Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations addressing the classification of cloud transactions and transactions involving digital content. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Tom Callahan
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations addressing the Classification of Cloud Transactions and Transactions involving Digital Content

These Comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (“the Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Carol Tello and John Karasek of the Committee on Foreign Activities of U.S. Taxpayers (“FAUST”). Substantial substantive contributions were made by Kimberly Majure, Seevun Kozar, Karen Sam, Michael Karlin, David Shapiro, and Carol Kern; additional contributions were made by a working group comprising over 20 members of FAUST and the Committee on U.S. Activities of Foreigners and Tax Treaties (“USAFTT”). The Comments were reviewed by Edward Tanenbaum of the Committee on Government Submissions and Eric B. Sloan, Vice Chair for Government Relations. These Comments were also reviewed by Stephen Y. Chow, Chair of the American Bar Association Section on Intellectual Property Law (“ABA-IPL”) Specialized IP Division, and June M. Besek, Chair-Elect of the ABA-IPL.

Although the content of these Comments relates to the taxation of certain transactions potentially involving U.S. copyright law, these Comments do not address the substance of U.S. copyright law itself, which continues to be developed by the United States Congress and in the courts. No inference should be drawn from these Comments relating to any U.S. copyright laws, including for example, the existence or scope of copyright protection and the legal significance of transactions concerning copyrighted works.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contact: Rachel Kleinberg
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Date: February 11, 2020
I. Executive Summary

On September 30, 1998, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published final regulations under Treas. Reg. § 1.861-18¹ that address the characterization of certain international transactions involving computer programs (the “1998 Software Regulations”).² In the last two decades, the technology sector has grown both in size and reach, employing new technologies and creating new products and services not anticipated by the 1998 Software Regulations.³ This growth has prompted responses from other countries, as well as collective initiatives, such as the recent “Pillar One” proposal by the Organisation for Economic Co-operation and Development (the “OECD”).⁴

On August 14, 2019, Treasury and the Service issued proposed regulations under section 861 to update their guidance and clarify the treatment of transactions involving digital content (beyond computer programs) and the use of cloud computing technologies (the “Proposed Regulations”).⁵ We commend Treasury and the Service for issuing the Proposed Regulations, which would provide much needed direction with respect to these transactions. As discussed below, we respectfully recommend that certain portions of the Proposed Regulations be clarified and reconsidered to increase their efficacy and administrability.

Our recommendations are summarized below and discussed in more detail in Part III of these Comments.

1. We recommend that the definition of the term “digital content,” in Prop. Treas. Reg. § 1.861-18(a)(3), be expanded to include content that exists in the form of digital data and that is available for download, distribution, or access on electronic media, and that is not otherwise protected by U.S. copyright law. Transactions involving such digital data occur frequently and Prop. Treas. Reg. § 1.861-18 should apply to classify the income generated from such transactions regardless of whether such digital data is protected by copyright law. This expanded definition of the term “digital content” should include consumer or user data and similar types of data files.

¹ Unless indicated otherwise, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury regulations promulgated under the Code, all as in effect on the date of these Comments.


2. We recommend that the potential characterization of cloud transactions in Prop. Treas. Reg. § 1.861-19 be expanded to include transactions that are more properly characterized as licenses when the facts and circumstances suggest that non-\textit{de minimis} copyright rights have been transferred as part of the same transaction involving what would otherwise be classified as a cloud computing transaction under Prop. Treas. Reg. § 1.861-19. In the alternative, Prop. Treas. Reg. § 1.861-19 should permit bifurcation of cloud computing transactions into digital content and cloud computing components.

3. We recommend that examples be added to Prop. Treas. Reg. § 1.861-18 illustrating that transactions involving the purchase of streaming digital content be treated as sales of copyrighted articles despite the fact that there is no delivery of the copyrighted article to the consumer for storage on the customer’s personal device.

4. We recommend that the final regulations clarify that the “end user” sourcing rule for income from sales of copyrighted articles contained in Prop. Treas. Reg. § 1.861-18(f)(2)(ii) is intended to create symmetry among the source of income rules for all transactions involving transfers or assignments of digital content; namely, that the source of income from sales, leasing, and licensing of digital content is intended to be the same under Treas. Reg. § 1.861-18. Further, the “end user” rule should be clarified, or examples should be provided that demonstrate how to apply the rule where it may be difficult to ascertain one single location of download or installation where the “end user” has more than one way to access the digital content.

