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Digital Content, Cloud Rules See Mostly Clear Skies Ahead: Part I

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In this first article of a two-part series, Baker McKenzie practitioners analyze the most significant aspects of the final digital content and cloud regulations and will discuss the proposed cloud sourcing regulations and Notice 2025-6 in part two.

Treasury and the IRS made significant changes to the digital content and cloud regulations that have provided more clarity to practitioners. On January 10, 2025, Treasury and the IRS released the long-awaited final regulations under Reg. §1.861-18 (the "**Final Digital Content Regulations**") and Reg. §1.861-19 (the "**Final Cloud Regulations,**" and together with the Final Digital Content Regulations, the "**Final Regulations**") (T.D. 10022, 90 Fed. Reg. 2,977 (Jan. 14, 2025)). Treasury and the IRS also published proposed regulations under Reg. §1.861-19(d) relating to the source of income from cloud transactions (the "**Proposed Cloud Sourcing Regulations**") (REG–107420–24, 90 Fed. Reg. 3,075 (Jan. 14, 2025)), as well as a notice requesting comments on whether the Final Digital Content Regulations and the Final Cloud Regulations should apply for all purposes of the Code, and not just for purposes of the enumerated international provisions of the Code (Notice 2025-6, 2025-8 I.R.B. __ (Feb. 18, 2025)).

The Final Regulations are generally very responsive to the numerous comments made with respect to the 2019 proposed regulations under Reg. §1.861-18 and Reg. §1.861-19 (the "**2019 Proposed Regulations**") (REG-130700-14, 84 Fed. Reg. 40,317 (Aug. 19, 2019)) and reflect a sensible approach that aligns closely with current business models. While the -19 regulations were first proposed in 2019, the prior version of Reg. §1.861-18 was adopted in 1998 (the "**Prior Regulations**") (T.D. 8785, 63 Fed. Reg. 52,977 (Oct. 2, 1998)).

The most significant changes made by the Final Regulations, including from the Prior Regulations and the 2019 Proposed Regulations, are as follows:

- Expansion of the -18 regulations beyond computer programs to cover certain transactions involving "digital content";
- Replacement of the de minimis/bifurcation approach for mixed transactions with a new "predominant character" rule that is used to classify mixed transactions not only within -18 but

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also for purposes of classifying mixed transactions as falling under either -18 or -19 *or* as another type of transaction not within the scope of either -18 or -19;
- Addition of a new source rule for transfers of digital content downloaded through an electronic medium;
- Clarification of examples from the 2019 Proposed Regulations and addition of certain new examples (e.g., distinguishing a licensed website operator from a platform operator providing agency and hosting services to an app developer);
- The addition of new examples in both -18 and -19 involving resellers and the proper characterization of income from reseller arrangements as giving rise to only income from the provision of services; and
- Deeming income from a cloud transaction to be classified as income from the provision of services.

The Final Regulations generally apply to taxable years beginning on or after January 14, 2025, although taxpayers may, in certain cases, elect to apply the regulations retroactively to taxable years beginning on or after August 14, 2019, and to all subsequent taxable years. If finalized, the Proposed Cloud Sourcing Regulations would apply to taxable years beginning on or after the date of publication of final regulations.

I. Final Digital Content Regulations

A. Background and Scope

The rapid development of technology mandated that the Prior Regulations be revisited and amended to address business models and the new types of transactions with digital content that did not squarely fit within the framework of the Prior Regulations, which were limited to transactions involving a "computer program."

The 2019 Proposed Regulations extended the application of Reg. §1.861-18 to also cover certain transactions involving "digital content." For these purposes, "digital content" is defined as "a computer program or any other content, such as books, movies, and music, in digital format that is either protected by copyright law or not protected by copyright law solely due to the passage of time or because the creator dedicated the content to the public domain" (Reg. §1.861-18(a)(2)). The Final Digital Content Regulations added the reference to digital content not being protected by copyright law solely because the creator dedicated the content to the public domain).

Several comments to the 2019 Proposed Regulations requested that Reg. §1.861-18 also be extended to cover certain items not protected by copyright law but that are transferred electronically and are similar to copyrightable content. For example, the commenters requested to include in the definition of "digital content" such items as consumer or user data, text files of recipes, government-produced documents, and sets of fonts and typefaces (i.e., transfers that, in the commenters' view, are economically and functionally similar to transfers of digital content).

Treasury and the IRS helpfully declined to adopt this approach, explaining that Reg. §1.861-18 generally follows copyright law. Broadening the scope of the regulations to cover non-copyrightable material would require a wholesale revision of the copyright law framework underlying the regulations and could yield unintended results.

