



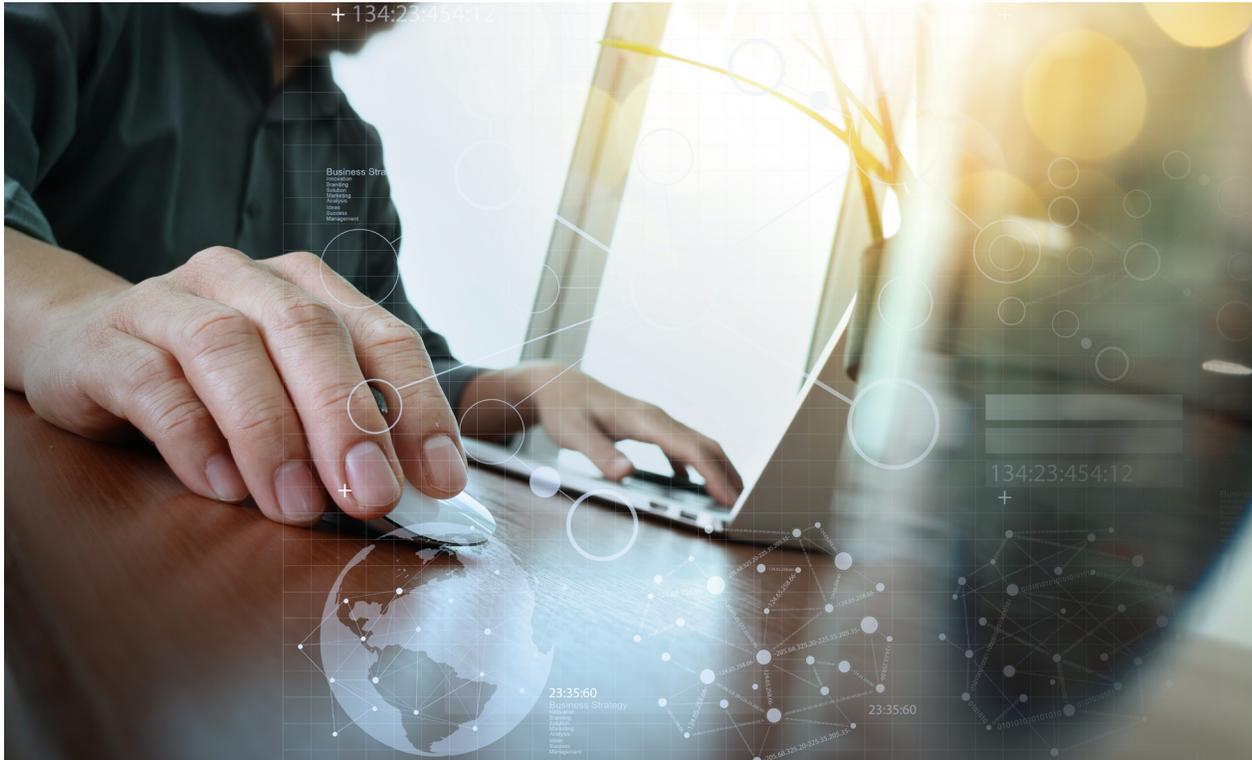
TAX CLASSIFICATION OF DIGITAL TRANSACTIONS

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PART 1: TRANSFERS OF DIGITAL CONTENT

INTRODUCTION	1
I. TAX IMPLICATIONS OF CLASSIFYING DIGITAL TRANSACTIONS	2
II. TAX CLASSIFICATION OF TRANSACTIONS RELATED TO DIGITAL CONTENT	4
TRANSFERS OF COPYRIGHT RIGHTS	5
TRANSFER OF COPYRIGHTED ARTICLES	6
PROVISION OF SERVICES	7
PROVISION OF KNOW-HOW	7
MIXED TRANSACTIONS AND DE MINIMIS RULE	7
TAX ACCOUNTING METHOD CHANGE	7
III. SOURCE OF INCOME FROM THE TRANSFER OF COPYRIGHTED ARTICLES THROUGH AN ELECTRONIC MEDIUM	8
IV. CONCLUSION	9



The U.S. international tax rules were developed in a “brick-and-mortar” economic environment. In general, the domestic tax laws and tax treaties contemplate transactions and investments involving physical property or physical services. The digitalization of the global economy has resulted in uncertainty in applying U.S. tax laws to transnational business.

