November 12, 2019

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

RE: IRS REG-130700-14 – Classification of Cloud Transactions and Transactions Involving Digital Content

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding the classification of cloud transactions and transactions involving digital content. USCIB supports the overall direction of the proposed regulations. Our comments generally relate to making the regulations more precise and expanding their reach.

Comments on the proposed changes to section 1.861-18

Expansion to digital content

The proposed regulations would expand the scope of §1.861-18 beyond computer programs to other digital content not covered by §1.861-19. Thus, the transfer of digital books, movies, music and games (or other digital content protected by copyright law or no longer protected by copyright law solely due to the passage of time) would be included within the scope of the regulations. Thus, the character of the transaction would be determined based on whether a copyright right was transferred or not. USCIB agrees with this expansion of the scope of the regulations under §1.861-18. In the absence of guidance on these transactions, companies have been analogizing to the treatment of computer programs to determine the character of these transactions, so this expansion should be generally consistent with how businesses have treated these transactions.

Section 1.861-18(a)(1) provides that classification rules only apply for certain purposes of the Internal Revenue Code that are listed in that subparagraph. USCIB believes that §1.861-18 should apply for all purposes of the Code. We believe the conclusions reached under the existing (and proposed) regulations are correct; we, therefore, believe that other characterizations would be

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[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

incorrect. Thus, regardless of which Code section applies, to the extent that character is relevant, the §1.861-18 regulations should apply to determine that character.

Public performance

USCIB supports the clarification of the rule pertaining to the public performance. Public performance should not include advertising that does not permit the display of the entire copyrighted article.

Source rule for digital content

The proposed regulations state that income from sales or exchanges of a copyrighted article is sourced under section 861(a)(6), 862(a)(6), 863, or 865(a), (b), (c), or (e). The proposed regulations provide that income from leasing a copyrighted article is sourced under section 861(a)(4) or 862(a)(4). The proposed regulations should be amended to clarify that income from licensing of copyright rights from a copyright owner to a distributor, as described in proposed regulation §1.861-18(h) Example 19(ii)(B), is sourced under section 861(a)(4) or 862(a)(4).

The proposed regulations provide a new source rule for sales or exchanges of copyrighted articles when sold and transferred through electronic medium. The new rule would deem the sale to occur at the location of the download or installation onto the end user's device. If the seller does not have information concerning the location of the user's device, then the sale is deemed to have occurred at the location of the customer based on the taxpayer's records.

USCIB believes that this approach may be ambiguous, burdensome and would leave gaps that would require further guidance.[2] USCIB recommends instead that the billing address is a more reliable indicator of where the end-user will be consuming content and provides a clear administrable rule that uses information already collected in the ordinary course of business and that taxpayers should, therefore, be able to use the billing address in all cases.

There may be cases in which the seller does not have information on either the location of the end user's device or a business record of the taxpayer's location.

For example, if a download is to a business under a global enterprise license, is that business considered an end-user or is there a need to look-through to the location of each employee/person using the download? If the latter, how would this be determined? USCIB understands that merely looking to the location of the company entering into the global enterprise license might be considered too open to tax planning, however looking through to

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[2] For example, it is unclear what is meant by the location of download or installation onto an end-user's device, geolocation information is not always a reliable indicator of a user's location, even if accurate geolocation represents a location where a user is at a specific moment in time and not where the content is consumed, the rule does not address incomplete downloads or downloads while in transit. The use of this information for tax purposes would also require taxpayers to record, store, and place controls around this additional piece of data for every transaction and maintain that data for years in order to support audits, which will create large costs and may violate data privacy protections.

actual use may be too difficult especially among unrelated parties. The OECD's 2015 VAT Guidelines provide rules for services and intangibles provided to multi-location entities one of which looks to how businesses recharge centralized services out to their affiliates.[3] A similar rule might provide a safe harbor that would avoid having to actually look through to the end-user, which may be impossible in a third-party setting. Because this rule would have to apply to transactions with unrelated parties, it might be possible to require the allocation based on a look-back to prior years, which would be applied to current-year transactions at the time of sale. USCIB members believe that it would be appropriate to permit other reasonable methods of determining the source of income in such cases including allowing the seller to source the transaction to the billing location of the first unrelated purchasing entity. Sellers that currently have or eventually develop the capability to identify the location of the end user should be able to elect to source the transaction to the primary location of the end user.

