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Proposed Regulations Rationalize Source of Income Rules for Digital Deliveries of Software and Content

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The Treasury and IRS recently issued the long-awaited proposed regulations relating to the classification of cloud transactions and transactions involving digital content.[1] The proposed regulations would add a new section to the §861 regulations, Reg. §1.861-19, to supplement the existing guidance in Reg. §1.861-18 relating to the classification of transactions involving computer programs (the ″Software Regulations″), as initially promulgated in 1998.[2] The new Reg. §1.861-19 regulations, which classify a cloud transaction as either the provision of services or a lease of property, will be welcomed by U.S. businesses operating in the cloud computing sector, and hopefully will serve as a guide to tax administrations abroad as they develop their own guidance on the classification of cloud transactions.

Included in the package was an unexpected bit of useful and practical guidance for software companies, which have struggled to comply with the source of income rules in the Software Regulations. In general, the Software Regulations provide that if a computer program is transferred to a person, and the person does not receive any of certain enumerated copyright rights, the transaction will be classified as the transfer of a copyrighted article.[3] If the benefits and burdens of ownership of that copy are transferred to the user, then the transaction is treated as a sale of the copyrighted article. If the benefits and burdens of ownership are not transferred, the transaction is classified as a lease of that copyrighted article.[4] The source of income from transactions characterized as a sale will be sourced according to the normal rules for sourcing income from the sale or exchange of property under §861(a)(6), §862(a)(6), §863, §865(a), §865(b), §865(c), or §865(e), as appropriate. Income from transactions classified as the lease of a copyrighted article would be sourced according to the normal rules for rents and royalties under sections §861(a)(4) or §862(a)(4).[5]

Transfers of software copies subject to perpetual user licenses normally are treated as sales of copyrighted articles. In that case, the source of income determination required a reference to the title passage rule of Reg. §1.861-7(c). The preamble to the Software Regulations noted that taxpayers could face challenges applying the title passage rule to software transactions. In most, if not all, cases, IP counsel drafting the end user license agreement (EULA) would carefully stipulate that ″title″ to the software copy would not pass to the user, in order to ensure that the continuing contractual restrictions on use contained in the EULA would be enforceable. Many IP counsel also considered it appropriate to state that title to the tangible media also would not pass to the user, for the same purpose.

In the absence of a title passage term in the commercial transaction, the title passage rule requires the taxpayer to identify the time and place of passage to

[1] REG-130700-14, Classification of Cloud Transactions and Transactions Involving Digital Content, 84 Fed. Reg. 40,317 (Aug. 9, 2019).

[2] T.D. 8785, 63 Fed. Reg. 52,971(Oct. 2, 1998). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise indicated.

[3] Reg. §1.861-18(c)(1)(ii).

[4] Reg. §1.861-18(f)(2).

[5] *Id.*

the buyer of beneficial ownership and risk of loss.[6] Perhaps in an attempt to assure taxpayers that this rule could be applied in a straightforward manner to deliveries of digital copies, the preamble to the Software Regulations noted as follows:

> As to the issue of determining the place of sale under the title passage rule of §1.861-7(c), the parties in many cases can agree on where title passes for sales of inventory property generally. Consistent with the overall policy of the regulations, income from electronic transfers of computer programs that constitute inventory property, classified as sales of copyrighted articles, will be sourced under similar principles.[7]

Nevertheless, the concept of ″risk of loss″ of a digital item proved challenging to implement. The typical solution was to focus on those terms of the user agreement that described the supplier's delivery obligations towards the user. While in principle taxpayers could provide in their commercial terms that all delivery obligations would not be fulfilled until the program had been installed on the user's computer, that commercial solution frequently ran into conflict with the company's revenue recognition policies, which in most cases sought to allow revenue to be recognized as soon as the files were made available for download, not at some later moment when the seller could prove that the program had been installed.[8] Some taxpayers solved the revenue recognition/source of income problem simply by delivering copies to foreign users from master files residing on servers located outside the United States, which ensured that even if the supplier had met all of its delivery obligations at the time the files were made available for download on the server, that event occurred outside the United States.

In response to these difficulties in applying the title passage rule to the delivery of an item where there is no title to pass, the proposed regulations provide:

> When a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of download or installation onto the end-user's device used to access the digital content for purposes of §1.861-7(c), subject to the tax avoidance provisions in §1.861-7(c). However, in the absence of information about the location of download or installation onto the end-user's device used to access the digital content, the sale will be deemed to have occurred at the location of the customer, which is determined based on the taxpayer's recorded sales data for business or financial reporting purposes.[9]

Transactions characterized as the lease of a copyrighted article will continue to be sourced under the rules for rents.

The preamble to the proposed regulations explains that the customer location is the appropriate determinant of source, as the contractual specification of a location of transfer ″could be easily manipulated and would bear little connection to economic reality in the case of a transfer by electronic medium of digital content, given that a sale and transfer of digital content by electronic medium generally would not be considered commercially complete until the customer has successfully downloaded the copy.″[10]

This generally will be a welcome development for U.S. software companies. Given that nothing is ever simple in the world of software taxation, however, there are some important observations to make and some uncertain areas to work through in the final regulations.

First, this proposal apparently will create different rules for software (or other content) delivered on tangible media and that delivered digitally. Companies that still deliver on media will need to continue to grapple with the title passage rule, even though IP counsel will continue to recommend against transferring title to the software copy and the media. In many cases, suppliers both deliver digitally and provide a copy on media. If the original installation occurred with the digitally delivered copy and the media version is designated as a back-up, one would expect that the digital delivery source rule would control. Given that the software industry has migrated overwhelmingly to digital deliveries, perhaps Treasury will want to consider adopting the same rule for deliveries on media on the grounds that there is little, if any, commercial difference between the two forms of delivery.