One of the most fundamental income tax problems posed by the digital transformation of the economy is the question of how to classify digital transactions for tax purposes. The Treasury and Internal Revenue Service (“IRS”) have issued guidance to classify digital transactions involving either (1) a transfer of digital content (including computer programs) or (2) a cloud transaction (including SaaS, PaaS, IaaS, etc.). Income from these two categories of digital transactions is broadly classified as one of the following types for U.S. federal income tax (“FIT”) purposes:

1. Income from the sale of personal property;
2. Rental income from the lease of personal property;
3. Royalty income from a license; or
4. Income from the performance of services.

Part 1 of this whitepaper series provides an overview of the importance of properly classifying income arising from digital transactions and summarizes the U.S. FIT rules for classifying transactions related to digital content. Part 2 will address the classification of cloud transactions and associated income for U.S. FIT purposes.

I. TAX IMPLICATIONS OF CLASSIFYING DIGITAL TRANSACTIONS

The way in which digital transactions are classified can have a significant impact on a taxpayer's bottom-line tax liability. Such classification affects the types of income arising from the transaction, which further impacts the application of many U.S. FIT rules. To name a few, it impacts the assessment of withholding taxes, subpart F income, foreign tax credit ("**FTC**") utilization, deduction of foreign derived intangible income ("**FDII**"), income tax treaty provisions, etc. (as prescribed in the following Code sections: sections 861 to 1000, sections 59A, 245A, 250, 267, 267A, 367, 404A, 482, 679, 1059A, sections 1441 to 1474, sections 842 and 845, etc.)



Importantly, the income sourcing rules vary significantly depending on the classification of income. In turn, determining the source of income (from within the U.S. vs. foreign jurisdiction) is critical to apply the proper international taxation rules in many cross-border transactions. For example, under the general U.S. FIT rules, royalty income arising from a license is sourced based on where the licensed intellectual property is used; service income is sourced based on where the service is performed; and sales income from a sale of tangible property is sourced based on where the property is manufactured or the location where the sale is effectuated.

For a transfer of digital content (developed in the U.S.) from a U.S. taxpayer to a foreign person for use in foreign markets, the related income would be treated as foreign sourced if classified as a royalty, while it may be treated as U.S. sourced if classified as a sale. How the transfer of digital content is classified (and, accordingly, sourced) may significantly impact the ability of the taxpayer to claim an FTC because utilization of the FTC mechanism is highly dependent on the amount of foreign source income. Broadly speaking, the FTC cannot exceed the U.S. FIT that otherwise would have been imposed on the foreign source income of the taxpayer.

Additionally, the determination of whether the U.S. or a foreign jurisdiction has taxing rights over income and the applicable withholding tax rate under an income tax treaty depends on the classification and sourcing of such income. Imagine a U.S. company that transfers digital content to foreign persons. In many cases, such a transaction would result in a 30% withholding tax if the associated income is classified as a royalty (from a license) or rent (from a lease) but not if the transaction is classified as a sale.



There are additional areas where the classification is crucial in assessing the ultimate tax impact of a transaction. For example, the classification of a digital transaction impacts a U.S. taxpayer's incentive under section 250 ("foreign derived intangible income" or "FDII"). The documentation requirements for claiming the FDII deduction can be substantially different for different types of transactions. The classification can also have a significant impact when determining whether certain payments from a U.S. taxpayer to related foreign parties are base erosion payments for application of Base Erosion and Anti-Abuse Tax ("**BEAT**") rules. For example, if the payment is considered a royalty paid to a foreign related party, it would generally be a BEAT payment potentially causing a negative impact to the U.S. taxpayer's tax liability, while it would not be viewed as a BEAT payment if it is considered a payment for purchase of inventory (from a sale by the foreign party).

