



Software, Services and Cloud Transaction Payments

1. Software

A payment for software is analyzed to determine whether to characterize the payment as

- a goods purchase (there are two subcategories of goods purchase)
- a rental payment
- a royalty payment.

First, note that the right to “use the copyright of” a software program *is different than* the right to simply “use the software” program.

Second, note that the IRS analyzes software purchases under copyright law. As such, it looks to see whether any rights to the software were purchased and, if so, how many rights were purchased.

There are four copyright 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.

Goods Purchase (first type of goods purchase)

If you have acquired substantially all of the copyright rights (three or more), the purchase constitutes the transfer of a copyrighted article and is treated as a goods purchase not subject to tax reporting. *This result is rare*, as it would require that your organization has purchased the source code and now owns the software program, rather than just the right to use the program. A goods purchase is not reportable on Form 1099-MISC or 1099-NEC. (Reference specific exception in Reg. sec. 1.6041-3(c))

Goods Purchase (second type of goods purchase)

If the benefits and burdens of ownership transfer, the transaction is the sale of a copyrighted article which is treated as a goods purchase and is not reportable. For example, if you purchased a copy of a computer software program and you are not required to renew the “license” each year, it’s a goods purchase. Most “canned” software purchases with the equivalent of shrink-wrapped license agreements fall into this category. These are goods purchases, so they are not reportable on Form 1099-MISC or 1099-NEC.

Royalty Payment

If you have acquired at least one of the four copyright rights, your organization has purchased a “license to use the copyright” of the software which, for tax reporting purposes, is treated as a royalty payment. *This result is rare* unless your company is also in the software business and has paid for the right to make copies of the computer program and resell it or use the source

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code to develop a derivative software product. If “royalty” is the correct characterization for the payment, it is reportable in box 2 of Form 1099-MISC.

Rental

If there is a time limitation on use of, or access to, the program, such as with a requirement to renew the “license” each year, the transaction is not a goods purchase, and the payment is treated as rental income. Most software “license” purchases will likely fall into this category. The payment is reportable in box 1 of Form 1099-MISC.

Service

If a vendor provides services to your organization by receiving information electronically and processing it with the vendor’s software on the vendor’s equipment, then returning or making accessible a file, report or similar end product to your organization, the payment to the vendor is characterized as a payment for a service. The payment is reportable in box 1 of Form 1099-NEC.

2. Cloud Transactions

A “cloud transaction” is understood to be a transaction through which there is on-demand network access to any of the following: computer hardware; digital content; or similar resources. A “cloud transaction” is characterized as either a lease (rental), or the provision of services. Payments for services are reportable in box 1 of Form 1099-NEC. Lease (rental) payments are reportable in box 1 of Form 1099-MISC.

Regulations proposed in 2019 offer a nine-factor test for determining whether to characterize a cloud transaction payment as a payment for services. It’s a balancing, not an all-or-nothing, test.

Cloud provision of services

Factors demonstrating that a cloud transaction is classified as the provision of services rather than a lease of property include the following factors—

- (i) The customer is not in physical possession of the property;
- (ii) The customer does not control the property, beyond the customer’s network access and use of the property;
- (iii) The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property;
- (iv) The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated;
- (v) The customer does not have a significant economic or possessory interest in the property;
- (vi) The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;
- (vii) The provider uses the property concurrently to provide significant services to entities unrelated to the customer;
- (viii) 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; and
- (ix) The total contract price substantially exceeds the rental value of the property for the contract period.

[quoted from REG-130700-14, proposed regulations August 2019]

Cloud transaction characterized as a lease (rental)

If the cloud transaction doesn't satisfy a preponderance of the factors (i) through (ix) listed above, it's characterized as a lease (rental).

3. Additional Notes

Note: The reportability information referencing Forms 1099-MISC and 1099-NEC applies to payments to U.S. vendors. If the vendor's status is non-U.S. by certification or presumption, refer to the regulations under I.R.C. chapter 3 in regard to Form 1042-S reporting.

Note: Corporations, tax-exempt entities and governmental agencies and instrumentalities are exempt recipients not reported on Forms 1099-MISC or 1099-NEC (except in the case of payments to corporations which are providers of medical and health care services, and corporations paid for legal services).

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