

Client Alert

IRS Issues Guidance on Taxation of Cloud Transactions

August 15, 2019

In light of recent IRS guidance, companies should evaluate their tax treatment of cloud transactions. On August 9, 2019, the IRS issued [Proposed Treasury Regulation § 1.861-19](#) on the classification of cloud transactions. The classification of the transaction (that is, as either a lease of property or as a provision of services) determines the tax consequences of the transaction. Companies should confirm whether their classifications of cloud transactions are consistent with the proposed regulations.

“Cloud transactions” defined

In the proposed regulation, the IRS defines a “cloud transaction” as a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources. Under the proposed regulations, digital content is a computer program or content in digital format that is protected by copyright law (or no longer eligible to be protected due to passage of time), regardless of whether the content is transferred in a physical medium (e.g., digital books, digital movies). Prop. Treas. Reg. § 1.861-18(a)(3).

Cloud transactions do not include on-demand network access that is de minimis when taking into account the overall arrangement and the surrounding facts and circumstances. Cloud transactions also do not include network access to download digital content for storage and use on a person’s computer or other electronic device. In the preamble to the proposed regulations, Treasury states that, although the definition of a cloud transaction is broad, it does not encompass every transaction executed or completed through the internet.

Classification of cloud transactions

Under the proposed regulations, a cloud transaction is classified as either a provision of services or a lease of property. The classification depends on several factors listed in the regulations. The relevance of each particular factor depends on the factual situation and not all factors may be relevant to a particular cloud transaction.

The factors demonstrating that a cloud transaction is a provision of services include:

- The customer is not in physical possession of the property.
- The customer does not control the property, beyond the customer’s network access and use of the property.
- The provider had the right to determine the specific property used in the cloud transaction and replace such property with comparable property.
- The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated.

- The customer does not have a significant economic or possessory interest in the property.
- The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.
- The provider uses the property concurrently to provide significant services to entities unrelated to the customer.
- 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.
- The total contract price substantially exceeds the rental value of the property for the contract period.

If an arrangement involves multiple transactions, each transaction is classified separately.

Bottom line

The proposed regulations will be effective for tax years beginning on or after the date they are finalized. Although the proposed regulations are not yet in effect, they provide insight into Treasury's approach to the issue. All taxpayers conducting cloud transaction should review whether their classifications of cloud transactions are consistent with the proposed regulations.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Eleanor Moran McWaters

Counsel – Washington, D.C.

Phone: +1.202.624.2702

Email: emcwaters@crowell.com