B. "Predominant Character" Rule

The Prior Regulations described four types of transactions involving computer programs:

- the transfer of a copyright right,
- the transfer of a copy of a computer program (a copyrighted article),
- the provision of services for the development or modification of a computer program, and
- the provision of know-how relating to computer programming techniques.

Where a transaction consisted of more than one of the four types of the enumerated transactions, the Prior Regulations required that each such transaction should be treated as a separate transaction, unless any transaction was de minimis (Reg. §1.861-18(b)(2) (2019)). In such cases, any such de minimis transaction was required to be treated as part of another transaction.

Whether a transaction was de minimis was determined by "taking into account the overall transaction and the surrounding facts and circumstances" (Reg. §1.861-18(b)(2) (2019)). In other words, the Prior Regulations generally required taxpayers to bifurcate transactions into their component parts, and to separately apply the regulations to each component part, unless any such part was de minimis. The Prior Regulations did not include any particularly helpful examples demonstrating the application of the de minimis standard. The 2019 Proposed Regulations preserved the basic bifurcation approach of the Prior Regulations, but used the term "overall arrangement" to describe a transaction that may include more than one element or component. In addition, as discussed further below, the 2019 Proposed Regulations applied a similar bifurcation/de minimis standard for purposes of classifying a cloud transaction. The 2019 Proposed Regulations also did not provide a coordination rule for purposes of classifying transactions involving multiple elements, one or more elements of which involve a transfer of digital content and one or more elements of which involve a cloud transaction (e.g., a platform that allows end users, for a single monthly fee, to both download music for offline listening and to stream the music while connected to the internet).

Several commenters requested that Treasury/IRS replace the bifurcation/de minimis approach with a "predominant character" rule. The commenters reasoned that it was often difficult and burdensome to apply the de minimis approach. In addition, bifurcation potentially required taxpayers to allocate income among different categories of non-de minimis transactions in situations where the taxpayer did not otherwise commercially make such an allocation or maintain records that would facilitate such an allocation (e.g., where the taxpayer charges the customer a bundled fee that covers a transaction with multiple elements, such as the music service described above).

Treasury and the IRS agreed with the commenters and replaced the bifurcation/de minimis approach with a new predominant character rule. The new predominant character rule applies both for purposes of the Final Digital Content Regulations as well as for purposes of the Final Cloud Regulations, including for purposes of classifying a transaction that includes elements involving both a transfer of digital content and a cloud transaction classified as the provision of services (Reg. §1.861-18(b)(2) and (3) and Reg. §1.861-19(c)(2)). The addition of a predominant character rule is an extremely helpful and welcome development.

As Treasury and the IRS explain in the preamble to the Final Regulations (90 Fed. Reg. 2,977, at 2,978 (Jan. 14, 2025)), the predominant character rule is familiar to both taxpayers and the IRS, as it also

applies in other areas of the Code, such as for purposes of the foreign-derived intangible income rules (Reg. §1.250(b)-3(d)) and in subpart F (Reg. §1.954-1(e)(3)). Further, the Treasury and the IRS acknowledged the practical difficulties arising from bifurcation for some business models that offer both online and offline functionality. Namely, such business models may face challenges in bifurcating a single transaction into a digital content transaction and a cloud services transaction. The preamble cites examples involving video games (where the customer purchases a copy of the video game primarily to play games online with other players but which also may be played offline in single-player mode) and an anti-virus program that includes code which executes on the user's device as well as code that is deployed in the cloud (90 Fed. Reg. 2,977, at 2,978 (Jan. 14, 2025)). One can think of many other examples. As discussed further below, the Final Regulations include several examples involving both video games and platforms that provide certain digital content for streaming and temporary download in exchange for a single payment.

