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Tax treatment of cloud computing: Resolving the threshold classification issue

Industry experts believe that cloud computing could revolutionize the information technology industry. An examination of the tax treatment of cloud transactions first requires an understanding of cloud computing and how the many varieties of cloud services are to be classified from a tax perspective.

Background

Cloud computing -- the popular term for the delivery of infrastructure, platform, or software to external customers via the internet -- has expanded tremendously. Providers on the forefront of change in the digital age potentially face many complexities in determining the proper tax treatment of their cloud computing transactions.

The difficulty in analyzing cloud computing transactions is not articulating the method and principles by which such transactions should be evaluated. Rather, it is breaking down complex fact patterns into manageable parts and analyzing those parts within a legal framework that in some areas is ambiguous. The law has been relatively static for a number of years, but the complexity and novelty of the transactions to which the law is applied have not. Understanding the legal nature of a particular transaction is an essential step in identifying which set of rules will govern its tax treatment.

Classification Options

When speaking of cloud computing transactions, it may seem intuitive, in a non-legal sense, that such transactions are services transactions, but that label is somewhat vague in that it broadly encompasses many types of electronic transactions. Since the label applied by a company's sales and marketing department (or the industry generally) to a transaction may not be an accurate indicator of its tax character, the



first step in analyzing a cloud computing transaction is to determine its character for tax purposes.

Potential characterizations include service, sale, lease, or license. The correct initial transaction classification is important because differing federal tax rules may apply for each transaction type. Classification, moreover, is important with respect to tax treaty determinations as well -- for example, determining whether a treaty's business profits, royalty, or rental articles apply to a transaction.

A distinguishing feature of a sale, lease, or licensing transaction, as opposed to a services transaction, is that for transactions in the former categories, property or property rights are transferred from the taxpayer to its customer. In a pure services transaction, property is not transferred. To determine character for tax purposes, therefore, it is necessary to ascertain whether any type of property or property right is being transferred in the transaction. If no property or property rights are transferred, the default classification under the suggested approach would be to treat the transaction as a services transaction. If property or property rights are transferred, it would be necessary to perform further analysis to determine whether the transaction is a sale, lease, or license transaction.

Once a cloud computing transaction has been classified, the next step in the U.S. federal income tax analysis is to determine the source of the income from the transaction under the applicable sourcing rules. However, the Internal Revenue Code's main source rules, sections 861 to 865 and the related regulations, do not contain either a predominant character rule or a *de minimis* exclusion rule. Thus, a single electronic transaction may contain one or more character components, each of which theoretically should be dealt with separately under the Code's sourcing provisions, especially if each separate component represents a significant portion of the transaction's value. Although there is no explicit regulatory or statutory basis for doing so, in a transaction in which both services and property are transferred to a customer, in a particular factual situation it may be appropriate to treat the entire transaction as a services transaction for which the property component of the transaction is incidental to the services provided.

Separate character identification also is the general rule under the subpart F rules, although the regulations provide that in "unusual circumstances [character] may not be separately determinable. If not . . . separately determinable, it must be classified in accordance with the predominant character of the transaction." **Observations:** The rationale appears unclear for allowing predominant character analysis for purposes of subpart F, yet not for other purposes of the Code, but that appears to be the rule. The slight upside is that, if a transaction is subject to subpart F, a predominant character analysis may be appropriate and relieve taxpayers from making difficult allocations.

Classifying Transactions

As mentioned above, for transaction classification purposes, the initial inquiry is to determine whether property or property rights are transferred to the customer. There is no specific set of classification rules for electronic transactions such as those carried out in the cloud computing context, but the method set forth in Reg. sec. 1.861-18 (sometimes referred to herein as the "-18 rules") could be helpful. The -18 rules specifically govern the characterization and sourcing of income from computer program transactions. The -18 rules might be helpful because property or property rights transferred in an electronic transaction, to the extent thereof, are likely to be similar to those transferred in a computer program transaction. The commentary to the OECD Model Income Tax Convention would support this approach.

In the -18 rules, the IRS recognized that computer programs were literary works subject to copyright protection under both U.S. and foreign copyright laws. The IRS observed that computer programs had many attributes in common with more commonplace types of protectable property such as books, records, and motion pictures. The chief similarity was that, as with books, records, and similar property, the value of a computer program emanated from the exclusive rights and protections that copyright law afforded such property.

If property transferred in an electronic transaction were considered similarly situated, it could be reasonable to borrow the -18 rules methodology for purposes of evaluating whether a property transfer has taken place. **Note:** Relying on the -18 rules engenders some uncertainty. The IRS would not be bound to follow the -18 rules in reviewing a transaction. Moreover, the -18 rules were meant to provide guidance only for specific portions of the Code, such as subchapter N (generally the international tax sections) and sections 367 and 482, among others. Other sections of the Code (for example, section 451) and state law may require alternative analyses.

In the -18 rules, the IRS sought to distinguish between transfers of copyright rights and transfers of copyrighted articles based on the type of rights transferred to the transferee. Either type of transfer can give rise to a sale or exchange under the -18 rules. In addition to constituting a sale, however, the transfer of a copyright right also can constitute a license. For the transfer of a copyright right, the sale-versus-license determination generally turns on whether there has been a transfer of all substantial rights in the copyright right. This determination is highly fact-intensive. In addition to the factors outlined in the regulations, other potentially applicable sources of authority influencing the sale-versus-license determination include sections 1235 (dealing with patents) and 1253 (dealing with trademarks), case law, and the OECD commentaries and discussion papers on the OECD Model Income Tax Convention.

As with transfers of copyright rights, transfers of copyrighted articles can give rise to sale treatment under the -18 rules, but such transfers also may give rise to rent/lease treatment. Under the -18 rules, the sale-versus-rent/lease analysis generally turns on whether the benefits and burdens of ownership have been transferred in the transaction. With respect to electronic transactions, a benefits-and-burdens analysis may be a useful but potentially incomplete standard for determining rent/lease treatment. Not all electronic transactions will encompass the transfer of a copyright right or a copyrighted article. Thus, in addition to the -18 rules, other sources of authority, such as section 7701(e) focusing on whether there is control or a possessory interest in property, are likely to be helpful, especially for purposes of classifying services and leasing transactions.

Final Observations

Classification of complex electronic transactions is likely to be highly fact-intensive. Services that companies may consider to be a service may be classified differently for tax purposes. Careful factual development and consideration of all the facts is essential when classifying a transaction.

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