5. We also recommend that the final regulations extend the business records safe harbor rule contained in Prop. Treas. Reg. § 1.861-18(f)(2)(ii) to apply to licenses and leases of digital content.
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II. Background

A. Overview

Under the Code and Treasury regulations, the character assigned to an item of income generally determines the source of that income, and source, in turn, determines which jurisdiction has the right to tax that income. Historically, characterization and source rules for different types of income have been well defined statutorily. Those rules, which were developed in a world of physical goods and physical locations, do not work very well in the contemporary digital economy. In certain circumstances, the source rules for income from services, licenses, and transfers of property may yield very different taxing results even though the business activities that give rise to that income may be quite similar. Taxing authorities, including Treasury and the Service, have recognized the need for new guidance, particularly guidance that is flexible enough to accommodate continually evolving technology.6

B. OECD Efforts on Digital Taxation

Responding to the global influence of the internet and the increased market share occupied by companies using it to engage in commerce, the OECD included consideration of the “digital economy” as part of its Base Erosion and Profit Sharing (“BEPS”) project, and, in 2015, released a report highlighting the tax challenges presented by the “digitalisation” of the economy (“2015 OECD Report”).7 The 2015 OECD Report suggested that then-current rules regarding data collection and nexus should be reexamined in light of digital economy issues, but deferred specific recommendations pending future deliberations.8 The 2015 OECD Report noted, however, that individual jurisdictions could introduce additional safeguards into their domestic laws. France, Italy, and others have begun adopting individual regimes, each in the form of a digital services tax (a “DST”).9

The OECD issued an interim report in 2018 and conducted public consultations to determine whether sufficient commonality exists for a unified approach to digital taxation.10

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6 See, e.g., Preamble to Prop. Treas. Reg. § 1.861-18, 84 Fed. Reg. 40317 (2019), stating that “Existing Reg. § 1.861-18, finalized in 1998, provides rules for classifying transactions involving computer programs as, for example, a license of a computer program, a rental of a computer program, or a sale of a computer program. These existing regulations, however, do not explicitly cover transactions involving other digital content, such as digital music and video, or to cloud computing transactions, and thus taxpayers must determine how these transactions should be classified for tax purposes without clear guidance. The proposed regulations are needed to reduce this uncertainty.”


8 Id. at 148.


October 2019, the Secretariat released a proposal, commonly known as “Pillar One.”\(^\text{11}\) As proposed, Pillar One would apply to “large” businesses based on a specified revenue threshold\(^\text{12}\) and would implement a new taxable nexus concept based on sales, as opposed to the more traditional basis of physical presence.\(^\text{13}\)

C. Treas. Reg. § 1.861-18

Treas. Reg. § 1.861-18 provides a basic framework for analyzing and characterizing transactions for purposes of the international provisions of the Code.

Before 1998, the tax characterization of transactions involving computer programs was unclear due to the complexity of applying traditional tax concepts to such transactions\(^\text{14}\) and the inconsistent treatment of such transactions by courts.\(^\text{15}\) In 1998, the Service sought to clarify the characterization of transactions involving transfers of computer programs by promulgating the 1998 Software Regulations. The 1998 Software Regulations characterize transactions involving “computer programs” for certain international provisions of the Code.\(^\text{16}\)

The 1998 Software Regulations define a computer program as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result . . . , includ[ing] any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.”\(^\text{17}\) Notably, the definition of a computer program does not include other types of digitized information (e.g., databases that are not incidental to the operation of a


\(^{12}\) Id. at 7.

\(^{13}\) Id. at 5.

\(^{14}\) A computer program is subject to protection under copyright law; however, in most cases no copyright rights are transferred in traditional “shrinkwrap” licenses. While the purchases of the computer program is technically “using” the copyrighted article, such use is generally limited in scope. Under traditional tax concepts, these facts suggest that computer programs should be treated as licenses. See id. However, custom-created programs are labor intensive, which under traditional tax concepts would suggest that such programs may partially constitute services. See Prop. Reg. § 1.861-18(h), Example 15.

\(^{15}\) Compare Ronnen v. Comm’r, 90 T.C. 74 (1988) (holding that computer software was intangible property under the “intrinsic value” test) with Northwest Corp. v. Comm’r, 108 T.C. 358 (1997) (holding that computer software could constitute tangible personal property).

\(^{16}\) The relevant provisions are: subchapter N of chapter 1 of the Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679. Reg. § 1.861-18(a).

