

TEI-SJSU High Tech Tax Institute

Breakout F: Getting Your Head Out of the Clouds

Discussion of Cloud and Digital Content Regulations

November 4, 2025

1:30-2:45 pm

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MST Program

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Objectives

1. Learn about key updates relating to the digital content and cloud regulations.
2. Understand key takeaways of the framework for classifying and sourcing of income from digital content transactions and cloud transactions.
3. Understand the “predominant character” rule as it applies to transactions involving digital downloads and cloud-based transactions.

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Relevance

- The digital content and cloud regulations are relevant for:
 - Technology companies, especially software-as-a-service (SaaS) providers
 - Companies offering other types of on-demand network access to computer hardware & digital content
 - Character and source of income determinations from these transactions may impact international tax provisions such as foreign tax credit calculations, GILTI, subpart F, FDII, and BEAT
 - Withholding tax obligations of US payors paying foreign payees and
 - Effectively connected income (“**ECI**”) determinations

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Regulations Issued

- On January 14, 2025, The IRS published final regulations (TD 10022, the “**Final Regulations**”) and proposed regulations (REG-107420-24, the “**2025 Proposed Regulations**”) addressing the classification and sourcing of income from digital content and cloud transactions.
- **Final Characterization Rules**
 - Digital Content Transactions (Treas. Reg. § 1.861-18)
 - Cloud Transactions (Treas. Reg. § 1.861-19)
 - A coordination rule between -18 and -19 to classify mixed cloud and digital transactions in their entirety by reference to their “predominant character”
- **Final Source Rule for Certain Digital Content Transactions**
- **Proposed Source Rules for Cloud Transactions** (Treas. Reg. § 1.861-19(d))
- Treasury and IRS also requested comments on whether the characterization rules under the Final Digital Content and Cloud Regulations should apply for all purposes of the Code. (Notice 2025-6)
- The Final Regulations generally apply to taxable years beginning on or after January 14, 2025, but taxpayers can early adopt them for years beginning on or after August 14, 2019.

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Updates Since Regulations Issued Jan. 2025

- Comments submitted to IRS/Treasury regarding Proposed Cloud Regulations
 - Overwhelmingly suggest removal of regulations or changes to three factor formula
- July 17 Hearing on Proposed Cloud Regulations
- Cloud regulations are not on the IRS Priority Guidance Plan released in early October
 - Plan focuses on OBBBA guidance
- OECD plans to issue discussion draft of updates to Chapter VII of its Transfer Pricing Guidelines (spring 2026), which will include how transfer pricing interacts with “high-value-added services” such as cloud computing

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Regulatory Structure

- Treas. Reg. § 1.861-18 Digital Content Transactions
 - Governs the following transactions:
 - Transfers of digital content;
 - Provision of services with respect to digital content; or
 - Provision of know-how with respect to digital content.
 - Each transaction is treated as being solely one of the following:
 - A transfer of a **copyright right** in the digital content;
 - A transfer of a copy of the digital content (a **copyrighted article**);
 - Provision of **services** for the development or modification of the digital content; or
 - Provision of **know-how** relating to development of digital content.
- Treas. Reg. § 1.861-19 Cloud Transactions

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Final Digital Content Regulations

Treas. Reg. § 1.861-18 &

Cloud Regulations Treas. Reg. § 1.861-19

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Characterization of Digital Content Transactions

- Digital content transactions are characterized as:
 - Transfers of content protected by copyright law and
 - Transfers of content not protected by copyright law because:
 1. a creator dedicated the content to the public domain, or
 2. the copyright is no longer protected due to the passage of time.
- Commentators recommended broadening the definition of digital content to include:
 - content not protected by copyright law that is transferred electronically (such as consumer or user data and government produced documents),
 - any property in digital format in which a person has a right or interest, including any property bought and sold in real marketplaces, in virtual marketplaces and in in-game economies.
- **The Final Regulations do not broaden the definition of digital content beyond content protectable by copyright law.**

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Sourcing Rules for Digital Content Transactions

- Copyright Right
 - Were all substantial rights were transferred? Yes, then a sale or exchange. No, then license.
 - Source under § 865(a), (c), (d), (e), and (h) – personal property sale sourcing rules
- Copyrighted Article
 - Was there a transfer of the benefits and burdens of ownership? Yes, then a sale or exchange. No, lease.
 - Sourced under § 861(a)(6), 862(a)(6), 863, or 865(a), (b), (c), or (e)
 - New Rule: When a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of the **billing address of the purchaser** as a proxy for title passage for purposes of Treas. Reg. § 1.861-7(c).