II. TAX CLASSIFICATION OF TRANSACTIONS RELATED TO DIGITAL CONTENT

The prevailing U.S. tax rules for classifying transactions related to "computer programs" and "digital content" are codified in Treas. Reg. § 1.861-18 (1998) and Prop. Treas. Reg. § 1.861-18 (2019) (collectively, "**-18 Regulations**"). A computer program is a "set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result and includes any media, user manuals, documentation, data base, or similar item" under the 1998 regulations. The Treasury and IRS expanded the scope of the -18 Regulations to apply to transactions involving digital content of all kinds in the 2019 proposed regulations. For this purpose, digital content is defined as "a computer program or any other content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time, whether or not the content is transferred in a physical medium."

Pursuant to these -18 Regulations, transactions relating to digital content are classified according to a two-step analysis. First, transactions are classified as one of the following four types:

1. A transfer of a copyright right in digital content;
2. A transfer of a copy of digital content ("copyrighted article");
3. A provision of services for the development or modification of digital content; or
4. A provision of know-how relating to the development of digital content.



Then, for each type of transaction, the associated income is classified as sales income, rent, royalty, or service income depending on the specific characteristics of the transaction.

Transfers of Copyright Rights

A transfer of digital content is treated as the *transfer of a copyright right* if the transfer involves one or more of the following:

- The right to make copies of the digital content for purposes of distribution to the public;
- The right to prepare derivative digital content based upon the copyrighted content;
- The right to make a public performance of the digital content; or
- The right to publicly display the digital content.



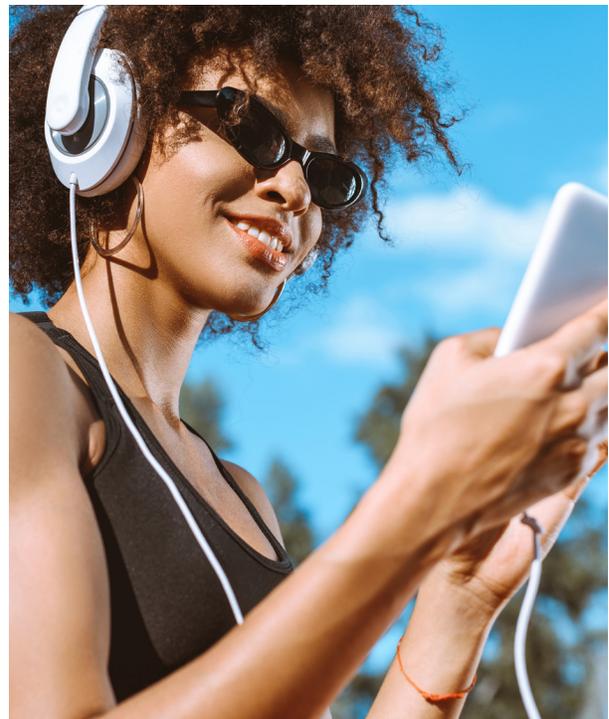
Note that under the Proposed Regulations, the right to make a public performance of digital content or the right to publicly display the digital content is not a transfer of a copyright right if the purpose of such transfer is for advertising the digital content performed or displayed.

If a transfer of digital content is classified as a *transfer of a copyright right*, the transaction is further classified either as a sale or license based on all the facts and circumstances. The transfer of a copyright right is considered a sale if “there has been a transfer of all substantial rights in the copyright.” Otherwise, the transfer of a copyright right would constitute a license giving rise to royalty income.

Transfer of Copyrighted Articles

If a transaction involves a transfer of a copy of digital content but does not transfer any of the “copyright rights,” and the transaction involves no more than a *de minimis* provision of services or of know-how, the transfer of the copy of the digital content is classified as a *transfer of a copyrighted article*. The transaction will be classified as either *a sale or a lease* of the copyrighted article, depending on whether the benefits and burdens of ownership have been transferred. If, for example, after a relatively short-term period, the transferee of digital content constituting a copyrighted article must return, destroy, or deactivate the copyrighted article, the arrangement would generally be considered a lease (generating rental income) rather than a sale of the copyrighted article.

