NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1511
April 14, 2025

The Honorable Shelley Leonard
Acting Deputy Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Melanie Krause
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Andrew De Mello
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1511 - Comments on Proposed Regulations on the Source of Income From Cloud Transactions

Dear Ms. Leonard, Ms. Krause, and Mr. De Mello:

Please see attached Report No. 1511 of the Tax Section of the New York State Bar Association (the "Report"), which comments on proposed regulations (the "Proposed Regulations") issued by the Department of Treasury and the Internal Revenue Service ("IRS") under section 861 of the Internal Revenue Code of 1986, as amended (the "Code") on the source of income from "cloud transactions," REG-107420-24, 90 Fed. Reg. 3075 (Jan. 14, 2025).

Final regulations on classifying transactions involving computer programs and other digital content, including on-demand network access to digital content, define a "cloud transaction" as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined), or other similar resources, other than on-demand network access that is de minimis taking into account the overall arrangement and the surrounding facts and circumstances. They

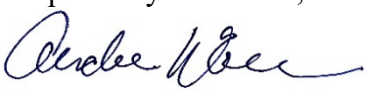
characterize cloud transactions as the performance of services. The approach of the final regulations classifying cloud transactions generally is beyond the scope of this Report.

The Proposed Regulations addressed by the Report would determine the "source" of income from cloud transactions following from the conclusion that cloud transactions are services. The source of income from the provision of personal services generally depends on the location where those services are performed. The Proposed Regulations would prescribe the source of cloud transaction income under a formulary approach based on three factors: an intangible property factor, a personnel factor, and a tangible property factor. A U.S. source portion would be determined for each factor by reference to where specified expense items were incurred.

The Report, in Parts I and II, provides an introduction and summary of our principal recommendations. Part III, as background, describes the primary tax consequences of a source determination under the Code, an overview of the Code's provisions that determine the source of income and a summary of the applicable regulations and the Proposed Regulations. Part IV contains a detailed discussion of certain issues presented by the approach of the Proposed Regulations and our recommendations.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,



Andrew Walker
Chair

Enclosure

cc: Rebecca O. Burch
Deputy Assistant Secretary for International Affairs
Department of the Treasury

Lindsay Kitzinger
International Tax Counsel
Department of the Treasury

Jim Wang
Deputy International Tax Counsel
Department of the Treasury

Natalie Punchak
Attorney-Adviser
Department of the Treasury (Office of Tax Policy)

Peter H. Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Daniel M. McCall
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John Merrick
Senior Level Counsel, Office of the Associate Chief Counsel (International)
Internal Revenue Service

Robert Z. Kelley
Chief (Branch 6), Office of the Associate Chief Counsel (International)
Internal Revenue Service

Christopher E. Fulle
Office of the Associate Chief Counsel (International)
Internal Revenue Service

Michelle L. Ng
Office of the Associate Chief Counsel (International)
Internal Revenue Service

Report No. 1511

New York State Bar Association Tax Section

Comments on Proposed Regulations on Source of Income From Cloud Transactions

April 14, 2025

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Comments on Proposed Regulations on Source of Income From Cloud Transactions

I. Introduction

This report (the "**Report**")[1] of the Tax Section of the New York State Bar Association ("**NYSBA**") comments on proposed regulations (the "**Proposed Regulations**")[2] published by the Department of the Treasury (the "**Treasury**") and the Internal Revenue Service ("**IRS**," and when referred to collectively, "**Treasury**") on January 14, 2024, under section 861 regarding the source of income from cloud transactions.[3]

At the same time, Treasury published final regulations on classifying transactions involving computer programs and other digital content, including on-demand network access to digital content (the "**2025 Final Regulations**"). The 2025 Final Regulations are generally beyond the scope of this Report. The 2025 Final Regulations distinguish as a general matter between the transfer of a copyright right, the transfer of a copyrighted article, the provision of services for the development or modification of a computer program, and the provision of know-how relating to the development of a computer program.[4]

The 2025 Final Regulations define a "cloud transaction" as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined), or other similar resources, other than on-demand network access that is de minimis taking into account the overall arrangement and the surrounding facts and circumstances. On-demand access may be distinguished, for example, from transactions whose predominant character involves downloading a program to the user's own computer or transferring rights in the content that extend beyond online use. Importantly, for purposes of this Report, a "cloud transaction" (and hence, the source rules applicable to such a transaction) apply to cloud transactions as specifically defined. The same source rules do not apply generally to transactions that might, in a colloquial sense, be considered to be transacted through the "cloud," such as a sale or lease of digital content.

Unlike previous proposed regulations,[5] the 2025 Final Regulations characterize a transaction under one of these general categories based on its "predominant character" (rather than potentially bifurcating a commercial transaction into one or more such components). In addition,

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[1] The principal drafters of this Report were Raymond Stahl and David Hardy. Helpful comments were received from Andrew Braiterman, Charles Cope, Kevin Glenn, John Lutz, John Narducci, Cory O'Neill, Deborah Paul, Jason Sacks, Michael Schler, Ansgar Simon, Alaukik Singh, and Andrew Walker.

[2] REG-107420-24, 90 Fed. Reg. 3075 (Jan. 14, 2025).

[3] Prop. Reg. § 1.861-19(d). Unless otherwise noted, references herein to "**section**" are to sections of the Internal Revenue Code of 1986 (the "**Code**").

[4] Treas. Reg. § 1.861-18(b)(1).

[5] REG-130700-14, 84 Fed. Reg. 403017 (Aug. 14, 2019).

the preamble to the 2025 Final Regulations (the "**Preamble**") indicates that neither commentators nor Treasury could identify "cloud transactions" (as specifically defined) that would properly be characterized as leases.[6] Therefore, the 2025 Final Regulations treat all cloud transactions as the provision of services.

The source of income from the provision of personal services ("**services income**") depends on the location where those services are performed, a standard that is particularly difficult to apply in the context of automated services that rely heavily on intangible property.[7] The rules for determining the source of services income are largely unchanged since they were first enacted in 1921.[8] While the Code's source rules have remained static, change has been the constant when it comes to market jurisdictions' approach to taxing cloud transactions and the digital economy more broadly. Thus, the Proposed Regulations represent a significant development in the United States' engagement with evolving norms in this area.

The Proposed Regulations address the source of cloud transactions by adopting a formulary approach. As explained in greater detail in Part III.D, the Proposed Regulations would determine the source of gross income from cloud transactions based on three factors: an intangible property factor, a personnel factor, and a tangible property factor. A U.S. source portion would be determined for each factor by reference to where specified expense items were incurred.

We commend Treasury and the IRS for providing guidance regarding the source of income from cloud transactions. We recognize that it is extremely challenging to develop source rules that are coherent with the economic and commercial context of cloud transactions and the very limited existing law that are also predictable and administrable, and we appreciate the desire to achieve a reasonable balance between these objectives. In this Report, we offer our observations and suggestions on various aspects of the Proposed Regulations, with the aim of enhancing their clarity, consistency, and fairness. We also identify certain areas in which we believe further guidance or clarification would be helpful or is necessary. Part II of this Report provides a summary of our principal recommendations. Part III provides background on the relevant law and the Proposed Regulations, and Part IV contains a detailed discussion of our comments and recommendations.

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[6] 90 Fed. Reg. 2977, 2982-83 (Jan. 14, 2025).

[7] *See* 90 Fed. Reg. at 3076 ("The distinctive attributes of cloud transactions, including the network-based and increasingly automated nature of the service delivery and the role of intangible property (such as proprietary software and other proprietary digital content) in ensuring the functionality, reliability, and performance of the service, raise questions regarding how to determine the place of performance of a cloud transaction.").

[8] *See* Revenue Act of 1921, ch. 136. For a discussion of the origins of the Code's sourcing provisions, see Michael Graetz & Michael O'Hear, *The Original Intent of U.S. International Taxation*, 46 Duke L.J. 1021 (March 1997).

II. Summary of Principal Recommendations

The following is a summary of the principal recommendations in this Report. All terms capitalized in this Part II have the meanings ascribed to them in Parts I, III, and IV of this Report.

A. We support the general approach of the Proposed Regulations, which would determine the place of performance of a cloud transaction by reference to a multi-factor Apportionment Fraction. We also generally agree that the Apportionment Fraction should reflect the respective contributions of intangible property, direct service personnel, and tangible property. However, we make several recommendations as to the specific aspects of each of these inputs.

B. Although we recognize that there are trade-offs, we believe final regulations should adopt a multi-year formula that averages each of the three factors and determines the U.S. source portion thereof over a specified number of prior years.

C. Consideration should be given to different approaches that would assign an even greater weight to the intangible property factor than the other factors, including by (i) determining the relative value of the factors based on all relevant facts and circumstances or (ii) formulaically assigning a limited return to tangible property and service delivery personnel.

D. In determining the U.S. source portion of the intangible property factor, final regulations should include rules for determining where expenses other than compensation paid to R&E personnel were incurred rather than apportioning those expenses solely by reference to the location of R&E personnel.

E. For purposes of computing the U.S. source portion of the intangible property and personnel factors, final regulations should adopt rules disregarding foreign-based employees' limited travel to the United States and U.S.-based employees' limited travel outside the United States.

F. Certain essential costs attributable to the operation of tangible property, such as the cost of electricity, should be included in the tangible property factor.

G. The tangible property factor should be deemed to be zero in two specific instances: (i) when the U.S. source portion of the intangible property factor and the U.S. source portion of the personnel factor would represent 100 percent of each factor and (ii) when the U.S. source portion of the intangible property factor and the U.S. source portion of the personnel factor would represent 0 percent of each factor.

H. Foreign branches of U.S. persons and U.S. branches of foreign persons should be treated as separate entities under final regulations. In the alternative, final regulations should

include rules mitigating double taxation and double nontaxation resulting from the Proposed Regulations.

I. Final regulations should retain the Proposed Regulations' treatment of members of a multinational group as separate entities.

J. Consolidated groups should be treated as a single taxpayer for purposes of applying the Apportionment Fraction to cloud services income earned by a consolidated group member.

K. Final regulations should confirm that partnerships are respected as separate entities rather than as an aggregate of their partners. Consideration should be given to whether it would be appropriate to prevent manipulation of the Apportionment Fraction by incurring expenses at the level of a partnership.

L. Final regulations should not include the Proposed Regulations' broad anti-abuse rule. If an anti-abuse rule is included in final regulations, the rule should provide specific guidance as to outcomes, structures, and transactions that would, and would not, be subject to the anti-abuse rule.

M. Final regulations or other guidance should provide relief for withholding agents, particularly with respect to cloud transactions between foreign persons.

III. Background

A. The Relevance of Source

The Code's provisions for determining the source of income are fundamental to determining the allocation of taxing rights between the United States and foreign jurisdictions. Generally, the Code imposes tax on all of the income of U.S. residents and citizens ("**U.S. persons**"),[9] but permits a credit against foreign source income for certain foreign taxes paid or deemed paid.[10] By contrast, the Code taxes nonresident alien individuals and foreign corporations ("**foreign persons**") primarily on their U.S. source income, with most foreign source income earned by a foreign person being exempt from federal income tax.[11] Thus, when a U.S. person earns U.S. source income, the Code subjects that item to federal income tax; when the same person earns foreign source income, the Code often effectively cedes primary taxing rights with respect to that income to foreign jurisdictions.[12] By the same token, a foreign person earning U.S. source

[9] I.R.C. §§ 1 & 11.

[10] IRC §§ 27 & 901.

[11] I.R.C. §§ 871, 881 & 882. Regarding foreign source income, see *infra* note 30.

[12] As discussed in Part III.A.1, the nature of the Code's foreign tax credit limitation is such that taxing rights may be ceded to the foreign jurisdiction from which the income arose, but they may also be ceded to other

income is subject to federal income tax, but generally exempt from federal income tax with respect to its foreign source income. With limited exceptions, the same Code provisions apply to U.S. persons and foreign persons,[13] which promotes consistent and principled determinations as to when the United States asserts primary taxing jurisdiction and when it does not.

1. Taxation of U.S. Persons; The Foreign Tax Credit

For U.S. persons, the source of income is primarily relevant for foreign tax credit purposes. The foreign tax credit provisions of sections 901 through 909 are the Code's primary mechanism for relieving double taxation of U.S. persons, doing so by ceding primary taxing rights to foreign jurisdictions. Section 901 allows a taxpayer to claim a credit for the amount of any foreign income taxes paid or accrued during a taxable year.[14] Under section 904(a), the allowable foreign tax credit is limited to the amount of U.S. federal income tax that would have otherwise been paid on the taxpayer's foreign source income.[15] In applying this limitation, foreign source income and foreign income taxes are further subdivided into four separate limitation categories: (i) any amount includible in gross income under section 951A (other than passive category income); (ii) foreign branch income; (iii) passive category income; and (iv) general category income.[16] Income and foreign taxes within a single separate limitation category are blended, such that any increase or

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foreign jurisdictions imposing a higher effective rate of tax on other income in the same separate limitation category.

[13] Noteworthy exceptions include sections 865(e) and 904(h). Section 865(e)(1) causes certain gain from the sale of personal property by a U.S. person to be treated as foreign source income to the extent that the gain is attributable an office or other fixed place of business in a foreign country maintained by the U.S. person. Similarly, section 865(e)(2) treats certain gain from the sale of personal property by a foreign person to be treated as U.S. source income to the extent that the gain is attributable a U.S. office or other fixed place of business maintained by a non-U.S. person. Section 865(e)(2) applies to a wider range of sales of personal property than section 865(e)(1) (including inventory). Furthermore, section 865(e)(1) applies only to income subject to a 10 percent or greater foreign income tax. Solely for purposes of the section 904 foreign tax credit limitation, section 904(h) treats certain related party payments as U.S. source income to the extent those payments are attributable to U.S. source income of the related party payor.

[14] I.R.C. § 901(a) & (b); Treas. Reg. §§ 1.901-1(a) & 1.901-2(a); *see also* I.R.C. § 903 (treating a foreign tax imposed in lieu of a foreign income tax as an income tax).