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Digital Content Transactions – Coordination of Billing Address Rule with § 863(b)

- No further guidance on interaction with § 863(b) which sources sales of *inventory* to **place of production**
- The Final Regulations do not adopt the comment recommending allowing taxpayers to elect to apply a billing address source rule for sales of digital content where § 863(b) would apply.
 - Section 863(b) provides, in part, that income from the sale or exchange of inventory property produced (in whole or in part) by the taxpayer within the United States and sold or exchanged outside the United States, shall be allocated and apportioned between sources within and without the United States solely **on the basis of the production activities with respect to the property**.
- If § 863(b) applies, property produced and sold by a taxpayer must be sourced “**solely on the basis of the production activities with respect to the property**.” Per the Preamble, there is nothing to suggest that the billing address of the customer is relevant to this statutory rule based on place of production.

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Anti-Abuse Rule for Sourcing Digital Content Transactions

- Anti-abuse rule included: if a digital content transaction is arranged in a particular manner for “**a principal purpose** of tax avoidance,” the purchaser’s billing address for -18 purposes is determined by the “facts and circumstances” of the transaction overall
- Factors include where copyrighted article will be used, the place where negotiations and the execution of the agreement occurred, and the terms of the agreement.

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Characterization of Cloud Transactions

- The Final Regulations state that **all “cloud transactions” are treated as the provision of services** and remove the multi-factor lease vs. services factors listed in the 2019 Proposed Regulations.
- The IRS indicated they could not identify a single cloud transaction that would be properly classified as a lease.
- The Final Regulations define a “cloud transaction” as “a transaction through which a person obtains **on-demand network access to computer hardware, digital content, or other similar resources**” (Treas. Reg. § 1.861-19(b)). It does not include network access to download digital content for storage and use on a person’s computer or other electronic device.

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Characterization of Cloud Transactions, cont.

- Updated Example 2 highlights the importance of the definition of cloud transaction
 - In Example 2, a provision of computing capacity on dedicated **on-premises servers** is a cloud services transaction where the customer accesses computing capacity on-demand through the provider's network
 - Apparently would not be a cloud transaction if customer accesses computing capacity through its own network (i.e., if the transaction involved “only the provision of a server” without more)

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Predominant Character: General Rule

- Previously, the 2019 Proposed Regulations provided that transactions that include both a transfer of a copyrighted article and access to a cloud platform would generally be treated separately, unless one or more segments were *de minimis* in the context of the overall transaction.
- The Final Regulations adopt a new **predominant character rule**, which applies to both digital content transactions and cloud transactions. Under this rule, a transaction with multiple elements should be characterized based on the predominant character of the transaction, taking into account the overall transaction and surrounding facts and circumstances.
- The predominant character is **determined by ascertaining the primary benefit or value received by the customer in the transaction.**

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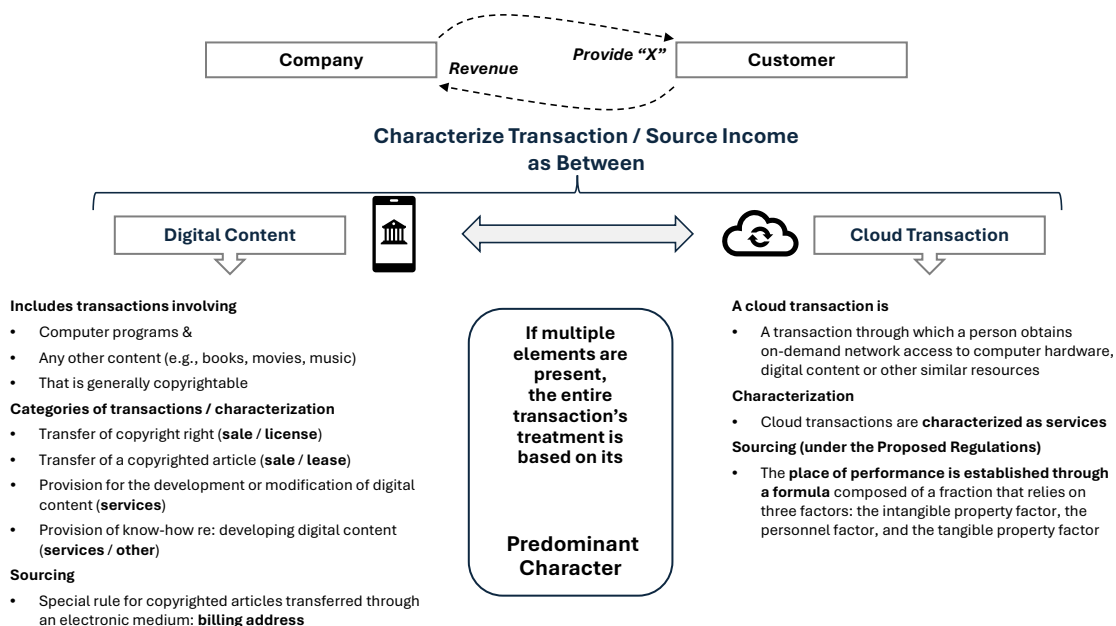
Predominant Character: Special Rule

