create other computer programs consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the library with any program developed using Program Y. The example concludes that because the copyrights rights to the libraries are considered de minimis, the transaction is treated as a sale of Program Y, which is a copyrighted article.[17]

DEFINING THE "RENTS" FOR PURPOSES OF DIGITAL TAXATION

The Income Tax Regulations use the term "rents" when attempting to classify the lease of software. The term "rents" is an extremely important concept. In this context, the term "rents" typically means the amounts received for the use or the right to use tangible property. In other words, the term "rents" can be defined as a payment or interest reserved by an owner in return for permission to use the property loaned and in proportion to use. For U.S. tax purposes, rents can be classified as FDAP income. For the purposes of defining the lease of

software, the Software Rules provide that there must be a transfer of a copyrighted article where all the benefits and burdens of ownership have not been transferred. A transfer will be treated as a lease that generates rental income in a circumstance where the benefits and burdens of ownership of the copyrighted article have been transferred, such that an individual other than the transferee is properly treated as the owner of the copyrighted article. Below, see Example 4 in which the regulations describe a lease of software.

Example 4

Corp A owns the copyright in a computer program ("Program X") and copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a "shrink wrap license." The transferee receives the right to use the program on two of its own computers and the right to make one copy of the program on each machine as an essential step in using the program. P, a resident of Country X receives a disk but only for one week. The example concludes that the label "license" is not determinative and that none of the copyright rights has been transferred to P. P has acquired a copyrighted article and based on all the facts and circumstances is not considered the owner of the copyrighted article. Therefore, there has been a lease of a copyrighted article and Corp A recognizes rental income. [18] It should be noted that the same conclusion applies where the software is made available through a website rather than as a disk. [19]

DEFINING THE TERM LICENSE FOR PURPOSES OF DIGITAL TAXATION

According to the Software Rules, to be a license, all the facts and circumstances must indicate that a transfer of copyright rights took place, and the transfer must be for less than "all substantial rights." Thus, the difference between a sale and a license for the purposes of the Software Rules is the amount of rights granted. Typically, the grant of nonexclusive copyright right to use electronic software is a license. The income generated by a license is royalty income rather than a sale. Royalty income is typically classified as FDAP for U.S. tax purposes.

Below, see Example 5 which describes a license of software for income tax purposes.

Example 5

The Software Rules provide the following example of a transaction treated as a license: Corp A, a U.S. corporation, transferred a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers which Corp D manufactures and sells to the public. The term of the agreement is for two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads onto its computers. In this example, Corp D has acquired a copyright right to make copies of Program X and to load the copies onto the computers it makes and sells. However, after taking into account all facts and circumstances, Corp D has not acquired all substantial rights in the copyright to Program X because the agreement between the two parties ends before the end of the copyright's remaining life. Thus, there is no sale of the copyright and, instead Corp D has acquired only a license of Program X in exchange for its obligations to pay royalties to Corp A.[20]

SERVICES FOR PURPOSES OF DIGITAL TAXATION

Because compensation for personal services performed abroad is foreign-source and not subject to U.S. tax, it is not uncommon for businesses to have agreements between themselves stating that any personal services will be performed outside the United States. Obviously, these agreements can be manipulated for U.S. federal tax purposes. In order to avoid manipulation, the Treasury Regulations provide that the determination of whether a transaction is treated as either the provision of services or another transaction is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.[21]

Below please see Example 6 which discusses a service arrangement involving software.

Example 6

The Software Rules provide the following example of a transaction that is treated as a provision of services: Corp H, a Country Z corporation, enters into a license agreement for a new computer program, Program Q. Program Q is to be written by Corp A and the parties agree that when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the agreement, but Corp A will retain all payments owed prior to termination. All of the payments are labeled royalties. The example concludes that taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H because Corp H bears all the risk of loss associated with Program Q and is the owner of all copyrights rights in Program Q.[22]

INTRODUCTION TO CLOUD COMPUTING

In general, cloud computing is the provision of information technology resources in a virtual environment. This virtual environment, or the "cloud," comprises remote, interconnected computer networks, servers, data storage devices, and software applications operated by third parties. Instead of maintaining their own hardware and information technology infrastructure, companies use information technology resources stored on remote third party servers that are operated by third party cloud service providers.

For instance, a designer may choose to pay Adobe a monthly subscription fee to use Adobe's graphics software application known as Photoshop. The designer in this example is engaging in a cloud computing transaction with Adobe. More specifically, this is an example of software as a service or ("SaaS") cloud computing model transaction. The designer is obtaining access to software and applications that are stored on servers that Adobe owns and operates remotely. The designer also obtains space on Adobe's servers where the designer stores images and other data. Under the SaaS model, the designer no longer needs to install, run, and maintain a program on his or her internal system.