As another example, if a customer makes a one-off purchase using PayPal or another service that does not disclose the location of the purchaser, how should the seller source the sale? The seller may have neither the location of the device nor a business record of the location of the purchaser. It is not clear what proxy might be most appropriate in such a case. USCIB believes that it might be appropriate to look to the location of the seller, as long as the number and value of these cases does not exceed a certain threshold.

Effective date

The proposed regulations under §1.861-18 are proposed to be effective for contracts entered into in taxable years beginning on or after the date of publication of the regulations as final regulations. USCIB believes that the regulations should be made effective earlier. An effective date that applies to contracts entered into in taxable years after the date of publication of the regulations as final regulations may result in different rules applying to similar transactions of the same taxpayer long after the regulations are finalized. At a minimum, the regulations should apply to transactions occurring in taxable years beginning on or after the date of publication of the regulations as final regulations, regardless of the date the contract is entered into. The government should also consider permitting elective application of final regulations to taxable years ending after the date of publication of the proposed regulations.

Change in method of accounting

The proposed regulations provide that the new rules may require a taxpayer to change its method of accounting. The proposed regulations would treat any such change as a taxpayer-initiated change and, thus, would require the taxpayer to request a change in method and IRS

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[3] The VAT rule does not provide a complete analogy because VAT is intended to operate through a staged collection process. Each vendor is responsible for proper collection and filing at its stage. So, a sale to a business may require collection and payment of VAT and purchaser will, in turn, be responsible for VAT with appropriate input credits. Thus, the recharge will occur at the later stage and the purchaser will have knowledge of the internal use being recharged.

approval of that request. USCIB believes that since the taxpayer will be required by the final regulations to make this change, it should not be treated as a taxpayer-initiated change and, therefore, should not require an application and approval.

Comments on the proposed regulations under section 1.861-19

<u>Characterization of cloud transactions</u>

USCIB generally supports the standards and conclusions of the proposed regulations concerning cloud transactions and believes that the regulations could be improved by expanding the scope of the rules to fill what will otherwise be gaps in their application.

USCIB believes that the application of these regulations can be summarized as follows:

1. A single "cloud transaction" is classified entirely as either the provision of services or as a lease of property.
2. For an arrangement comprised of more than one cloud transaction, each cloud transaction must be classified entirely as either the provision of services or as a lease of property.
3. For an arrangement comprised of multiple transactions at least one which is a cloud transaction and another of which is not a cloud transaction, the cloud transaction must be classified entirely as either the provision of services or as a lease, and the non-cloud transactions must be classified under other provisions of the Code and the regulations (e.g., under -18, as the transfer of a copyrighted article).
4. As an exception to 2. and 3., any transaction (within an arrangement comprised of multiple transactions) that is de minimis is not treated as a separate transaction.

Generally, the proposed regulations require separation of an arrangement comprised of multiple transactions into its component transactions, unless the de minimis exception applies. The examples illustrate several instances where the de minimis exception applies, such as in Example 11 where the download of the digital content is said to be de minimis relative to the end-user's access to the online database on the theory that the "primary benefit" to the end-user is access to the database or Example 7, where the end-user's access to certain online "ancillary" features with respect to the downloaded office software is also de minimis.

Even though the proposed regulations do not use the term "predominant character" there seems to be a "predominant character" test both in determining whether a cloud transaction is the provision of a service or the lease of property and in determining whether a transaction is de minimis. USCIB believes it would be helpful to explicitly adopt a "predominant character" standard in determining whether a cloud transaction is the provision of services or a lease of property and whether the de minimis exception applies. The adoption of the predominant character rule to source transactions would replace the need for a de minimis rule.