\(^{17}\) Treas. Reg. § 1.861-18(a)(3).
computer program, content provided as part of the transaction),\textsuperscript{18} and Treasury and the Service specifically declined to expand that definition when it promulgated the final regulations.\textsuperscript{19}

Generally, the 1998 Software Regulations apply when a transfer of a computer program has occurred. The 1998 Software Regulations also provide that a transaction involving the transfer of a computer program will be treated as one of the following:

1. Transfer of one of four “copyright” rights in a computer program;
2. Transfer of a copy of the computer program (a “copyrighted article”);
3. The provision of services for the development or modification of a computer program; or
4. The provision of know-how relating to computer programming techniques.\textsuperscript{20}

Further, although a transaction involving more than one category may be bifurcated into separate transactions, if any part of such transaction is \textit{de minimis}, taking into account the overall transaction, such part will be treated as included in the one overall transaction, wholly within a single category.\textsuperscript{21} A transaction is treated as a transfer of copyright rights (Part II.C.1, above) if the transferee receives one or more of the following rights:

1. The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
2. The right to prepare derivative computer programs based upon the copyrighted computer program;
3. The right to make a public performance of the computer program; or
4. The right to publicly display the computer program.\textsuperscript{22}

For example, if a person receives a copy of a computer program that enables the person to exercise a non-\textit{de minimis} right to copy and sell the computer program to the public, and the transaction does not involve more than a \textit{de minimis} provision of services or know-how, the

\textsuperscript{18} Offerings by providers of solely digital content, PaaS, and IaaS, in a strict and narrow sense, may be outside the scope of the 1998 Software Regulations to the extent that they provide a customer with non-incidental digitized information.

\textsuperscript{19} T.D. 8785, 1998-2 C.B. 494 (stating that “suggestions to expand the scope of the regulations . . . by applying the regulations to other types of digitized information were not adopted”).

\textsuperscript{20} Treas. Reg. § 1.861-18(b)(1). As stated above, these Comments do not address matters relating to U.S. copyright law. Any references to U.S. copyright law in these Comments are made strictly in the context of the definitions and analytical framework set forth the 1998 Software Regulations. None of the recommendations herein are intended to address the characterization of transactions under U.S. copyright law.

\textsuperscript{21} Treas. Reg. § 1.861-18(b)(2).

\textsuperscript{22} Treas. Reg. § 1.861-18(c)(1)(i) and (c)(2).
transfer is classified solely as a transfer of a copyright right. On the other hand, if a person
acquires a copy of a computer program, but does not acquire any of these rights (or only acquires
a de minimis grant of such rights) and no (or only a de minimis amount of) services or know-
how, the transaction is classified solely as a transfer of a copyrighted article.

The 1998 Software Regulations specifically state that a transfer may occur for purposes
of the 1998 Software Regulations even though a transfer does not occur for commercial law
purposes and clearly indicate that the means by which the computer program is transferred is
irrelevant.

A transfer of copyright rights will result in a sale or exchange, or a license generating
royalty income, depending on whether there has been a transfer of all substantial rights in the
copyright, applying the principles of sections 1222 and 1235. The transfer of a copyrighted
article results in a sale or exchange, or a lease generating rental income, depending on whether
the “benefits and burdens of ownership” have been transferred. Acknowledging the unique
characteristics of computer programs, the rules further provide that if a program deactivates after
a specified period of time, it is generally the equivalent of having to return the copy. The 1998
Software Regulations then provide 18 examples illustrating the application of the rules, in
particular indicating that “shrink-wrap licenses” are not necessarily licenses for federal income
tax purposes; that electronic transfers are treated the same as transfers of physical disks; and
illustrating the characterization analysis under the new rules.

The 1998 Software Regulations do not address transactions involving electronic delivery
of other media (such as books, records, or motion pictures) that might be protectable under U.S.
copyright law and which fall outside the scope of “computer programs,” as defined.
Additionally, while the 1998 Software Regulations anticipate transfers by “physical or electronic

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23 Treas. Reg. § 1.861-18(c)(i); see also Treas. Reg. § 1.861-18(g)(3) (clarifying that related party transfers are not considered distribution to “the public” and that the number of copies or people permitted to use the copies is irrelevant).

24 Treas. Reg. § 1.861-18(c)(i). Additionally, whether a transaction is a provision of services or another form of transaction noted in Part II.C.1, above, will be based on all the facts and circumstances, including the intent of the parties (as evidenced by their agreement and conduct), a determination as to which party owns the copyright rights, and how the risk of loss is allocated between the parties. Treas. Reg. § 1.861-18(d). Moreover, the provision of information with respect to a computer program is the provision of know-how only if the information relates to computer programming techniques, is furnished under conditions preventing unauthorized disclosure, and is considered property subject to trade secret protection. Treas. Reg. § 1.861-18(e).

25 Treas. Reg. § 1.861-18(g)(1) and (2).


29 See, e.g., Treas. Reg. § 1.861-18(h), Example 1.

30 See, e.g., Treas. Reg. § 1.861-18(h), Example 2.

31 See, e.g., Treas. Reg. § 1.861-18(h), Example 1.
or other medium,” they do not expressly deal with on-demand delivery mechanisms and cloud computing, which were not in popular use at the time the rules were written.