[15] *See* I.R.C. § 904(a) ("The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire income) bears to his entire taxable income for the same taxable year.").

[16] I.R.C. § 904(d)(1). Taxes paid with respect to certain "specified separate category income" – income re-sourced under an income tax treaty – is also subject to a separate limitation. *See* I.R.C. §§ 865(g), 904(d)(6) & (h); Treas. Reg. § 1.904-4(m).

decrease in a separate limitation category corresponds to an increase or decrease in a taxpayer's capacity to claim a foreign tax credit for foreign taxes assigned to that category.

Thus, although the Code imposes tax on all of a U.S. person's worldwide income, it effectively relinquishes the right to tax foreign source income in a separate limitation category to the extent that one or more foreign countries imposes foreign income tax on any income in the same category.

2. U.S. Taxation of Foreign Persons

For foreign persons, the source of income is primarily relevant for purposes of determining whether the payment is subject to U.S. tax. Different rules apply depending on whether or not the income is effectively connected with the foreign person's conduct of a trade or business within the United States (a "**U.S. trade or business**").[17]

A 30 percent gross-basis tax applies to certain income that is not effectively connected with a U.S. trade or business.[18] This tax is collected through a withholding mechanism, which generally requires the payor to withhold 30 percent of the gross amount and remit such amount to the IRS.[19] Income subject to gross basis withholding under the Code generally includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical ("**FDAP**") gains, profits, and income.[20] Whether or not income is treated as FDAP is generally determined under the withholding regulations.[21] Under

[17] To be engaged in a U.S. trade or business, a foreign person's profit-oriented activities typically must be considerable, continuous, and regular. *See generally Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940); *Lewenhaupt v. Comm'r*, 20 T.C. 151, 163 (1953) *aff'd* 221 F.2d 227 (9th Cir. 1955); *De Amodio v. Comm'r*, 34 T.C. 894 (1960) *aff'd*, 299 F.2d 623 (3rd Cir. 1962). However, the performance of *any* personal services in the United States during a year may give rise to a U.S. trade or business absent the application of (i) a limited de minimis exception for the provision of services to a foreign employer or (ii) the trading safe harbors. *See* I.R.C. § 864(b) ("the term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year.").

[18] I.R.C. §§ 871(a) & 881(a).

[19] *See generally* I.R.C. §§ 881(a)(1), 1441 & 1442.

[20] *See* I.R.C. §§ 871(a) & 881(a)(1).

[21] *See* Treas. Reg. §§ 1.871-7(b); 1.881-2(b)(1).

those regulations, all income not expressly excluded is treated as FDAP.[22] Services income is not excluded, and therefore constitutes FDAP.[23]

If a foreign person is engaged in a U.S. trade or business, the Code imposes tax on a foreign person's income on a net basis if the income is effectively connected with the person's U.S. trade or business (such income, "**effectively connected income**").[24] Effectively connected income is subject to tax at regular rates.[25] U.S. source FDAP is treated as effectively connected income based on the application of (i) the asset-use test or (ii) the business-activities test.[26] Under the asset-use test, gross income may be treated as effectively connected income if the income is derived from assets used in, or held for use in, the conduct of a U.S. trade or business.[27] Under the business-activities test, gross income may be treated as effectively connected income if the activities of the trade or business conducted in the United States were a material factor in the realization of the income.[28] The business activities test is of primary significance when income arises directly from the active conduct of a taxpayer's U.S. trade or business.[29] U.S. source income that is not FDAP is subject to the "residual force of attraction" rule under section 864(c)(3), which treats all U.S. source income of a foreign person that is not FDAP as effectively connected income even if the income is not related to the foreign corporation's conduct of a U.S. trade or business.[30]

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[22] Treas. Reg. § 1.1441-2(b).

[23] *Id.*; *see also* Treas. Reg. § 1.864-4(c)(3) (providing that the business activities test is of primary significance in determining whether services fees are derived in the active conduct of a U.S. trade or business that is a servicing business).

[24] I.R.C. §§ 871(b)(1) & 882(a)(1). Foreign taxpayers eligible for the benefits of an income tax treaty are subject to U.S. taxation on certain business profits attributable to a U.S. permanent establishment. Although the standards for attributing business profits to permanent establishments vary, there is often significant overlap between the Code's standards for effectively connected income and the attribution rules in U.S. income tax treaties.

[25] I.R.C. §§ 871(b) & 882(a).

[26] I.R.C. § 864(c)(2); Treas. Reg. § 1.864-4(c)(1)(i).

[27] *Id.* An asset is used or held for use in a U.S. trade or business if the asset is held for the principal purpose of promoting the present conduct of the trade or business in the United States, acquired and held in the ordinary course of the trade or business conducted in the United States, or otherwise held in a direct relationship to the trade or business conducted in the United States. Treas. Reg. § 1.864-4(c)(1)(ii).

[28] Treas. Reg. § 1.864-4(c)(1)(i).

[29] Treas. Reg. § 1.864-4(c)(3)(i).

[30] In contrast, effectively connected income includes only limited categories of foreign source income. Foreign source income that is effectively connected income only includes certain rents, royalties, dividends, interest, guarantee fees, and inventory sales, and in all instances such foreign source income must be derived by a foreign person engaged in a U.S. trade or business that has an office or fixed place of business within

B. Selected Source Rules

1. Statutory Provisions

Under sections 861 through 865, different rules apply to determine the source of different classes of income. The Code's provisions regarding source were first adopted as part of the Revenue Act of 1921.[31] Like several of the Code's other current rules on source, the statutory provisions governing the source of services income are largely unchanged since 1921.[32]

a. Services Income

Under the Code, the place where a service is performed determines the source of the resulting services income. Specifically, section 861(a)(3) provides that gross income from U.S. sources includes "[c]ompensation for labor or personal services performed in the United States."[33] Similarly, section 862(a)(3) specifies that gross income from foreign sources includes compensation for labor or personal services performed outside the United States. However, the Code is silent as to how to determine where services are performed.

Section 863(b) addresses the treatment of certain gross income derived from both U.S. and foreign sources, including services income. Section 863(b) requires a taxpayer to first compute taxable income by allocating and apportioning expenses, loss, and other deductions to such income. Next, the statute provides that "the portion of such taxable income attributable to sources

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the United States to which such income is attributable. I.R.C. § 864(c)(4)(B). All other types of foreign source income are not effectively connected income. I.R.C. § 864(c)(4)(A).

[31] *See* Revenue Act of 1921, ch. 136.

[32] *Id.* at § 217(a)(3) ("[I]n the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following item s of gross income shall be treated as income from sources within the United States: Compensation for labor or personal services performed in the United States"), (c)(3) ("The following items of gross income shall be treated as income from sources without the United States…[c]ompensation for labor or personal service performed without the United States") & (e) ("In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary."). In 1986, section 863(b) was updated to replace "transportation or other services" with "services" in connection with the adoption of special source rules in section 863(c) regarding transportation income. Tax Reform Act of 1986, P.L. 99-514, § 1212(e).

[33] A limited exception applies for services performed by certain nonresident alien individual employees who are temporarily present in the United States. I.R.C. § 861(a)(3)(C).

within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary."[34]

b. Rents and Royalties

In contrast to the rules governing the source of services income, rules governing the source of rental and royalty income are based on the location where the leased or licensed (tangible or intangible) property is used. Rents and royalties from property located in the United States are U.S. source income and rents and royalties from property located outside the United States are foreign source income. Although the location of leased tangible property is ordinarily intuitive, the Code provides no guidance as to how to determine where intangible property is used.[35]

c. Gain from Sales of Personal Property

Section 865(a) provides that gain from the sale of personal property is sourced based on the residence of the seller. Accordingly, under the general rule of section 865(a), a United States resident recognizes U.S. source income from the sale of personal property, and a nonresident recognizes foreign source income from the sale of personal property.[36] This general rule is subject to several important exceptions, including for (i) inventory property,[37] (ii) depreciable personal property,[38] (iii) certain intangible property,[39] and (iv) sales attributable to a U.S. or foreign office.[40]

d. Other Source Rules

While the Code's source rules attempt, in general, to determine the source of an item of income by reference to the situs of the activity giving rise to the income,[41] a number of special rules apply to income whose location is difficult (or impossible) to determine. In some instances,

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[34] I.R.C. § 863(b).

[35] I.R.C. §§ 861(a)(4) & 862(a)(4). Authorities provide some guidance on where certain types of intangible property are used, although the authorities do not offer a comprehensive (or entirely consistent) set of principles. *See, e.g.*, *Wodehouse v. Comm'r*, 178 F.2d 987 (4th Cir. 1949); *Sanchez v. Comm'r*, 6 T.C. 1141 (1946), *aff'd* 162 F.2d 58 (2d Cir. 1947); *SDI Netherlands v. Comm'r*, 107 T.C. 161 (1996); Rev. Rul. 68-443, 1968-2 C.B. 304; Rev. Rul. 72-232, 1972-1 C.B. 276; Rev. Rul. 84-78, 1984-1 C.B. 173.

[36] *See* I.R.C. § 865(g)(1)(A) (defining the terms "United States resident" and "nonresident").

[37] I.R.C. § 865(b); *see also* I.R.C. §§ 861(a)(6), 862(a)(6) & 863. The rules relating to sales of inventory property are discussed in greater detail in Part IV.F.

[38] I.R.C. § 865(c).

[39] I.R.C. § 865(d).

[40] I.R.C. § 865(e).

[41] *See* Rev. Rul. 73-252, 1973-1 CB 337.

the source of those items is based on the residence of the taxpayer.[42] In other instances, the Code adopts a simple percentage-based split.[43]

2. Regulations on the Source of Services Income

Regulations addressing services income are set forth in Treas. Reg. § 1.861-4, and generally follow the relevant statutory provisions applicable to services performed entirely within or without the United States.[44] Regulations under section 863(b)(1) provide that, in the case of services performed partly within and partly without the United States, the portion of services income that is treated as U.S. source income is "on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on the time basis … will be acceptable."[45]

The Treasury regulations providing guidance on apportionment on the time basis primarily address the application of that rule to individuals performing services for an employer within and without the United States.[46] In that context, apportionment on a time basis determines the amount of services income attributable to services performed within the United States by reference to the amount that bears the same relation to an individual's total compensation as the number of days of performance of the labor or personal services by the individual within the United States bears to the individual's total number of days of performance of labor or personal services.[47] For example, if an individual was employed by a domestic corporation for a 300-day period within a year, received $80,000 in compensation, and performed services for the domestic corporation within the United States for 180 days and without the United States for 120 days, the individual would recognize $48,000 of U.S. source income and $32,000 of foreign source income under the time basis rule.[48]

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[42] *See, e.g.*, I.R.C. § 863(d) (providing that the source of space and ocean activity is determined based on the residence of the taxpayer).

[43] *See, e.g.*, I.R.C. 863(c) (providing that certain international transportation income is deemed to be 50 percent U.S. source income and 50 percent foreign source income) & (e) (providing a similar rule for international communications income).

[44] *See* Treas. Reg. § 1.861-4(a).

[45] Treas. Reg. § 1.861-4(b).

[46] Treas. Reg. § 1.861-4(b)(2)(ii)(E).

[47] *Id*. Under certain circumstances, a unit of time used under the time basis rule may be less than a day. *Id*.

[48] *See* Treas. Reg. § 1.861-4(b)(2)(ii)(G) (Example 1). If the individual's particular facts and circumstances demonstrated that an alternative approach was appropriate, the time basis rule would not apply. *Id.*

3. Authority Interpreting the Code's Source Rules for Services Income

Case law interpreting the Code's place of performance standard is limited. In 1942, the Fifth Circuit addressed the source of advertising services income earned by a radio broadcaster in *Commissioner v. Piedras Negras Broadcasting Company*.[49] Because *Piedras Negras* involved the remote provision of services across borders, it addressed many of the same issues presented by cross-border cloud (and similar) services.

Piedras Negras Broadcasting Company was organized as a corporation in Mexico. Its principal office was located in Piedras Negras, Mexico, which is directly across the Rio Grande from Eagle Pass, Texas. The taxpayer earned income from selling advertising over the radio and from renting its facilities, which was referred to as the sale of radio time. Ninety-five percent of the taxpayer's income from advertising was from advertisers that were located in the United States, as were most of the radio station's listeners. The taxpayer sold advertising through advertising agents that the court described as independent agents. The radio station's broadcast personnel and equipment were located in Mexico.[50] The Fifth Circuit held that the advertising income was foreign source, stating—

> Since the taxpayer's income was derived exclusively from the operation of its broadcasting facilities located in Mexico, or from the rental of those facilities in Mexico, its income therefrom was either compensation for personal labor or services, or rentals or royalties from property, or both, under the statutory classification…. We think the language of the statutes clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of respondent's broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico. None of its income was derived from sources within the United States.[51]

Thus, the Fifth Circuit concluded that in the context of a remotely provided service, the place of performance should be determined by the location of the taxpayer when it performed the service, and not the location of its customers. To make this determination, the court considered the location of the taxpayer's personnel and its assets, but not those of its independent agents. Authority

[49] 127 F.2d 260 (5th Cir. 1942), *aff'g* 43 B.T.A 297 (1941).

[50] *Id.* at 260-261.

