Bloomberg Tax

Tax Management
International Journal™

Final FDII Regulations Clean Up Classification Issues Relating to Software and Digital Content Deliveries

By Gary Sprague[*]
Baker & McKenzie LLP
Palo Alto, California

Treasury and the IRS released the final foreign derived intangible income (''FDII'') regulations on July 9.[1] The final FDII regulations included an important improvement over the proposed regulations relating to how software transactions are classified under the FDII analytical framework, which applies separate rules to transactions in property and in services, and within the property category, to transactions in general property and intangible property. In general, the principles that classify transactions in computer programs under Reg. §1.861-18[2] now will apply for purposes of distinguishing between transactions in general property and intangible property under the FDII rules. This should remain the case if the proposed changes to those regulations to expand their scope to include transfers of digital content are adopted, which will provide a single classification regime for transactions in digital content and software.[3] Finally, the proposed rules of Prop. Reg. §1.861-19[4] regarding the classification of cloud transactions, including SaaS (software as a service), also should apply for purposes of the FDII classification rules to distinguish between transactions in property and transactions in services.

The statute itself divides transactions that may be FDII-eligible into two categories: transactions in property and transaction in services. Section 250(b)(4) defines ''foreign-derived deduction eligible income'' (''FDDEI'') to mean deduction eligible income which is derived in connection with ''property . . . which is sold by the taxpayer'' and ''services provided by the taxpayer'' subject to requirements that the property is sold to a foreign person for a foreign use and that the services are provided to foreign persons. While the statute itself does not distinguish between types of property, the final FDII regulations create several subclassifications of property for purposes of applying rules to determine when an item of property has been sold to a foreign person for foreign use. The two significant categories for software suppliers are ''general property'' and ''intangible property.''[5] The term ''sale'' of property is defined to include, among other transactions, a lease or license of that property.[6]

Due to the different treatment of general and intangible property, and of transactions in property vs. transactions in services, the final FDII regulations require software suppliers to address classification issues similar to those addressed in Reg. §1.861-18 and Prop. Reg. §1.861-19. The software classification regulations of Reg. §1.861-18 distinguish between the transfer of a copyrighted article and the transfer of a copyright right. The proposed cloud transaction classification regulations of Prop. Reg. §1.861-19 distinguish between the provision of services (including SaaS) and the lease of property. The — 18 regulations also contemplate the separate category of the provision of programming services, but that type of transaction normally does not create a challenging classification issue.

---

[*] Gary Sprague is a partner in Baker McKenzie LLP's Palo Alto, California, office and focuses his practice on international corporate tax planning and advice, tax controversies, and tax issues affecting software and digital enterprises.

[1] T.D. 9901, 85 Fed. Reg. 43,042 (July 15, 2020).

[2] All section references are to the Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[3] REG-130700-14, 84 Fed. Reg. 40,317 (Aug. 14, 2019).

[4] *Id.*

[5] Reg. §1.250(b)-3(b)(10) (general property), §1.250(b)-3(b)(11) (intangible property).

[6] §250(c)(5)(E); Reg. §1.250(b)-3(b)(16).

ISSN 0090-4600

The proposed-19 regulations by their terms apply to specified sections of the Code, including §250. The final FDII regulations include as elements of the definition of ''electronically supplied services'' references to several types of online services, including ''access to digitalized products (such as streaming content without downloading the content),'' and ''on-demand network access to computing resources, such as networks, servers, storage and software.''[7] While the definition in the final FDII regulations does not precisely match the definition of cloud transactions under the proposed-19 regulations,[8] there is no obvious case where a SaaS or streaming content transaction that is classified as a service under the proposed cloud transaction regulations would be treated as other than an electronically supplied service under the final FDII regulations, and thus a ''general service'' for purposes of applying the foreign use test for services.

