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In this article, the authors review the recently proposed U.S. cloud regulations and compare the entity-by-entity approach with the look-through or unified approach.

It seems like just yesterday that the U.S. government issued clear and concise guidance on classifying transactions involving computer programs (T.D. 8785). Incredibly, those software regulations were issued in proposed form almost 25 years ago (REG-251520-96). Under the regulations, transactions involving computer programs are classified as: (i) a transfer of a copyright right; (ii) a transfer of a copy of a computer program (a copyrighted article); (iii) the provision of services for developing or modifying a computer program; or (iv) the provision of know-how regarding computer programming techniques.[1]

Since the software regulations were issued, the provision of computing services has dramatically changed. Over the past few years, end-users have come to rely more and more on cloud computing for their computing needs.[2] Cloud computing transactions typically are described for nontax purposes under one of three models: software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS).[3] Unfortunately, the software regulations do not provide a comprehensive basis for categorizing cloud computing transactions.

Further, content in digital format and subject to copyright law, including music, video, and books, has become a common basis for

[1] Under the regs, a transfer of a computer program is classified as the transfer of a copyright right if there is a non-de minimis grant of: (i) the right to make copies of the program for distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending; (ii) the right to prepare derivative computer programs based on the copyrighted program; (iii) the right to make a public performance of the computer program; or (iv) the right to publicly display the computer program.

The transfer of a copyright right is further categorized as either a sale or license, and the transfer of a copyrighted article is further categorized as either a sale or a lease.

[2] *See, e.g.*, National Institute of Standards and Technology, "Evaluation of Cloud Computing Services Based on NIST SP 800-145," Special Publication 500-322 (Feb. 2018).

[3] SaaS allows customers to access applications on a provider's cloud infrastructure through an interface such as a web browser. PaaS allows customers to deploy applications they create onto a provider's cloud infrastructure using programming languages, libraries, services, and tools supported by the provider. IaaS allows customers to access processing, storage, networks, and other infrastructure resources on a provider's cloud infrastructure. *See id.* at 9-11.

commercial transactions. Again, the software regs do not address that content.

To address those gaps, on August 14, 2019, Treasury and the IRS proposed much-anticipated and much-needed cloud computing regulations (REG-130700-14) and proposed amendments to the software regulations.[4] Like the software regulations, the proposed cloud regulations provide clear and concise guidance — here, on the classification of cloud transactions.

However, the proposed regs leave open one very important question: What is the source of cloud transactions for U.S. tax purposes? In the regs' preamble, Treasury sought suggestions on "administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865"; it received a slew of comments in response.[5] The comments can generally be divided into two buckets: those that advocate for sourcing rules based on an entity-by-entity approach and those that advocate for a grouping or look-through basis in which legal entities would be disregarded and the worldwide assets and employees that contributed to the provision of the cloud services would be aggregated to determine the source of the cloud transactions. The vast majority of commentators advocated for the entity-by-entity approach.

This article reviews the proposed regulations, compares the two approaches, and concludes that the entity-by-entity approach is the more administrable and sensible way to source cloud transactions.

Nothing could be more administrable and sensible than sourcing cloud services (regardless of the number of participants) the same way that services income has been sourced for decades. And, oh, by the way, the entity-by-entity approach probably gets you very close to the exactly right mix of U.S.- and foreign-source income.

The Proposed Cloud Regs

As noted, a cloud computing transaction typically does not involve a transfer of a computer program. Thus, the software regulations do not apply to classify cloud computing transactions. A cloud transaction involves access to property or use of property, instead of the sale, exchange, or license of property and therefore should be classified as either a lease of property or the provision of services. Section 7701(e) and its case law provide factors relevant for determining whether a transaction is a lease of property or the provision of services. Section 7701(e)(1) provides that a contract that purports to be a service contract will be treated as a lease by taking into account all relevant factors, including whether:

- the service recipient is in physical possession of the property;
- the service recipient controls the property;
- the service recipient has a significant economic or possessory interest in the property;
- the service provider does not bear any risk of substantially diminished receipts or increased expenditures if there is nonperformance under the contract;
- the service provider does not use the property concurrently to provide significant services to unrelated entities; and
- the total contract price does not substantially exceed the property's rental value for the contract period.