As an example, assume Corporation A, a U.S. company, offers customers a membership that provides them with unlimited access to Corporation A’s catalog of copyrighted music in exchange for a monthly subscription fee. The music is not streamed, but each end-user customer must download each song onto their personal computer, phone, or other electronic device. The end-user customer may listen to the music but is not permitted to reproduce or distribute the music. When a customer ceases to pay Corporation A the monthly fee, an electronic lock is activated to prevent the customer from having any further access to Corporation A’s music.



In this example, the transaction does not involve the transfer of any of the four copyright rights that would result in the transaction being a transfer of a copyright right. Instead, a copyrighted article (a digital copy of music) is transferred to the end-user customer (and downloaded to their electronic device). The activation of the electronic lock at the end of the payment term is equivalent to a requirement of the customer to return the copy of any music downloaded. Consequently, the transaction is classified as a lease generating rental income for U.S. FIT purposes because the right to access the music is limited and insufficient benefits and burdens of ownership are transferred for the transaction to be treated as a sale.

Provision of Services

Whether a transaction involving digital content is treated as the provision of services or another kind of transaction is highly dependent on the facts and circumstances, including the intent of the parties (as evidenced by the relevant agreement and conduct), which party is to own the copyright rights, and how risks are allocated between the parties.



Provision of Know-how

A transaction related to digital content will be classified as a provision of know-how if the provision of information is (1) related to the development of digital content,

(2) furnished under conditions preventing unauthorized disclosure (specifically contracted for between the parties), and (3) considered property subject to trade secret protection. Income arising from such transactions could be treated as service income or royalty income for application of different FIT rules.

Mixed Transactions and De Minimis Rule

An arrangement that involves digital content transactions in more than one of the four types listed above is generally treated as a separate transaction for classification purposes. However, *de minimis* transactions are not treated as separate and, instead, are treated as part of a more significant digital content transaction.

Tax Accounting Method Change

For tax years beginning on or after the effective date of the -18 Regulations, a taxpayer may be required to change its method of accounting to conform with the classification of digital content transactions in accordance with the Regulations.

III. SOURCE OF INCOME FROM THE TRANSFER OF COPYRIGHTED ARTICLES THROUGH AN ELECTRONIC MEDIUM

The Proposed Regulations also include an explicit rule for sourcing income from the sale of copyrighted articles through an electronic medium, such as the internet. Given the importance of determining the source of income (as discussed earlier) and the uncertainty associated with assessing the source under current rules, the additional technical guidance is useful.