[51] *Id.* at 261.

addressing remotely provided services has been fairly limited since the case was decided.[52] As a result, *Piedras Negras* is often cited by commentators when considering how to determine the source of income from remotely-provided services, including cloud transactions.[53]

4. Agents and Subcontractors

a. Separate Entity Status and Agency

In *Moline Properties, Inc. v. Commissioner*,[54] a taxpayer that held real estate through a wholly-owned corporation claimed that the corporation should be treated as an agent of the taxpayer.[55] If this view had been correct, gain from the corporation's sales of property would have been subject to tax solely at the shareholder level.[56] The Supreme Court rejected the taxpayer's position, concluding that the corporation was a separate entity with a "tax identity distinct from its stockholder" and noting that there was neither an agency agreement nor "the usual incidents of an agency relationship."[57]

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[52] *See, e.g.*, *Container Corp. v. Comm'r*, 134 T.C. 122, 132, *aff'd* 2011 WL 1664358, 107 AFTR2d 2011-1831 (5th Cir. 2011) *(slip copy)* (citing *Piedras Negras* for the proposition that "[i]t is clear that the source of payments for services is where the services are performed, not where the benefit is inured."); LTR 6203055590A (ruling that a foreign corporation's income from advertising activities was foreign source based on the location of its assets and employees, notwithstanding the fact that its customers were in the United States).

[53] *See, e.g.,* Andy Kim, Larissa Neumann, Idan Nester, and Jim Fuller, *Character and Source of Income from Internet Business Activities*, The Contemporary Tax Journal: Vol. 1: Iss. 2, Article 5, p. 4-9 (Summer 2011); Stephen Bates, Michael Lukacs, and David de Ruig, *Every Cloud Has a Silver Lining: Proposed Cloud Computing Regs*, Tax Notes Federal, 1725, 1735-36 (Mar. 16, 2020); Gary Sprague, *Crowdsourced Guidance for Source of Income Rules for Cloud Transactions*, 49 Tax Mgmt. Int'l J. 43 (Jan. 10, 2020).

[54] 319 U.S. 436 (1942).

[55] *Id.* at 441.

[56] *Id.* at 438.

[57] *Id.* at 440.

The Supreme Court revisited agency arrangements between a shareholder and its controlled corporations in *National Carbide Corp. v. Commissioner*.[58] In *National Carbide*, a parent corporation entered into a written agency contract with several subsidiaries to run production plants. Consistent with this purported agency arrangement, the parent corporation reported the subsidiaries' income items as its own.[59] The IRS challenged this position, and the Supreme Court sided with the IRS. The *National Carbide* opinion outlined factors that would be relevant to determine whether a true agency relationship exists.

> What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. Whether the corporation operates in the name and for the account of the principal, binds the principal, by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent.[60]

The Supreme Court revisited the subject of a taxpayer's claims regarding an agency relationship in *Commissioner v. Bollinger*.[61] In *Bollinger*, the taxpayer was a partner in a real estate partnership. The partnership formed nominee corporations in order to hold title to real estate, which allowed the taxpayer to avoid Kentucky usury laws.[62] The Court held that the nominee corporations should be treated as agents of the partnership, adding the following gloss on the *National Carbide* standard:

> [I]t is uncontested that the law attributes tax consequences of property held by a genuine agent to the principal; and we agree that it is reasonable for the Commissioner to demand unequivocal evidence of genuineness in the corporation-shareholder context, in order to prevent evasion of *Moline.* We see no basis, however, for holding that unequivocal evidence can only consist of the rigid requirements (arm's-length dealing plus agency fee) that the Commissioner suggests. Neither of those is demanded by the law of agency, which permits agents to be unpaid family members, friends, or associates. It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding

[58] 336 U.S. 422 (1949).

[59] *Id.* at 426.

[60] *Id.* at 437.

[61] 485 U.S. 340 (1988).

[62] *Id.*

> manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent, and not principal, with respect to the asset for all purposes, and the corporation is held out as the agent, and not principal, in all dealings with third parties relating to the asset.[63]

Thus, after *Bollinger*, it is clear that genuine agency arrangements may be taken into account for federal income tax purposes, with the prophylactic evidentiary standard set forth in *Bollinger* governing taxpayers' claims regarding agency relationships.

b. Services and Subcontractors

Consistent with the foregoing, it is generally the case that only the activities of a taxpayer itself (directly or through certain agents) are taken into account for purposes of determining where the taxpayer performs services. In *Miller v. Commissioner*,[64] a foreign corporation ("**A-Alpha**") was paid to perform research and development for unrelated third parties. A-Alpha subcontracted the majority of its research and development contracts to other persons, including to its U.S. subsidiary ("**ESC**").[65] A-Alpha compensated ESC on a cost-plus basis. The IRS argued that a portion of A-Alpha's income was U.S. source income by reason of A-Alpha's subcontracting with ESC, such that A-Alpha was subject to U.S. tax.[66]

In a memorandum opinion,[67] the Tax Court rejected the IRS's position, stating "for A-Alpha to be considered as having U.S. source income by virtue of the performance of services, A-Alpha itself would have to perform the services through agents or employees of its own."[68] The court observed that ESC itself was subject to U.S. federal income tax on payments received from

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[63] *Id.* at 349-50.

[64] 73 T.C. Memo (CCH) 2319, T.C. Memo (RIA) ¶ 97,134 (1997).

[65] Other subcontractors included foreign affiliates and third parties. *Id.* at 2.

[66] The IRS's position was that withholding agents should have withheld on the entire amount, and A-Alpha should have applied for a refund to the extent that the amounts withheld exceeded its final liability. *Id.* at 1-2.

[67] Tax Court memorandum opinions are non-precedential. *See, e.g.*, *Nico v. Comm'r*, 67 T.C. 647, 654 (1977).

[68] *Id.* at 4.

A-Alpha,[69] and that section 482 would be the appropriate means for adjusting the allocation of income between ESC and A-Alpha if the payment terms were not arm's length.[70]

In a recent legal memorandum,[71] the IRS concluded that activities performed by a foreign subsidiary should not be attributed to the foreign subsidiary's U.S. shareholder for purposes of determining the source of the U.S. shareholder's services income. The memorandum described the subsidiary as a "subcontractor," stating that "unless the subcontractor is treated as an agent for such purpose, the source of income derived by the contractor is not determined by reference to the place of performance by the subcontractor."[72] The IRS concluded that in determining whether a taxpayer had performed a service, the Code considers solely the activities of the taxpayer and its agents. In the fact pattern before it, the IRS specifically concluded that the taxpayer's arrangement with its foreign subsidiary lacked the indicia of agency set forth in *National Carbide* and that, even if certain indicia of agency were present, the taxpayer would not have satisfied *Bollinger*'s heightened evidentiary standard.

C. Guidance Regarding Cloud Transactions

1. In General

Neither the Code nor the Treasury regulations provide comprehensive guidance on whether a transaction involving property should be characterized as a license or lease, on the one hand, or a provision of services, on the other hand.[73] Generally, whether a transaction is in the nature of a transfer involving intangible property or a service is a factual determination that depends on whether the value that a taxpayer conveys derives primarily from the rights obtained by the other party as opposed to the ongoing service activity performed by the taxpayer.[74]

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[69] *Id.* at 4 ("While it is true that amounts received in exchange for services are sourced at the place of performance of those services, such performance gives rise to income to the performer of those services. The performer of the services in this case was ESC.").

[70] *Id.* at note 12 ("ESC billed A-Alpha for the work it performed at cost plus 5 percent. If this was below fair market value for the type of services performed, an avenue of attack by respondent is sec. 482.").

[71] CCA 202502005 (Jan. 10, 2025).

[72] *Id*. at p.2. *See also* ILM 201343020 (Oct. 25, 2013) (concluding that the source of a foreign distributor's income depended on the location of services performed by that distributor, not related distributors to which it paid service fees).

[73] Section 7701(e) provides a list of factors to consider for purposes of determining whether a contract that purports to be a service contract should be treated as a lease of property.

[74] *See, e.g., Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932) (holding that a singer's compensation was services income rather than royalty income because the singer never obtained an ownership interest in the music produced; thus, the taxpayer had no intangible property rights to convey and the value he provided was attributable solely to labor); *Boulez v. Comm'r*, 83 T.C. 584 (1984) (similar); Rev. Rul. 84-78, 1984-1 C.B.

2. Cloud Transactions under the 2025 Final Regulations

Concurrently with the publication of the Proposed Regulations, Treasury and the IRS published the 2025 Final Regulations addressing the classification of cloud transactions and other transactions involving the transfer of digital content.[75] The 2025 Final Regulations, which were originally proposed in 2019 (the "**2019 Proposed Regulations**"), amended existing regulations regarding the classification of certain software transactions that were initially finalized in 1998.[76]

Under the 2025 Final Regulations, a cloud transaction is "a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in § 1.861-18(a)(2)), or other similar resources."[77] The 2019 Proposed Regulations provided that a cloud transaction would have been treated as a lease of computer hardware, a lease of digital content, or a service. The appropriate classification would have depended on all relevant factors, with a list of factors set forth in the 2019 Proposed Regulations.[78] Nonetheless, the 2019 Proposed Regulations included examples concluding that many common forms of cloud transactions should be treated as services transactions based on the relevant factors,[79] and requested comments as to

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173 (ruling that a payment received by a domestic corporation from a foreign person in exchange for the right to broadcast a sporting event in a foreign country gave rise to foreign source royalty income because the contract did not give the foreign person "any control over when or where the prize fight will take place or how the arrangements for the fight will be made, nor does it confer any legal rights over the contestants in the fight; it merely gives FX the right to broadcast the fight if it occurs.").

[75] T.D. 10022, 90 Fed. Reg. 2977 (January 14, 2025).

[76] REG-130700-14; 84 Fed. Reg. 40317 (Aug. 14, 2019). For a detailed description of the 2019 Proposed Regulations, see the 2019 NYSBA Report No. 1427, *Report on Proposed Section 861 Regulations* (Nov. 12, 2019).

[77] Treas. Reg. § 1.861-19(b). For this purpose, digital content is a computer program or any other content, such as books, movies, and music, in digital format that is protected by copyright law, or not protected due to the expiration of the copyright or because the creator of the content dedicated it to the public domain. Treas. Reg. § 1.861-18(b)(2)(i). The 2025 Final Regulations include a number of changes to the 2019 Proposed Regulations. As relevant for purposes of this Report, the 2019 Proposed Regulations would have required taxpayers to bifurcate transactions with multiple non-de minimis elements and separately characterize each element of the transaction. Distinct elements with a different character could be subject to different rules for determining source. For example, the 2019 Proposed Regulations would have treated a taxpayer providing streaming and download capabilities to customers as providing a service (with respect to the streaming functions) and leasing or selling copyrighted articles (with respect to the downloads). In response to comments, the 2025 Final Regulations instead adopted a predominant character rule, pursuant to which a transaction with multiple elements (including cloud services) must be characterized based on the predominant character of the transaction. Treas. Reg. §§ 1.861-18(b)(2) & 1.861-19(c)(2).

[78] Prop. Reg. § 1.861-19(c) (2019).

[79] Prop. Reg. § 1.861-19(d)(1) - (11) (2019).

whether any cloud transactions would appropriately be classified as other than a service.[80] The 2025 Final Regulations eliminated this factor test. Instead, they provide that a cloud transaction is always treated as a service transaction.[81]

By virtue of classifying cloud transactions as services, the Final Regulations ensure that the source of income from a cloud transaction is governed by the Code's rules for determining the source of services income. As discussed in Part III.B, the Code determines the source of services income based on the place where services are performed. However, neither the 2019 Proposed Regulations nor the 2025 Final Regulations provide direct guidance for determining where cloud services are performed. Instead, the preamble to the 2019 Proposed Regulations requested comments on "administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865."[82]

D. Summary of the Proposed Regulations

1. Background

The Proposed Regulations, citing the statutory rules of sections 861(a)(3) and 862(a)(3), state that gross income from a cloud transaction is sourced "as services income … according to where the service is performed."[83] To determine where a taxpayer performs that service, the Proposed Regulations would adopt a formula that uses three factors: an intangible property factor, a personnel factor, and a tangible property factor and in each case the U.S. source portion thereof. The factors would be comprised of specified expense items.[84]

More specifically, the U.S. source portion of gross income from a cloud transaction would be determined by multiplying the gross income by a fraction (the "**Apportionment Fraction**"), the numerator of which is the sum of the U.S. source portions of each of the three factors and the denominator of which is the sum of the three factors.

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[80] 84 Fed. Reg. at 40321 (requesting "realistic examples of cloud transactions that would be treated as leases under proposed § 1.861-19").

[81] Treas. Reg. § 1.861-19(c)(1).

[82] *Id.*

[83] Prop. Reg. § 1.861-19(d)(1). The Proposed Regulations would be prospective, applying to taxable years beginning on or after the date of publication of the Treasury decision adopting them as final regulations in the Federal Register.

[84] *Id*.

$$\textit{U.S. source gross income} = \textit{Gross income} \quad X \quad \frac{\textit{Sum of the U.S. portion of each factor}}{\textit{Sum of the three factors}}$$

This three-factor formula would apply separately with respect to each cloud transaction, subject to certain exceptions.[85] First, a taxpayer would be permitted to aggregate substantially similar cloud transactions unless it knows or has reason to know that doing so would materially distort the source of gross income from any cloud transaction.[86] Second, and more significantly, the Proposed Regulations would require the aggregation of expenses comprising the intangible property factor to the extent that they relate to cloud transactions within a single product line.[87]

As discussed below, while there are competing ways to look at the how the formula works in practice, the "factors" are intended to measure the contribution of each of intangible property, tangible property and direct service personnel to the cloud service provided and resulting gross income.[88] Then as to each factor, the U.S. versus non-U.S. nexus is assessed. In that sense, the relative size of the three factors "weights" the U.S. versus non-U.S. indicia. For example, if all of the tangible property used in connection with a particular cloud transaction is outside the United States, but associated tangible property expense to be taken into account is small compared to relevant intangible property and direct personnel expense allocated to the transaction, the fact that all tangible property is located outside the United States would have a fairly limited impact on how much of the gross income from the cloud transaction is foreign source income.

2. Intangible Property Factor

The first factor in the Apportionment Fraction is the intangible property factor. The intangible property factor would be the sum of a taxpayer's (i) specified research and experimental

[85] For rules regarding the allocation of expenses relating to multiple transactions, see text accompanying notes 92, 100, and 105.