D. Proposed Regulations


Prop. Treas. Reg. § 1.861-18 (the “Proposed Digital Content Regulations”) generally retains the 1998 Software Regulations, but modifies their operation in three important ways.\(^{32}\) First, the Proposed Digital Content Regulations expand the scope from solely computer programs to “digital content.” Digital content is defined to include a computer program or any other content in a digital format that is either protected by copyright law or subject to an expired copyright, whether or not the content is transferred in a physical medium (\textit{e.g.}, on a disk).\(^{33}\) This expressly includes books, movies, and music in digital format.\(^{34}\) The basic definition of computer program remains unchanged.\(^{35}\)

Second, the Proposed Digital Content Regulations provide that, with respect to advertising, the right to make public performance or public display of digital content for the purpose of advertising the digital content that is displayed, is not a transfer of a copyright right.\(^{36}\)

Finally, the Proposed Digital Content Regulations provide a new rule for determining the source of income from sales of copyrighted articles.\(^{37}\) While the Proposed Regulations note that sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, and 865, as appropriate,\(^{38}\) they provide a specific operating rule for determining the “place of sale” in Treas. Reg. § 1.861-7(c) when the sale involves a copyrighted article transferred through an electronic medium. In those cases, the sale is deemed to occur at the location of download or installation onto the end-user’s device used to access the digital content.\(^{39}\) In the absence of information about the location of download or installation onto the end-user’s device, the sale is deemed to have occurred at the location of the customer, determined based on the taxpayer’s recorded sales data for business or financial reporting purposes.\(^{40}\) The Proposed Digital Content Regulations also clarify that income from leasing a copyrighted article is to be sourced under section 861(a)(4) or 862(a)(4), as appropriate.\(^{41}\)

\(^{32}\) We note that neither the existing 1998 Software Regulations nor the Proposed Digital Content Regulations have any simplified compliance procedures for small businesses.


\(^{34}\) Id.

\(^{35}\) Id.


\(^{38}\) Id.

\(^{39}\) Id. For clarity, the Proposed Digital Content Regulations also contain this modification directly in Prop. Reg. § 1.861-7(c).


\(^{41}\) Id.
Digital Content Regulations would add three new examples to illustrate transactions involving digital content more broadly, as well as to differentiate between transactions that would fall under the Proposed Digital Content Regulations versus those that would be governed by Prop. Treas. Reg. § 1.861-19.\(^{42}\)

2. **Prop. Treas. Reg. § 1.861-19**

Prop. Treas. Reg. § 1.861-19 (the “Proposed Cloud Regulations”) provides rules for classifying cloud transactions for purposes of the international provisions of the Code.\(^{43}\) A “cloud transaction” is defined as a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources, other than *de minimis* on-demand access, and does not include network access used to download digital content for storage and use on a person’s computer or other electronic device.\(^{44}\)

Under the Proposed Cloud Regulations, a cloud transaction is characterized as either a lease of computer hardware, digital content, or “other similar resources,” or as services based on all relevant facts and circumstances and taking into consideration certain identified factors.\(^{45}\) Significantly, the preamble notes that “[i]n 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.”\(^{46}\) If an arrangement comprises more than one transaction that is non-*de minimis*, each transaction is separately characterized, and the Proposed Cloud Regulations are used to classify only the cloud transaction.\(^{47}\)

The Proposed Cloud Regulations also provide 11 examples illustrating how taxpayers would identify a cloud transaction and apply the relevant factors in determining characterization of a transaction\(^ {48}\) and differentiating between cloud transactions and transactions that would be characterized under the Proposed Digital Content Regulations.\(^ {49}\)

We discuss both the Proposed Digital Content Regulations and the Proposed Cloud Regulations further below, in Part III, as relevant to the Comments.

\(^{42}\) See Prop. Reg. § 1.861-18(h)(19)-(21).

\(^{43}\) Prop. Treas. Reg. § 1.861-19(a). Like the 1998 Software Regulations, the Proposed Cloud Regulations apply for purposes of subchapter N and the other sections noted above. The Proposed Cloud Regulations also apply for purposes of sections 59A, 245A, 250, and 267A.

\(^{44}\) Prop. Treas. Reg. § 1.861-19(b).

\(^{45}\) See Prop. Treas. Reg. § 1.861-19(c)(2) for the list of factors.


\(^{47}\) Prop. Treas. Reg. § 1.861-19(c)(3).

\(^{48}\) There are no examples addressing leases.