The "predominant character" of a transaction that contains multiple elements, one or more of which would be a digital content transaction or a cloud transaction if considered separately, generally is determined by reference to "the primary benefit or value received by the customer in the transaction" (i.e., by the *particular* customer in the tested transaction) under Reg. §1.861-18(b)(3)(i). If that information is not reasonably ascertainable, the special rule in Reg. §1.861-18(b)(3)(ii)(A) provides that the predominant character is determined by the primary benefit or value received by "a typical customer in a substantially similar transaction." In the first instance, the primary benefit or value received by a *typical* customer in a substantially similar transaction is determined by data on how a typical customer uses or accesses the digital content. If data on how a typical customer uses or accesses the digital content is not available, Reg. §1.861-18(b)(3)(ii)(B) then requires that other factors indicative of the primary benefit or value received by a typical customer must be examined, including how the transaction is marketed, the relative development costs of each element of the transaction, and the relative price paid in an uncontrolled transaction for one or more elements compared to the total contract price of the transaction in question. The Final Regulations require taxpayers to use "reasonable efforts" to identify the data required to make the determinations described immediately above. However, Reg. §1.861-18(b)(3)(iii) provides that taxpayers are not required to develop any data that it does not otherwise develop in the ordinary course of business. As noted in the preamble, the Final Regulations do not purport to define the term "transaction," instead directing taxpayers to general tax principles, case law, and existing administrative guidance (90 Fed. Reg. 2,977, at 2,978 (Jan. 14, 2025)). As a practical matter, we would expect that many (or even most) taxpayers will rely on information regarding the primary value or benefit to a typical customer rather than the particular customer in the transaction.

Example 22 describes an arrangement between the streaming platform and the content creators whereby the content creators grant the streaming platform a non-exclusive license to use, reproduce, distribute, and display their videos. The example concludes that the transaction between the content creators and the streaming platform consists of two elements (1) uploading of the video to the streaming platform, which would be separately classified as a transfer of a copyrighted article, and (2) the right to reproduce, distribute, and display the videos, which would be separately classified as a transfer of a copyright right. The facts state that the content creators have ascertained that the primary benefit or value that the platform operator receives from transactions with content creators is the right to use, reproduce, distribute, and display their videos. Thus, the example unsurprisingly concludes that the predominant character of the transaction between the content creators and the platform operator is the transfer of a copyrighted right, even though the overall transaction includes the transfer of a copy of the video by the content creators to the platform operator.

Observation: One could likely have easily concluded that the transfer of a copy of the video by the content creators to the platform operator would have been de minimis under the formulation of the Prior Regulations.

Several other examples illustrate a more nuanced application of the predominant character rule. Example 24 in the Final Digital Content Regulations demonstrates the application of these factors to a fact pattern involving the sale of video games that include both online and offline functionality using the marketing and relative development costs factors.Under the facts of the example, the primary benefit or value to the particular customer is not known, nor is the primary benefit or value to a typical customer. However, the facts state that the video game is primarily marketed as a single-player game and specifies the portion of the development costs allocable to single-player content vs. multi-player content or to both, with most of such costs being allocated to the development of the single-player/offline functionality. Based on the application of the multi-factor analysis, the example concludes that the predominant character of the transaction between the retailer (who resells copies of video games that it acquires from the game developer) and the end customer is the transfer (sale) of a copyrighted article despite having multiple elements (i.e., offline functionality classified as the sale/purchase of a copyrighted article and online functionality classified as a cloud transaction involving the provision of services). In Example 7, a platform operator offers both streaming and temporary download of digital content to customers in exchange for one flat monthly fee. The example concludes that the predominant character is a cloud transaction because the facts assume that data shows that most customers stream digital content rather than download it to their devices. Similarly, Example 9 in the Final Cloud Regulations concludes that the platform operator that offers both movies for rent or purchase via either streaming or download is a cloud transaction classified as the provision of services under the "predominant character" rule because the data shows that a typical customer views movies by streaming rather than download. This conclusion stands even though the download alone would be separately classified as the lease or sale of a copyrighted article or digital content.

As observed above, the introduction of a predominant standard rule is a very welcome and sensible development. As the examples demonstrate, taxpayers should have leeway to prove the appropriate predominant character of a given transaction involving multiple elements through a reasonable marshalling of probative data. In cases where it is commercially reasonable to segregate the different elements into separately priced transactions, a taxpayer could create separate transactions with different characters.

C. Source of Income for Digital Content Downloaded through an Electronic Medium

The Final Digital Content Regulations provide a new source rule for sales of copyrighted articles transferred through an electronic medium. Under the new source rule of Reg. §1.861-18(f)(2)(ii), when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of the billing address of the purchaser for purposes of Reg. §1.861-7(c).

Note: Reg. §1.861-7(c) generally provides that a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer (the title passage rule). The 2019 Proposed Regulations provided that the location of download or installation onto the end user's device used to access the digital content generally should control. Prop. Reg. §1.861-18(f)(2)(ii) (2019) also provided an alternative rule pursuant to which, 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.