[86] Prop. Reg. § 1.861-19(d)(7).

[87] Prop. Reg. § 1.861-19(d)(2)(i). For this purpose, the Proposed Regulations define a product line as "all products within the same Corresponding Index Entry under a North American Industry Classification System (NAICS) code number." Prop. Reg. § 1.861-19(d)(8). Further, "[o]nce a taxpayer selects a Corresponding Index Entry and NAICS code number for the first taxable year for which this section applies, it must continue to use that Corresponding Index Entry and NAICS code number in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in Corresponding Index Entry and NAICS code number is appropriate." *Id.*

[88] 90 Fed. Reg. at 3077 ("the intangible property factor is intended to reflect the contribution of intangible property to the provision of the cloud transaction; the personnel factor is intended to reflect the contribution of certain employees to the provision of the cloud transaction; and the tangible property factor is intended to reflect the contribution of tangible property to the provision of the cloud transaction.").

expenditures within the meaning of section 174(b) ("**R&E expenditures**") that are associated with cloud transactions in the same product line as the cloud transaction performed,[89] and (ii) the taxpayer's amortization and royalty expense for intangible property for the taxable year to the extent directly used to provide the cloud transaction.[90] R&E expenditures taken into account would include all R&E expenditures incurred in a taxable year, whether or not they are deductible in the taxable year.[91] Costs and expenses that would be taken into account under the intangible property factor for two or more cloud transactions would be apportioned among cloud transactions by reference to the relative amounts of gross income generated by each transaction.[92]

The U.S. source portion of the intangible property factor would be based solely on compensation paid to certain employees performing research and experimentation ("**R&E personnel**") in the relevant product line.[93] Specifically, the Proposed Regulations would determine the U.S. source portion of the intangible property factor by multiplying the intangible property factor by a fraction. The numerator of the fraction would be the sum of the total compensation paid to R&E personnel for services performed within the United States (determined under the principles of the time basis rule), and the denominator would be the total compensation paid to the R&E personnel.[94]

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[89] Under section 174(b), the term "specified research or experimental expenditures" means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.

[90] Under section 174(a)(2), R&E expenditures generally must be capitalized and amortized ratably over a 5-year period (or a 15-year period, to the extent attributable to foreign research). To prevent double-counting, amortization taken into account excludes amounts capitalized under section 174(a)(2). Prop. Reg. § 1.861-19(d)(2)(i).

[91] Prop. Reg. § 1.861-19(d)(2)(i).

[92] *Id.*

[93] Prop. Reg. § 1.861-19(d)(2)(ii). The Proposed Regulations would define an employee by reference to Treas. Reg. § 31.3121(d)-1(c) (providing that an individual is treated as an employee if, under the usual common law rules, the relationship between the individual and the person for whom the individual performs services is the legal relationship of employer and employee).

[94] *Id.* The principles of Treas. Reg. § 1.861-4(b)(2)(ii)(E), which sets forth rules for apportioning compensation for personal services on a time basis, apply for purposes of determining the portion of R&E personnel compensation performed within the United States. Thus, for example, if an employee were to spend 50 percent of the year in the United States and 50 percent of the year outside the United States, 50 percent of the employee's compensation would be taken into account in determining the U.S. source portion of the intangible property factor.

$$\text{U.S. source portion (intangible property factor)} = \text{Intangible property factor} \times \frac{\text{R\&E personnel compensation (within U.S)}}{\text{R\&E personnel compensation (total)}}$$

The intangible property factor would include expenditures other than R&E personnel compensation, but the factor would be apportioned solely by reference to the compensation paid to R&E personnel. The Proposed Regulations would not permit a taxpayer to determine where other elements of the intangible property factor are incurred for purposes of apportioning the factor between U.S. and non-U.S. sources. For example, in a taxable year, a taxpayer may have an intangible property factor of $200 comprised of $50 of R&E personnel compensation within the United States, $50 of R&E personnel compensation performed outside the United States, and $100 of R&E expenditures relating solely to U.S.-based personnel (such as computer hardware for U.S.-based researchers). Under the Proposed Regulations, the U.S. source portion of the intangible property factor would be $100, rather than $150.

3. Personnel Factor

The second factor in the Apportionment Fraction is the personnel factor. The personnel factor would be the sum of the total compensation paid to all of the taxpayer's employees ("**direct service personnel**") whose "primary function is to directly contribute to the provision of the cloud transaction."[95] Compensation paid to R&E personnel would be excluded from this personnel factor. Personnel would be considered to directly contribute to the provision of a cloud transaction to the extent the personnel "personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are managers who directly support or immediately supervise such technical or operational personnel."[96] The Proposed Regulations include lists of activities and functions that would, and would not, be considered to directly contribute to the provision of a cloud transaction:

[95] Prop. Reg. § 1.861-19(d)(3)(i). An employee's primary function would be the set of tasks to which they are assigned to spend the majority of their working time. Prop. Reg. § 1.861-19(d)(5).

[96] *Id*.

Activities directly contributing to the provision of a cloud transaction[97]	*Activities <u>not</u> directly contributing to the provision of a cloud transaction*[98]
• Conduct of scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction; • Provision of monitoring, diagnostics, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security; • Management of the cloud transaction's infrastructure; • Delivery of end-user support with respect to the cloud transaction; and • Similar functions.	• Business strategy; • Leadership; • Legal or compliance; • Marketing; • Communications; • Sales; • Business development; • Finance; • Accounting; • Clerical; • Human resources or administrative; and • Similar functions.

Similar to costs and expenses taken into account under the intangible property factor, compensation paid to an employee whose primary function is to directly contribute to multiple cloud transactions must be allocated among cloud transactions. However, in the context of the personnel factor, the allocation is based on the relative amount of time the employee spends contributing to each cloud transaction rather than the relative amounts of gross income generated by each transaction.[99] Such compensation would be allocated on the basis of gross income only if an employee contributes to multiple cloud transactions simultaneously.[100]

[97] *Id*.

[98] Prop. Reg. § 1.861-19(d)(3)(iv).

[99] *Id*.

[100] *Id*.

The U.S. source portion of the personnel factor would equal the part of that factor paid for services performed in the United States, as determined under the principles of the time basis rule.[101] Thus, with respect to a cloud transaction, the personnel factor would be determined by multiplying the personnel factor by a fraction, the numerator of which would be the sum of the total compensation paid to the relevant personnel for services performed within the United States, and the denominator would be the total compensation paid to such personnel.[102]

$$\textit{U.S. source portion (personnel factor)} = \textit{Personnel factor} \times \frac{\textit{Direct service personnel compensation (within U.S)}}{\textit{Direct service personnel compensation (total)}}$$

4. Tangible Property Factor

The third factor in the Apportionment Fraction is the tangible property factor. The tangible property factor would equal the sum of (i) the depreciation expense for that taxable year for tangible property owned by the taxpayer and (ii) rental expense for that taxable year for tangible property leased by the taxpayer.[103] Expenses would be included in the tangible property factor only to the extent directly used to provide the cloud transaction.[104] Expenses relevant to more than one cloud transaction during the taxable year would be allocated among the cloud transactions based on relative gross income earned from each cloud transaction.[105] The U.S. source portion of the tangible property factor would equal the part of that factor attributable to property located within the United States.[106]

$$\textit{U.S. source portion (tangible property factor)} = \textit{Tangible property factor} \times \frac{\textit{Depreciation and rental expense for property located within the US}}{\textit{Depreciation and rental expense (total)}}$$

In computing the tangible property factor, taxpayers would be required to determine depreciation expense using the alternative depreciation system described in section 168(g)(2),

[101] Prop. Reg. § 1.861-19(d)(3)(ii).

[102] Treas. Reg. § 1.861-4(b)(2)(ii)(E).

[103] Prop. Reg. § 1.861-19(d)(4)(i).

[104] *Id.*

[105] *Id.*

[106] Prop. Reg. § 1.861-19(d)(4)(ii).

without regard to the election to expense certain depreciable property under section 179 and without regard to any additional first-year depreciation provision.[107]

5. Anti-Abuse Rule

The Proposed Regulations include an anti-abuse rule.[108] First, the rule summarizes the purpose of the Proposed Regulations' source rule in broad terms: "to attribute the source of the taxpayer's gross income from a cloud transaction to the location where the cloud transaction is performed."[109] Then, the Proposed Regulations provide that if a taxpayer enters into, or structures, one or more transactions with a principal purpose of reducing its U.S. tax liability in a manner inconsistent with this purpose, appropriate adjustments will be made so that the source of the taxpayer's gross income reflects the location where the cloud transaction is performed.[110]

IV. Discussion

A. Introduction

Cloud transactions highlight the fundamental tensions between the Code's rules regarding the source of services income and the source of royalties. The source of services income depends on the place of performance, which generally aligns with residence-country taxing rights. The source of royalties depends on where intangible property is used, which aligns with market-country taxing rights.[111] When the Code's source rules were initially adopted in 1921, this stark distinction may have been less remarkable given the lack of technology-intensive services. Today, however, intellectual property is often intrinsic to services being provided and the digitalization of the economy has therefore brought the allocation of taxing rights for cloud transactions and other digital transactions to the fore.

Cloud transactions may be (and frequently are) provided remotely, rely heavily on the use of intangible property, and involve less purely "human" labor than traditional services. Moreover, because they can be provided remotely, cloud transactions may facilitate base erosion. Each of these factors has encouraged market jurisdictions' assertion of taxing rights based on the location

[107] Prop. Reg. § 1.861-19(d)(4)(iii).

[108] Prop. Reg. § 1.861-19(d)(9).

[109] *Id*.

[110] *Id*.

[111] *Supra* note 35.

of end-users through digital services taxes ("**DSTs**"), withholding taxes applied to digital services, equalization levies, and similar unilateral measures.[112]

In response to the proliferation of these unilateral measures, the allocation of taxing rights between source and residence countries has been the subject of ongoing work by the OECD and other multilateral organizations. On October 8, 2021, the OECD/G20 Inclusive Framework (the "**Inclusive Framework**") on Base Erosion and Profit Shifting agreed a two-pillar solution intended to address what it described as the tax challenges arising from the digitalization of the economy.[113] Pillar One is of particular relevance for purposes of this Report.[114] Pillar One would entail a reallocation of primary taxing jurisdiction over profits of large multinational enterprises ("**MNEs**") to jurisdictions in which end-users are located ("**market jurisdictions**"), without regard to the MNEs' physical presence in those jurisdictions. This reallocation would be based on two amounts: Amount A and Amount B.[115] Amount A would provide market jurisdictions a new taxing claim over a portion of the residual profits of the large MNEs.[116] Amount B would provide a simplified approach for applying the arm's length principle to baseline marketing and distribution activities.[117] The two-pillar solution proposed by the Inclusive Framework represents an attempt to allocate taxing rights and reduce double taxation with respect to the digital economy through a multilateral regime, in lieu of the unilateral measures asserting taxing rights with respect to remotely-provided services.

This Report does not take a view on the appropriate allocation of taxing rights between market jurisdictions and residence jurisdictions in the context of cloud (or other) transactions as this is ultimately a question of broad tax policy and international relations rather than a technical issue.

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[112] At least 19 countries have enacted DSTs, including Canada, the United Kingdom, France, Italy, and Spain. The vast majority (with Canada the most notable exception) have agreed to a observe a moratorium on those taxes to allow for multilateral negotiations to proceed. *See* Congressional Research Service, *Canada's Digital Services Act: Issues Facing Congress* (Jan. 6, 2025).

[113] OECD (2021), Tax Challenges Arising from Digitalisation—Report on the Pillar One Blueprint ("**Pillar One Blueprint**"), *available at* http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-onpillar-one-blueprint-beba0634-en.htm.

[114] Pillar Two introduces a book-income based global minimum tax intended to require MNEs to pay a minimum level of tax on their profits. OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS ("**2021 Pillar Two Report**"), OECD, Paris, *available at* http://oecd.org/en/topics/sub-issues/global-minimum-tax/global-anti-base-erosion-model-rules-pillar-two.html.

[115] Pillar One Blueprint at 11.

[116] *Id.*

[117] *Id.*

The Preamble expressly rejected the notion that the location of end-users is relevant to the place-of-performance standard, instead embracing a determination of the location where the taxpayer engages in actual physical activities through personal labor (that is, "people functions") and capital expenditures:

> The Treasury Department and the IRS are of the view that, because of the technical nature of a cloud transaction, the place of performance for purposes of sourcing gross income is the place where the resources and personnel responsible for the development, management, and delivery of the service are located because this is where the key activities in the provision of the service occur, as opposed to ancillary activities such as marketing, sales, and contracting. This approach is consistent with case law on the sourcing of income involving analogous traditional business models where services are provided from a location that differs from the customers' location, specifically, the *Piedras Negras* case. In line with the approach in *Piedras Negras*, the proposed rules do not consider the location of the customer or end-user, as it merely reflects the place where the service is consumed, not where the performance actually takes place as prescribed by sections 861(a)(3) and 862(a)(3).[118]

From a policy perspective, the stark distinction between sourcing income from licenses of intangible property (based on where an end-user makes use of the property) and intangible property enabled services has disadvantages. Although we acknowledge that some important substantive distinctions exist between true licenses and service arrangements, it will inevitably create systemic pressure by treating very differently for tax purposes transactions that may reflect substantial commercial similarities. *Piedras Negras*, while the primary authority in this area, is a single case, and the dissenting opinion would have considered the location of the taxpayer's service recipients to determine where the services were performed.[119] Furthermore, section 863(b) contemplates a general apportionment formula without limiting the inputs to that formula. Nonetheless, this Report takes as given the underlying premise of the Proposed Regulations that the location of end-users should not be relevant in the context of the Code's place of performance standard. We do, however, observe some of the consequences of that premise and the resulting approach, in Part IV.B.

