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# Letter from Jeffery M. Kadet and David L. Koontz to Internal Revenue Serv. (Aug. 20, 2019) on Notice of Proposed Rulemaking: Classification of Cloud Transactions and Transactions Involving Digital Content

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August 20, 2019

Internal Revenue Service  
Attn: CC:PA:LPD:PR (REG-130700-14) Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

Re: Notice of Proposed Rulemaking: Classification  
of Cloud Transactions and Transactions  
Involving Digital Content

Dear Sir or Madam:

We applaud the work that Treasury and the IRS have done to develop and release these proposed regulations. They are an important addition to the regulatory framework of this major sector of our economy.

The undersigned, Jeff Kadet and David Koontz, are retired CPAs who have worked both domestically and internationally for many years. Based on our prior working experience and in connection with some recent articles we have written, we have identified certain items that we hope will improve these regulations when finalized. Should it be helpful, we would be happy to discuss any of these items either through email exchanges or by telephone.

**General**

1. Recognition that Income Classification Is Important for Taxation of Foreign Persons

The “Background” section in the “Special Analyses” portion of REG-130700-14 (pages 17-18) notes the importance of characterization and sourcing of income for U.S. resident taxpayers, making mention of the foreign tax credit calculation. The section also notes the importance of income characterization for determining the subpart F income of controlled foreign corporations (CFCs). However, there is no mention of the characterization and sourcing of income for

applying direct taxation to the effectively connected income of foreign persons. Foreign persons, of course, include both CFCs and non-CFCs.

It may be helpful to explicitly state that the rules of Part I of Subchapter N affect the direct U.S. taxation of foreign persons. While this may be generally known to many, it seems appropriate to make this clear in the explanatory material. Accordingly, when final regulations are issued, we suggest that the importance of these characterization and sourcing of income rules for the direct taxation of foreign persons be included, as applicable, within the final Treasury Decision.

### **Proposed Changes to Reg §1.861-18**

#### **2. Suggested Amendment to New Examples 19, 20, and 21 to Reflect Industry Practice**

The three additional examples in Prop Reg §1.861-18(h) all include in the factual situations that a user may only use the relevant digital content on a limited number of devices. Whether the content is a digital book, music, or a video (e.g. TV programs and movies), today's developing practices often have no limitation on the number or type of devices. Rather, the restricted use ties not to specific devices, but rather to access by the user on any device through a proprietary application. With such applications allowing access to digital content only upon the user signing in with a password or other security mechanism, the content provider restricts content use to the specific user's authorized devices. There could also be a limitation on how many devices may simultaneously access the digital content. Thus, an individual user account might be limited to one authorized device at a time while a family account might be limited to, say, six authorized devices accessing the content at one time. In the case of video content purchased from certain vendors, there is even a sharing mechanism that allows content purchased from one vendor to be used on the software of certain other vendors, again, though, only after sign-in with a user name and password.<sup>1</sup>

As we understand the principles within Reg §1.861-18, it is important for "copyrighted article" classification that there be some limitation on the user's ability to pass on the content to others. In particular, Reg §1.861-18(c)(2)(i) makes this a right that causes a transfer to be classified as a transfer of a copyright right. With this in mind and with the likelihood that mechanisms for such limitations will further evolve in the future,<sup>2</sup> we suggest that these three examples delete this "limited number of devices" condition and include some more general background that explains that the user agreement and the conditions and features of the provider's website and applications adequately restrict the end-user's ability to lend or otherwise transfer the digital content.

As an example of this, we provide the following amended language for Prop Reg §1.861-18(h)(19)(i):

... When purchasing a book on Corp A's website, the end-user must acknowledge the terms of a license agreement with the content owner that states that the end-user may view the electronic book but may not reproduce or distribute copies of it. In addition, in accordance with the agreement and the conditions and features of Corp A's website and applications, the end-user's access to the book is restricted in a manner that assures that only that end-user will have access to the book, whether connected to the Internet or not.

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<sup>1</sup> See <https://moviesanywhere.com>.

<sup>2</sup> Some now say that future security features will eliminate the need for passwords. See for example: <https://www.forbes.com/sites/valleyvoices/2015/10/12/are-passwords-becoming-obsolete>

The end-user owes no additional payment to Corp A for the ability to view the book in the future.

Similar amendments could be made to Examples 20 and 21.

### 3. Suggestion for Future Amendment to §904

We agree with the practical approach of the sourcing clarification for the sale of digital content that is proposed for Reg §1.861-18 (i.e., that if the information is known to the seller, the sale is deemed to occur at the location of download or installation onto the end-user's device). Given the likelihood that in the future increasing numbers of countries will impose taxation on digital earnings from some form of digital presence within their jurisdictions, the foreign source treatment of such sales income allows use of the foreign tax credit mechanism to eliminate double taxation.

