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NEWS ANALYSIS

The Character of the Cloud

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The IRS and Treasury are ready to clarify some tax issues regarding cloud computing transactions this year, and the new rules could help the United States lead the way on the international stage as well.

Cloud computing issues have been on the government's radar screen for several years, and the priority guidance plan has advertised the possibility of regulations under sections 861, 862, and 863(a) since 2011. The regulation project was likely delayed by the necessity for officials to address bigger projects like the Foreign Account Tax Compliance Act and the OECD's base erosion and profit-shifting project. The project started its life on the priority guidance plan as regulations on the source of income, but it has shifted to focus first on the character rules. An incremental approach to the guidance was preordained, as Treasury Deputy International Tax Counsel Danielle Rolfes explained in 2012. (Prior coverage: *Tax Notes*, May 21, 2012, p. 991.) Officials explained in January that sourcing issues would be addressed in later guidance. (Prior coverage: *Tax Notes*, Feb. 8, 2016, p. 667.)

Taxpayers struggle to apply the regulations governing computer programs in reg. section 1.861-18 to cloud computing transactions because the hallmark of those regulations is a transfer of software, but there is no transfer in cloud transactions. Ideally, the new regulations will feature two main design elements. First, "we need something that is administrable and that can deal with a multitude of contexts," said Chad Hungerford of Deloitte Tax LLP. Second, it will be important that the rules are flexible enough to account for some future technological changes.

Taxpayers want the rules to be consistent not only in their domestic interpretation but also across borders, said David G. Shapiro of Saul Ewing LLP. "If this is addressed on a country-by-country basis, it could result in double taxation or worse," Shapiro said.

"I am very much looking forward to Treasury issuing guidance on this," said Gary D. Sprague of Baker & McKenzie LLP. There are important domestic questions to be resolved, but perhaps even more important is the potential influence of U.S. rules on foreign law. "On the international front, one reason for the United States to provide guidance is that we don't have specific guidance internationally," Sprague said. Many observers have raised questions about how cloud computing transactions should be taxed, but there is no clear international guidance on how they should be treated. "U.S. guidance on the character of cloud computing transactions likely would be an important first step towards developing an international consensus on the 'business profits' nature of cloud computing payments, just as reg. section 1.861-18 was important in encouraging an international consensus on the character of user payments for computer software," he said. "I am hoping that the international consensus will result in the determination that cloud computing payments are for services and thus business profits for treaty purposes."

Character

Determining whether a transaction should be treated as a service or for the use of property is the essential issue in most cloud computing transactions, Sprague said. Section 7701(e), which was enacted well before cloud transactions were common, draws a line between leases of property and the provision of services using property. "That line is essentially the same line that we are trying to draw in cloud computing transactions," Sprague said. "The vast majority of cloud computing transactions, whether platform-as-a-service [PaaS], infrastructure-as-a-service [IaaS], or software-as-a-service [SaaS], all fall on the side of services characterization under section 7701(e) because the hardware remains under the possession and control of the service provider."

The guidance in reg. section 1.861-18 is the presumptive starting point for the coming character regulations. But like reg. section 1.861-18, the new rules will have to both address current technology and establish basic principles that can be applied to future innovations. Reg. section 1.861-18 was finalized in 1998, and even then, was quickly on its way to becoming outdated. The question that prompted the rulemaking project was what to do with shrink-wrapped software, said Carol P. Tello of Sutherland Asbill & Brennan LLP, who worked on the rules while employed at the IRS. The rules for computer programs require a transfer of either a right or a

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copy of a copyrighted article, so they come up short for many cloud transactions, which generally do not include a transfer of tangible or intangible property. It might be possible to build on reg. section 1.861-18, but the more likely course is for the government to put the rules in a new reg. section 1.861-19 to distinguish them from the transfer-bound rules for computer programs.

Whether to ''unbundle'' mixed transactions is still undecided. In *Tidewater Inc. v. United States*, 565 F.3d 299 (5th Cir. 2009), the Fifth Circuit applied the government's all-or-nothing approach to character determinations and held that a bareboat charter was a lease, not a service. The IRS issued an action on decision in which it disagreed with how the court applied the physical possession and control factors of section 7701(e), asserting that the charters should be treated as service contracts. (AOD 2010-01, 2010-22 IRB 698.)

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Presumably, the IRS will stick with the all-or-nothing approach of the action on decision. That is satisfactory from an administrability standpoint, but it may also be the right answer generally for cloud computing transactions. ''I see very few if any commercial transactions that would warrant unbundling,'' Sprague said. He added that if a company presents a transaction to the market as a single transaction with a single price, the tax law normally ought to require the taxpayer to determine whether it is a service or a lease in its entirety, but not require the taxpayer to unbundle the transaction into separate components.