B. Determining Where Intangible Property is Located

A central feature of the Proposed Regulations is that they require taxpayers to determine a cloud transaction's place of performance by reference to the location of intangible property. The rationale for doing so is straightforward: cloud transactions involve heavily automated processes that are enabled by software and other intangible property. Moreover, many cloud service providers

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[118] 90 Fed. Reg. 3075, 3076-77. *Citations omitted.*

[119] 127 F.2d at 261.

expend substantial resources on the development of intangible property. Research and experimentation activity is the most significant day-to-day business activity of many cloud service providers. Moreover, although authority on the place-of-performance standard is limited, that limited precedent does take into account the location of assets that enable the provision of a service.[120] Nonetheless, treating intangible property as an asset used to provide a service raises fundamental issues.[121]

By virtue of being "intangible," intangible property has no obvious (or, perhaps, no inherent) physical location.[122] As a result, the Proposed Regulations adopt a new proxy for the location of intangible property: the location of R&E personnel.[123] One might argue that treating intangible property as located where R&E occurs conflates capital investment or the creation of an asset with the deployment of the asset itself in performing a service. For example, a doctor who attends medical school outside the United States builds a knowledge base that is akin to intangible property that the doctor uses to treat patients. If the doctor treats patients in the United States after graduating from medical school, the development of that knowledge base plays no role in determining the source of the doctor's income from providing services in the United States. (On the other hand, the federal income tax system generally does not treat human capital as a distinct asset, which is not true of intellectual property.) Similarly, in *Piedras Negras*, the Fifth Circuit's majority opinion did not consider where the taxpayer's radio broadcast equipment was manufactured. By analogy, one may question whether the place where intangible property is created should determine where that intangible property is deemed to be deployed.

Furthermore, there is an unavoidable tension between the 2025 Final Regulations' classification of all cloud transactions as a service, on the one hand, and the Proposed Regulations' attempt to identify the contribution of intangible property to a cloud transaction, on the other hand. This approach leads to the result that the source of a taxpayer's economic return on intangible property will differ depending on how a taxpayer exploits that intangible property.

> Example 1. Cloud service provider. USP, a domestic corporation, earns $500 from providing cloud services in a single transaction to a foreign customer in a taxable

[120] 127 F.2d at 260-61.

[121] This issue is not unique to cloud transactions. Indeed, as technologies continue to develop, many service providers will continue to automate portions of the service that they provide, integrate technology, and rely more heavily on embedded intangible property. On the other hand, cloud transactions and other digital services may be unique in the extent to which the core intangible property is synonymous with the service itself.

[122] *See generally* 90 Fed. Reg. at 3077-78. Similar issues arise under section 865(d)(3), which determines the source of gain from goodwill based on the country in which the goodwill "was generated." In some instances, it can be difficult to determine whether that occurred where a taxpayer's customers are located or where the taxpayer's activity took place.

[123] Prop. Reg. § 1.861-19(d)(2).

year. USP's expenses relating to the cloud transaction for the taxable year are as follows:

Intangible property factor
U.S. R&E personnel ……$65
Royalties……...…….....$5

Personnel factor
U.S. direct service personnel……$12
Foreign direct service personnel……..……...$8

Tangible property factor
U.S. server lease…….....$6
Country X server lease……...$4

Under the Proposed Regulations, USP's intangible property factor would equal $70, with the U.S. source portion of the intangible property factor equal to $70.[124] USP's personnel factor would equal $20, with the U.S. source portion of that factor equal to $12.[125] The tangible property factor would equal $10, with the U.S. source portion equal to $6.[126] Accordingly, USP's Apportionment Fraction would be $88/$100.[127] Thus, $440 of USP's gross income ($500 multiplied by the $88/$100) would be U.S. source income and $60 ($500 minus $440) would be foreign source income.

Example 2. Cloud technology licensor. US1 spends $70 on R&E expenditures in Year 1, comprised of $65 paid to R&E personnel located in the United States and $5 related to a royalty payment. US1 licenses intangible property to US2 for $160. US1 and US2 are not members of the same consolidated group. US2 earns $500 from providing cloud services in a single transaction to a foreign customer in a

[124] The U.S. source portion of the intangible property factor would equal the intangible property factor multiplied by a fraction, the numerator of which is total compensation paid to R&E personnel for services performed within the United States ($65) and the denominator of which is total compensation paid to R&E personnel ($65). Accordingly, the U.S. source portion of the intangible property factor would be $70, or $70 multiplied by $65/$65. Prop. Reg. § 1.861-19(d)(2).

[125] Prop. Reg. § 1.861-19(d)(3).

[126] Prop. Reg. § 1.861-19(d)(4).

[127] The numerator of the Apportionment Fraction would be the sum of the U.S. source portion of the factors ($88, which is the sum of $70, $12, and $6) and the denominator would be the sum of all three factors ($100, which is the sum of $70, $20, and $10). Prop. Reg. § 1.861-19(d)(1).

taxable year. US2's expenses relating to the transaction for the taxable year are as follows:

Intangible property factor
Foreign R&E personnel ……..……..……..$10
Royalties……...…….$160

Personnel factor
U.S. direct service personnel……$12
Foreign direct service personnel……..……...$8

Tangible property factor
U.S. server lease…….....$6
Country X server lease……...$4

US1 earns royalty income rather than services income, and thus would not be subject to the Proposed Regulations. Assume that under section 862(a)(4), all $160 of US1's gross income is foreign source income.[128]

Under the Proposed Regulations, US2's intangible property factor would equal $170, with the U.S. source portion of the intangible property factor equal to $0.[129] US2's personnel factor would equal $20, with the U.S. source portion of that factor equal to $12.[130] The tangible property factor would equal $10, with the U.S. source portion equal to $6.[131] Accordingly, US2's Apportionment Fraction would be $18/$200.[132] Thus, $45 of US2's gross income ($500 multiplied by $18/$200) would be U.S. source income and $455 ($500 minus $45) would be foreign source income.

These examples illustrate that, under the Proposed Regulations, taxpayers engaged in substantially comparable activities could face notably different sourcing outcomes depending on

[128] *But see* FSA 200222011 (May 31, 2002).

[129] The U.S. source portion of the intangible property factor would equal the intangible property factor multiplied by a fraction, the numerator of which is total compensation paid to R&E personnel for services performed within the United States ($0) and the denominator of which is total compensation paid to R&E personnel ($10). Accordingly, the U.S. source portion of the intangible property factor would be $0, or $170 multiplied by $0/$10. Prop. Reg. § 1.861-19(d)(2).

[130] Prop. Reg. § 1.861-19(d)(3).

[131] Prop. Reg. § 1.861-19(d)(4).

[132] The numerator of the Apportionment Fraction would be the sum of the U.S. source portion of the factors ($18, or the sum of $0, $12, and $6) and the denominator would be the sum of all three factors ($200, or the sum of $170, $20, and $10). Prop. Reg. § 1.861-19(d)(1).

whether they license intangible property to support a cloud service or use the intangible property to provide a cloud service. This difference is more pronounced when the incremental expenditures necessary to utilize intangible property to provide a service (that is, those expenditures that comprise the personnel factor and the tangible property factor) are comparatively low because these functions are more routine. Given the substantial investment cloud service providers make in R&E expenditures, this may often be the case. Furthermore, among related parties, it will often be possible to adopt a business model under which one party develops and owns intangible property and licenses it to affiliates that contract with customers. (It is less likely in practice that a taxpayer would be willing to license critical intangible property to unrelated persons.)

Regardless of the extent to which the activities of the taxpayers in Example 1 and Example 2 are truly comparable, it is far from clear what one should infer from this discrepancy. Under one view, the Proposed Regulations' approach bears some similarity to bifurcating cloud transactions between a service and an implicit license for the use of the intangible property necessary to effect cloud transactions. Despite this, the rules for determining the source of income from this implicit license do not align with the Code's rules for determining the source of royalty income. A contrary view is that the discrepancy highlights a shortcoming in the Code's source rule for royalties.[133] Under this view, sound tax policy dictates that the source of royalty income should similarly be determined by reference to (or at least reflect) the location where resources and labor occurred to develop the intangible property.

Yet another perspective would be that there is no inherently "correct" source outcome in this context; that is, both source (or end-user) and residence countries have reasonable claims with respect to the right to tax the economic return on intangible property, however that return is

[133] *See* Paul Oosterhuis, *Revisiting an Age-Old Issue: What Taxes Should Be Treated as Income Taxes?*, Tax Notes Federal, Vol. 113, 471, 473 (Jan. 22, 2024) ("Tracing back to the development of income taxes after World War I, many countries treated rents as sourced at the location of the property, based on the location of tangible property. Royalties tagged along with rents. Services were sourced where performed, also based on clear physical nexus considerations. The sourcing rules for rents back then made intuitive sense … But royalties are different than rents. They require no physical presence; any presence is best described as legal, which is not a presence that otherwise matters for income taxation.") (citations omitted); UF Incubator, *Considerations for Reforming the U.S. Source of Income Rules*, Tax Notes Int'l, Vol. 115, 333, 342 (Jul. 15, 2024) ("More fundamentally, the rationale for treating royalties as sourced in the jurisdiction of use rather than the jurisdiction where the royalty is beneficially received (typically where the licensed IP is developed or owned) is questionable. Surely the jurisdiction where development costs are incurred should have some primary right to tax the resulting income from development efforts. Nonetheless, sourcing based on the location of use, or more generally on the location of the royalty payer, has been the international consensus going back to the League of Nations model treaty and has been U.S. law since 1921."); Michael Graetz, Tax Notes International, *Sovereignty, Sins, and the Reassertion of Primary Taxing Rights by the United States*, Vol. 117, 1031, 1038 (Feb. 24, 2025) ("The source rule for royalties, when first enacted in 1921, was not analyzed by Treasury or Congress separately from rents. It is simply a historical accident—another original sin—whose time has passed.").

realized. Under this view, approaches to bridge those competing claims should include multilateral solutions such as those discussed in Part IV.A, or apportionment methods that take into account end-users' locations. For example, most U.S. states have adopted formulary apportionment for determining how much of a corporation's income is subject to the state's corporate income tax. A traditional three-factor apportionment formula assigned equal weight to sales, property, and payroll factors, although some states have altered the formula or adopted a single-factor approach.[134] An even more straightforward approach may be to simply treat some stated percentages of cross-border cloud services income as U.S. source income and foreign source income.[135]

Given the critical role intangible property plays in cloud services, we believe that determining the source of income from a cloud transaction by reference to intangible property is appropriate, and therefore we agree that final regulations should retain the intangible property factor as part of the Apportionment Fraction. Any method for determining the location of intangible property will necessarily be a surrogate, because intangible property has no corporeal form or apparent physical location. Consider several potential proxies for the location of intangible property:

- The residence of the cloud service provider;
- The location of end-users;
- The location of the servers used to provide the service; and
- The location of R&E personnel and the location of resources used to create intangible property.

Among these, the location of R&E personnel (and other assets used to create intangible property) is arguably the most reasonable proxy for determining where intangible property is located and used to perform a service. A standard based on the residence of the service provider would be manipulable and a poor measure for the economic activity necessary to generate the income from cloud transactions. A cloud service provider organized anywhere in the world can provide cloud services globally while licensing intangible property, employing individuals from other countries, and leasing servers.

As discussed in Part IV.A, under the Code, the location of an end-user is not generally relevant for determining where the activity of a service provider has taken place, and this Report does not express a view as to whether section 863(b) is sufficiently open-ended as to permit the location of end-users to be taken into account. The Report also takes as given the conclusion of

[134] Ara Stepanyan, Evan Cohen, & Margaret McKeehan, *An Empirical Economic Framework for State Tax Corporate Apportionment*, Tax Notes State (Jul. 17, 2023).

[135] *See supra* note 43.

the 2025 Final Regulations that cloud transactions are best viewed as services rather than leases or licenses, as discussed above.

There is some logic to treating intangible property as being located in the same location as the tangible property used to deploy that intangible property: software runs on servers, for example. However, this approach fails to give due weight to a taxpayer's key functions relating to the intangible property itself.

By contrast, using the location of R&E personnel and resources used to develop intangible property as a proxy for the location of intangible property aligns the location of that intangible property with the key "people functions" and resources necessary to create and enhance the intangible property. In an industry in which technological advances are constant, the consistent improvement of intangible property deployed in cloud transactions is central to the service itself. Thus, the location of R&E personnel and resources used to develop intangible property appears to be the best proxy for the location of intangible property, because it best captures where a taxpayer undertakes much of the economic activity necessary to perform a cloud service. We do note however that, as with any proxy, it is imperfect. For example, if a cloud service provider acquires another company (or the assets of another company) in order primarily to obtain exclusive rights to its existing valuable intangible property, the location of the acquiring taxpayer's R&E personnel, at least in the short run, may have a somewhat attenuated relationship to the value of the intangible property being used and where that was created. On the other hand, if the particular intangible property is of core importance to the service being provided, given rapid evolution of new intangible property and competition in the sector, presumably one could expect the taxpayer to undertake extensive ongoing R&E investment through its R&E personnel in enhancing and maintaining the value of the acquired intangible property.[136]

[136] Another issue raised by this approach is the difficulty in reconciling the Proposed Regulations' approach with the rules for allocating and apportioning deductions for R&E expenditures. Under Treas. Reg. § 1.861-17, R&E expenditures are allocated to a broad class of income termed "gross intangible income," which generally includes all gross income earned by a taxpayer that is attributable to a sale or license of intangible property and gross income from sales or leases of products or services if the income is derived directly or indirectly (in whole or in part) from intangible property. Treas. Reg. § 1.861-17(b)(2). Gross intangible income excludes dividends, or any amounts included in income under sections 951, 951A, or 1293. *Id.* Then, the expenditures are apportioned among statutory and residual groupings (for example, U.S. and foreign source income) by reference to gross receipts in the respective statutory or residual groupings relating to the gross intangible income. Treas. Reg. § 1.861-17(d). (For section 904 purposes, if more than half of a taxpayer's R&E expenditures are performed in the United States or outside the United States, half of the taxpayer's R&E expenditures are apportioned to U.S. source income or foreign source income. Treas. Reg. § 1.861-17(c).) Treasury adopted this approach because "research and experimentation is an inherently speculative activity, […] findings may contribute unexpected benefits, and […] the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and

C. The Apportionment Fraction

This Part IV.C considers the composition of the Apportionment Fraction. As described in Part IV.A, the Preamble states that the premise underlying the Apportionment Fraction is that the place of performance with respect to cloud transactions is the place where "resources and personnel responsible for the development, management, and delivery of the service are located."[137] But the Preamble includes comparatively little commentary as to what motivated the relative weight assigned by the Apportionment Fraction to the factors and their inputs. It notes that Treasury preferred an administrable rule that "recognizes the economic contribution of" intangible property but does not provide detail as to precisely how Treasury conceived of that economic contribution.[138] As discussed in the following section, we believe there are different ways to conceive of intangible property's economic contribution to a cloud services transaction.