\(^{49}\) Prop. Treas. Reg. § 1.861-19(d). Example 3 demonstrates *a de minimis* transfer of a computer program, concluding that there is only a cloud transaction in the case where there is a “small” download of scripting code used to facilitate logins and access to the software platform. See Prop. Treas. Reg. § 1.861-19(d)(3)(C); see also Prop. Treas. Reg. § 1.861-19(d)(6)(C) (providing a *de minimis* download via an application).
III. Detailed Discussion

A. Digital Content

One of the issues for which Treasury and the Service requested comments is whether the definition of the term “digital content” should be defined more broadly than the definition in the Proposed Digital Content Regulations. Under Prop. Treas. Reg. § 1.861-18(a)(3), the term “digital content” means a computer program or any other content in digital format that is either protected by copyright law or no longer protected by copyright law due solely to the passage of time. Prop. Treas. Reg. § 1.861-19(b) defines the term digital content by reference to Prop. Treas. Reg. § 1.861-18(a)(3). Thus, for purposes of both Prop. Treas. Reg. § 1.861-18(a)(3) and Prop. Treas. Reg. § 1.861-19(b), the Proposed Cloud Regulations apply directly to transactions involving “on-demand network access to computer hardware, digital content (as defined in Treas. Reg. § 1.861–18(a)(3)), or other similar resources.”

Moreover, the preamble states that the Proposed Cloud Regulations are “intended . . . to apply to other transactions that share characteristics of on-demand network access to technological resources, including access to streaming digital content and access to information in certain databases.”

We recommend that the scope of the term “digital content” be expanded to include other intangible property that may not be copyrightable for the reasons discussed below.

1. Definition of Copyright

A copyright initially belongs to the author of the work. The copyright comes into existence automatically when an original work is fixed in a tangible medium by the work’s author. Registration of a work with the Copyright Office provides additional protection for the copyright, but registration is not required to copyright an original work.

In examining whether the scope of the term “digital content” should be expanded, it is important to determine what is covered under copyright law and what is not. According to the U.S. Copyright Office, copyright law currently applies to literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic, and sculptural works, motion pictures and other audiovisual works, sound recordings, and architectural works. Specifically excluded are such items as ideas, methods, and systems, names, titles, and short phrases, typeface, fonts, and lettering, blank forms, and familiar symbols and designs. Words and short phrases such as names, titles, and slogans are not copyrightable because they contain an insufficient amount of constitutional authorship (originality).

Intangible property such as user data and other data collected from an online marketplace, an internet platform, or other collection points may or may not be copyrightable depending on

50 Prop. Treas. Reg. § 1.861-19(b) (emphasis added).
52 See Copyright Basics (Circular 33) by the U.S. Copyright Office at https://www.copyright.gov/circs/circ01.pdf.
whether it demonstrates original selection, coordination or arrangements of the facts or data. Many of such datasets are created automatically through the collection of data when a user or customer engages with a marketplace or other collection point or device. These items are similar to types of works such as names, titles, and short phrases that the U.S. Copyright Office explicitly identifies as not qualifying for copyright protection.

It should be noted, however, that a proprietary search platform containing customer data is copyrightable, despite the fact that the customer data would not be. This result is suggested by the U.S. Copyright Office. In its discussion of works not protected by copyright, the U.S. Copyright Office notes that certain aspects of the non-copyrightable work may have enough original expression to be copyrightable.

2. Expanded Scope of Term “Digital Content”

We recommend that the term “digital content” for purposes of the Proposed Digital Content Regulations be expanded to include content that exists in the form of digital data, which would include information available for download, distribution, or access on electronic media. This expanded definition of the term “digital content” would include consumer or user data and similar types of data files.

Whether legally protected or not, transactions involving digital data are increasingly common. To avoid uncertainty and the potential for inconsistent treatment by taxpayers, the Digital Content Regulations should include such transactions in the analytical framework. We believe that such transactions should, for tax purposes, be treated similar to transactions involving digital content that is copyrightable. The fact that user data and databases are not copyrightable or subject to other forms of legal protection should not prevent the analysis in the Proposed Digital Content Regulations from being applied to such property that has similar characteristics. In our view, transactions involving such data and databases are substantially similar from an economic perspective to transactions involving computer programs (and, under the Proposed Digital Content Regulations, transfers involving digital content) and therefore should be characterized similarly. For example, customer or user data can be sold or leased by transferring the customer or user data either electronically or in hard copy form in perpetuity (a sale) or for a finite period of time (a lease).

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53 See 17 U.S.C. § 1, et. seq., which provides that copyright protection shall be available for “original works of authorship fixed in any tangible medium of expression … from which they can be perceived, reproduced or otherwise communicated” (emphasis added).

54 See, footnote 52. “Data” as “facts” are excluded from copyright under 17 USC 102(b); certain data sets, in which the data are selected, coordinated or arranged in a manner that demonstrates creativity qualify as compilations under the copyright law, and may enjoy copyright protection from appropriation of the organized data set (compilation) as distinguished from a data element.