The determination of the number of transactions included in a contract with a customer could be based primarily on the seller's business facts and circumstances. By allowing a facts and

circumstances approach, the regulations would be less likely to result in divergent treatment of different business practices such as related to contracting, invoicing, pricing, product offerings and other factors which should not be determinative of whether a contract is comprised of a single or multiple transactions. Under a facts and circumstances approach businesses could rely on, among others, the above factors. The transactions so determined would be characterized based on the predominant character rule.

Although the regulations posit that a cloud transaction may be either a provision of a service or a lease of property, none of the examples conclude that a cloud transaction is properly characterized as a lease of property. USCIB members have attempted to come up with a realistic example of a cloud transaction that would be a lease of property but have been unable to do so. In the absence of a realistic example of a cloud transaction being treated as a lease, the government should consider a rule that treats cloud transactions as services in all cases. If the government wishes to leave open the possibility of a lease transaction, the government could consider a presumption that a cloud transaction is the provision of services. Related party transactions resulting from the participation of related entities in the delivery of cloud services to a customer should be characterized consistently with the predominant character of the transaction with the customer.

The more difficult cases are those in which it is not clear what the predominant character of an arrangement involving multiple transactions should be. The regulations appear to purposefully avoid the issue (e.g., an example where a user may stream music but is not permitted to download a copy of the song (example 9 in §1.861-19(d)), whereas an example illustrating a transfer of a copyrighted article provides that the user must download the music and is therefore presumably not able to stream the music (example 20 in §1.861-18(h)). USCIB believes that the proposed regulations should be modified to reflect "real-world" fact patterns. In such cases, query whether taxpayers should be able to elect whether to classify the arrangement entirely as a service under §1.861-19 or entirely as a lease or sale of a copyrighted article under §1.861-18 based on the predominate character of the transaction. This would avoid the difficulties of bifurcation, including how to allocate revenue between the various transactions.

USCIB believes a more realistic example would permit the end-user of a subscription service to download digital content onto a limited number of devices, and access to the content is lost once the subscription service ends. This is a common feature of subscription services and should not change the character of the subscription service: it would still be a service. Bifurcation of this transaction should not be necessary, because there is really only one transaction, providing access to the subscription content for the duration of the subscription.

Using whether there has been a download to determine whether there has been a "transfer" of a copyrighted article is outdated. Technological and practical limitations (and not differences in business model, for example) drive the decision regarding whether a user downloads digital content to their own computer or other electronic device or rather streams such content.

Books, even when otherwise identical to an on-demand, all you can access model, may be downloaded as opposed to streamed because book file sizes are small and easily transmitted to the user and stored by the user at a very low cost.

Alternatively, videos may be streamed – even when end-user acquires all perpetual rights - because video file sizes are very large and thus the cost of downloading and storing multiple files by the user can be large.

Thus, USCIB recommends that 1.861-18(h) examples 20 and 21 should be revised consistent with above. Therefore, where the subject of the overall transaction between provider and end-user is for a copy of a specific copyrighted article and that right is time-limited that should give rise to lease. If that transaction is not time limited, the transaction should be treated as a sale or exchange. This should be the relevant framework whether the copyrighted article is ever downloaded.

Similarly, the analytical framework under §1.861-19 should provide that if a subscription that generally provides access to a catalog of content via streaming services also offers the user, at its sole discretion, the option to download such catalog content merely as a matter of convenience, that should not change the character of the transaction.

Proposed regulation 1.861-19(d) Ex. 9 should come to the same conclusion as Prop. 1.861-19(d) Ex. 11 because the no-download fact pattern is not in line with real-world fact patterns and would otherwise imply that the type of digital content accessed is relevant to character.