1. Composition of the Apportionment Fraction

In evaluating the appropriateness of the Apportionment Fraction's composition, different policies may support different approaches. Consider two different models: a "**relative-value model**," which attempts to estimate the relative contributions to value that property (tangible and intangible) and other inputs (service delivery personnel) provide in the delivery of a cloud transaction. This model would emphasize the relative values that an objective third party would assign to the components of a cloud transaction. In contrast, an "**activity model**" would focus on identifying where labor and resources have been expended rather than measure the value that they respectively contributed to the aggregate value of the service delivered.

In many respects, the Proposed Regulations appear more aligned with the activity model than the relative-value model. Under the Proposed Regulations, taxpayers may not weigh the respective contributions to value of intangible property, personnel, or tangible property using the relevant facts and circumstances. Rather, the Proposed Regulations simply sum certain costs and expenses associated with each factor. This approach may undervalue the contribution of intangible property in many cloud transactions, because intangible property often may have appreciated significantly in value since its creation when other inputs and assets used to deliver cloud services have not. Arguably, this approach follows from Treasury's view that the place of performance must be determined by reference to "the place where the resources and personnel responsible for the development, management, and delivery of the service are located."[139] That is, the Proposed Regulations are premised on the notion that the place of performance is measured by reference to

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experimentation." Treas. Reg. § 1.861-17(b)(1). Nonetheless, the Proposed Regulations effectively treat that very same inherently speculative activity as a direct proxy for the performance of a cloud service itself.

[137] 90 Fed. Reg. at 3077.

[138] *Id.*

[139] *Id*. at 3076.

activities and expenditures of a taxpayer without regard to the extent to which any particular activity or expenditure contributed to the service.

Nonetheless, we believe that a place-of-performance standard does not preclude assigning relative values to the inputs to a service, and such an approach would more accurately capture the degree to which a taxpayer's labor and investment contribute to the resulting income. In addition to being more accurate, this approach may also limit manipulation as both the location of tangible property and the location of service delivery personnel may be more mobile (today) than the location of R&E personnel.

However, we acknowledge that determining the relative value of various inputs would be difficult. While facts and circumstances or the principles of section 482 could theoretically be employed to assign weights to each factor, doing so would be challenging for taxpayers and the IRS, increase controversy, and reduce certainty.[140] Despite these challenges, we believe final regulations could adopt changes to the Apportionment Fraction to better measure the contributions of each factor to the provision of a cloud service. If, for example, Treasury believes that intangible property is a more significant input than the other factors (and relative expenses incurred imperfectly measure that relative significance), the Apportionment Fraction could assign greater weight to that factor (for example, by doubling the intangible property factor for all taxpayers, or by requiring that it account for no less than a stated percentage of a taxpayer's expenditures and scaling back the other factors as needed to reach the appropriate percentage).

An alternative approach would be to determine the portion of a taxpayer's gross cloud services income attributable to a return on intangible property by assigning a limited, assumed return to tangible property and/or service delivery personnel. This approach would be consistent with existing approaches to measuring intangible income under other international provisions of the Code.[141] Under current law, a domestic corporation is entitled to a 37.5 percent deduction with respect to its foreign-derived intangible income ("**FDII**").[142] Furthermore, a United States shareholder of a controlled foreign corporation must include in its gross income an amount equal to the shareholder's global intangible low-tax income ("**GILTI**").[143] Thus, each regime applies special rules to a taxpayer's return on intangible property. Under each regime, a taxpayer must first

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[140] *Cf.* Treas. Reg. § 1.482-7 (providing, in the context of determining controlled parties' respective shares of intangible development costs, that those costs must be shared in proportion to the parties' shares of reasonably anticipated benefits associated with the cost sharing arrangement).

[141] This approach would also be consistent with the determination of top-up tax liability for purposes of Pillar 2. Generally, a top-up tax liability is determined after computing net GloBE income, which is an amount in excess of a specified return on certain tangible assets and payroll expenditures (referred to as the "substance-based income exclusion" or "SBIE"). *See* 2021 Pillar Two Report at Art. 5.2.2 & 5.3.

[142] I.R.C. § 250(a)(1)(A).

[143] I.R.C. § 951A(a).

determine its "deemed tangible income return," and the remainder of the relevant income is presumptively treated as a return on intangible property.[144] For both FDII and GILTI purposes, the deemed tangible income tax return is an amount equal to 10 percent of qualified business asset investment ("**QBAI**"), which generally includes the average of the aggregate of the adjusted bases in certain tangible property used in the production of the relevant income.[145]

Treasury could consider adopting a conceptually similar approach for cloud services. Under one approach, the personnel factor and the tangible property factor with respect to a cloud transaction would be multiplied by a specified percentage, such as 110 percent. The source of gross income from the cloud transaction up to the resulting amount would be determined solely by reference to a fraction based on the personnel factor and the tangible property factor (rather than QBAI). The source of any gross income in excess of that amount would be determined solely by reference to the intangible property factor. This approach would be more administrable than an approach that would require the application of section 482 or similar principles but may be more accurate than the Proposed Regulations in weighing the value of each factor's contribution to a cloud service transaction. Furthermore, it would better differentiate between taxpayers whose services derive more or less value from intangible property.

2. Incentives

Independent of what the Apportionment Fraction is intended to capture, consideration should be given to its effects. As a general matter, it is often difficult to formulate a rule on source (other than a rule based on the location of the place of use by a consumer) that does not affect (and arguably distort) commercial decisions about where and how production will occur. The U.S. source portion of the intangible property factor and the personnel factor increases with compensation paid to employees located in the United States. The U.S. source portion of the tangible property factor increases when tangible property within the United States is acquired or leased. Thus, the Apportionment Fraction tends to disincentivize taxpayers from incurring additional compensation or capital expenditures in the United States as opposed to a foreign country.

We recognize that many elements beyond tax influence a taxpayer's decision as to where to hire R&E personnel and direct service delivery personnel. Similarly, technical and practical considerations influence a taxpayer's decisions as to where tangible property, including servers, should be located. Nevertheless, the Proposed Regulations' effects on production decisions are an unavoidable consequence of adopting the place-of-performance standard.

[144] I.R.C. §§ 250(b)(2) & 951A(b)(1)(B).

[145] I.R.C. §§ 250(b)(2)(B) & 951A(d).

3. Current-Year Expenses

Each of the factors relies on inputs that relate to a single year.[146] We recommend that the final regulations adopt a multi-year formula that averages each of the three factors and their respective U.S. source portions over a specified number of prior years, such as the prior three years. This approach is preferable to the Proposed Regulations' approach for several reasons. First, as is true for many transactions, the technology involved in a cloud transaction is often the product of multiple years' efforts, with incremental improvements building on existing technology. Accordingly, prior years' inputs (particularly the inputs into the intangible property factor) would often be relevant to current-year cloud transactions. Second, the use of a multi-year average would promote more consistency and predictability. Third, single-year non-ordinary course transactions will often have a multi-year impact. For example, large one-time R&E expenditures, bonuses, and other expenses may be significant in a particular year but provide multi-year benefits. Finally, using a multi-year approach would limit taxpayers' ability to distort the formula in a particular year.

The number of years and approach to each factor need not (and arguably should not) necessarily be the same. For example, the time lag between the incurrence of R&E expenditures and realization of corresponding income may be much more significant than in the case of some direct personnel activities and expenditures or use of tangible property. As a consequence, it may be appropriate to use a longer period for the intangible property factor than the other factors. On the other hand, there is some countervailing administrative benefit to simplicity.

Treasury could adopt a multi-year approach that includes current-year inputs, but we believe that consideration should be given to whether current year inputs should be taken into account at all, in particular for the intangible property factor. If current-year inputs (determined based on a complete year) are relevant, the source of cloud transaction income will only be determinable with certainty following the end of the applicable year. There are also generally practical delays as an accounting matter before a period's expenditures or other inputs can be determined and reported with finality. Therefore, we believe that the Apportionment Fraction should only take into account inputs for prior years. This approach would promote greater certainty. Moreover, as the existing Apportionment Fraction inputs are in any event used as a proxy in establishing where the aggregate cloud service is "performed," this should not materially undermine the Proposed Regulations' conceptual approach. It would also align cloud services income with many other forms of gross income, for which source must be determinable at the time

[146] As described in Part III.D, each of the factors generally takes into account certain expenses that are deductible in the current year. The intangible property factor takes into account a taxpayer's current-year R&E expenditures incurred, without regard to whether these are currently deductible. Prop. Reg. § 1.861-19(d)(2)(i).

the income accrues.[147] Finally, Congress has adopted similar standards recently, including for purposes of determining whether a taxpayer is an applicable corporation under section 59(k) or an applicable taxpayer under section 59A(e).[148]

A test incorporating prior years should include rules addressing short periods, major acquisitions or dispositions (including acquisitions or departures of members of a consolidated group),[149] transition periods,[150] and taxpayers that were not in existence for prior years.[151]

4. Determining the U.S. Source Portion of the Intangible Property Factor

We recommend that changes be made to the Proposed Regulations' approach to determining the U.S. source portion of the intangible property factor. With respect to a cloud transaction, the intangible property factor would be comprised of a large pool of costs and expenses, including R&E expenditures and the taxpayer's amortization and royalty expense for intangible property to the extent directly used to provide the cloud transaction. R&E expenditures for this purpose include compensation for R&E personnel, but they are not limited to such compensation. Generally, "research or experimental expenditures" include all such costs incident to the development or improvement of a product or a component or subcomponent of the product,

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[147] This is particularly critical insofar as source affects FDAP withholding. For example, when the source of income depends on the residence of the payor, a taxpayer generally is able to determine the source of the income ahead of time. On the other hand, under the time basis rule, a taxpayer may not be able to determine the precise balance of U.S. and foreign source income with respect to services income provided within and without the United States until the close of the year. Treas. Reg. § 1.861-4(b)(2)(ii)(E).

[148] For purposes of the corporate alternative minimum tax, an applicable corporation is any corporation other than an S corporation, a regulated investment company (a "**RIC**"), or a real estate investment trust ("**REIT**") that meets one of the average annual financial statement income tests under section 59(k)(1)(B) for one or more taxable years that (i) are *prior to that taxable year* and (ii) end after December 31, 2021. I.R.C. § 59(k)(1)(A). For purposes of the base erosion anti-abuse tax, an applicable taxpayer is a corporation other than a RIC, REIT, or an S corporation, the average annual gross receipts of which *for the 3-taxable-year period ending with the preceding taxable year* are at least $500,000,000 with a base erosion percentage of at least 3 percent (or 2 percent for certain banks and securities dealers). I.R.C. § 59A(e).

[149] As discussed in Part IV.G, *infra*, this Report recommends that members of a consolidated group should be treated as a single taxpayer for purposes of determining the source of cloud services income.

[150] Transition rules permitting the use of estimates, or truncated measurement periods, would be appropriate in any initial years during with final regulations applied. For example, if final regulations required a three-year look-back period, it may be appropriate to allow taxpayers to use reasonable estimates or to rely solely on one year of pre-applicability date information.

[151] *Cf.* Treas. Reg. § 1.59A-2 & Prop. Reg. § 1.59-2.

as well as the costs of obtaining a patent.[152] They may include certain attorneys' fees,[153] certain materials,[154] as well as amounts paid to subcontractors for research and experimentation services.[155] However, the U.S. source portion of the intangible property factor would be based solely on the relative compensation paid to R&E personnel that are employed by a taxpayer.[156] Thus, even though expenses may form part of the intangible property factor and may have a clear and direct factual connection to a particular location, they would be assigned to the U.S. or non-U.S. source portion of the intangible property factor by reference to the location of R&E personnel.[157]

> Example 3. Non-R&E personnel compensation expenses. USP, a domestic corporation, provides cloud services to customers. In a taxable year, USP earns gross income from a cloud transaction with a customer located in Country Y. USP's relevant expenses for the taxable year with respect to the cloud transaction are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel ……$35
> Country X R&E personnel……...$35
> Country X computer hardware…….....$10
> Country Y patent expenses……...$20
> **Total…….....$100**
>
> USP's intangible property factor would equal $100, and the U.S. source portion of USP's intangible property factor would equal $50, determined as follows:[158]

[152] Treas. Reg. § 1.174-2(a)(1); Notice 2023-63, § 2.01(1).

[153] *Id*.

[154] *See* Treas. Reg. § 1.174-2(a)(11).

[155] Treas. Reg. § 1.174-2(a)(10) & (b)(3); Notice 2023-63, § 2.01(1).

[156] Prop. Reg. § 1.861-19(d)(2)(ii).

[157] In certain instances, a taxpayer may not employ any R&E personnel because it licenses or acquires intangible property, or because it subcontracts all research and experimentation activity to related or unrelated persons. In those instances, the Proposed Regulations would multiply the intangible property factor by a fraction, the numerator and denominator of which would both equal zero (an undefined number). *See* Prop. Reg. § 1.861-19(d)(2)(ii). The Proposed Regulations provide no guidance as to how to determine the U.S. source portion of the intangible property factor in those instances.