55 Id.

56 For example, for purposes of section 351 transactions, the exchanged item need not be copyrighted for purposes of determining whether it is in fact “property.” Courts and the IRS have concluded that “property” can be interpreted broadly for purposes of tax law. For example, in Matter of Chromeplate, 614 F.2d at 995, the court concluded that a letter of intent can be treated as “property” for purposes of contribution to a partnership, and similarly, the IRS concluded in Rev. Rul. 79-288 that the transfer of a trade name and goodwill to a newly formed corporation is a transfer of “property” for purposes of Section 351. 1979-2 C.B. 139.
We believe that digital data transactions should be subject to the same characterization and source rules that apply to works that are copyrightable.

**B. Character of Income**

1. **License of Streamed Digital Content**

We believe that the proposed characterization of a cloud transaction as either a provision of services or a lease of property is too narrow and that it should be expanded to include potential license transactions.

Consider the screening of movies in theaters. When a movie is streamed directly from a studio to a theater such that the theater need not download a copy of the movie for long-term storage on a hard drive, the arrangement is would be a cloud transaction within the meaning of the Proposed Cloud Regulations. The theater obtains non-\textit{de minimis} “on-demand network access to . . . digital content.” Accordingly, the theater’s transaction with the studio would be characterized as a service or a lease based on facts and circumstances and the factors enumerated in Prop. Treas. Reg. § 1.861–19(c)(1). By contrast, if a movie is transferred in a digital format to a theater, downloaded onto the theater’s internal system, and then screened to an audience, the Proposed Digital Content Regulations would apply instead of the Proposed Cloud Regulations. Under the Proposed Digital Content Regulations, if a film is transferred in a digital format, the transaction is characterized as a license if copyright rights have been transferred, but there is not a transfer of “all substantial rights.” In our example, the movie theater receives from the studio the right to publicly perform and display the digital content for a limited period. The transaction, therefore, would be a transfer of a copyright right, but not all substantial rights, and therefore characterized as a license.

We believe that, in our example, the manner in which a movie is delivered to a theater — via streaming, download, or a physical reel — should not alone change the character of the transaction from a license to a service or lease unless there are other significant differences in such transactions. Under the Proposed Regulations, however, this would be the result. We are concerned that under the Proposed Regulations, tax results could be easily altered by taxpayers structuring a transaction to fall within the Proposed Digital Content Regulations rather than the Proposed Cloud Regulations and vice versa, depending on which characterization is most beneficial, by choosing to download the purchased or licensed content, rather than streaming it. That is, we believe that the Proposed Regulations provide for taxpayer electivity where we do not believe electivity is warranted.

We believe that the character of income from the streaming of digital content in such transactions under the Proposed Cloud Regulations is unclear, and neither service nor lease is

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58 Id.
59 Id.; see also Prop. Treas. Reg. §§ 1.861-18(h)(21), Ex. 21, and 1.861-19(d)(5) and (10), Ex. 5 and 10.
60 Prop. Treas. Reg. §1.861-18(a)(3); see also Treas. Reg. § 1.861-18(b)(1), (c), and (f)(1).
61 See Treas. Reg. § 1.861-18(c)(2)(iii) and (iv).
appropriate. Continuing with our example, the theater is granted a copyright license to publicly display the movie, which is the hallmark of a license. We therefore recommend that the classification of cloud transactions be broadened to include a license, when the facts suggest that non-de minimis copyright rights have been transferred. In the alternative, Prop. Treas. Reg. 1.861-19 should permit bifurcation of cloud computing transactions into digital content and cloud computing components.

2. Purchase of Streamed Digital Content

As a related matter, we believe that, in certain circumstances, a transaction should be treated as either a license of a copyright right or sale of a copyrighted article even when there is no “transfer” of the digital content. For example, a consumer might pay an online video store an amount to “purchase” a movie. The consumer would have the right to stream that movie at any time and may have the right to download the movie to a personal device or devices. In our view, if the consumer has the right to download the movie and retain the download in perpetuity to continue playing it, then the transaction should be treated as a “transfer” under Treas. Reg. § 1.861-18 regardless of whether the consumer actually downloads the movie because the customer has the perpetual right to access the digital item. We do not believe that the fact that the movie may be stored on a server in the location of the vendor as opposed to the consumer should alone be dispositive to characterizing the transaction as either a digital content transaction or a cloud computing transaction.