Factor Test

As an alternative to eliminating the "service - lease" continuum in favor of a statement that cloud transactions generally are classified as services, USCIB recommends more clarity on when a given characterization factor is not relevant in a given instance. For example, one factor – whether the total contract price substantially exceeds the rental value of the property for the contract period, is only analyzed in Example 2 and Example 11. In particular, USCIB notes that this factor does not appear relevant for an IaaS transaction and Treasury appears to agree as it is not addressed in either Example 1 or Example 8. We think it is could also appropriately be excluded from Example 2. In that example, in what seems to be a circular reasoning – where Corp A does not provide a separate rental price from the overall contract price, application of the factor would require Corp A to come up with a notional rental value that is somehow separate from the overall contract price. In many cases there is no comparable property which is being formally rented, as the taxpayer may operate a purely services business and may have specially designed and proprietary equipment which is unavailable on a rental market.

Another factor could benefit from a "real-world" example in an IaaS context is the factor that 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. In particular, there are circumstances where a capacity reservation is made for an amount of computing power for a yearly term which must be paid

even if not fully used. To simplify it would have the same facts as e.g. Example 2, except that customers can pre-commit to a certain amount of computing power in a single year or multiple years and must still pay for the full amount of the commitment even if not used. The example should specify that in this situation, the 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, such that this factor in the example supports the overall conclusion that the transaction is services.

Example 6 of the proposed regulations provides that customers are billed on the basis of a time element but also on the level of use – number of employees with access – during a period of time. The example concludes that Corp A's compensation, though based in part on the passage of time, is also determined by reference to Corp B's level of use (that is, the number of Corp B employees with access to the software). Taking into account all of the factors, the transaction between Corp A and Corp B is classified as the provision of services. USCIB recommends that the government provide similar clarity for the common use case discussed above.

USCIB also believes that, it would be helpful to include examples addressing resellers of services. Broadly, there have been examples of jurisdictions around the world in which fees for the resale of services have been asserted as royalties subject to withholding. The regulations could include a variation on Example 1 in which the services provided therein are resold to another party.

Source rule for cloud transactions

The proposed regulations do not provide a source rule for cloud transactions and the government has invited comments on how to determine the source of a cloud transaction. Because cloud transactions will generally be treated as services, looking to guidance with respect to services may be appropriate. Some companies' structures may permit them to source the income based on the location of the relevant people functions, assets and operations of the service entity that are directly related to earning the services income. Specifically, actions of independent contractors should not cause income to be sourced to their jurisdiction of operation. Generally, so long as all parties involved (i) are separate entities with no agency or fiduciary relationship, (ii) respect all relevant corporate formalities, and (iii) engage in arm's length transactions, the actions of one taxpayer should not be attributed to another for U.S. federal income tax purposes. For many companies looking to the actual place of performance of services would be exceedingly difficult where there are multiple and varied legal entities – related and unrelated – contributing concurrently to the performance of the relevant services. Thus, if a source rule is to be administrable it may need to be based on simplified methods.

One possible option for those companies would be to determine the source of the income based on the location of the personnel and property of the company/provider entering into the cloud transaction. The government could combine such a simplified rule with anti-abuse provisions that would look beyond the provider in limited cases.

USCIB is also concerned that developments under the OECD's Pillar 1 proposals may end up being inconsistent with any final source rule provided in these regulations. One option might

be to reserve any final decision and in the interim permit taxpayers to use any reasonable method to source cloud. In that case, if the Pillar 1 results require a particular source in order to eliminate double taxation, then that would be a reasonable method.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Annex Examples

Examples under section 1.861-18(f)(2(ii)

Example 1

Facts.

Corp A is located in Country X and produces software in Country X. Based on the facts and circumstances, each software license produced by Corp A is inventory property. The software licenses are copyrighted articles under § 1.861-18, and the copyrighted articles are delivered electronically. Corp A sells software licenses to Distributor D. Distributor D, located in Country X, sells software licenses to Reseller R for resale to end customers. Reseller R is located in Country Y. Corp B purchases Corp A software licenses from Reseller R. Corp B is located in Country X, with 50% of its employees located in Country X and 50% located in Country Z. Corp A, Distributor D, Reseller R, and Corp B are unrelated.

Analysis.