As originally proposed, however, the FDII regulations would have classified a transfer of computer programs to a user for internal use as a transaction in ''intangible property'' for purposes of the FDII distinction between ''general property'' and ''intangible property,'' even though that same transaction would be classified as a transfer of a copyrighted article under the-18 regulations.[9] The proposed regulation was the source of significant consternation in the software industry, as it ran counter to the longstanding effort to establish that the tax treatment of the price paid for the transfer of software copies should be no different than the tax treatment of payments to acquire other copyrighted articles, such as books, records and video recordings.

As relevant to the distinction between general property and intangible property in §250, the software classification regulations set forth four categories of transactions: (i) a sale of a copyright right; (ii) a license of a copyright right; (iii) a sale of a copyrighted article; and (iv) a lease (or rental) of a copyrighted article.[10] A copyright right includes, among other things, the right to make copies of a computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending.[11] A copyrighted article includes a copy of a computer program.[12] Under the framework of the software classification regulations, the first two categories of transactions are characterized for the specified federal income tax purposes as transactions involving intangible property, whereas the latter two categories of transactions are characterized as transactions in copyrighted articles, i.e., not involving intangible property.

The preamble to the final FDII regulations acknowledged the software industry's concern over the proposed treatment of transfers of software copies as transactions in intangible property. In response, the final regulations define intangible property to have the meaning set forth in §367(d)(4), except for an express carve out that for purposes of §250 ''intangible property'' does not include a copyrighted article as defined in Reg. §1.861-18(c)(3).[13] If the proposed revisions to the software classification regulations are finalized in their proposed form, this cross-reference then also would include deliveries of copies of digital content.

Accordingly, it is now clear that a sale of a software copy treated as a copyrighted article under the software classification regulations is evaluated for FDII purposes under the general property rules rather than the rules for sales of intangible property. This conclusion should not change regardless of how the copyrighted article is delivered to the user. Finally, the proposed revisions to the software classification regulations would add §250 to the list of specified sections for which the software classification regulations are applicable.[14]

The preamble to the final FDII regulations nevertheless noted that no inference is intended with respect to the treatment of sales of copyrighted articles under other sections of the Code. The ''no inference'' observation is consistent with the fact that the-18 regulations themselves are expressly made applicable to only specified sections of the Code (including §250 under the proposed changes to Reg. §1.861-18).

That said, the cross-reference to Reg. §1.861-18 in the §250 regulations is a little awkward from the perspective that user copies of software should as a general matter be treated as inventory items passing in commerce, and not as items of intangible property. The final FDII regulations do not define transactions in ''general property'' to include transactions in copyrighted articles as defined in the-18 regulations. Rather, ''intangible property'' is defined as having the meaning set forth in §367(d)(4), which includes copyrights, but ''[f]or purposes of section 250'' as excluding copyrighted articles as defined in Reg. §1.861-18(c)(3). The implication is that perhaps, absent the exclusion, copyrighted articles might be included in a general definition of ''intangible property'' or even ''copyrights.'' It would seem that the presumption

[7] Reg. §1.250(b)-5(c)(5).

[8] *Compare* Prop. Reg. §1.861-19(a).

[9] REG-104464-18, 84 Fed. Reg. 8188 (Mar. 6, 2019).

[10] Reg. §1.861-18(b)(1)(i), §1.861-18(f).

[11] Reg. §1.861-18(c)(2).

[12] Reg. §1.861-18(c)(3).

[13] Reg. §1.250(b)-3(b)(11).

[14] Prop. Reg. §1.861-18(a)(1). The proposed FDII regulations (March 2019) predated the proposed changes to-18 (July 2019), perhaps showing an emerging coordination on this point within Treasury.

ISSN 0090-4600

should be in the other direction, — i.e., that as a general matter, software copies should be treated as any other copyrighted articles, and not as ''copyrights.''

