



# TaxNewsFlash

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## KPMG report: Initial impressions of cloud-computing, digital-content transactions (proposed regulations)

The U.S. Treasury Department and the IRS on Friday, August 9, 2019, released for publication in the Federal Register proposed regulations (REG-130700-14) that modify and expand the scope of the rules in Reg. section 1.861-18 for classifying transactions involving computer programs, and address the classification of cloud transactions.

Like the old rules under Reg. section 1.861-18, these new rules would apply only for purposes of the international provisions of the Internal Revenue Code, though their principles may be applied in other contexts.

Read the [proposed regulations](#) [PDF 352 KB] (13 pages as published in the Federal Register)

Comments and requests for a public hearing must be received by November 12, 2019.

### **Cloud transactions**

New proposed regulation section 1.861-19 provides rules for classifying cloud transactions solely as either services or leases. Cloud transactions are defined broadly to include all transactions through which a person obtains more than de minimis on-demand network access to computer hardware, digital content, or other similar resources. They do not, however, include the download of digital content for use on a person's own device.

While a cloud transaction must be assigned only a single character, the preamble notes that in some cases, facts and circumstances may indicate that an arrangement consists of multiple transactions. In such a case, each non-de minimis transaction must be separately classified. The proposed regulations include as an example the provision of downloadable software (which would be classified under Reg. section 1.861-18) combined with access to online data storage (which would be classified under Reg. section 1.861-19).

The proposed regulations specify that all factors must be taken into account in classifying a cloud transaction as a lease or as a service, including the new list of non-exclusive factors specified in Reg.

section 1.861-19, which the preamble indicates is based on the statutory factors set forth in section 7701(e)(1), as well as factors that have been applied by courts in determining whether a transaction is a service or a lease. The preamble notes that this analysis must take into account inherent differences between transactions involving physical access to property and transactions involving on-demand network access.

The preamble acknowledges that the application of the proposed regulations is expected to result in a broad range of cloud computing transactions being classified as services, and solicits comments on whether there are realistic examples of cloud transactions that would be treated as leases under the proposed rules. The preamble notes, however, that Treasury and the IRS believe that the principles underlying the proposed regulations reflect current industry practice for characterizing cloud transactions.

### **KPMG observation**

It is notable that while, as discussed in more detail below, the proposed regulations address the source of sales of digital content, they do not address the source of income from cloud transactions. The preamble requests comments on administrable rules for sourcing such income.

### **Digital content**

The proposed regulations also modify the rules under Reg. section 1.861-18 for classifying transactions involving computer programs, including by expanding the scope of those rules to cover transfers of digital content.

Digital content includes, in addition to computer programs, any content in digital format that is protected by copyright law (or is not protected solely due to passage of time), including in particular books, movies, and music in digital formats. The focus on copyrighted content means that items such as customer data and databases generally would remain outside the scope of Reg. section 1.861-18, though taxpayers and the IRS may still look to Reg. section 1.861-18 as analogous authority. Comments are requested as to whether a broader definition of digital content should apply. The requirement of the existing regulations to bifurcate transactions that consist of more than one (non-de minimis) category of transaction has been retained.

The proposed regulations also would modify the existing rules under Reg. section 1.861-18 to provide that the transfer of a right to publicly perform or display digital content solely for purposes of advertising its sale should not be treated as the transfer of a copyright right.

Finally, the proposed regulations would modify the source rules for transactions classified as sales or exchanges of copyrighted articles, by providing that for sales and transfers through electronic media, the sale is deemed to occur at the location of download and installation to the end-user's device. In the absence of such information, however, the sale is deemed to occur at the location of the customer, determined based on recorded sales data for business or financial reporting purposes.

### **Change in method of accounting**

The proposed regulations note that complying with the rules prescribed therein may require a change in method of accounting, which must be done in accordance with the applicable procedures under section 446(e) for obtaining the Commissioner's consent.

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