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Application of the Computer Program Classification Regulations to Software and Digital Goods Transactions Through Online Platforms

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In several prior commentaries, I have discussed aspects of the recently issued proposed regulations relating to the classification of cloud transactions and transactions involving digital content.[1] This commentary will address a very specific case which falls within the scope of the proposed additions to the software classification regulations, but warrants some further clarification in the final regulations. That case is the classification of transactions between a software developer or digital content creator and the provider of an online platform, in business models where the developer distributes its content to users through the digital platform under either a principal model or an agency model.[2]

Digital platforms, of course, are now a common feature of the digitalized economy, for supplying content to customers in both business-to-consumer and business-to-business transactions. The most well-known platforms are those focused on the consumer market, namely those platforms that allow consumers to access music, software applications, games, video content, and the like. Digital platforms focused on B2B sales may be less visible to consumers, but they perform the same role of bringing the distribution efficiencies of the internet to sales of digital content, including software, to business customers.

Some aspects of sales through digital platforms are common to both principal and agency models. In most cases, the platform provider will invoice the full customer price payable for the acquisition of the digital good, and remit the agreed amount earned by the developer. In the agency model, the remittance usually is the customer price net of the platform's commission. In the principal model, it is the amount required under the content owner's license agreement with the principal.[3] Also in most cases, the digital content will be hosted on infrastructure maintained by the platform provider, or the platform provider may arrange for the content to be hosted by third-party providers of cloud storage services. Customers who have made a purchase of digital content obtain the requisite credentials to allow them to download the purchased content from the site hosted on the relevant hardware. As a matter of copyright law, the software developer or content creator normally will authorize the platform provider to host master copies of the content on the provider's infrastructure, and to allow customers to access those files in order to download their purchased copies.

The classification of the transaction from the purchaser's perspective is straightforward under the soft-

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[1] REG-130700-14, *Classification of Cloud Transactions and Transactions Involving Digital Content*, 84 Fed. Reg. 40,317 (Aug. 9, 2019); *Crowdsourced Guidance for Source of Income Rules for Cloud Transactions*, 49 Tax Mgmt. Int'l J. 43 (Jan. 10, 2020); *Proposed Cloud Transactions Regulations: Analysis of the Classification Factors Derived From §7701(e)*, 48 Tax Mgmt. Int'l J. 572 (Nov. 8, 2019); *Proposed Regulations Rationalize Source of Income Rules for Digital Deliveries of Software and Content*, 48 Tax Mgmt. Int'l J. 442 (Sept. 13, 2019).

[2] The proposed regulations define both software and digital content as included in the term "content," so I will follow that approach here.

[3] The platform provider may also have an obligation to invoice indirect tax (value-added tax, goods and services tax, or sales tax) to the customer depending on the customer's jurisdiction, under now widespread requirements that nonresident sellers charge and collect VAT on remote sales of digital content.

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ware classification regulations. The proposed regulations have provided the useful clarification that the classification rules of Reg. §1.861-18 apply to digital content as well as to computer programs, although most practitioners had assumed that such would be the case all along.[4] In cases where a purchaser of a copy of digital content downloads that copy from a platform provider's infrastructure, there has been a transfer of a copyrighted article to the purchaser. The user agreement invariably will specify the period of time that the purchaser is entitled to use that content. Commonly for consumer transactions involving downloaded content, the user agreement allows the purchaser to enjoy the content for a perpetual term, although limited term use rights are also possible. The user agreement also may prohibit the user from reselling the content or taking other actions detrimental to the copyright rights of the content copyright owner. Pursuant to Reg. §1.861-18(f)(2), this transaction for perpetual use is classified for the specified U.S. federal income tax purposes as a sale or exchange of a copyrighted article.[5]

More interesting is the classification of the remittance from the platform provider to the developer. If the platform provider has control of the funds payable to the developer, then the platform provider could be responsible to withhold tax under §1441 or §1442, if the payment constitutes a U.S.-source rent or royalty.[6] If, instead, the payment constitutes a payment for the purchase of inventory property, then normally no withholding would be required.[7]

A close examination of digital platform distribution models shows that both cases exist, depending on the specifics of the business model adopted by the digital platform provider. Given the dramatically different compliance consequences which flow from the conclusion whether or not the platform provider has an obligation to withhold on gross payments, it will be useful for the proposed regulations to provide specific guidance to clarify and distinguish the treatment of the two models.

In general, the two business models can be described as a principal model and an agency model. In the principal model, the platform provider itself is the person which is party to the contractual obligation to sell a copy of the copyrighted content to the purchaser.[8] In that model, the platform provider normally will operate under a license from the content owner granting the platform provider the rights to reproduce and distribute copies of the content for sale to customers. Under Reg. §1.861-18(f)(1), in the principal model payments by the platform provider to the developer normally would be classified as royalties.

The agency model is very different, both commercially and as a matter of the application of Reg. §1.861-18. Under the agency model, the platform may facilitate the transaction by acting as the marketplace where customers may find sellers (or vice versa), but the contractual terms of sale run between the developer and the purchaser. This contractual relationship created through the intermediation of an agent is not unique to digital goods; agents facilitate transactions between purchasers and suppliers in any number of circumstances. Under the agency model, the character of the payment to the developer should be determined by the classification of the transaction at the customer level. If the customer's payment is for the purchase of a copyrighted article under Reg. §1.861-18, then that same character should persist as the character of the payment remitted by the agent to the developer. There is no reason to think that the actions of an agent handling funds should affect the character of the payment as the payment flows through the agent's hands to the owner of the payment.