The final regulations also include a useful addition to the rules for demonstrating foreign use of general property for sales of digital content, including software, which is transferred electronically. Reg. §1.250(b)-(3)(1) provides a definition of digital content that parallels the proposed revisions to the-18 regulations by defining ''digital content'' to mean ''a computer program or any other content in digital format.''[15] The preamble notes that the general rules for determining foreign use for general property purposes are not suitable for sales of digital content, including copyrighted articles, that are transferred electronically, because the general rules focus on the physical transfer of property to end users.[16] Accordingly, the final regulations provide an additional rule for sales of general property that primarily contains digital content that is transferred digitally.[17] Under that rule, the place of use is determined by the location of the end user's device when the end user ''downloads, installs, receives, or accesses'' the purchased digital content.[18]

This rule apparently does not apply to the sale of software copies that are delivered on a physical medium. Even though the definition of ''digital content'' includes a reference to ''any media, user manuals, documentation, data base, or other similar item if [such item] is incidental to the operation of the computer program,''[19] the foreign use rule for sales of ''digital content'' expressly refers to sales of content that is transferred electronically rather than in a physical medium. Accordingly, the foreign use rules are different for sales which involve digital deliveries compared to sales which involve deliveries on tangible media.[20] In that case, taxpayers would need to prove foreign use for sales of software copies carried on tangible media by reference to the general rules, including those applicable to property delivered by a carrier or freight forwarder. Software companies that deliver through a combination of tangible media and electronic transmission will need to apply both rules. Other interesting issues will arise if the software supplier makes an initial delivery digitally but also delivers media for backup purposes, or supplies updates digitally when the original installation was made from software supplied on a tangible medium.

The final FDII regulations do not prescribe particular methods by which a taxpayer must prove the location of a user's device, although IP address is given as an example. This contrasts with the user location rules which have been developed in the case of many extraterritorial value-added tax regimes for business-to-consumer sales, which frequently require the taxpayer to collect two pieces of nonconflicting information from a specified list to determine a user's location. The final FDII regulations thus appear to provide more flexibility to prove user location for FDII purposes than is typically the case for cross-border B2C sales of digital goods or services under VAT compliance obligations.

Importantly for direct-to-consumer sales of digital content that is transferred electronically, the final regulations also provide a rule to allow reliance on a foreign billing address in cases where location information regarding the device is ''unavailable'' and the gross receipts ''from all sales with respect to the end user'' are in the aggregate less than $50,000. The sales threshold essentially will cause all direct B2C transactions to be eligible for this alternative rule, as long as the other relevant location information is ''unavailable.'' It is not clear what proof the taxpayer must adduce to demonstrate that user device location is ''unavailable.'' Taxpayers should be allowed to rely on information they collect in their normal course of business, rather than undertaking affirmative efforts to prove that device location information is unavailable.

It is also not clear how this rule would apply to sales of digital copies through resellers if the user device location is unavailable, as in the case of sales through resellers, where the software supplier normally would not have billing addresses for the end users.[21] This ambiguity will encourage software suppliers to take what measures are necessary to prove the

---

[15] The §250 definition omits the following qualification to the term ''content'' which appears in the proposed-18 definition: ''. . . that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time.'' The §250 definition also refers to an ''other electronic device'' in addition to a ''computer'' on which the content can be perceived. The significance of omitting the qualifier in the proposed-18 regulations relating to copyright law is not clear; it will be interesting to see whether the final-18 regulations conform to the definition of ''digital content'' as expressed in the final FDII regulations.

[16] The general rules apply to property delivered through a carrier or freight forwarder, property not delivered through a carrier or freight forwarder but which is located outside the United States at the time of sale, and sales for resale. Reg. §1.250(b)-4(d)(1)(ii).

[17] Reg. §1.250(b)-4(d)(1)(ii)(D).

[18] Perhaps as a reflection of the digitalization of the economy, the final FDII regulations refer to all persons who ultimately use or consume property as an ''end user.'' Reg. §1.250(b)-3(b)(2). Accordingly, at least in the FDII world, those who sit down at the breakfast table with a bowl of cornflakes are ''end users'' of cornflakes.