The billing address, based on the comments submitted by the taxpayers, is a more reliable indicator of where the purchaser will use the digital content and is the type of information that the sellers already collect. The Final Digital Content Regulations also contain a special anti-abuse rule, which applies in any case in which the sales transaction is arranged in a particular manner for the principal purpose of tax avoidance. Under the special anti-abuse rule in Reg. §1.861-18(f)(2)(ii), all of the facts and circumstances relevant to the transaction should be taken into account to determine the purchaser's billing address. Such factors include the place where the copyrighted article will be used, the place where negotiations and the execution of the agreement occurred, and the terms of the agreement.

The examples illustrated in Reg. §1.861-18(h)(25), Ex. 25 and Reg. §1.861-18(h)(26), Ex. 26 of the Digital Content Regulations demonstrate the application of the anti-abuse rule. In Example 25, the determination of the source of income is made with respect to the MNE group's non-U.S. procurement entity. The example concludes that the source of income is foreign because the procurement entity's billing address is foreign, and there is no evidence of the tax abuse which would mandate the application of the anti-abuse rule.Under the facts of Example 26, a U.S. parent entity enters into an arrangement with its foreign affiliate to purchase digital copies of a computer program from a third-party seller for the use of the program in the U.S. parent entity's business. In contrast to Example 25, the facts of Example 26 provide that the foreign affiliate does not act as a procurement hub regularly purchasing products for use by the U.S. parent's affiliates, never intends to use the purchased digital copy in its own business, and will distribute the copies to the U.S. parent entity immediately after the purchases. Applying the anti-abuse rules, the example concludes that the sale should be treated as occurring at the location of the parent entity, and thus generates U.S. source income, taking into account "all facts and circumstances," including that the U.S. parent negotiated the purchase, and the software will be used by the U.S. parent in its business.

Coordination of New Sourcing Rule with §863(b). Notably, the preamble to the Final Digital Content Regulations explains that Treasury and the IRS declined to provide a rule pursuant to which taxpayers could elect not to apply the sourcing rules for income from the sale or exchange of inventory property produced (in whole or in part) by the taxpayer under §863(b) (90 Fed. Reg. 2,977 at 2,985 (Jan. 14, 2025)). Treasury and the IRS also stated later in the preamble that "guidance on whether the categories of transactions in Reg. §1.861-18 are considered tangible or intangible property for purposes of [§250, §367(d), and §482] is outside the scope of these regulations." (90 Fed. Reg. at 2,986 (Jan. 14, 2025)). When §863(b) applies, it sources such income solely on the basis of the location of production activities with respect to the property. In such cases, the title passage rule of Reg. §1.861-7(c) does not apply. The Final Digital Content Regulations neither address instances where §863(b) would apply to the transfers of copyrighted articles, nor do they provide whether transactions involving the transfers of copyrighted articles are transactions in inventory property. Therefore, there will continue to be lingering ambiguity regarding the application of §863(b) to transactions involving digital content (e.g., whether such digital content constitutes "inventory property"/"personal property" and, if so, how and where the place of production with respect to such property should be determined).

D. Licensed Website Operator vs. Agency Platform Operator

The Final Digital Content Regulations include helpful clarifications and changes to Example 19 of the regulations involving a website operator which has a license to reproduce and sell e-books. The facts of

Example 19 in the 2019 Proposed Regulations were confusing in several respects. For example, the facts of Example 19 in the 2019 Proposed Regulations referred to the content owner granting to the website operator a non-exclusive right to distribute for sale to the public an unlimited number of copies of the book, whereas Example 19 in the Final Cloud Regulations helpfully clarifies that the non-exclusive rights granted by the content owner include the right to "reproduce an unlimited number of copies of the book for purposes of distribution and sale to the public."

In the final version of Example 19, the website operator receives a digital master copy of a copyrighted book from the content owner with the right to reproduce an unlimited number of copies of the book for distribution and sale to the public. The website operator then offers electronic books for download onto customers' computers or other electronic devices. Although the customer purchases a copy of the book directly from the website operator, the customer is required to acknowledge the terms of a license agreement with the content owner, which states that the customer may download and view the electronic books in perpetuity but may not reproduce, distribute, or sell copies of it. The example concludes that the download by a customer of a copy of a book from the website operator's servers is a digital content transaction with one element, which is classified as a transfer of the copyrighted article from the website operator to the customer, notwithstanding the customer's acknowledgement of the terms of a license agreement between the customer and the content owner granting the customer rights to use the book. The transaction between the content owner and the website operator, in turn, consists of two elements (1) a transfer of the master copy of the book, which should be classified as a transfer of a copyrighted article, and (2) the grant of the right to reproduce and sell an unlimited number of copies to customers, which should be treated as a transfer of a copyright right. The example concludes that because the primary benefit to the website operator is the ability to distribute an unlimited number of copies of the book, the predominant character of the transaction should be the transfer of a copyright right.