The choice of adopting a principal or agency platform model is driven by various legal and commercial considerations. Distributors of software or digital content must be cognizant of legal liabilities that may attach to the responsible person under various legal regimes. These can include, for example, liability for distributing content prohibited under local rules regulating political or cultural content, restrictions on distribution of export-controlled products such as encryption software and technology, exposure under intellectual property law for infringement of intellectual property rights owned by others, exposure under trade sanctions for distributing content to blacklisted par-

[4] All section references herein are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder.

[5] Reg. §1.861-18(a)(1) provides that these classification rules apply only for certain provisions of the Code, principally addressing international transactions. It is hard to see why these classification rules would not also be appropriate for other areas of the Code.

[6] Section 1441(a) imposes the obligation to withhold tax on persons ''having the control, receipt, custody, disposal, or payment'' of certain items of U.S.-source fixed or determinable annual or periodical income paid to nonresident aliens and not effectively connected with a U.S. trade of business. Section 1442(a) imposes a similar obligation for payments to foreign corporations.

[7] Reg. §1.1441-2(b)(2)(i). The proposed changes to. Reg. §1.861-18 also includes a proposed change to the source rule for sales of digitally delivered content, which would cause some nonresident sellers of copyrighted articles to U.S. users to have U.S.-source income. That source result would put a premium on such nonresidents ensuring that they could not be treated as engaged in a U.S. trade or business, so as to avoid that U.S.-source income becoming effectively connected income.

[8] Cases where the user obtains a copy of the content for only a limited duration of time normally will give rise to rents for the use of a copyrighted article. For simplicity, I will discuss in this commentary only cases treated as a sale of a copyrighted article.

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ties, and the like. In a digitalized world, where customers may access the platform from any corner of the earth, the responsible person potentially faces those liabilities under the law of any country from which a customer may access and purchase the offending content.

These legal and commercial risks create a strong incentive for some businesses to adopt the agency model to distribute software and digital content. While adopting the agency model may not completely insulate the platform provider from these risks, it provides arguments that the responsible person should be the developer, not the platform provider.

Turning then to applying Reg. §1.861-18 to the agency model, two connected points distinguish this model from the principal model. The first is that under agency principles, for U.S. federal income tax purposes the acts of an agent generally are attributed to the principal.[9] The second is that for the classification rules of Reg. §1.861-18 to apply, there needs to be a ''transfer of a computer program'' (or a ''transfer of digital content'' in the proposed amendments) to a party, presumably to that party which is acquiring the content being transferred, which then constitutes either a ''transfer of a copyright right'' in the content or a ''transfer of a copy'' of the content, depending on the rights which were transferred along with the copy.[10] As noted, under the agency model, the content owner normally will grant the platform operator those rights necessary to allow the platform operator to perform its functions as an agent. Since the actions of an agent generally are imputed to the principal, actions taken by the agent in performance of its functions as a platform services provider should be imputed to the content owner. As such, acquiring a copy of the content and allowing users to download copies should not be regarded as a ''transfer'' of a copyright right to the platform operator within the meaning of Reg. §1.861-18(c)(1)(i).

This critical difference between the principal and agency models can be analogized to the similar treatment of the transfer of IP rights in a manufacturing context. As in the principal model, a manufacturer that licenses the right to use a patent or copyright from the owner and then sells products in its own name that incorporate those rights normally is regarded as exploiting the rights under a license arrangement with the patent or copyright owner, so that its payments to the patent or copyright owner are characterized as royalties. In contrast, a contract manufacturer may provide manufacturing services to a principal which owns the relevant patent or copyright and receive a royalty-free license to use the patent or copyright to allow the manufacturer to legally perform the manufacturing services. In that case, the manufacturer receives service fees, and there should be no suggestion that those service fees are net of a royalty notionally payable by the manufacturer to its principal. In both models, the manufacturer needs the relevant patent or copyright rights to manufacture the product, but in the latter case there is no license for commercial exploitation on the market by the manufacturer because it is the IP owner/licensor which sells the finished products directly to its customers. Similarly, in the context of digital content, a platform provider operating under the agency model which merely hosts the master digital copy in order to allow downloads on behalf of the content owner should not be regarded as having been transferred a copyright right from the content owner under Reg. §1.861-18(c)(1)(i).

The proposed amendments to Reg. §1.861-18 introduce an example to provide guidance on platform distribution models, but the new guidance only covers half of the picture. New Example 19 appears to describe content distribution effected through the principal model, in which case the example properly concludes that the payment to the developer is classified under Reg. §1.861-18 as a royalty.[11] In order to provide comprehensive guidance to taxpayers, however, the proposed regulations should be expanded to provide an example of sales of copyrighted articles through a platform operating under the agency model, in which case the payment to the developer would be classified as income from the sale for a copyrighted article.[12] The side-by-side comparison of examples illustrating both the principal and the agency model would provide useful guidance to taxpayers contemplating the tax compliance consequences of choosing between the two models.

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[9] *See, e.g.*, *Md. Casualty Co. v. United States,* 251 U.S. 342 (1920) (acts of a collection agent imputed to its principal).

[10] Reg. §1.861-18(b)(1), §1.861-18(c)(1)(i), §1.861-18(c)(1)(ii).

[11] Prop. Reg. §1.861-18(h)(19) (*Ex.* 19).

[12] The sale character would be appropriate if the user acquired the copy for a perpetual term. If the user acquired the copy under a term limited to less than the useful life of the copy, or otherwise did not obtain the full benefits and burdens of ownership of the copy, the transaction at the user level normally would be characterized as a lease, and the rental character of the user payment should flow through to the developer.

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