The global approach of §904(d) allows “cross-crediting”, under which high-taxed and zero- or low-taxed income within the same foreign tax credit limitation basket may be combined. This situation means that a decision by a foreign country to impose a relatively high tax on a U.S. resident's sales income may be partially or fully offset through the use of foreign tax credits due to the averaging that cross-crediting allows. This means that the U.S. Treasury partially or fully bears the cost of such high taxation since a taxpayer obtains a reduction in U.S. tax on its zero- or low-taxed income.

With this in mind, we suggest that the Treasury consider whether §904 should be amended for certain sales income earned by U.S. residents. One approach would be to treat as a separate §904(d)(1) basket any sales income earned from customers within a country that imposes either no tax or tax at an effective rate that is less than 90 percent of the maximum rate of tax specified in section 11. With or without such a separate §904(d)(1) basket, any sales income earned from customers within a country that does not apply any income tax to that income could be treated as U.S. source solely for purposes of the foreign tax credit. Such non-imposition of taxation could be due, for example, to the belief by that country that the seller's digital presence is not sufficient to cause a permanent establishment or other taxable presence. This approach is conceptually similar to the “throwback” rules that many U.S. states impose.<sup>3</sup>

### **Prop Reg §1.861-19**

#### 4. Suggested Amendment to Example 9 to Reflect Industry Practice

Example 9 at Prop Reg §1.861-19(d)(9) includes in the factual situation presented that end-users may only stream digital content in the form of videos and music from servers located in data centers owned and operated by the Data Center Operator. It is emphasized that:

Content that is streamed to the end-user is not stored locally on the end-user's computer or other electronic device and therefore can be played only while the end-user's computer or other electronic device is connected to the Internet.

One of the major providers of video content, Netflix, allows a limited number of downloads of content for offline viewing provided certain conditions are met.<sup>4</sup> It would seem that such

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<sup>3</sup> For some explanation of this concept in the state tax area, see the Tax Foundation report available at: <https://files.taxfoundation.org/20190723094724/Throwback-and-Throwout-Rules-A-Primer-FF-662.pdf>

<sup>4</sup> See <https://help.netflix.com/en/node/54816>

restricted downloads should be considered to be de minimis in the context of the overall arrangement.

Considering this, to better reflect current and developing business practices, we suggest that Example 9 be amended to read as follows:

(i) Facts. Corp A streams digital content in the form of videos and music to end-users from servers located in data centers owned and operated by Data Center Operator. ... Content that is streamed to the end-user is not stored locally on the end-user's computer or other electronic device and therefore can be played only while the end-user's computer or other electronic device is connected to the Internet. Corp A does, however, provide a limited ability to download digital content for offline viewing on certain devices provided defined conditions are met. ...

...

(ii) Analysis. (A) ...

(B) A transaction between Corp A and an end-user is a cloud transaction described in paragraph (b) of this section because the end-user obtains a non-de minimis right to on-demand network access to digital content of Corp A. The limited ability to download digital content for end-user offline access is de minimis in the context of the overall arrangement.

(C) ...

##### 5. Additional Example to Reflect Profit-Shifting Structures

Many groups that conduct cloud transactions that constitute the provision of services under Prop Reg §1.861-19 have structured themselves through licenses or cost sharing agreements so that certain intangibles reside within zero- or low-taxed foreign group members. By then contracting directly with end-users, these foreign group members record the relevant revenues from users, who are typically located outside the U.S. In many cases, these foreign group members perform none (or virtually none) of the DEMPE functions (development, enhancement, maintenance, protection, and exploitation of intangibles). Rather, most or all DEMPE functions are performed by group members physically within the U.S. Typically as well, the central management and operational units are within the U.S. that direct and conduct much or all of the group's worldwide cloud business. Despite this centralization in the U.S. of DEMPE, management, and other functions, the tax-motivated structure is designed so that revenue from U.S. end-users is recorded by U.S. group members while revenue from non-U.S. end-users is recorded by foreign group members.

DEMPE functions include not only the R&D activities that create and improve the software platform and digital content, but they also include the day-to-day operation of the platform and management and decision-making regarding what digital content is to be offered and how it will be updated, how content will be marketed, the pricing at which content will be offered, etc. In addition, U.S. group members are responsible for maintaining and replacing servers and any other hardware within the U.S. required for the online platform and its content. Further, they will normally have management and other responsibilities concerning servers and other hardware located elsewhere in the world.

To the extent the functions performed by U.S. group members relate to services provided to end-users who legally contract with the foreign group members (who record the revenues from those end-users), there should be appropriate intercompany charges. Such charges could be reflected within licensing or cost sharing agreements and/or within intercompany service agreements that provide that the U.S. group members will perform these functions for the foreign group members.<sup>5</sup>

Given that so many groups have structured themselves in this manner, consideration could be given to including an example that reflects a factual pattern consistent with today's tax structuring. With this in mind, we propose an additional Example 6A.