[158] Prop. Reg. § 1.861-19(d)(2).

$$\$50 \text{ U.S. source portion} = \$100 \text{ Intangible property factor} \times \frac{\$35 \text{ R\&E personnel compensation (within U.S)}}{\$70 \text{ R\&E personnel compensation (total)}}$$

Example 3 illustrates that although USP may be able to establish a factual connection between an expense that is taken into account as part of the intangible property factor, the Proposed Regulations would not permit that location to be taken into account in determining the U.S. source portion of the intangible property factor. In Example 3, computer hardware expenses are directly related to, and incurred in, Country X. Similarly, the Country Y patent expenses presumably relate to USP's conduct of business specifically in Country Y. However, the Proposed Regulations would apportion each of these expenses by reference to the location of USP's R&E personnel. This would be true even if those expenses may be reflected on the books and records of a foreign branch or foreign disregarded entity or directly relate to a foreign activity.

The Preamble indicates that the location of R&E personnel is a "logical and accurate" proxy for the location of intangible property for several reasons. First, the Preamble notes the importance of R&E personnel to the development of intangible property.

> [T]he research and experimentation personnel contribute to the creation, design, and refinement of the intangible property either through their own efforts or by managing and facilitating research and experimentation work carried out by third parties. Therefore, the value of the intangible property used to provide the cloud transaction depends on their personal efforts and expertise.[159]

This statement, by itself, does not provide an adequate basis for declining to determine where other expenses have been incurred. Furthermore, while we acknowledge the logic of using this proxy, we question its accuracy. The contribution of R&E personnel to the creation, design, and refinement of intangible property is often a crucial factor in the value of intangible property, but an underlying premise of the Proposed Regulations is that they are not the only factor. The Proposed Regulations include other expenses in the intangible property factor, presumably, because those expenditures meaningfully contribute to creating the value of the intangible property and failing to reflect them in Treasury's view could distort the source of cloud transactions. If so, from the standpoint of their contribution to creating intangible property value, there is no good reason to ignore these expenditures for purposes of determining the U.S. source portion of the intangible property factor.

[159] 90 Fed. Reg. at 3078.

Next, the Preamble indicates that basing the U.S. source portion of the intangible property factor solely on the location of R&E personnel is more easily administrable, in part because it can be more easily determined.

> [W]hile intangible property does not have a physical form that can be easily located, the place where research and experimentation personnel operate is tangible and verifiable. Relatedly, taxpayers generally know or should know the location of their research and experimentation personnel, and thus, relying on the location of these personnel would avoid a burdensome compliance process that might otherwise be required to determine the location of intangible property used to provide cloud transactions. For similar reasons, in determining gross income of a taxpayer, the rule does not look to research and experimentation personnel other than those of the taxpayer, and uses the taxpayer's own personnel as a proxy for all research and experimentation personnel working on the relevant intangible property.[160]

Administrability is a more compelling policy reason to ignore for this purpose expenses whose location is not readily determinable. It is true that the location of R&E personnel will frequently be readily determinable.[161] On the other hand, the location in which other expenses are incurred will also often be readily determinable. For example, costs associated with materials and other tangible property taken into account as an R&E expenditure have a verifiable physical location. Other costs, such as the Country Y patent expenses incurred in Example 3, bear a clear factual relationship to a particular jurisdiction.

Certain other expenses that form part of the intangible property factor would often have a less clearly defined relationship to a particular location. In other cases, it would be more difficult for a taxpayer to determine the relevant location. For example, a taxpayer that licenses intangible property may include royalty expenses in the intangible property factor. As a theoretical matter, the location in which the licensed intangible property was developed may (or may not)[162] be relevant to determine the U.S. source portion of the intangible property factor in that fact pattern. If it is relevant, a taxpayer may nonetheless be unable to make that determination or obtain the relevant information from the licensor.[163]

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[160] *Id*.

[161] *See* Part IV.C.4.

[162] Arguably, the source of the licensor's royalty income would be an equally appropriate way to determine where the licensed intangible property is used by the licensee in providing a service. *Cf.* I.R.C. §§ 861(a)(4) & 862(a)(4).

[163] On the other hand, while that determination presents administrative challenges, the Proposed Regulations would give rise to similar administrative challenges in many fact patterns, most notably in situations involving branches. *See* Part IV.D.

We recommend that to the extent that there is a demonstrable and objectively determinable factual connection between an expense and a specific jurisdiction, the formula for determining the U.S. source portion of the intangible property factor take such location into account. This approach could be implemented in a number of different ways. A taxpayer could make the relevant determination based on all relevant facts and circumstances, applying the principles of existing rules on the allocation and apportionment of expenses.[164] Taxpayers have extensive experience with the allocation and apportionment of expenses under existing Treasury regulations, which require taxpayers to allocate deductions to classes of gross income to the extent that they are "definitely related" to a class of gross income,[165] and then to apportion among classes in a manner that "reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income."[166]

In the context of determining the U.S. source portion of the intangible property factor, expenses would be allocated to jurisdictions rather than to classes of gross income, but the underlying principles would remain the same; in this context, a factual relationship between an expense and a location would need to be established. If a taxpayer could not establish the necessary factual relationship between an expense and a location, the expense could be apportioned based on the location of all other expenses taken into account as part of the intangible property factor or based on the Proposed Regulations' current approach (that is, apportioned based on the location of R&E personnel). Furthermore, final regulations could deem certain types of expenses to be *per se* unrelated to any specific location. This could include both expenses for which establishing a factual connection presents conceptual difficulties (such as royalties), factual difficulties (such as fees paid to unrelated subcontractors), or both.

This approach could be subject to safeguards, including documentation and substantiation requirements. For example, final regulations could provide that when a taxpayer fails to maintain adequate contemporaneous documentation substantiating the factual connection between an expense and a foreign jurisdiction, the U.S. source portion of the expense is determined by reference to the U.S. source portion of the remaining expenses. This could occur automatically or at the discretion of the IRS.

Alternatively, final regulations could adopt a books-and-records approach. Similar rules have been adopted in the context of the dual consolidated loss ("**DCL**") and foreign currency branch regulations (the "**section 987 regulations**"). Those rules attribute deductions and losses reflected on books and records to separate units (in the case of the DCL regulations) or section 987

[164] *See* Treas. Reg. §§ 1.861-8 and 1.861-8T.

[165] Treas. Reg. § 1.861-8(b)(1).

[166] Treas. Reg. § 1.861-8T(c)(1).

qualified business units (in the case of the section 987 regulations).[167] Under this approach, any expenses taken into account as part of the intangible property factor that were reflected on the books and records of a legal entity (or a taxable unit)[168] would be attributable to the jurisdiction in which the legal entity (or taxable unit) is resident. Any such rule would require safeguards. For example, to decrease the U.S. source portion of its intangible property factor, a domestic corporation would be able to capitalize a foreign disregarded entity in a low-tax jurisdiction, license or purchase intangible property through the disregarded entity, and cause the foreign disregarded entity to sub-license the intangible property to the domestic corporation. Rules reattributing expenses in the case of disregarded payments would be necessary to prevent manipulation of the intangible property factor under this approach.

5. Location of Personnel

Both the intangible property factor and the personnel factor would require a determination of the location of a taxpayer's employees when they perform certain tasks relating to cloud transactions.[169] The Preamble describes the advantage of rules based on the location of taxpayers' employees as being that taxpayers generally know or should know the location of their personnel.[170] As a general matter, this is true. However, taxpayers' employees frequently travel for both business and personal reasons, often working remotely.[171] Tracking the precise location of employees at all times presents difficult compliance burdens that would, to an extent, undermine the administrative advantages of using the location of personnel to determine the U.S. source portion of the intangible property factor and the personnel factor.

To address this, final regulations should include a limited exception that would deem an employee to be located in the United States or outside the United States for the entire taxable year if certain conditions are satisfied. This test could be formulated in a number of different ways, and it could include both a percentage requirement and a numerical limitation. For example, the test could provide that if an employee spends at least 90 percent of the employee's time in the United States and does not work outside the United States for more than 10 consecutive business days, the employee would be deemed to spend the entire taxable year within the United States. A similar rule would apply for employees based outside the United States.

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[167] Treas. Reg. §§ 1.987-2(b)(2) & 1.1503(d)-5(c)(3); *see also* Prop. Reg. § 1.954-1(d)(1)(iv)(B) (allocating expenses by reference to books and records for purposes of the section 954(b)(4) high-tax exception).

[168] *See* Treas. Reg. § 1.861-20(d)(3)(v)(E)(*9*).

[169] Prop. Reg. § 1.861-19(d)(2)(i) & (d)(3)(i).

[170] 90 Fed. Reg. at 3078.

[171] As is well-documented, remote work has increased significantly in recent years and may be particularly prevalent in this context.

6. Tangible Property Factor

We recommend two changes to the tangible property factor. First, the tangible property factor includes only (i) the depreciation expense for a taxable year for tangible property owned by the taxpayer and (ii) rental expense for a taxable year for tangible property leased by the taxpayer.[172] Taxpayers may incur other expenses necessary to operate tangible property, including electricity costs, permitting costs, and other current expenses that may not be capitalized and depreciated, but would nonetheless be crucial to the operation of the tangible property in connection with cloud transactions. We recommend that such critical costs be included in the tangible property factor.

Second, there may frequently be practical difficulties in associating expenses included in the tangible property factor with a particular cloud transaction. While a taxpayer often would or should know where tangible property that it owns is located, it may be less likely to know where leased property, including a server, is located.[173] Furthermore, for taxpayers with an extensive array of tangible property, associating specific tangible property with specific transactions may be impractical in some instances. Final regulations should provide that when a taxpayer cannot determine the location of tangible property with respect to a particular cloud transaction with precision, the taxpayer can apply a reasonable allocation methodology. Reasonable methodologies may include the location of end-users, because the location of end-users is more likely to serve as a reasonable proxy for the location of tangible property than it does for other expenses (such as direct service personnel compensation).

D. Branch Distortions

Under current law, taxpayers determine where a service is performed separately with respect to each transaction. For example, a consultant may spend 200 hours performing a service for one client (Client A) outside the United States and 300 hours performing a service for a different client (Client B) within the United States. The consultant's services income attributable to Client A would be foreign source income and her services income from Client B would be U.S. source income.[174]

Although the Proposed Regulations would nominally determine the source of income from each cloud transaction separately (subject to an elective aggregation rule), in substance the Apportionment Fraction applies a hybrid approach that would aggregate all gross cloud services

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[172] Prop. Reg. § 1.861-19(d)(4)(i).

[173] In addition to making factual determinations with respect to leased property, taxpayers would often be required to make a complex legal determination that need not be made under current law. For example, a cloud service provider that obtains the right to use third-party servers would be required to determine whether its arrangement constitutes a lease or a service.

[174] *See* I.R.C. §§ 861(a)(3) & 862(a)(3); Treas. Reg. § 1.861-4.

income from a particular product line and determine a taxpayer's place of performance for such income on a blended basis to the extent that the source of the income is influenced by the intangible property factor. Specifically, the intangible property factor would require the aggregation of R&E expenditures and other expenses comprising the intangible property factor to the extent that they relate to cloud transactions within a single product line.[175] This approach would generate striking results in the context of branches.[176]

> Example 4. Inbound cloud service provider with a U.S. branch. FP, a foreign corporation, provides cloud services to customers in Country X through its Country X employees. Through employees in a U.S. branch, FP provides cloud services in the same product line to customers in the United States. In a taxable year, FP earns $1,000 from a cloud transaction with a single Country X customer (the "**Country X cloud transaction**"). The U.S. branch personnel and tangible property has no directly traceable relationship to or involvement in the non-U.S. branch transaction and vice versa. As a result, under current law, FP treats no portion of the $1,000 it earned from the Country X cloud transaction as effectively connected income. FP also earns $1,000 from a cloud transaction with a single U.S. customer (the "**U.S. cloud transaction**"), all of which it treats as U.S. source effectively connected income under current law. FP's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel ……..…$150
> Country X R&E personnel…….$150
>
> *Personnel factor*
> U.S. direct service personnel……$30
> Country X direct service personnel……...$30
>
> *Tangible property factor*
> U.S. server lease……...$20
> Country X server lease…….$20

[175] Prop. Reg. § 1.861-19(d)(2)(i).

[176] These results are more prevalent when a taxpayer operates through a branch that gives rise to a taxable presence in another country, but they are not limited to such cases. For example, the utilization of a server in another country may not, by itself, give rise to a permanent establishment. OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary to Art. 5, pp. 151-154. As discussed below, consideration should be given to an approach that disregards, for purposes of the tangible property factor, property located in a jurisdiction (including the United States) if the taxpayer has limited activity in that country.