Corp A. Because Corp A produces the software in Country X, and each copyrighted article of the software is treated as inventory property for the purposes of section 863, Corp A sources the income from the sale of these copyrighted articles under section 863(b) to Country X.

Distributor D. Because Distributor D sells copyrighted articles and delivers them electronically, D must source its income from the sale of copyrighted articles transferred digitally under the amended rule above. Accordingly, Distributor D sources its income by reference to the billing location of Reseller R. Reseller R's billing location is in Country Y, so Distributor D sources its income to Country Y. Distributor D does not make an election to source its income based on the location of the ultimate end user.

Reseller R. Similar to Distributor D, R sources its sale of copyrighted articles transferred digitally under the amended rules. Reseller R properly sources all of its income from the sale to Corp B to Country X.

Example 2

Facts.

The facts are the same as in Example 1, except that Reseller R makes an election to source its income based on the location of the ultimate end users of the copyrighted articles it sells.

Analysis.

The results are the same as in Example 1, except that Reseller R sources 50% of its income from Corp B to Country X and 50% to Country Z.

Example 3

Facts.

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The facts are the same as in Example 1, except that Corp A does not produce software. Corp A purchases software from an unrelated party located in Country X. Corp A and Distributor D are related parties.

Analysis.

The results are the same as in Example 1, except that Corp A must look to the location of the first unrelated purchaser for the purposes of sourcing its income. Because Corp A and Distributor D are related parties, and Corp A does not make a sourcing election, Corp A sources its income to Country Y based on the billing location of Reseller R.

Example 4

Facts.

The facts are the same as Example 1, except that Corp B has two billing locations: Corp B's billing office in Country X purchases software for employees located in Country X; and Corp B's billing office in Country Z purchases software for employees located in Country Z.

Analysis

The results are the same as in Example 1, except that Reseller R sources its income from its sales to Corp B according to the location of the Corp B billing office. Because the Country X billing office purchases software for the employees located in Country X (50% of Corp B's total employees), Reseller R sources 100% of the income from its sales to the Country X billing office to Country X. Because the Country Z billing office purchases software for the employees located in Country Z (50% of Corp B's total employees), Reseller R sources 100% of the income from its sales to the Country Z billing office to Country Z.

Example 5

Facts.

The facts are the same as Example 4, except that Reseller R makes a sourcing election under the proposed rule above.

Analysis.

The results are the same as in Example 4. Because the Corp B billing offices in Country X and Country Z purchase software only for the employees located in those countries, Reseller R's sourcing under the election is the same as in Example 4.

Examples under section 1.861-19 Bundled Products

Example

Facts.

Corp B purchases subscriptions to a suite of products that includes both software and services from Corp A. The suite is offered by Corp A as an integrated offering under a single SKU to all customers. The suite includes several related, but independent components. The subscriptions

are sold under a single SKU and with a single price per unit. Corp A provides Corp B with a single invoice with one-line item.

The suite includes word processing, spreadsheet, and presentation software. This software is made available for access over the internet but only to download the software onto a computer or onto a mobile device in the form of an app. The downloaded software contains all the core functions of the software. Employees of Corp B can use the software on their computers or mobile devices regardless of whether their computer or mobile device is online.

The suite also includes email and collaboration software in addition to security and enterprise management services hosted on Corp A's server systems. This software allows employees of Corp B to access the software over the internet through a web browser. Corp B has no ability to alter the software code. The software is hosted on servers owned by Corp A and located at Corp A's facilities and is used concurrently by other Corp A customers.

The suite provides data storage to Corp B on Corp A's server systems, and Corp B employees may store files on Corp A's data storage system or on the employee's computer.

Corp A bundles these components into a suite to allow customers to leverage Corp A's cloud offerings. Revenue from sales of the suite is reported for financial purposes as part of Corp A's cloud business segment. Corp A also sells copyrighted articles for the components of the suite independently.

Corp B pays a monthly fee based on the number of employees with access to the software. Upon termination of the arrangement, Corp A activates an electronic lock preventing Corp B's employees from further utilizing the app, Corp A stops providing services to Corp B, and Corp B's employees are no longer able to access the software via a web browser.

