

Testimony of the Information Technology Industry Council (ITI) on Regulations on Classification of Cloud Transactions and Transactions Involving Digital Content (REG-130700-14)

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My name is Sarah Shive and I am Senior Director and Counsel for Government Affairs at the Information Technology Industry Council. The Information Technology Industry Council – ITI – represents approximately seventy companies from across the technology sector, including hardware, software, semiconductors, platforms, services, and nontraditional tech companies that derive a significant part of their value-add from technology. Our association includes both U.S.-based and foreign-headquartered companies. As you can imagine, updated regulations concerning how cloud and digital content transactions are taxed are of particular interest to our membership.

These regulations are also of particular interest to us because we believe that Treasury and the IRS are the first taxing authority to issue regulations to specifically tackle how cloud transactions should be taxed. Half of all value in the global economy created over the next decade will be created digitally, so we applaud U.S. leadership in addressing how cloud and digital content transactions should be taxed.

We also appreciate the opportunity to weigh in, both because we believe the simplicity and administrability of these regulations can be improved, but also because we can provide additional insight about these regulations based on the technology and technological limitations. I hope to hit the high points of our comments today.

With respect to the proposed regulations contained in Section 1.861-18, related to sourcing of digital content transactions, we believe that these regulations would be very difficult to administer due to technological limitations, and recommend that the government take one of two approaches to significantly simplify them.

We believe that the approach laid out in the proposed regulations to source income from these transactions based on the location of the user when they downloaded or installed the content would introduce unnecessary ambiguity, and would be too burdensome to administer in light of the information realistically available. Additionally, we believe that this approach may intersect unfavorably with various data privacy laws being enacted and proposed both inside and outside the United States.

Notably, the most reliable information that could be used to establish the customer's location is the geolocation corresponding to the device's IP address. However, this information can be very unreliable in terms of either the customer's actual location or the location where the content will

be accessed or used. Moreover, the customer may download the content multiple times, on multiple devices, across multiple tax years as part of the same transaction. This places the taxpayer in the unenviable situation of attempting to reconcile conflicting information about locations where a download or multiple downloads of the same material may have taken place, and attempting to determine which location is more accurate, reliable, or controlling.

Additionally, employing geolocation information for income tax reporting and compliance purposes would be difficult, which is reflected in the fact that we do not believe that any taxpayers currently base the source of their sales on this data. As previously mentioned, data privacy laws may also affect retention of IP geolocation data by companies, which would make auditing difficult or impossible.

In light of these limitations, we recommend allowing taxpayers to choose between the two approaches included in the regulations, rather than allowing the use of sales data – which we believe could be substantiated with the customer’s billing address – only if information about the customer’s location at the time of the download is not available. Alternatively, we recommend allowing taxpayers to source sales of digital content based on the customer’s billing address.

These revisions would be consistent with other parts of U.S. law that permit taxpayers to rely primarily on the address of the customer and should not result in abuse as long as they are applied consistently. They would also significantly reduce the burden and complexity of complying with these regulations.

In further service of those objectives, we also recommend clarifying that the taxpayer’s analysis should not be required to extend beyond the first sale to an unrelated party. It would be overly burdensome to require the taxpayer to engage in further efforts to obtain information about the location of the ultimate end-user, if that information is available at all. We would, however, recommend including an election to allow for sourcing to the primary location of the individual user of the copyrighted article, if the taxpayer has that information.

Turning to the Section 1.861-19 regulations related to cloud transactions, we believe these regulations can also be significantly simplified, benefiting both taxpayers and the government.

Broadly, we believe that the facts and circumstances analysis of these transactions will lead to the conclusion that they are services in every case. Accordingly, to simplify administrability and create consistency, we recommend that Treasury revise the final regulations to conclude that all cloud transactions are services transactions.

In addition to simplifying administration of these regulations for both taxpayers and the IRS, we also believe this would set an excellent global precedent to encourage other taxing authorities to take similar positions. As discussed previously, we applaud U.S. leadership on these issues.

If the decision is not made to presumptively determine that cloud transactions are transactions for services, we recommend updating the relevant factors. Our written comments detail some of the adjustments that we think would be most appropriate given the realities of both how cloud services work, and the business models under which these services are offered.

We also anticipate that significant complexity will arise under these regulations based on the transaction-by-transaction characterization rules. An arrangement that involves multiple transactions and includes at least one cloud transaction requires a separate classification of each component transaction, except any transaction that is de minimis. Language in the regulations themselves clarifying that analysis should examine the “primary benefit,” “core function,” or “predominant character” based on the facts and circumstances would help to clarify that analysis should be qualitative and should not focus on numerical comparison of the notional value of elements of a transaction, which might not be knowable. An elective numerical safe harbor might be beneficial in helping taxpayers determine when an element of a transaction is “de minimis.”

In the absence of adopting a predominant character analysis, it would be helpful for these regulations to further clarify the distinction between what may be considered a separate transaction that is part of an arrangement, and what should be considered a component or an ancillary feature that is included in a transaction.

We also recommend that Treasury provide additional guidance on sourcing cloud transactions, given that the operations and employees involved in providing these services are often dispersed.

Moreover, we suggest broadly that the binary option created by the regulations that categorizes downloaded digital content that is not a sale of a copyrighted article as a “lease,” while considering digital content provided online or streamed to the user to be a transaction for “services,” is not a helpful distinction to draw. As outlined in our comments, technological and practical reasons – rather than differences in the transaction or the underlying business model under which the services are provided – tend to drive decisions about whether users download digital content to their computer or other device, or stream the content instead. Ultimately, the underlying transaction is fundamentally the same.

Finally, we point out that these regulations could have significant impacts on other provisions – specifically, the FDII deduction. Whether a cloud transaction is considered a “lease” or a “service” would impact eligibility of that income for the FDII deduction, given the differing rules for establishing “foreign use” and providing acceptable documentation, and the lack of clarity as to whether certain transactions relate to tangible or intangible property.

Broadly, clarity related to intercompany transactions would also be helpful.

Thank you for this opportunity to comment further on our views on these regulations.