The case is more difficult if the consumer has no right to download that particular movie, but if under the terms of the “purchase” the consumer has the right to view that particular movie at any time – and the movie cannot be substituted with other movies. In our view, any rule that relies upon the physical transfer or even download of a copyrighted article will be obsolete very soon, as cloud-based transactions come to dominate the marketplace. For this reason, we believe that, just as the 1998 Software Regulations acknowledged that the legal status of a transaction as a “license” should not drive tax treatment of that transaction, new rules should acknowledge that physical possession of a copyrighted article should not be the exclusive determinant of whether that article has been “transferred” for purposes of Treas. Reg. § 1.861-18.

3. Source of Income

The source of an item of income is critical to both U.S. and non-U.S. taxpayers. For U.S. taxpayers, the ability to earn foreign source income is important for various international tax-related provisions, such as the foreign-derived intangible income deduction and limitation on foreign tax credits. And for non-U.S. taxpayers, source is perhaps even more critical because non-U.S. taxpayers ordinarily are subject to U.S. tax only on their U.S. source income, with

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62 See Prop. Treas. Reg. §1.861-19(c)(2) for the factors demonstrating classification as the provision of services, rather than a lease of property.

certain exceptions.\textsuperscript{64} The source of income is determined by its character under U.S. tax principles.\textsuperscript{65}

To summarize, the Proposed Regulations provide new rules for classifying income from digital content and cloud transactions as income arising from sales, license, leasing, or services activities.\textsuperscript{66} Prop. Treas. Reg. § 1.861-19 also provides that cloud transactions potentially could be characterized as leases, although the preamble to the Proposed Regulations notes that a cloud transaction generally will be treated as the provision of services rather than as a lease of property. As noted earlier, the Proposed Regulations do not include any examples that support lease characterization in the cloud transaction context.

The Proposed Regulations rely on traditional income classifications for determining the treatment of income from digital content and cloud transactions; these classifications are associated with well-established sourcing principles. Income from personal services is sourced based on the location of the services;\textsuperscript{67} the source of rental or royalty income is dependent on place of use of the underlying tangible or intangible property;\textsuperscript{68} and, relevant to our discussion, income from the sale of inventory property is sourced based on place of sale or place of production, depending on the type of property sold.\textsuperscript{69}

By focusing on the “use” of property, traditional leasing and licensing rules already look to end-user facts for determining the source of income. While these sourcing principles are well-established, their application to digital content and cloud transactions are not. The location or place of use of a tangible object is comparatively easy to determine, and it can exist only in one place at a time. While it is possible to locate digital content at certain moments in time (e.g., upon production), a single consumer transaction can result in multiple “users” and even multiple concurrent uses. Identifying which of those multiple or concurrent users is the “end user” can be difficult. The general title passage test, applicable for sourcing income from sales of inventory property under sections 861 and 862,\textsuperscript{70} is even more difficult to apply to sales involving digital content, as there is not a physical “space” in which such property is transferred.

Prop. Treas. Reg. § 1.861-18(f)(2)(ii) would clarify application of the title passage test to income from the sale of copyrighted articles, focusing the sourcing analysis on the end-user. More specifically, Prop. Treas. Reg. § 1.861-18(f)(2)(ii) provides that, subject to the tax avoidance provisions in Treas. Reg. § 1.861-7(c), when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location in which the end-user downloaded or installed the digital content (the “download test”). Absent information to determine that location, the Proposed Regulations deem the sale to have occurred

\textsuperscript{64} See I.R.C. § 864.
\textsuperscript{65} See generally I.R.C. §§ 861 and 862.
\textsuperscript{66} See 84 Fed. Reg. 40318, 40324 (digital content), 40326 (cloud transactions).
\textsuperscript{67} I.R.C. § 861(a)(3).
\textsuperscript{68} I.R.C. § 861(a)(4).
\textsuperscript{69} See I.R.C. §§ 861, 862 and 863(b).
\textsuperscript{70} See also Treas. Reg. § 1.861-7(c).
at the customer’s location, determined based on the taxpayer’s recorded sales data for business or financial reporting purposes (the “commercial records test”).

The introduction of the new sourcing rule for sales of copyrighted articles accomplishes a significant step toward harmonizing the sourcing rules for sales, leasing, and licensing in the digital content context. As noted above, the source rules for leasing and licensing income already, under current law, look to the location of an end-user, and the proposed rule for sales of copyrighted articles is clearly intended to do the same in the sale context. This is a welcome move toward eliminating disparate treatment of similar transactions, as it would reduce what we believe to be inappropriate taxpayer electivity. Consequently, we recommend that the final regulations explicitly adopt a uniform rule for sourcing income from sales, leasing and licensing transactions involving digital content based on the location of the end-user. It would be helpful for the final regulations to provide examples that illustrate the application of the download test to fact patterns involving mobile consumers (e.g., a download occurring in multiple countries), multiple downloads (e.g., a single customer who downloads the same content via the same subscription to multiple devices in multiple jurisdictions), and repeated downloads (e.g., a consumer who re-downloads content multiple times under the same subscription).