Section 7701(e)(2) provides that those factors apply to determine whether an arrangement — not just a contract — that purports to be a service contract is properly treated as a lease. The legislative history indicates that this list is meant to be nonexclusive and constitutes a balancing test — that is, the presence or absence of a single factor may not always be dispositive.[6]

[4]The proposed regs would broaden the scope of the software regs to apply to all transfers of digital content. While a full discussion of those changes is beyond the scope of this article, two points are worth noting. First, Treasury has decided that the transfer of the right to publicly perform or display digital content for advertising the sale of that content should not constitute the transfer of a copyright right. Second, because of uncertainty associated with determining the source of sales of copyrighted articles, particularly for downloaded software, the proposed regs provide that when copyrighted articles are sold and transferred through an electronic medium, the sale is deemed to occur at the location of the download or installation onto the end-user's device that accesses the digital content.

[5]*See, e.g.*, comments from the Silicon Valley Tax Directors Group, the Software Finance & Tax Executives Council, Baker McKenzie on behalf of the Software Coalition, the Entertainment Software Association, the National Foreign Trade Council, the Tax Executive Institute, Jeffery M. Kadet and David L. Koontz, the New York State Bar Association, and the United States Council for International Business.

[6]S. Prt. 169, at 138 (1984); and Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 60 (Dec. 31, 1984).

Further, courts have considered other factors in determining whether transactions are leases of property or the provision of services, including whether the service provider had the right to replace the property with comparable property, whether the property was a component of an integrated operation in which the service provider had other responsibilities, whether the service provider operated the equipment, and whether the service provider's fee was based on a measure of work performed rather than the mere passage of time.[7]

Consistent with section 7701(e), the proposed cloud regulations provide rules for classifying a cloud transaction as either a provision of services or a lease of property.[8]

Single Classification

Prop. Treas. reg. section 1.861-19(c) provides that a cloud transaction is classified solely as either a lease of property or the provision of services, although some transactions may have characteristics of both. Those kinds of transactions are generally classified in their entirety as either a lease or a service, and not bifurcated into a lease transaction and a separate service transaction.[9]

The facts and circumstances might sometimes support the conclusion that an arrangement involves multiple cloud transactions to which the proposed cloud regulations apply. In those cases, the regs require a separate classification of each cloud transaction other than those that are de minimis.

Determination Based on All Relevant Factors

Like section 7701(e)(1), the proposed regs provide a nonexclusive list of factors for determining whether a cloud transaction is classified as the provision of services or a lease of property and state that all relevant factors must be taken into account. The relevance of any factor varies depending on the factual situation, and any particular factor might not be relevant in a given instance.

In general, application of the relevant factors to a cloud transaction will result in the transaction being treated as the provision of services rather than a lease of property.[10] In addition to the statutory factors in section 7701(e)(1), the proposed regulations list several factors applied by courts that Treasury determined are relevant in demonstrating that a cloud transaction is classified as the provision of services:

- whether the provider has the right to determine the specific property used in the transaction and replace it with comparable property;
- whether the property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated; and
- whether the provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time.[11]

[7] *See, e.g.*, *Musco Sports Lighting Inc. v. Commissioner*, T.C. Memo. 1990-331, *aff'd*, 943 F.2d 906 (8th Cir. 1991); *Xerox Corp. v. United States*, 656 F.2d 659 (1981); and *Smith v. Commissioner*, T.C. Memo. 1989-318.

[8] Prop. Treas. reg. section 1.861-19(a) specifies that the rules apply for sections 59A, 245A, 250, 267A, 367, 404A, 482, 679, and 1059A; subchapter N of chapter 1; chapters 3 and 4; and sections 842 and 845 (to the extent involving a foreign person); as well as to transfers to foreign trusts not covered by section 679.

The proposed definition of a cloud transaction is not limited to computer hardware or software, or to the IaaS, PaaS, and SaaS models because it is intended to also apply to other transactions that share characteristics of on-demand network access to information in some databases. Although the definition is broad, it does not encompass every transaction executed or completed through the internet. For example, the mere download or other electronic transfer of digital content for storage and use on a person's computer hardware or other electronic device does not constitute on-demand network access to the digital content and is not considered a cloud transaction.

[9] That is consistent with section 7701(e)(1), which classifies a purported service contract as either a lease or a service contract and does not contemplate mixed classifications of a single, integrated transaction. The Fifth Circuit applied the factors in that section to determine the single character for a time charter for an ocean-going vessel, rather than following the taxpayer's allocation of consideration from the transaction into separate service and lease components. *Tidewater Inc. v. United States*, 565 F.3d 299 (5th Cir. 2009), *nonacq.*, AOD 2010-01.