If the primary benefit or value to the customer *cannot* be reasonably ascertained under the general rule, the predominant character rule looks **to primary benefit or value received by “a typical customer in a substantially similar transaction.”** Treas. Reg. § 1.861-18(b)(3)(ii).

- Generally determined by data on how typical user uses or accesses the digital content. Treas. Reg. § 1.861-18(b)(3)(ii)(A).
- If data unavailable, other factors indicative of the primary benefit or value received by a typical customer under Treas. Reg. § 1.861-18(b)(3)(ii)(B) include:
 - how the transaction is marketed;
 - the relative development costs of each element of the transaction,
 - the relative price paid in an uncontrolled transaction for one or more elements compared to the total contract price of the transaction in question.
- See *Treas. Reg. § 1.861-18(h)(8)* Example 8 (streaming service) for streaming analysis; *Treas. Reg. § 1.861-18(h)(24)* Example 24 (video game with online and offline functionality).

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Summary



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Cloud Example: SaaS Reseller

Example of SaaS Reseller. Treas. Reg. § 1.861-19(d)(Ex. 10)

- Facts
 - Foreign wholly-owned SaaS reseller resells access to SaaS it receives from its US Parent.
 - US Parent owns the copyrights in the SaaS and hosts it on its own servers. Parent is exclusively responsible for providing access to the SaaS.
 - In separate transactions, Reseller sells that SaaS access to Customers. Reseller “is responsible for the purchase / sale interaction with” its customers.
- Analysis
 - Reseller’s payments to US Parent for initial SaaS access are cloud transactions “governed solely by [the Final Cloud Regulations]” and classified as services.
 - In one transaction, Parent provides Reseller on-demand access to the SaaS. There is no transfer of a copyright article or right.
 - Reseller merely resells that access to its customers in a second cloud transaction where it provides customers on-demand network access to SaaS hosted by Parent
 - Both transactions are cloud transactions (on-demand network access to SaaS). No transfer of content or rights in SaaS. Thus, transactions are classified as services and payments between the Reseller and Parent are compensation for cloud services, not royalties.

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IRS Notice 2025-6

- The Final Regulations apply solely to specifically enumerated international provisions of the Code.
- Notice 2025-6 requested comments on:
 - i. the consequences or interactions that would result if the characterization rules in the Final Regulations were to apply to all provisions of the Code,
 - ii. possible impacts and guidance that may be necessary, including the suggested approach of the guidance, and
 - iii. possible impacts and guidance that may be necessary for certain provisions identified in the Notice.

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Proposed Source Rule for Cloud Services Transactions (Proposed Treas. Reg. § 1.861-19(d))

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Sourcing Cloud Services: Taxpayer-by-taxpayer rule

- The Proposed Cloud Sourcing Regulations adopt a taxpayer-by-taxpayer approach. (*Miller*).
- This rule does not preclude the IRS from asserting “common law principles” (economic substance, rules of agency, step transaction) or statutory or regulatory provisions (e.g., § 482 rules) to ensure that the federal income tax consequences reflect the economic realities of the transaction (including contributions of affiliates).

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Sourcing Rules for Cloud Transactions

- The **Final Regulations do not address the sourcing rules** for where the cloud transaction service is performed. The current rules for the sourcing of income from services state that income from the provision of services is sourced based on the **location where the services are performed**.
- The **2025 Proposed Regulations** introduce a **three-factor test for determining the source of income from cloud transactions**:
 - **Personnel factor**: The total compensation paid to the employees whose primary function is to directly contribute to the provision of the cloud transaction by managing, operating, and maintaining the cloud infrastructure.
 - **Tangible property factor**: The sum of depreciation and rental expense (for leased or owned tangible property) directly used to provide the cloud transaction.
 - **Intangible property factor**: A ratio based on (i) the total compensation paid for services performed within the US to employees whose primary function is to perform R&E related to cloud transactions within a product line to (ii) total cloud transaction R&E compensation in the product line.
- Location where a contract for a cloud transaction is executed is irrelevant.