The proposed guidance seems to have conceptualized the problem under an assumption that all software deliveries would be directly to the device of the ultimate user. Especially in the case of enterprise licenses, that is not necessarily the case, as the software may be delivered for installation on a server in a data center, to which access is then granted to many em-

[6] Reg. §1.861-7(c).

[7] T.D. 8785, 63 Fed. Reg. 52,971, 52,973 (Oct. 2, 1998).

[8] *See e.g.*, T.M. 555, *Federal Taxation of Software and E-Commerce, Working Papers, Worksheet 6*: *Sample Language for Foreign Source Income for Physical Delivery* and *Worksheet 7: Sample Language for Foreign Source Income for Electronic Delivery*.

[9] Prop. Reg. §1.861-18(f)(2)(ii).

[10] REG-130700-14, *Classification of Cloud Transactions and Transactions Involving Digital Content*, 84 Fed. Reg. 40,317 (Aug. 9, 2019).

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ployees of the enterprise on a SaaS basis. In this case, the language of the proposed regulation might point to the data center as the location which determines source, on the basis that the server is the location at which the software instance is created (although hardly a ″device,″ in normal usage). It is not obvious from a policy perspective whether the appropriate customer location in this case would be the data center or the location of the actual human users, even if those users do not install the enterprise software on their ″device.″ If a data center installation is not regarded as installation on an end-user's device, then the supplier would need to be able to identify the actual user location to prove the ″location of the customer.″

One clear case where the software supplier will want to look through the ″location″ of the legal entity contracting party to identify the actual places of use of the software is in the case of enterprise licenses. It is common for U.S. software companies to enter into an enterprise license with a U.S. person as the contractual counterparty, even though copies of the software may be used by employees of the customer enterprise throughout the world. In order to capture the foreign part of that sale as foreign source income, the supplier will want to be able to prove the location of all downloads or installations outside the United States. This will then produce the unusual (but appropriate) result that a commercial transaction between a U.S. supplier and a U.S. customer can generate foreign source income, at least in part.

Consideration also needs to be given to foreign persons exporting software or other content to the United States through digital deliveries, as the Software Regulations apply equally to inbound transactions. In the inbound case, foreign suppliers of software and content delivered digitally to U.S. users will now have U.S. source income under the proposed regulations, regardless of the delivery terms in their commercial agreements or the EULA. This could create effectively connected income issues for suppliers not beneficiaries of a tax treaty. Treaty residents may need to consider filing Form 1120F in order to timely claim treaty protection against taxation of their U.S. source income.

Treasury may need to give some further guidance (including possibly in the preamble to the final regulations) to coordinate this rule with the new text of §863(b), added by the Tax Cuts and Jobs Act.[11] Section 863(b) now states that any gain from the sale of inventory property produced in whole or in part by the taxpayer within the United States and sold without the United States, or vice versa, shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property. Inventory property is defined in §865(i)(1) as personal property described in §1221(a)(1). That section defines inventory property as ″stock in trade″ or other property which would be properly included in inventory if on hand at the close of the taxable year, or ″property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.″ Prior to the TCJA, the title passage rule could apply to treat some part of the income as sourced at the location of title passage, even if production occurred entirely in the United States. In cases where §863(b) did not apply (for example in cases where the taxpayer did not produce the property it sold), then 100% of the income would be sourced by reference to the title passage rule under §861(a)(6) and §862(a)(6).

Presumably, Treasury's goal behind the proposed rule is to create foreign source income for all export sales of digital content, regardless where that content was created or developed. To escape the mandate of §863(b) to determine source solely by the location of production, therefore, it would seem that a copy of digital content either would need to not be ″inventory property,″ or not be subject to a ″production.″ How and where software might be ″produced″ is a thorny issue, and Treasury probably would not want to answer that question in the context of these proposed regulations.[12] The rules could be harmonized if a digital copy of software or other content doesn't fall within the definition of inventory property in §1221(a)(1), perhaps on the theory that the copyrighted article itself is not stock in trade or property ″held″ for sale, as the copy itself normally doesn't exist as a property item separate from the master copy until the user copy is created on the user's device. That approach would have the peculiar result of causing gain on the sale of digital copies to be capital gain, as there is no other logical exclusion from the capital asset definition of §1221 for digital copies. Treasury actually has already expressed a view on this; the preamble to the current regulations stated that ″income from electronic transfers of computer programs that constitute inventory property, classified as sales of copyrighted articles, will be sourced under similar principles.″[13] If the goal indeed is to provide a rule that produces 100% foreign source income on software exports, this may be another circumstance where the rule simply needs to recognize the ″special

[11] Pub. L. No. 115-97 (Dec. 2017).

[12] See, e.g., §954(d), which applies to a sale of property purchased by the taxpayer if that property had been manufactured, produced, grown, or extracted outside the CFC's country of incorporation.

[13] T.D. 8785, 63 Fed. Reg. 52,971 (Oct. 2, 1998).

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circumstances of software programs″ in order to provide a foundation for the correct policy result.[14]

It is gratifying to see Treasury keeping up with innovations in the digitalized economy, and proposing rules which create appropriate results and simplify compliance.

[14] *Cf.* Reg. §1.861-18(f)(3).

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