At the request of commenters, the Final Digital Content Regulations then add a new Example 20 involving a platform operator acting as an agent for application developers. The facts provide that "under general tax principles" the platform operator (Corp A) and the app developer establish an agency relationship whereby Corp A acts as an agent to offer the application for sale to customers on behalf of the application developer. Whether a taxpayer is acting as an agent on behalf of another taxpayer is determined under general tax principles (*See* 90 Fed. Reg. 2,981-2,982 (Jan. 14, 2025)).

The platform and agency services facilitate the sale of the apps to customers. In addition, Corp A provides hosting services to the app developers pursuant to which Corp A hosts the apps on its servers for download by customers. In this regard, Corp A receives a digital master copy of the app along with a non-exclusive right to make copies of the app and allow customers to download the copies. The facts state that Corp A receives the right to make copies of the app "merely to perform its activities as an agent on behalf of the application developer." In exchange for its services, Corp A retains a fixed percentage of each purchase price of the application and remits the remaining balance to the app developer. The analysis section of the example explains that the transaction between the platform operator and the app developer includes four elements: (1) the transfer of a copyrighted article (i.e., the transfer of the master copy of the app by the developer to Corp A); (2) the transfer of a copyright right (i.e., the right to make and distribute copies of the app for sale to customers); (3) platform and agency services that are outside the scope of Reg. §1.861-18 (and presumably also outside the scope of Reg. §1.861-19); and (4) hosting services within the scope of Reg. §1.861-19. However, because the primary benefit or value received by the customer (here, the application developer) in the overall transaction between the app developer and the platform operator are the platform and agency services, the

predominant character of the transaction is the platform and agency services, which are neither a digital content transaction nor a cloud transaction. Although the example does not further elaborate on the treatment of the platform and agency services, presumably they would be sourced by reference to the general place-of-performance rule for services under §861(a)(3) and §862(a)(3), without regard to the proposed sourcing rule for cloud transactions, if/when such proposed rules are ultimately finalized.

The clarifications to Example 19 and the addition of Example 20 are also welcome developments. Taxpayers had requested both the clarifications to Example 19 and the new example to clearly distinguish between the two different business models.

E. Applicability Dates

The Final Digital Content Regulations generally apply for taxable years beginning on or after January 14, 2025. However, if certain requirements are satisfied taxpayers may elect to apply the Final Digital Content Regulations retroactively to taxable years beginning on or after August 14, 2019. Although many taxpayers already applied the principles enunciated in the Final Digital Content Regulations for taxable years beginning before their applicability, taxpayers should consider making the election to apply the regulations retroactively, as in many cases that would potentially provide additional certainty as to the tax treatment of affected transactions.

II. The Final Cloud Regulations

A. Background and Scope

The 2019 Proposed Cloud Regulations also included rules for classifying “cloud transactions” involving computer hardware, digital content, and other similar resources, recognizing that emerging cloud-based business models for streaming, software, and gaming did not include a “transfer” of content to users and thus could not be classified under the regulations for digital content transactions.

The 2019 Proposed Regulations defined a cloud transaction in Prop. Reg. §1.861-19(b) (2019) as “a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in…), or other similar resources.” The modified definition of a cloud transaction under Reg. §1.861-19(b) of the Final Regulations reiterates that a cloud transaction is one “through which a person obtains on-demand network access to computer hardware, digital content…, or other similar resources” but explicitly clarifies that "[a] cloud transaction does not include network access to download digital content for storage and use on a person’s computer or other electronic device.” Further, Example 8 of the Final Cloud Regulations clarifies that “similar resources” may include an online database (*See* Reg. §1.861-19(d)(8), Ex. 8 (access to online database)). Unlike digital content transactions, a cloud transaction occurs without any “transfer” of content as required by the Digital Content Regulations.

Treasury and the IRS greatly simplified and clarified the classification of cloud transactions in the Final Cloud Regulations by two major modifications. First, the Final Cloud Regulations define cloud transactions as the provision of services. This is a significant favorable change from the 2019 Proposed Regulations, which required classifying cloud transactions as either a lease of property or the provision of services based on a non-exclusive list of factors drawn from §7701(e).Second, as already discussed for digital content transactions, Reg. §1.861-18(b)(3) eliminates the bifurcation/de minimis rule and instead

characterize mixed transactions with cloud and digital content elements in their entirety by reference to their predominant character. Accordingly, if the predominant character of a transaction is the provision of computer hardware, software, digital content, or other similar resources through on-demand network access, the transaction is classified in its entirety as the provision of services. The challenge for taxpayers and planners will be in ascertaining whether a cloud-based business model includes a cloud transaction element and, if so, establishing the "primary benefit or value" to customers.