Cloud computing transactions differ from the traditional provisions of traditional software transactions. The most significant feature of cloud computing that differentiates it from traditional software transactions is that cloud computing occurs entirely in the virtual world. In the past, businesses would purchase or license software and applications in digital form from online vendors. Under this business model, sellers would electronically transfer the computer program to the purchaser, who would download the program onto his or her computer for a duration of time. Cloud computing on the other hand, involves neither the physical nor electronic transfer of possession of a computer program to the purchaser. The program does not reside on the purchaser's computer. In a cloud computing transaction, a cloud vendor solely provides the purchaser with electronic access to a computer program, application, and corresponding data. The only physical components to a cloud transaction are on the vendor's servers. Because cloud vendors control the program, a cloud transaction may be characterized as the provision of services rather than a transfer of an intangible asset. By eliminating many of the physical components involved in traditional technology transactions, the cloud reduces any connections between revenue-generating activity and a particular geographic location. Under current law, a country's taxing authority over a cross-border transaction generally requires a geographic connection to the economic activity that creates income. However, a vendor's servers and other computer infrastructure can be located almost anywhere in the world with little or no economic activity.

U.S. TAXATION OF CLOUD COMPUTING

Approximately four years ago, the Treasury Department and the Internal Revenue Service or ("IRS") promulgated Proposed Regulations on how to classify cloud computing transactions and other transactions involving on-demand network access. In addition, the Proposed Regulations supplement the Software Rules, the cloud computing transactions and other transactions involving on-demand network access.

The Proposed Regulations have defined a "cloud transaction" to be "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 arrangements and the surrounding facts and circumstances."[23] Examples of a "cloud transaction" are the "streaming music and video, transactions involving mobile device applications, and access to data through remotely hosted software."[24]

For tax purposes, the Proposed Regulations provide that a cloud transaction is classified solely as either a lease of property or the provision of services, taking into account all relevant factors.[25] Each transaction requires a separate classification unless any transaction is de minimis.[26] The Proposed Regulations go on to provide a list of factors to determine when cloud transactions will be classified for tax purposes as a provision of services rather than a lease of property. These factors are:

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.

Proposed Regulations, however, do little to clarify the U.S. tax treatment of cross-border cloud computing transactions.

Consider the example of a foreign corporate software developer that has created software for which it currently holds intellectual property rights. The foreign corporation has customers in the U.S. that it charges a monthly subscription fee to electronically access the software stored on servers located outside the U.S. Although the Proposed Regulations address how to classify the foreign corporation's transactions with its U.S. customers (as either services or leases), they are silent on how to determine whether the subscription fees paid by the U.S. customers constitute income generated in or sourced to the U.S. In the absence of specific rules, the Treasury has usually adopted and applied existing tax principles to new developments in technology.

However, because of the unique features of cloud computing, applying these existing principles to cloud computing transactions is challenging. Its arrangement with its U.S. customers is unlike a traditional software sale where software is purchased or delivered electronically to the customer's computer where it is installed. The foreign developer's customers will neither possess nor store the program on their computers. Instead, the developer, as the cloud service provider, hosts the program on its hardware or infrastructure and the customer has no control over the software. Thus, the cloud vendor, rather than the customer, owns the software. These differences may mean, however, that no "transfer" takes place when a customer accesses software in the cloud. If so, then such a transaction may fall outside the scope of the Software Rules altogether. Below are brief discussions as to how the Software Rules may treat cloud computing transactions.

CLASSIFICATION OF A CLOUD COMPUTING TRANSACTION OF SERVICES

The Software Rules typically will not classify services transactions as "services." The regulations only classify a transaction as services if the transaction involves the provision of services for the development or modification of a computer program or the provision of know-how relating to programming techniques. The determination of whether the regulations treat a transaction

of a computer program depends on all the facts and circumstances of the transaction.

CLASSIFICATION OF CLOUD COMPUTING TRANSACTION AS A COPYRIGHTED ARTICLE

The Software Rules may classify a cloud computing transaction as a transfer of a copyrighted article that gives rise to rental income.[27] A transfer of a computer program constitutes a transfer of a copyrighted article if a person acquires a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device, and such transfer is not de minimis relative to the overall transaction.[28] Since the foreign corporate cloud vendor in our example transfers online access to its software to U.S. customers in exchange for a monthly subscription fee, none of the transactions transfer any copyrights. The rights obtained by the U.S. customers are similar to the rights they would have obtained had they acquired an actual copy of the software. In this case, the customer has the right to use the software, but does not have the right of ownership. A SaaS transaction that involves a transfer of a copyrighted article will likely give rise to rental income because the customer does not acquire sufficient benefits and burdens of ownership. The Software Rules treat a transfer of a copyrighted article as a lease of a computer program, rather than a sale, if the facts and circumstances indicate that a transaction does not transfer substantial benefits and burdens of ownership of the program.

SOURCING CLOUD-RELATED INCOME OF CLOUD COMPUTING TRANSACTIONS

According to the sourcing rules, if services are performed in the United States, the income is U.S.-sourced income, and subject to U.S. federal income tax. On the other hand, if the services are performed outside the United States, then the income is foreign-sourced income. In certain cases, this means that the services will not be subject to U.S. taxation. Applying these concepts to cloud computing transactions and determining where such services are performed for tax purposes can be difficult. For example, computer equipment that facilitates delivery of the digital product might be located in one country, and the employees that maintain and monitor such equipment might be located in another country, and the coders who develop the software might reside in a third country.