[19] Reg. §1.250(b)-3(b)(1).

[20] T.D. 9901, 85 Fed. Reg. at 43,054.

[21] The definition of ''end user'' expressly excludes resellers. Reg. §1.250(b)-3(b)(2).

ISSN 0090-4600

location of end users and their devices, even when sales are made through resellers.[22]

As a consequence of the revised treatment of software and digital content transactions, the final regulations revised two examples in the proposed regulations dealing with software and added a further example dealing with digital content transactions. These examples provide useful guidance on classification issues, and on how the software supplier may be able to prove foreign use.

Example 5 involves a limited use license of copyrighted computer software acquired by a foreign purchaser.[23] The software is downloaded by the foreign purchaser's employees, all of whom are located outside the United States. The licensed software is treated as digital content as defined in Reg. §1.250(b)-3(b)(1) and is downloaded by an end user as defined in Reg. §1.250(b)-3(b)(2). Accordingly, all of the annual fee for use of the software is treated as gross FDDEI for the year. Example 6 provides a similar analysis but for a fact pattern in which the foreign purchaser uses the licensed software at its offices both within and outside the United States.[24] The example concludes that 50% of the annual payment qualifies as FDDEI based on the U.S. seller's ''internal records'' which indicate that half of the downloads were onto computers located outside the United States. The example does not refer to whether the ''internal records'' of the taxpayer captured IP addresses or some other information.[25]

Further, the final regulations added an Example 7 which involves the sale of copyrighted music available for download from the domestic corporation's website.[26] The downloaded music is analyzed as digital content and because the recipient acquires no ownership in copyright rights to the music, the sale is considered a sale of a copyrighted article, and thus is a sale of general property for FDII purposes.[27] The sale is considered for a foreign use under Reg. §1.250(b)-4(d)(1)(ii)(D) because the supplier ''has data'' that the user accessed the website for download onto a device located outside the United States. The reference to the general term ''data'' demonstrating the foreign use also is an apparent indication that taxpayers have some flexibility to demonstrate the foreign use of copyrighted articles via means of proof other than IP addresses.

It is important to note that these detailed rules for determining foreign use for property and service transactions for software and digital content are not necessarily the same rules that determine whether an item of income is U.S. or foreign source under the source rules of §861, §862, §863, and §865. In a future Commentary, I will note the circumstances in which an item of income may qualify as FDII but still be U.S.-source income, and when it may be foreign-source income but not qualify as FDII.

---

[22] The location-of-use test for electronically supplied services for consumers is similar to, but not identical to, the rule for supplies of digital content as property. As with the case of digital content as property, the digital services rules call for a primary test of the location of the device used to access the service, and a possible default to billing address if the device location data is unavailable. In contrast to the sale-of-content case, however, in the streaming content case the supplier is required to make ''reasonable efforts'' to obtain the customer's device location. Reg. §1.250(b)-5(d)(2). Similar, yet again different, rules apply to the provision of electronically supplied services to business recipients. Reg. §1.250(b)-5(e)(2)(iii).

[23] Reg. §1.250(b)-4(d)(1)(v)(B)(5) (*Ex.* 5).

[24] Reg. §1.250(b)-4(d)(1)(v)(B)(6) (*Ex.* 6).

[25] The fact that the user was a foreign purchaser is relevant for the FDII result. Due to the requirement that any sale of property must be to a foreign person to qualify under §250, a transaction with a U.S. counterparty with facts identical to Example 6 apparently would result in no FDDEI, even if the U.S. purchaser also had the same functional profile of half of the group's employees downloading the software onto computers located outside the United States.

[26] Reg. §1.250(b)-4(d)(1)(v)(B)(7) (*Ex.* 7).

[27] The regulations refer to Reg. §1.250(b)-3(b)(10) and §1.250(b)-3(b)(11), the latter of which contains the cross reference to the copyrighted article classification rule in Reg. §1.861-18(c)(3).

ISSN 0090-4600