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Sourcing Guidance for Cloud Transactions

Step 1 – Calculate US Performance Ratios (Measures US performance by activity/asset. If all are ratios are 0 analysis ends here)



Intangible Ratio

The Intangible Ratio looks at employees whose primary function is to perform R&D activities associated with cloud transactions in the same product line in that taxable year (“**R&D Employees**”). The US Intangible Ratio is calculated as follows:

$$\frac{\text{R\&D Employee comp for services within the US}}{\text{Total R\&D Employee comp}}$$



Personnel Ratio

The Personnel Ratio looks at employees whose primary function is to directly contribute to the provision of the cloud transaction, excluding R&D Employees. (“**Delivery Employees**”) The US Personnel Ratio is calculated as follows:

$$\frac{\text{Delivery Employee comp for services within the US}}{\text{Total Delivery Employee comp}}$$



Intangible Ratio

The Intangible Ratio looks at employees whose primary function is to perform R&D activities associated with cloud transactions in the same product line in that taxable year (“**R&D Employees**”). The US Intangible Ratio is calculated as follows:

$$\frac{\text{Depreciation/lease expense for US Delivery Assets}}{\text{Total depreciation/lease expense for Delivery Assets}}$$

Note: Performance ratios only look to employees/assets of taxpayer (i.e., legal entity and its DREs or branches).

Note: To the extent an employee/asset relates to more than one cloud transaction, it is apportioned evenly across those cloud transactions

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Sourcing Guidance for Cloud Transactions

Step 2 – Calculate Factors (Relative weight of each performance ratio)



Intangible Ratio

The Intangible Factor is the sum of a taxpayer’s R&E expenditures (regardless of deductibility), amortization (excluding capitalized R&E), and royalty expense for that taxable year that are associated with cloud transactions in the same product line as the cloud transaction.



Personnel Ratio

The Personnel Factor is sum of all compensation paid to Delivery Employees in the taxable year.



Intangible Ratio

The Tangible Property Factor is sum of all depreciation expense for Delivery Assets owned and all rental expense for Delivery Assets leased in the taxable year.

Sourcing Guidance for Cloud Transactions

Step 3 – Weigh US Performance Ratios by Factors (Using prescribed formula in Prop. Treas. Reg. § 1.861-19(d)(1))

The 2025 Proposed Regulations prescribe the following formula:

**% US
Source
Cloud
Income**

$$= \frac{(US\ Intangible\ Ratio \times Intangible\ Factor) + (US\ Personnel\ Ratio \times Personnel\ Factor) + (US\ Tangible\ Property\ Ratio \times Tangible\ Property\ Factor)}{(Intangible\ Factor + Personnel\ Factor + Tangible\ Property\ Factor)}$$

Subpart F treatment of Cloud Revenue

“Place of performance” under § 954(e) vs § 861(a)(3)

- Proposed source rule applies for purposes of subpart F
 - Prop. Treas. Reg. § 1.861-19(a) states that cloud source and character regulations apply for purposes of subpart F
 - Sec. 954(e) refers to services performed outside the country in which CFC was incorporated or organized
 - Sec. 861(a)(3) looks to whether services are performed within vs. without the US
- If the proposed cloud source rules apply for purposes of § 954(e), the intangible property factor will result in different costs determining the extent of services performed within or without the CFC’s country of incorporation.
- Where there is a related party transaction, place of performance becomes relevant under § 954(e).
 - *Piedras Negras* case looked to location of employees, activities, and assets to determine business was performing services outside the United States.
 - Both -19 proposed source and *Piedras Negras* looked to people and assets, but -19 proposed cloud source includes costs that may not seem to be included under the *Piedras Negras* analysis, such as costs for royalty expense, as a mechanical bright-line calculation.

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Antiabuse Rule

Proposed Treas. Reg. § 1.861-19(d)(9)

- Intended to “prevent taxpayers from circumventing the purpose of the proposed regulations—to attribute the source of gross income from a cloud transaction to the place where the transaction is performed.”
- Provides for “appropriate adjustments” if
 - the taxpayer has entered into or structured one or more transactions with a **principal purpose** of reducing its US tax liability
 - in a manner inconsistent with the purpose of Prop. Treas. Reg. § 1.861-19(d) to source taxpayer’s gross income to the location where the cloud transaction is performed.

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Thank you

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