We also respectfully recommend that the commercial records test be extended to apply to leases and licenses of digital content under Treas. Reg. § 1.861-18. As stated above, we believe that the traditional source rules for income from leasing and licensing transactions generally would look to the location of the end-user; however, the same difficulty exists in this context with respect to mobile end users and mobile downloads as with sales.

The following example illustrates the difficulty of identifying the “end-user”: Artist creates music and enters into a non-exclusive, global distribution agreement with Distributor. Under the contract between Artist and Distributor, Distributor has the right to modify the recording and bundle it with, for example, cover art for further distribution. Artist uploads a copy of the musical recording into Distributor’s database. Distributor enters into a non-exclusive, global distribution agreement with Music Platform and uploads the musical recording into Music Platform’s library. Music Platform offers the musical recording for sale to customers within and without the United States. Customers may download copies of the musical recordings onto personal devices such as cellular phones, and there is no restriction on use if a customer ceases using Music Platform.

Under the Proposed Regulations, we believe the contract between Artist and Distributor, and the contract between Distributor and Music Platform, constitute licenses. In addition, we believe that Music Platform is engaged in sales of copyrighted articles to customers. However, it is not clear who the “end-user” in each transaction should be. The Proposed Regulations imply that each leg of the transaction should be characterized separately, but the “end user” appears to be the ultimate consumer. In our example, should the Artist consider Distributor to be its end-user, or should Distributor consider Music Platform to be its end-user? Or should Artist and Distributor follow Music Platform in considering the customers as end-users? If different

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71 Income from leasing a copyrighted article continues to be sourced under the existing rules of sections 861(a)(4) and 862(a)(4). Prop. Treas. Reg. § 1.861-18(f)(2)(ii). The Proposed Regulations do not address how to source income from license transactions, and, thus, existing law continues to apply.
reference points serve as “end-users” in this example, the different persons in the supply chain could have different sources of income. If this is intended to be the result in the Proposed Regulations, we respectfully request that the final regulations clearly indicate that back-to-back digital content transactions could have different sources. However, we believe and respectfully recommend that the customers are the appropriate “end-users” for all purposes in the above example, because the customers’ consumption of the digital content ultimately drives all of the other transactions.

Notwithstanding this recommendation, we are concerned that the highly factual nature of the proposed sourcing rule in Prop. Treas. Reg. § 1.861-18(f)(2)(ii) could result in a difficult and expensive determination—both for a taxpayer seeking to comply with the Proposed Regulations and for examiners seeking to enforce them. This could be particularly difficult for unrelated stakeholders within the supply chain (e.g., Artist and Distributor in the example above) that are not customer-facing and do not have access to, or a current right to receive, such information.

To address these concerns, we respectfully recommend that Treasury and the Service consider extending the safe harbor of the commercial records test to apply in determining the source of income from digital content leases and licenses, in addition to sales. We believe that such an extension of the commercial records test is appropriate, given that there is already symmetry in the source rule being applied to sales, leases and licenses (i.e., by looking to the location of the “use” of the property by the end user). By extending the commercial records test to apply to all three categories of potential transactions involving digital content, there would be addition certainty for taxpayers attempting to source such income, and also less of an ability to arbitrarily manipulate the source of income by producing commercial records for one type of income, and not for another.

To the extent that the IRS concludes that the above “end user” test is too complex to administer, we believe that the commercial records rule could be adapted as the primary sourcing rule for income from sales, leases and licenses of digital content. The commercial records rule could be combined with a formulary apportionment approach to provide even greater ease of administration. For example, if an agreement grants rights to sell, consume, or use digital content solely within the United States, the income would be entirely U.S. source. If the agreement gives rights to sell, consume, or use the digital content solely outside the United States, the income would be entirely foreign source. Finally, if the agreement provides rights to sell, consume, or use the digital content both within and without the United States, or if the person deriving the income is the creator of the digital content going direct to market (so that there is no transaction agreement), the income would be treated as 50% U.S. source and 50% foreign source. Such an application of the sourcing rule for digital content transactions, which is not otherwise addressed in the Code or Treasury regulations, would be consistent with other sourcing rules that apply to cross-border economic activity, e.g., the rules of section 863(c) and (e), which apply to income arising from international transportation activities and international communications income, respectively. The benefit of a rule based on the legal rights granted to the licensee is that it would not require gathering voluminous data relating to the location of download by each end user, an item that could change rapidly and unpredictably from one time period to another. While we believe this approach merits consideration by Treasury and the Service, we acknowledge that it would be a departure from the construct of the current proposed “end user” test and commercial records safe harbor rule.