[10] It its request for comments, Treasury also asked for realistic examples of cloud transactions that would be treated as leases.

[11] The proposed regs include several examples applying the factors to different types of cloud transactions. They also note that some arrangements may involve multiple transactions, with at least one classified as a cloud transaction and at least one classified under the software regulations as a lease of a copyrighted article. In those cases, the proposed rules apply only to classify the cloud transaction; any non-cloud transaction is to be classified separately.

Comparing the Sourcing Approaches

The Entity-by-Entity Approach

The entity-by-entity approach is simple and straightforward: It is the location of the operations, capital, and employees of the entity that contracts with third-party end-users for the provision of cloud services (the principal) that dictates the source of cloud services income.[12] If the principal contracts with related and unrelated parties to provide services in support of its obligation to provide cloud services to its customers (the subcontractors), it is the location of the operations and employees of those parties that dictates the source of their services income.

Advocates of this approach make two assertions as the basis for their claims that new sourcing rules are not needed for cloud service transactions and that actions of one taxpayer should not be attributed to another taxpayer for U.S. tax purposes. First, there is a well-defined body of U.S. tax law that answers the sourcing question for the principal's cloud services income and the subcontractors' services income.[13] Second, taxpayers know how to structure their affairs so that all parties are respected as separate legal entities without the creation of any agency or fiduciary relationships,[14] all corporate formalities are respected, and all intercompany transactions meet the requirements of section 482 — that is, the arm's-length standard.

An example illustrates the entity-by-entity approach. Corp. A, a Country A corporation, provides cloud services to its customers and recognizes cloud services income. It employs in Country A the engineering, technical, and business personnel necessary to deliver the services. All personnel perform their duties and functions in Country A.

Corp. A contracts with its wholly owned subsidiary, Corp. B, a Country B company, for the use of Corp. B's data centers in Country B to deliver Corp. A's cloud services to Corp. A's customers. Corp. B employs personnel in Country B to maintain and service the physical components of its data centers. Corp. A does not have any assets or personnel in Country B. Corp.

[12]See *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941) (reviewed), *nonacq.*, 1941-2 C.B. 22, *aff'd*, 127 F.2d 260 (5th Cir. 1942), addressing whether a radio station broadcasting from Mexico into the United States and deriving all its revenues from English-language advertising there had a U.S. trade or business. The IRS argued that the station had a U.S. business and that the advertising revenue was U.S.-source business income. The U.S. Tax Court looked to the location of the taxpayer's capital and labor and found that the situs of the advertising services was the location of the taxpayer's radio broadcasting facilities in Mexico. The Fifth Circuit affirmed, stating that the station did not have U.S.-source income or a U.S. trade or business. It said that although the English-language broadcast was designed for and targeted at U.S. customers, there could be no U.S. business or U.S.-source income unless there was some kind of fixed physical presence in the United States. That set an important precedent for the age of electronic commerce. Although not expressly for cloud and digital content transactions, the Fifth Circuit has continued to affirm the principle that the source of income is the situs of the income-producing service — that is, the services required by the taxpayers under the contract. For example, in *Container Corp. v. Commissioner* 134 T.C. 122 (2010), *aff'd per curiam*, No. 10-60515 (5th Cir. 2011), it cited *Piedras Negras*, explaining that where service benefits are received or an agreement was entered into does not affect the source of services. In other words, the source of payments for services is where the services are performed, not where the benefit is inured. For a comment on *Piedras Negras*, see Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* 83 (2007).

[13]Under IRS sections 861(a)(3) and 862(a)(3), income from services is generally sourced to where the services are performed. For income from services performed partly within and partly outside the United States by a person other than an individual, the part of the compensation attributable to the services performed in the United States, and that is therefore included in gross income as income from U.S. sources, is determined on the basis that most correctly reflects the proper source under the facts and circumstances. Treas. reg. section 1.861-4(b)(1) goes on to provide that the facts and circumstances will often be such that an apportionment based on time will be acceptable.

The place where services are performed is also relevant for determining foreign base company services income under section 954(e). Under reg. section 1.954-4, determining whether a controlled foreign corporation performs services outside its country of incorporation is based on all the facts and circumstances.