(6) Example 6A: Access to online software via an application--(i) Facts. The facts are the same as in paragraph (d)(6)(i) of this section (the facts in Example 6), except that Corp A, a U.S. resident, and its foreign subsidiary, CFC, have entered into a cost sharing agreement that allows CFC to exploit outside the U.S. all intangibles for the word processing, spreadsheet, and presentation software. Corp A and CFC have each entered into a separate agreement with Corp B to provide the employees of Corp B access to the software. The Corp A/Corp B agreement covers employee access for all Corp. B employees based within the U.S. The CFC/Corp B agreement covers access for all Corp. B employees based outside the U.S. CFC's personnel are engaged in marketing and customer support functions, but they conduct only de minimis DEMPE functions (development, enhancement, maintenance, protection, and exploitation of intangibles). Instead, through the cost sharing agreement and a service agreement executed by Corp A and CFC, Corp A performs these DEMPE functions for CFC. The DEMPE and other functions performed by Corp A include not only the R&D that developed and enhances the software, but also the day-to-day operation of the web browser and app platforms as well as management and decision-making regarding what digital content is to be offered, how it will be updated, how content will be marketed, the pricing at which content will be offered, etc. In addition, Corp A directs the maintenance and replacement of servers and other required hardware worldwide, though CFC owns servers and hardware physically located outside the U.S. and performs certain maintenance and other functions for them.

(ii) Analysis: (A) For the reasons set out in paragraphs (d)(6)(ii)(A) and (B), both Corp A and CFC's transactions with Corp B are cloud transactions described in paragraph (b) of this section and are classified as the provision of services under paragraph (c) of this section. For the reasons set out in paragraph (d)(6)(ii)(C), the download of the app is de minimis, and under paragraph (c)(3) of this section, the entire arrangement is classified as a service.

(B) Although CFC is providing services to Corp B, all but a de minimis portion of those services are factually conducted by Corp A. To reflect the substance of this arrangement, the application of relevant source rules to CFC's income will be made as if Corp A's

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<sup>5</sup> When a foreign group member acquires its intangible property through its participation in a cost sharing agreement, the characterization rule of Reg §1.482-7(j)(3) applies. Under that rule, cost-sharing transaction payments made by a foreign participant to a U.S. participant in relation to the U.S. participant's activities in the U.S. will be considered the foreign participant's costs of developing intangibles in the U.S. Because of this, a foreign group member is considered to directly own its portion of the intangible property that is maintained, protected, and exploited on its behalf by group member personnel within the U.S.

performance of services were conducted directly by CFC. Thus, for example, if sourcing of this services income is determined by the location where the services are performed, then the services performed by Corp A will directly affect the source of CFC's income.

Since Prop §1.861-19 is focused on the distinction between a provision of services and a lease of property, this suggested additional example does not specify that the location of source of income for services would be determined, for example, under Reg §1.861-4. That could be made clear either through future sourcing regulation amendments or through a ruling or other appropriate IRS document if it will be some time before additional sourcing regulations are issued. For detailed recommendations of specific sourcing and other regulation amendments, please see Appendices A through D of our June 2, 2019, submission in response to Rev Proc 2019-30 regarding the 2019-2020 Priority Guidance Plan.<sup>6</sup> This suggested Example 6A is consistent with the recommendations made in that submission.

## **Other Matters**

### **6. Removal of Example 5 from Reg §1.937-3(e)**

The proposed regulation removes Example 5 from Reg §1.937-3(e). We strongly believe that this action to remove Example 5 is premature and should only be considered when new source regulations addressing digital issues are released in the future.

Example 5 concerns an application service provider. After describing the provider's business, the example includes:

... Assume for purposes of this example that Corporation B's income from these transactions is derived from the provision of services.

This assumption is fully consistent with the rules included in Prop Reg 1.861-19.

Example 5 then provides guidance under the existing regulations on the sourcing of the taxpayer's income, referring to §861(a)(3) and Reg §1.861-4(a) in the process. With the assumption of the classification of the transactions as the provision of services, the principal focus of Example 5's guidance is on sourcing.

With the principal guidance of Example 5 concerning sourcing rules, about which Prop Reg §1.861-19 is silent, future amendments to sourcing rules are needed to deal directly with digital business issues. However, *until those future amendments are released, Example 5 continues to provide relevant guidance and should not be removed.*

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<sup>6</sup> Available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3401498](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3401498)

We hope that the above information is useful to the Treasury and the IRS. Either of us would be glad to speak by telephone with you or to respond to emailed questions if that would be helpful.

Very truly yours,



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