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Deloitte Tax LLP | 15 January 2025

# US International Tax Alert

## Treasury, IRS release proposed cloud transaction sourcing regulations

On January 14, 2025, the Treasury Department and the IRS published proposed regulations (REG-107420-24) (the "Proposed Cloud Transaction Sourcing Rules") that provide specific rules for determining the source of income from cloud transactions for purposes of the international provisions of the Internal Revenue Code. These proposed regulations build upon the regulations addressing cloud transactions (i.e., Treas. Reg. § 1.861-19) and are intended to clarify the sourcing of such income. The Proposed Cloud Transaction Sourcing Rules were released along with final regulations (TD 10002) finalizing proposed digital content and cloud transactions regulations issued on August 14, 2019. Notably, Treasury and the IRS also issued Notice 2025-6 on January 10, 2025, seeking comments on the potential impact of extending the characterization rules outlined in Treas. Reg. §§ 1.861-18 and -19 to all provisions of the Internal Revenue Code. Those regulations are covered in a separate US International Tax Alert (see archive on Deloitte.com).

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the Federal Register.

### General framework of the proposed regulations

The Proposed Cloud Transaction Sourcing Rules retain the principle that cloud transactions are treated as services under Treas. Reg. § 1.861-19 and provide that cloud services are sourced to the place of performance. The proposed rules provide a sourcing methodology for determining the location of performance based on where operational resources and personnel responsible for the development, management, and delivery of the service are located, rather than where activities such as marketing, sales, and contracting occur, or where the service is consumed by the customer or end-user. The approach excludes management and oversight personnel.

The methodology focuses on three factors that would be determined by looking exclusively at the assets and personnel of the entity recognizing the income from cloud services.

1. The *intangible property factor* looks to contributions of intangible property to the cloud transaction.
    - Contributions of intangible property, such as proprietary software and algorithms, are measured based on expenses related to research and experimental activities, amortization, and royalties.
    - The portion attributable to US sources is determined by the location of the research and experimentation personnel and their relative cost.

2. The *personnel factor* considers contributions of personnel directly involved in delivering the cloud service.
    - Personnel contributions are determined based on compensation paid to employees directly involved in the technical or operational activities of the cloud transaction.
    - The sourcing rules exclude compensation for employees engaged in non-technical activities, such as marketing or finance.
3. The *tangible property factor* is based on contributions of tangible assets such as servers and hardware used to provide the service.
    - The tangible property factor includes depreciation and rental expenses for assets directly used in the provision of the cloud transaction, allocated to US or non-US sources based on asset location.

The income from a cloud transaction is apportioned between US and non-US sources using a fraction based on these factors, with the numerator representing US-based contributions and the denominator representing total contributions. Any gross income not treated as US source income is treated as sourced outside the United States. This sourcing fraction methodology aims to provide an administrable and consistent approach to determining the US source income from cloud transactions. This likely will benefit many offshore software-as-a-service (SaaS) principal structures with related party subcontractors in terms of eligibility for the same-country exception to subpart F. US SaaS principals with related foreign subcontractors that wish to increase foreign source income likely will not see a benefit from these changes. Notably, the proposed regulations declined to provide guidance regarding the interaction of section 863(b).

The Proposed Cloud Transaction Sourcing Rules permit taxpayers to aggregate substantially similar cloud transactions for sourcing purposes unless doing so materially distorts the income's source. The proposed regulations also include an anti-abuse provision to prevent taxpayers from structuring transactions to artificially reduce US source income.

### Applicability date

The Proposed Cloud Transaction Sourcing Rules are expected to apply to taxable years beginning on or after the date the final regulations are published in the Federal Register.

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