A more complex question might arise if a taxpayer offered a product that included both a significant SaaS element and a significant downloaded element for a single price, but that isn't common, Sprague said. If the rules reverse course and try to bifurcate transactions, a de minimis rule will be necessary. ''Almost all SaaS applications require the user to download client-side software to allow easier communication with the host. That download is a transaction that would fall within [reg. section 1.861-18] for transfers of computer programs as a literal matter, but the communications application is always a de minimis part of the whole,'' he explained. The reason for the SaaS offering is to allow the user access to processing or hosting somewhere else. ''So the right answer there is to disregard the downloaded element as de minimis, if the law in principle were to favor bifurcation in other, more appropriate cases,'' he said.

Some transactions might be difficult to address under an all-or-nothing approach. For example, a subscription to Amazon Prime includes two-day shipping on physical goods in addition to streaming videos and music, and it may be difficult to determine the dominant character, Shapiro said. ''There needs to be a set of rules where you can make an assumption,'' he said.

Source

The question of where transactions are sourced is potentially more complicated than the character question. Under reg. section 1.861-18, once the character is determined, applying the source rules is relatively easy because services are sourced at the place of performance and royalties are sourced where the property is protected. But sourcing cloud transactions at the place of the service could be difficult because servers can be moved, and some customers may request the use of specific servers. ''The place of the server really has so many infirmities to it'' that it is hard to think that would be the choice for sourcing cloud transactions, Tello said. She said that a possible new source rule would be to split 50-50 between the United States and foreign source on each cloud transaction payment, like the rules for transactions occurring in the ocean or in space.

The source questions come into sharp relief when more than one entity is involved in providing a service such as IaaS — for example, if a server is in one location, an entity selling services is in another location, and the customer is in a third location. ''We need ways to characterize the legs of that transaction for withholding tax, income tax, foreign tax credit, and subpart F purposes,'' Hungerford said. ''What people functions matter, and how do we boil that down into a rule that can be administered on the front end rather than back end?'' Because of the potential withholding tax implications, it is important that there be a rule that can be applied before a transaction is complete, Hungerford said. ''At the time of entering into the contract, you may not know where the server is or where the consumers are, and applying the rules is challenging in that particular situation.''

Hungerford said the IRS and Treasury will have to decide whether there will be a single set of source rules for withholding, FTCs, and subpart F. ''A one-size-fits-all approach would be more administrable, but there is a question about whether it is appropriate,'' he said. Possible legislative changes may foreclose the possibility of a single set of rules. In the fiscal 2017 budget, the Obama administration proposed adding a new category of subpart F

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income for foreign base company digital income, which would include a controlled foreign corporation's income from the lease or sale of a digital copyrighted article or the provision of a digital service when the CFC does not substantially contribute to the development of the property or service.

Sprague said that the policy of sourcing services where the provider provides them is both workable and desirable in the cloud context. ''The most difficult issue in the cloud context is that a service might be performed with inputs that are owned or provided by several legal entities in a group that may operate in different places,'' he said. Sprague suggested that in the case of multiple entities contributing to a service, the rule should be that ''you source the income of the entity that is recognizing the revenue by looking to where the [service-providing] entity's employees and assets are located and source its revenue according to that location. It is not really a new issue.'' For example, if a customer in one jurisdiction contracts with a service provider operating in a second jurisdiction and the service provider uses a data center owned by a separate legal entity located in a third jurisdiction, the data center's fee would be sourced to the jurisdiction where it is located, and the service provider's revenue would be sourced to the jurisdiction where its employees and assets are located.

Drafting for Today and Tomorrow

''I am optimistic that the rules can be written based on principles that will accommodate the evolution of technology,'' Sprague said. ''The [reg. section 1.861-18] rules are pretty robust and have managed to accommodate a lot of developments in the software space.'' Although the rules for computer programs don't cover SaaS because there is no ''transfer'' of a computer program, their distinction between the transfer of a copyrighted article and of copyright rights that is ''very farsighted, and a basic principle that will provide good guidance in the software space into the foreseeable future,'' he said.

Hungerford said that although it will be impossible to fully ''future-proof'' the rules, a principles-based drafting approach that provides practical guidelines and factors will help keep them from becoming stale too quickly. ''There is a danger in referencing specific transactions, because there is variability in a lot of transactions,'' he said. ''It is better to think about principles and concepts that are more broadly applicable.''

Issuing guidance quickly would give the United States an advantage because it is home to many major cloud computing companies. Market countries are interested in sourcing income to the location of the customer. ''For a company providing PaaS, for example, they may not know where the customers are going to be when they first enter into the arrangement,'' said Hungerford. ''When your customers are global enterprises, it becomes very challenging to use the customer as the sole source, and it cedes the U.S.'s right to tax that income.''

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To create durable rules for cloud computing transactions and future related transactions, the government will need to take a principles-based approach. Moving quickly on new rules will also help to establish the United States as a leader on cloud tax issues, which could help to form an international consensus that is relatively more palatable to U.S.-based companies. ■

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