B. Cloud Transactions Classified as Services

The Final Regulations classify cloud transactions (and transactions with cloud elements, if their predominant character is determined to be a cloud transaction) as the provision of services (Reg. §1.861-19(c)(1)). The preamble notes that Treasury and the IRS agreed with comments that overwhelmingly argued in favor of a services classification or, at a minimum, for a presumption of services classification (90 Fed. Reg at 2,979 (Jan. 14, 2025)). The preamble also states that "[t]he services classification is appropriate…in a typical business model that includes a cloud transaction, [because] the cloud provider retains economic control and possession over the relevant property (such as servers, software, or digital content, depending on the transaction) …[among] other hallmarks of a service transaction such as the provider having the ability to determine the specific property used to provide the cloud transaction and to replace such property with similar property."

Note: The "hallmarks" are in reference to the §7701(e) factors as tailored to cloud transactions from the 2019 Proposed Regulations (*See* Prop. Reg. §1.861-19(e)(2)(i)-(e)(2)(ix) (2019) (§7701(e) factors indicating a cloud transaction as the provision of services include, among others: (i) "customer not in physical possession of the property;" (ii) "provider has right to determine specific property used in the cloud transaction and replace such property with comparable property.").

However, the preamble adds that certain transactions, such as leases for infrastructure or on-premises computer hardware (e.g., servers), may be properly classified under the §7701(e) factors and general tax principles as a lease of property where there is no cloud transaction element. Treasury and the IRS modified Example 2 of the Final Cloud Regulations to include an example of an on-premises installation of computer hardware that is classified as a cloud transaction and a provision of services. In Example 2, a data center operator (Corp A) provides a customer (Corp B) computing capacity exclusively through designated servers located on Corp B's premises. Corp B accesses the computing capacity on-demand through Corp A's network, even though the servers are physically located on Corp B's premises. The analysis to Example 2 states this is a cloud transaction classified as a provision of services. But, the analysis adds, if Corp B accesses the servers through its own network, then there would be no cloud transaction and, presumably the transaction may, applying the factors in §7701(e) and depending on the facts, be properly characterized as a lease of property or a service, consistent with the statements in the preamble (90 Fed. Reg. at 2,983 (Jan. 14, 2025)).

Treasury and the IRS declined to adopt requests to explicitly include certain content offerings or common cloud-based business models as cloud transactions (e.g., "free" access to content funded by advertising (see Example 22), marketplace sites and apps that function as sales agents (see Example 20), gaming sites allowing access to a range of games for a subscription price (see Example 24), etc.). Instead, the preamble to the Final Cloud Regulations emphasizes that determination of a cloud transaction is fact-dependent and determined by the customer's access to the resources described in Reg. §1.861-19(b), not the content provided. Further, in regard to Example 22, the preamble notes that the transaction between advertisers and the platform operator advertising is unlikely a cloud transaction,

though the ads are viewable online, because "there is likely no on-demand network access to computer hardware, digital content, or similar resources provided by the platform to the advertisers" (90 Fed. Reg. at 2,983 (Jan. 14, 2025)).

C. Applying Predominant Character

Like the Final Digital Content Regulations, the Final Cloud Regulations classify "mixed transactions" involving elements of both digital content and cloud solely by their predominant character "taking into account the overall transaction and the surrounding facts and circumstances." (Reg. §1.861-18(b)(3), Reg. §1.861-19(c)(2) (cross-referencing same)). As discussed above, the predominant character rule was widely recommended by comments and better accommodates the cloud-based streaming and gaming platforms that would have proven difficult to bifurcate under the prior de minimis/bifurcation rule from the 2019 Proposed Regulations, which required separating mixed transactions into (non-de minimis) categories and allocating income between them. Under the general rule, the predominant character of the transaction is determined by its primary benefit or value to the customer (or a typical customer), if reasonably ascertainable. As applied in the Final Cloud Regulations, the test appears to be whether the primary benefit or value is on-demand access to computer hardware, digital content, or similar resources on the taxpayer's network, the transfer of a copyrighted article constituting a digital content transaction under Reg. §1.861-18, or even some other transaction that is not defined in either Reg. §1.861-18 or Reg. §1.861-19.