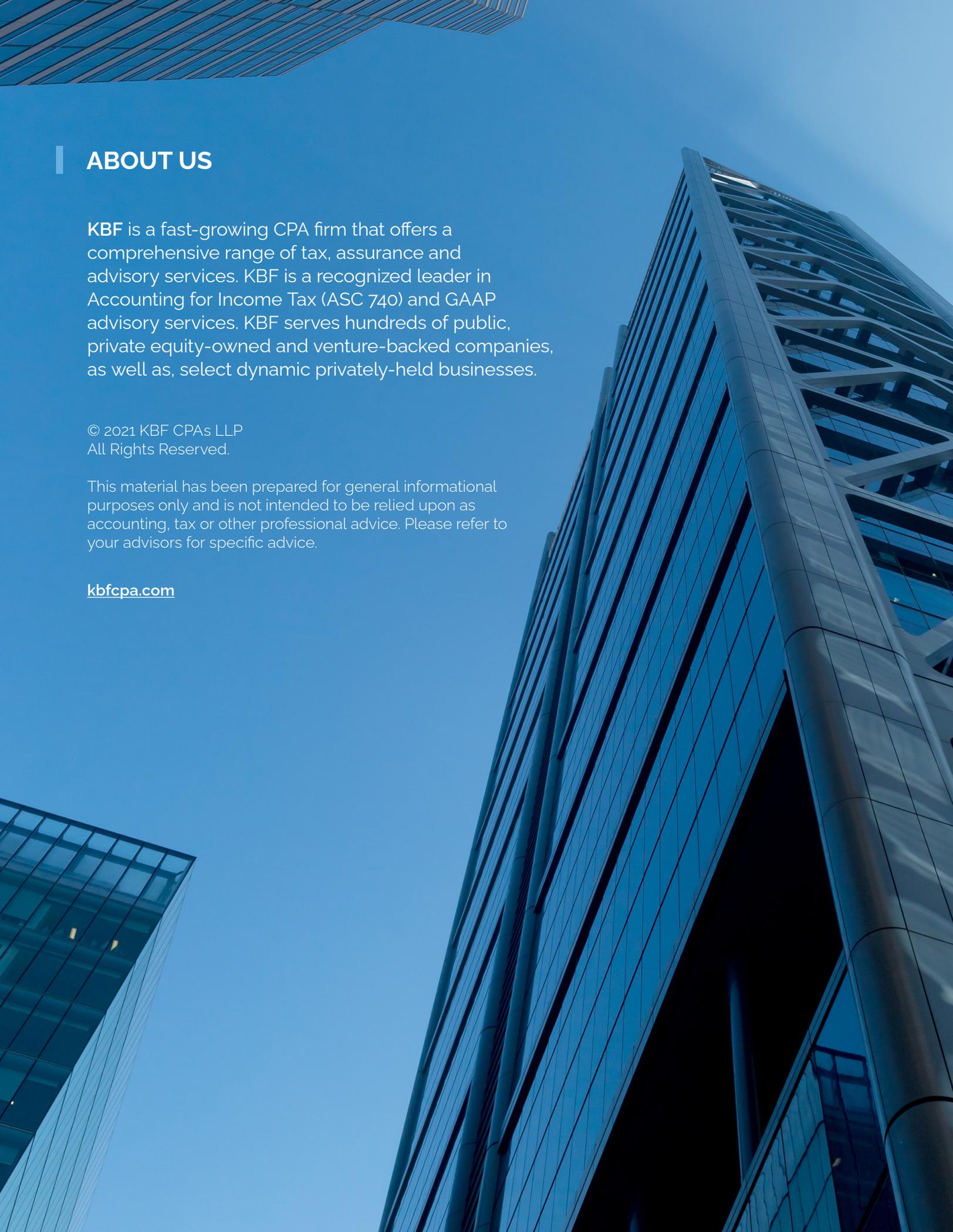


The Proposed Regulations provide that if “a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of download or installation onto the end-user’s device used to access the digital content.” If, however, information about the location of the end-user’s download or installation is lacking, a taxpayer may source the income from the sale of digital content through an electronic medium on the basis of “the location of the customer based on the taxpayer’s recorded sales data for business or financial reporting purposes.” However, if digital content that constitutes inventory is sold via an electronic medium, the general “place-of-production” sourcing rules would presumably apply rather than the “place-of-end-user-download” rule of the Proposed Regulations.

IV. CONCLUSION



The classification of transfers of digital content as sales, leases, or licenses is a fact-sensitive analysis, which can have important impacts on a taxpayer's tax liability and tax reporting requirements. In particular, the treatment of sales of digital content as occurring where an end-user downloads or installs the digital content may mean that non-U.S. companies selling to U.S. end-users could be subject to U.S. income or withholding taxes, or U.S. companies may find the sourcing of income affects their FTC. In addition, when taxpayers engaged in transfers of digital content change their contractual terms or mode of delivering the content to customers, this can result in a change in classification of income, which can affect a taxpayer's U.S. taxation and tax reporting. Companies engaged in the transfer of digital content should consider assessing the impact of the existing and proposed rules on their tax strategy and reporting.



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