Analysis.

Under prop. reg. §1.861-19(c)(3), arrangements comprised of multiple transactions generally requires separate classification for each transaction. Though the subscriptions include multiple components, because the subscriptions are sold under a single SKU and have a single per-unit price, the purchase of the subscriptions should be treated as a single transaction.

According to (c)(3), these regulations only apply to those transactions classified as cloud transactions. Corp B's purchase of software subscriptions includes on-demand network access, so Corp B's purchase of software subscriptions may be within the scope of prop. reg. §1.861-19 depending on the predominant character of the subscriptions.

Though the software subscription includes valuable components that are downloaded onto a computer or mobile device, the predominant character of the suite of software and services is, under these particular facts, in the remote management of Corp B's subscriptions and the mobility of data regardless of physical location. Because the remote management and data mobility components fall within the definition of cloud transaction, Corp A must characterize the revenue from the software subscriptions as solely a service.

Examples under section 1.861-19(c)(1) – Characterization of Related Party Transactions

Example

Facts

Corp A operates data centers on its premises in various locations in Country A. Corp A provides Corp B, a related-party, with computing capacity on Corp A's servers and use of other hardware in exchange for payments based on Corp A's operating costs plus a specified percentage under an intercompany agreement. Corp B is a cloud service provider (CSP) that utilizes Corp A's servers to deliver software, platform, and/or infrastructure as- a- service offerings to Corp B's customers. Corp A agrees to keep the servers operational, including by performing physical maintenance and repair, and may replace any server with another server of comparable functionality. Corp B does not have physical access to the DCs. Corp A makes all final decisions with regard to the computer servers it acquires and how they are maintained on its premises.

Analysis

Corp B, in its capacity as the CSP, receives income from its customers for its provision of software, platform, and/or infrastructure access. The character of Corp B's revenue from such offerings is determined by taking into account all relevant facts and circumstances, including the factors set forth under paragraph (c)(2) of this section. Because the factors of Treas. Reg. §1.861-19(c)(2) do not apply to Corp A's related party revenue, this revenue is characterized under existing law. Under section 7701(e) and related judicial authorities, the substantial majority of factors indicate "services" character. Thus, Corp A's related-party revenue is characterized as services revenue.

Examples under section 1.861-19 – Sourcing of Cloud Services

Example

Facts

Corp A is a cloud service provider that recognizes services income. Corp A employs in Country A engineering, technical, and business personnel necessary to deliver Cloud Transactions to its customers ("Cloud Operations Personnel"). All of Corp A's Cloud Operations Personnel perform their functions within Country A. Corp A centralizes its customer billing function in a low-cost location in Country X through a legal branch. Corp A also operates data centers on its premises in various locations in Country A.

Corp A contracts with Corp B, a related party, to utilize Corp B's data centers located in Country B in the delivery of Corp A's cloud services. Corp B employs personnel in Country B to maintain and service the physical components of Corp B's data centers. Corp A does not have any other operations in Country B with respect to its cloud service business. Corp A pays an arms-length transfer price to Corp B based on Corp B's costs, which is characterized as services income.

Analysis

Corp A recognizes services income from its Cloud Transactions with its customers. The source of such income takes into account all facts and circumstances of the relevant people functions, assets and operations required to deliver the Cloud Transactions.

The source of the Cloud Transaction income earned by Corp A is determined by looking to the location of Corp A's relevant assets and operations and the relevant employees when performing their activities. Corp A's relevant assets and operations are located in Country A, and its Cloud Operations personnel perform their functions within Country A. The customer billing function located in Country X is not directly related to the provision of cloud services. As a result, all of Corp A's cloud services income is sourced to Country A.

Corp B's services income for hosting the Country B data center is also sourced by looking to the location of its relevant employees when performing their activities and its relevant assets and operations. Because all of Corp B's relevant assets and operations are located in Country B and its employees perform their functions within Country B, all of Corp B's hosting income is sourced to Country B.