Examples 4 and 5 of the Final Cloud Regulations seem to suggest some taxpayer flexibility in demonstrating the predominant character of a cloud transaction where a primary benefit to a customer is reasonably ascertainable. Example 4 and Example 5 describe a mixed transaction involving software in which the taxpayer (Corp A) provides a corporate customer (Corp B) access to a suite of word processing, spreadsheet, and presentation software in exchange for a monthly fee. The software is accessible by a downloadable app that has both offline and online functionality. In Example 4, Corp A's software is online and can be accessed on a web browser, but Corp B employees primarily use the software through the app. Regardless, the app has only "limited" functionality offline and Corp B employees must be connected to the internet to "fully utilize" the software. In Example 5, employees must download the app in order to utilize the software. The software can be used online or offline once downloaded and has only "ancillary" online features, such as document templates.

The Final Cloud Regulations state that Example 4 and Example 5 are mixed transactions. When Corp B employees download Corp A's app to their devices, regardless of functionality, that is a transfer of a copyrighted article under Reg. §1.861–18(b)(1)(ii) that on its own would be classified as a digital content transaction (*See* Reg. §1.861-19(d)(4), Reg. §1.861-19(d)(5)). When Corp B employees utilize the online features of the software, regardless of whether they are core or ancillary, the on-demand network access to Corp A's software and computing resources by Corp B employees would on its own be classified as a cloud transaction.

Having established Example 4 and Example 5 are mixed transactions, the Final Cloud Regulations require classifying the transactions as a whole by their predominant character as determined by the primary benefit or value to the customer, if it can be reasonably ascertained (*See* Reg. §1.861-19(c)(2) (cross-referencing Reg. §1.861-18(b)(3)). In Example 4, the facts state "Corp A…ascertained that the primary benefit or value to Corp B is the right to access Corp A's software over the internet." The predominant character analysis in the regulations does not disturb this conclusion: the taxpayer (Corp A) reasonably ascertained that the primary benefit of the transaction is Corp B's right to on-demand network access to

Corp A's software and computing resources, which is a cloud transaction. The predominant character of the transaction is a cloud transaction that is classified as the provision of services. In Example 5, the facts state that Corp A "ascertained that the primary benefit or value to Corp B from the transaction is the right to download and use Corp A's software offline." As in Example 4, Example 5 seems to state as a fact the result of the necessary factual inquiry for the predominant character analysis, stating that the taxpayer (Corp A) reasonably ascertained that the primary benefit to Corp B is the right to download and use Corp A's software offline and thus the predominant character of the transaction is the transfer of a copyrighted article described in Reg. §1.861–18(b)(1)(ii) that is classified as a lease because access to the app is terminated when the monthly fee is no longer paid.

Example 4 and Example 5 suggest that a taxpayer may have little difficulty to determine the predominant character of a mixed cloud and digital content transaction, as long as the transaction's "primary benefit or value" to the customer can be reasonably ascertained from the overall facts and circumstances of the transaction.

Based on the facts presented, it appears that the primary benefit or value to the customer is self-evident from the facts provided even absent the assumed factual conclusion regarding the primary benefit or value to the customer. However, query whether the facts in Example 4 (suite of productivity software with most functionality requiring an internet connection) present as common a business model as the facts in Example 5 (suite of productivity software with mostly offline functionality). Regardless, the examples are helpful in that they explicitly acknowledge that "functionally similar" models can result in different tax classifications (the provision of services versus the lease of a copyrighted article generating rental income) depending on factors that may largely be within the taxpayer's control, albeit subject to what the consumer desires most and which business models are most practicable to the taxpayer.

D. Resellers of SaaS Access and Electronic Software Copies

Example 10 of the Cloud Regulations concerning electronic resales of SaaS access and Example 23 of the Digital Content Regulations concerning electronic resales of copies of computer software by foreign wholly-owned resellers appear to be, in part, a response to positions that some countries are taking that the amounts remitted from foreign wholly-owned resellers (CFCs) to their U.S. parents should be classified as royalties subject to withholding tax (90 Fed. Reg. 2,977 at 2,984 (Jan. 14, 2025). *See* Letter from Scott Levine, Acting Deputy Assistant Secretary (International Tax Affairs), Office of Tax Policy, U.S. Treasury Department to Mr. Marty Robinson, First Assistant Secretary–CBR, Corporate and International Tax Division, The Treasury (Australia) (April 5, 2024), *available* 2024 04 05 scott levine - out.pdf). Treasury and the IRS clarify in both examples that merely reselling copies of software (Ex. 23) or access to SaaS (Ex. 10) does not gives rise to a royalty between the foreign CFC reseller and the U.S. parent because no relevant copyright rights to the underlying software are transferred.