These rules may source cloud computing income either to: 1) the places where the customer is located, or 2) the place where the cloud vendor's servers are located. Given the nature of cloud computing, the location of the server that hosts the software or application will not necessarily be in the same country as the location of the customers. Thus, different U.S. tax consequences may result depending on how the sourcing rules are applied.

U.S.-TAXATION OF CROSS-BORDER CLOUD BASED TRANSACTIONS

A taxable presence in the U.S. is a threshold requirement for the U.S. to tax the business income of a foreign cloud service provider. A U.S. taxable presence means that the foreign cloud service provider either 1) operates a U.S. trade or business, or 2) has a permanent establishment in the U.S. If a U.S. taxable presence exists, then the U.S. has authority to tax the active business income of the foreign cloud vendor to the extent such income is effectively connected to a U.S. trade or business or attributable to a permanent establishment in the U.S. Income effectively connected with a U.S. trade or business includes certain passive income, portfolio interest, and gain or loss from the sale or exchange of capital assets that have a connection to the U.S. trade or business. If the foreign cloud service provider does not have a U.S. trade or business, the U.S. generally will not have taxing authority over the business profits generated by the cloud computing business.

Treasury Regulation Section 1.861-18 provides rules for classifying income from the transfer of computer programs as well as income from the provision of services or know-how with respect to computer programs. These rules, which were issued in 1998, did not directly address "cloud computing" transactions, which are a more recent phenomenon. Cloud computing permits consumers to access and use, via the internet, software programs stored on a provider's servers. The cloud computing customer typically does not acquire a copy of the program or any copyright rights in the program. The customer also typically does not receive any development services or programming know-how from the cloud computing provider.

Cloud computing transactions generally follow 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. 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.

In 2019, the Treasury and the IRS issued proposed regulations that sought to categorize cloud computing transactions as either a lease of property or the provision of services. These regulations, however, have yet to be finalized and adopted. Until then, Internal Revenue Code Section 7701(e)(1) and applicable case law are the relevant sources of guidance on how to categorize cloud computing transactions. Section 7701(e)(1) identifies six factors, each of which, if true, would weigh in favor of characterizing a transaction as a lease instead of a provision of services. These six factors are: 1) the customer is in physical possession of the property; 2) the customer controls the property; 3) the customer has a significant economic or possessory interest in the property; 4) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract; 5) the provider does not use the property concurrently to provide significant services to entities unrelated to the customer, and 6) the total contract price does not substantially exceed the rental value of the property for the contract period. These six factors are neither weighted nor all-inclusive.

CONCLUSION

This article is intended to acquaint foreign tech companies with some of the principal tax planning issues associated with U.S. taxation of intellectual property. This area is relatively complex and is constantly evolving with Congress entertaining new tax laws, the IRS issuing new regulations and

interpretations, and courts rendering new rulings in this area. As a result, it is crucial that foreign tech companies consult with a qualified international tax attorney both in the U.S. and its home country.

End Notes

1 IRC Sections 871(b) and 882(a).

2 IRC Sections 871(b) and 882(a).

3 IRC Sections 861 and 862.

4 IRC Sections 861(a)(4) and 862(a)(4).

5 *See* Treas. Reg. Section 1.861-18(a)(3).

6 *See* Treas. Reg. Section 1.861-18(f)(1).

7 *See* Treas. Reg. Section 1.861-18(c)(2).

8 Treas. Reg. Section 1.861-18(f)(1).

9 Treas. Reg. Section 1.861-18(c)(3).

10 Treas. Reg. Section 1.861-18(d).

11 Treas. Reg. Section 1.861-18(f)(2).

12 *See* IRC Section 861(a)(6); IRC Section 862(a)(6); Treas. Reg. Section 1.861-18(f)(2).

13 *See* IRC Section 861(a)(4); IRC Section 862(a)(4); Treas. Reg. Section 1.861-18(f)(1)(2).

14 *See* Treas. Reg. Section 1.861-18(h), Example 5.

15 *See* Treas. Reg. Section 1.861-18(c)(1)(ii).

16 *See* Treas. Reg. Section 1.861-18(h), Example 1.

17 *See* Treas. Reg. Section 1.861-18(h), Example 17.

18 *See* Treas. Reg. Section 1.861-18(h), Example 1.

19 *See* Treas. Treas. Reg. Section 1.861-18(h), Example s 3 and 4.

20 *See* Treas. Reg. Section 1.861-1(h), Example 8.

21 *See* Treas. Reg. Section 1.861-18(d).

22 *See* Treas. Reg. Section 1.861-18(h), Example 15.

23 Prop Reg. Section 1.861-19(b).

24 *See* REG-130700-14.

25 Prop. Reg. Section 1.861-19(c).

26 Prop. Reg. Section 1.861-19(c)(3).

27 Treas. Reg. Section 1.861-18(b)(1), (c).

28 Treas. Reg. Section 1.861-18(c).