[14]See *Miller v. Commissioner*, T.C. Memo. 1997-134, *aff'd*, 166 F.3d 1218 (9th Cir. 1998), in which a U.S. partnership paid A-Alpha, a Hong Kong company, to perform some research and development activities, which it then subcontracted to its Hong Kong and U.S. subsidiaries. The IRS asserted that the partnership and its general partner were liable for 30 percent withholding tax on the portion of the funds that reentered the United States on the theory that it was U.S.-source because the U.S. subsidiary was A-Alpha's agent. The Tax Court disagreed and held that the activities of an R&D service provider were not to be attributed to the principal for determining the source of R&D service fees paid to the principal. It said that for A-Alpha to be considered as having U.S.-source income by virtue of the performance of services, it would have to "perform the services through agents or employees of its own." The court did not look through A-Alpha to give regard to the activities of its U.S. subsidiary to determine the source of its income.

See also ILM 201343020 (source of service fees paid to a master distributor in a multilevel marketing arrangement based on the location of the master distributor's own activities and not those of its sub-distributors). *But see Le Beau Tours Inter-America Inc. v. United States*, 415 F. Supp. 48 (S.D.N.Y. 1976), *aff'd*, 547 F.2d 9 (2d Cir. 1976), *cert. denied*, 431 U.S. 904 (1977) (some affiliate activities attributed to the taxpayer).

A pays Corp. B an arm's-length, cost-plus fee for its data center services; that fee is characterized as services income.

Corp. A also contracts with its wholly owned subsidiary, Corp. C, a Country C company, for the provision of marketing services. Corp. C maintains an office and employs personnel only in Country C. Corp. A does not have any assets or personnel in Country C. Corp. A pays Corp. C an arm's-length, cost-plus fee for its marketing services; that fee is characterized as services income.

Corp. A recognizes services income from the provision of cloud services to its customers. The source of that income is determined by looking to the location of Corp. A's operations and relevant employees when performing their activities, so all of Corp. A's cloud services income is sourced to Country A.

Likewise, Corp. B's services income for hosting the Country B data center is sourced by looking to the location of its employees when performing their activities and operations. Because all of Corp. B's operations are in Country B and its employees perform their functions there, all of Corp. B's hosting income is sourced to Country B.

Finally, Corp. C's services income for providing marketing services is sourced by looking to the location of its employees when performing their activities and operations. Because all of Corp. C's operations are in Country C and its employees perform their functions there, all of Corp. C's marketing services income is sourced to Country C.

The Look-Through or Unitary Approach

Under the theory behind the look-through approach, a multinational group that provides cloud services to end-users, various group entities assist in the provision of the services on a borderless basis but are centrally managed and controlled by the principal. Advocates of this approach say the group of services providers should be considered one big company and the principal's services should be apportioned based on the providers' assets and personnel (sort of the way U.S. taxable income is apportioned for state purposes).[15]

There are two basic problems with the look-through approach. First, looking back at our example, what do we do with the intercompany service payments made by Corp. A to Corps. B and C? Do we eliminate them? And, if so, are we sourcing the third-party cloud services income on a gross basis?[16] Second, and more important, the approach is based on the false and disrespectful premise that multinational groups do not (and cannot) structure their affairs so that all involved parties are respected as separate legal entities without the creation of any agency or fiduciary relationships, all corporate formalities are respected, and all intercompany transactions meet the requirements of section 482.

For decades, multinationals have priced their intercompany services and established separately managed and controlled subsidiaries and intercompany legal relationships. There is no reason to believe the opposite and thus take up the fiction and complexity of the look-through approach and create new sourcing rules for cloud services income.

Conclusion

Treasury has asked for suggestions for administrable sourcing rules for cloud transactions. As noted, nothing could be more administrable than applying the longstanding sourcing rules for services income to cloud services. The entity-by-entity approach probably gets you very close to the right answer: The services income of Corps. A, B, and C is all sourced based on where the services are performed. The mix of U.S.- and foreign-source income should be correct. For those reasons, we are in accord with the commentators that have advocated for the entity-by-entity approach. ■

[15] *See* Kadet's October 2019 comments on Notice 2019-30, 2019-20 IRB 1180, and the proposed cloud regulations.

[16] Gary Sprague, "Crowdsourced Guidance for Source of Income Rules for Cloud Transactions," 49 *Tax Mgmt. Int'l J.* 43 (Jan. 10, 2020).