Note: Example 23 in the Final Digital Content Regulations explicitly acknowledges that the U.S. parent grants to its foreign subsidiary the right to distribute the copies of the computer software that the subsidiary resells to its customers, but that unless such right is coupled with the right to reproduce the software, it does not constitute a transfer of a copyright right described in Reg. §1.861-18(c)(2)(i) (the right to distribute copies to the public by sale or other transfer must be coupled with the right to make copies).

In Example 10, a foreign wholly-owned SaaS reseller (Corp B) resells access to SaaS it receives from its U.S. Parent (Corp A). Corp A owns the copyrights in the SaaS and hosts it on its own servers and is

exclusively responsible for providing access to the SaaS. The analysis to the example concludes that Corp B's payments to Corp A for SaaS access are cloud transactions "governed solely by [the Final Cloud Regulations]" because Corp A provides to Corp B on-demand access to the computer program, even though Corp B merely resells that access to its customers. Because cloud transactions are classified as the provision of services under Reg. §1.861-19(c)(2), the payments between Corp B, the foreign CFC reseller, and Corp A are compensation for services, not royalties. The transaction between Corp B and its customers is also a provision of on-demand network access to the SaaS, now to the customers, which is also a cloud transaction of a single element treated as the provision of services.

Example 23 of the Final Digital Content Regulations describes a foreign CFC reseller of electronic copies of computer software. The U.S. parent (Corp A) grants a wholly-owned foreign reseller (Corp B) a right to distribute copies of a computer program electronically to Corp B's customers that are located in Corp B's country. Under the agreement, Corp B pays Corp A fixed fee each time Corp A must create and deliver a copy of the computer program to a Corp B customer. In separate transactions, Corp B customers pay Corp B a fee in exchange for the right to receive a copy of the software for perpetual use. Corp B is only responsible for the purchase/sale interaction, not for creating the copy and delivering it to the customer. Corp A, which owns the copyright in the program and hosts it on its own servers, is responsible for creating and delivering the copies. The analysis states that the transactions between the foreign reseller and its U.S. parent and between the reseller and its customers are "functionally and economically equivalent" to back-to-back transfers of copyrighted articles (copies of the computer software) that are classified as sales of copyrighted articles. As in Example 24 of the Final Digital Content Regulations (a reseller of digital product keys with respect to computer software), the analysis concludes that the transaction between the foreign CFC reseller and its U.S. parent is essentially a fee paid by the CFC to purchase each "copy" of the computer software that it then sells on to customers in its own jurisdiction. The transaction between the CFC and its U.S. parent is treated as a digital content transaction classified as a sale of a copyrighted article under the benefits and burdens test in Reg. §1.861-18(f), and the transaction between Corp B and its customers is also a digital content transaction classified as a sale of a copyrighted article because the customer receives perpetual access to the software for a one-time fee. The analysis in Example 23 is also consistent with the Commentary to Article 12 of the OECD Model Tax Convention, which was added to the Commentary in 2008.

Note: The Commentaries on the Articles of the Model Tax Convention, Commentary on Article 12 (Concerning the Taxation of Royalties), at para. 14.4 describes arrangements between a software copyright holder and a distribution intermediary and concludes that the right to distribute copies without the right to also reproduce copies of the program does not involve any exploitation of copyright rights by the distribution intermediary, except "those necessary for the commercial intermediary to distribute copies," and that therefore the payments by the reseller should be treated as business profits under Article 7, rather than as royalties subject to Article 12.

Each of these examples emphasize the absence of a royalty between the foreign reseller CFCs and their U.S. parents. Example 23 highlights that no copyright rights to the software are transferred; the example states Corp B's right to distribute copies (in the absence of a right to reproduce), is not a copyright right described under -18. Thus, the foreign CFC reseller has no right to make the copies that it resells and delivers electronically to customers in its jurisdiction. Similarly, the retailers in Example 24 purchase and sell copyrighted articles in the form of digital keys. In Example 10, the U.S. parent grants the CFC SaaS reseller only the right to sell access to the hosted software; in transactions with its customers, the CFC is considered to provide on-demand access to the hosted program. Because the transaction between the U.S. parent and the CFC does not involve any of the copyright rights described in Reg. §1.861- 18(c)(2),

the example concludes that the transaction is a cloud services transaction, not a digital content transaction. The most useful part of the analysis in Example 10 is that it confirms that the transaction between the U.S. parent and the CFC "does not involve the transfer of any copyright rights" from the U.S. parent to the CFC.

E. Applicability Dates

See above (same as for Digital Content Regulations).

In part two, the proposed regulations will be analyzed.

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