> While the personnel factor and the tangible property factor provide for the direct allocation of expenses to a particular cloud transaction based on the relevant facts, the intangible property factor includes all of FP's relevant R&E expenditures because both transactions are in the same product line; those expenditures would be allocated to transactions in proportion to gross income from the transactions. As a result, FP's Apportionment Fraction would be $75/$200 with respect to its Country X cloud transaction and $125/$200 with respect to its U.S. cloud transaction. Therefore, $375 of FP's gross income from its Country X cloud transaction would be U.S. source income, with the remaining $625 being foreign source income. Furthermore, $625 of its gross income from its U.S. cloud transaction would be U.S. source income and the remaining $375 would be foreign source income.[177]

Example 4 demonstrates that the Proposed Regulations would promote both double taxation and double non-taxation because income that would ordinarily be subject solely to Country X taxation would become subject to tax in both Country X and the United States, and income ordinarily subject to tax solely in the United States could be exempt from any tax. By treating $375 of FP's gross income from cloud transactions with the Country X customer as U.S. source income, the Proposed Regulations would subject that income to U.S. tax.[178] The assertion of taxing rights by the United States with respect to a Country X customer would go well beyond any traditional norms relating to nexus. In theory, FP's Country X-based R&E personnel could conduct research benefiting only Country X transactions, and its U.S.-based R&E personnel could similarly conduct research supporting only U.S. transactions. In that case, no R&E or other support is provided in the United States to facilitate FP's delivery of service to Country X customers;

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[177] With respect to its Country X cloud transaction, FP's intangible property factor would equal $150, with the U.S. source portion of the intangible property factor equal to $75. FP's personnel factor would equal $30, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $20, with the U.S. source portion equal to $0. Accordingly, FP's Apportionment Fraction with respect to the Country X cloud transaction would be $75/$200. Thus, $375 of FP's gross income from the Country X cloud transaction ($1,000 multiplied by $75/$200) would be U.S. source income and $625 ($1,000 minus $375) would be foreign source income. With respect to its U.S. cloud transaction, FP's intangible property factor would equal $150, with the U.S. source portion of the intangible property factor equal to $75. FP's personnel factor would equal $30, with the U.S. source portion of that factor equal to $30. The tangible property factor would equal $20, with the U.S. source portion equal to $20. Accordingly, the numerator FP's Apportionment Fraction with respect to the U.S. cloud transaction would be $125 (that is, the sum of $75, $30, and $20) and the denominator would be $200 (the sum of $150, $30, and $20). Thus, $625 of FP's gross income ($1,000 multiplied by $125/$200) would be U.S. source income and the remaining $375 ($1,000 minus $625) would be foreign source income.

[178] *See* I.R.C. §§ 881(a) & 882. Under certain income tax treaties, U.S. withholding may be reduced or eliminated.

nonetheless, the Proposed Regulations would subject FP's services income from Country X customers to U.S. tax.

If the U.S.-based R&E personnel did not participate (directly or indirectly) in the Country X cloud transaction, one might expect that the U.S. source income would not be effectively connected income. In that case, the U.S. source portion of such income may nonetheless be subject to gross-basis U.S. taxation at a 30 percent rate.[179] On the other hand, it is possible that such income may be treated as effectively connected income. The Proposed Regulations effectively treat R&E expenditures as forming part of the performance of a cloud service for purposes of determining the source of income. Intangible property created from such R&E expenditures could be viewed as giving rise to all of FP's cloud services income. Applying the logic of the Proposed Regulations to the effectively connected income rules, the U.S. source portion of the income from the Country X cloud transaction may satisfy the asset-use test.[180] Similarly, since the Proposed Regulations would treat all of FP's R&E expenditures as collectively forming part of all cloud transactions within a particular product line, the U.S.-based R&E personnel's activities may be viewed as satisfying the business-activities test.[181]

As discussed below, we recommend several different approaches to U.S. and foreign branches that would reduce some or all of the effects described in Example 4. If, however, final regulations do not adopt this recommendation, we recommend that final regulations include guidance for taxpayers to determine the extent to which the Proposed Regulations' treatment of U.S.-based R&E personnel as contributing to the delivery of cloud services to foreign customers should be taken into consideration for purposes of treating the resulting income as effectively connected income. Whatever guidance is issued in that regard, it may also be appropriate to allow taxpayers to elect to treat such income as effectively connected income, which would allow taxpayers to allocate and apportion deductions and losses to such income.[182]

Beyond the fact that the results in Example 4 would be inconsistent with longstanding international norms, they would also present practical and administrative challenges. FP's Country X customers would be required to withhold on payments to FP and remit those amounts to the IRS.[183] If the income is subject to gross-basis withholding, information regarding FP's Apportionment Fraction would not be readily available to those customers, who would need to request the information from FP. If those customers request the information, FP may be unable to provide it. As discussed in Part IV.C.3, the Apportionment Fraction's use of current-year

[179] I.R.C. § 881(a).

[180] *See* Treas. Reg. § 1.864-4(c)(2).

[181] *See* Treas. Reg. § 1.864-4(c)(3).

[182] *See generally* Treas. Reg. § 1.882-4.

[183] *See generally* I.R.C. §§ 1441 & 1442. In rare instances, the rules may also implicate section 1446 withholding.

expenditures means that expenditures incurred after gross income is earned may influence the source of the income. Even if the final regulations adopt an approach that considers only prior year investments, it may be difficult to obtain information regarding the most recent year (particularly if the payment is made early in the following year).

Example 4 also demonstrates that the Proposed Regulations would result in double non-taxation. For example, Country X may apply a participation exemption to income earned through FP's U.S. branch, or FP's U.S. branch may be held through a hybrid entity. Section 864(c)(4) treats certain classes of foreign source income as effectively connected income, but services income is not among them. Thus, by virtue of converting $375 of FP's cloud services income from U.S. customers into foreign source income, the Proposed Regulations would reduce FP's gross effectively connected income from $1,000 to $625. As a result, $375 of FP's gross income would be subject to no tax in either the United States or Country X.

Similar distortions would occur with respect to domestic corporations with foreign branches.

> Example 5. Domestic cloud service provider with a foreign branch. USP, a domestic corporation, provides cloud services to customers in the United States through its U.S. employees. Through employees in a Country X branch, USP provides cloud services in the same product line to customers in Country X. In a taxable year, USP earns $1,000 from a cloud transaction with a single U.S. customer (the "**U.S. cloud transaction**"), which it treats as U.S. source income under current law. USP also earns $1,000 from a single Country X customer, which it treats as foreign source income in the foreign branch category (the "**Country X cloud transaction**"). USP's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel ……..…$150
> Country X R&E personnel…….$150
>
> *Personnel factor*
> U.S. direct service personnel……$30
> Country X direct service personnel……...$30
>
> *Tangible property factor*
> U.S. server lease……...$20
> Country X server lease…….$20
>
> The results under the Proposed Regulations would be similar to those described in Example 4. USP's Apportionment Fraction would be $125/$200 with respect to its U.S. cloud transaction and $75/$200 with respect to its Country X cloud

transaction.[184] Therefore, $625 of USP's gross income from the U.S. cloud transaction would be U.S. source income with the remaining $375 treated as foreign source income. Further, $375 of its gross income from the Country X cloud transaction would be U.S. source income with the remaining $625 treated as foreign source income.

As was true in Example 4, this result promotes both double taxation and double non-taxation. Country X is likely to impose tax on the $1,000 of income from the Country X cloud transaction.[185] By treating $375 of the gross income from the Country X cloud transaction as U.S. source income, the Proposed Regulations would assert that the United States is also entitled to tax the same income. On the other hand, treating $375 of USP's gross income from the U.S. cloud transaction as foreign source income would often result in double non-taxation. Because the transaction is between a domestic corporation and its U.S. customer, it is unlikely to be subject to foreign tax. The Proposed Regulations would also effectively exempt a portion of that income from *U.S.* taxation in many instances. That is, if USP has a greater than 21 percent effective foreign tax rate on its other foreign source general category income, then USP may use foreign taxes paid with respect to other income to eliminate its federal income tax liability on income from the U.S. cloud transaction.[186]

Taken together, these examples demonstrate that the Proposed Regulations, when applied to foreign taxpayers with U.S. branches or U.S. taxpayers with foreign branches, would result in a troubling mix of double taxation and double non-taxation. We recommend that Treasury consider approaches that would mitigate these effects. One approach would be to treat branches as separate taxpayers for purposes of applying the Proposed Regulations.[187] For this purpose, a branch could be defined by reference to existing concepts used in the Code. For example, a foreign person could be treated as having a U.S. branch to the extent that the foreign person is treated as engaged in a U.S. trade or business under the Code,[188] and a U.S. person could be treated as having a branch to

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[184] *See supra* note 177.

[185] If USP operated in Country X through a disregarded entity, this would almost certainly be true. On the other hand, a royalty paid by the disregarded entity to USP would complicate matters. *See infra* note 194.

[186] *See supra* Part III.A.1.

[187] For a similar recommendation, see Paul Oosterhuis, Will Shirey, and Moshe A. Gershenfeld, *Cloud Services Sourcing Regulations: Moving in the Right Direction*, Tax Notes Federal, Volume 117, 2159, 2160 (March 16, 2025).

[188] If, under the terms of an income tax treaty, the foreign person claimed that it was not subject to tax under section 882(a) because it did not have a U.S. permanent establishment, it may still be appropriate to separately determine the source of services income from cloud transactions by treating the foreign person's U.S. trade or business as a separate entity. As discussed in this Part IV.D, the Proposed Regulations' expansive source effects would occur regardless of whether a foreign person would potentially be subject

the extent that the person has a foreign branch within the meaning of section 904(d)(2)(J).[189] Treasury has treated certain branches as separate persons in previous guidance under section 863. Specifically, similar concepts apply for purposes of determining the source of notional principal contracts.[190] While the source of notional principal contract income depends on the residence of the taxpayer, the source of notional principal contract income is determined by reference to the residence of a QBU of a taxpayer if certain conditions are met.[191]

Under this approach, the distortions described in Examples 4 and 5 would be minimized. In Example 4, all $1,000 of FP's income from the Country X cloud transaction would be foreign source income and all $1,000 of FP's income from the U.S. cloud transaction would be U.S. source effectively connected income. Similarly, in Example 5, all $1,000 of USP's income from the U.S. cloud transaction would be U.S. source income and all $1,000 of USP's income from the Country X transaction would be foreign source income.

We acknowledge that this approach would, in certain instances, produce results that are in tension with the apparent policy goals of the Proposed Regulations, which is to align taxing rights with the creation of intangible property that enables cloud transactions. The following example demonstrates these effects.

> Example 6. Licensee branch. USP, a domestic corporation, provides cloud services to customers in the United States through its U.S. employees. USP owns FDRE, a disregarded entity organized in Country X. Through FDRE, USP provides cloud services in the same product line to customers in Country X. In a taxable year, USP earns $500 from a cloud transaction with a single U.S. customer (the "**U.S. cloud transaction**"), which it treats as U.S. source income. USP (through FDRE) also earns $500 from a single Country X customer, which it treats as foreign source income in the foreign branch category (the "**Country X cloud transaction**"). USP

to U.S. federal income taxation on its gross income under section 881 or its net income under section 882, and the relevant treaty may not reduce U.S. withholding tax to zero.

[189] For purposes of section 904(d), a foreign branch is defined by reference to the definition of a qualified business unit ("**QBU**") as set out in section 989(a), which defines a QBU as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." Regulations under section 904 alter this definition, including by taking into account solely activities conducted outside the United States. *See* Treas. Reg. § 1.904-4(f)(3)(vii). Alternatively, final regulations could treat any entity that would qualify as a separate unit under the dual consolidated loss rules as a foreign branch. *See* Treas. Reg. § 1.1503(d)-1(b)(4). This approach would broaden the scope of any potential rule, because separate units include hybrid entity separate units subject to foreign tax on the basis of residence, without regard to whether those entities are engaged in a foreign trade or business. Treas. Reg. § 1.1503(d)-1(b)(3) & (4).

[190] *See generally* Treas. Reg. § 1.863-7.

[191] Treas. Reg. § 1.863-7(b).

licenses intangible property necessary to perform the Country X cloud transaction to FDRE for $70. USP's relevant expenses for the taxable year are as follows:

Intangible property factor
U.S. R&E personnel ……..……$100
Country X R&E personnel...…….....$0

Personnel factor
U.S. direct service personnel……$25
Country X service personnel……...…….…...$25

Tangible property factor
U.S. server lease……...$25
Country X server lease…….$25

Under the Proposed Regulations, USP's Apportionment Fraction would be $100/$100 with respect to its U.S. cloud transaction and $50/$100 with respect to its Country X cloud transaction.[192] Therefore, $500 of USP's gross income from the U.S. cloud transaction would be U.S. source income and $250 of its gross income from the Country X cloud transaction would be U.S. source income. If FDRE were treated as a separate taxpayer, USP's Apportionment Fraction would be $150/$150 for the U.S. cloud transaction, but the Apportionment Fraction for the Country X cloud transaction would be $0/$50. As a result, all $500 of the gross income from the U.S. cloud transaction would be U.S. source and all $500 of the gross income from the Country X cloud transaction would be foreign source.[193]

[192] With respect to its U.S. cloud transaction, USP's intangible property factor would equal $50, with the U.S. source portion of the intangible property factor equal to $50. USP's personnel factor would equal $25, with the U.S. source portion of that factor equal to $25. The tangible property factor would equal $25, with the U.S. source portion equal to $25. Accordingly, the numerator USP's Apportionment Fraction with respect to the U.S. cloud transaction would be $100 (that is, the sum of $50, $25, and $25) and the denominator would be $100 (that is, the sum of $50, $25, and $25). Thus, $500 of USP's gross income ($500 multiplied by $100/$100) would be U.S. source income and no portion would be foreign source income. With respect to its Country X cloud transaction, USP's intangible property factor would equal $50, with the U.S. source portion of the intangible property factor equal to $50. USP's personnel factor would equal $25, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $25, with the U.S. source portion equal to $0. Accordingly, USP's Apportionment Fraction with respect to the Country X cloud transaction would be $50/$100. Thus, $250 of USP's gross income from the Country X cloud transaction ($500 multiplied by $50/$100) would be U.S. source income and $250 ($500 minus $250) would foreign source income.

[193] The analysis with respect to its U.S. cloud transaction would be unchanged under this alternative. However, with respect to its Country X cloud transaction, USP's intangible property factor would equal $0, with the U.S. source portion of the intangible property factor equal to $0. USP's personnel factor would

The alternative approach that we recommend better aligns U.S. taxation and foreign taxation in Example 6.[194] Moreover, it produces substantially the same outcome that would occur if FDRE were regarded and USP licensed intangible property to FDRE in a regarded transaction. On the other hand, it fails to align taxing rights with the creation of intangible property that enables the Country X cloud transaction.

If Treasury declines to adopt our recommendation, consideration should be given to alternative approaches to aligning the Proposed Regulations' outcomes with traditional allocations of taxing rights. One approach would be a reallocation rule that would provisionally determine U.S. and foreign source income from a cloud transaction using the aggregate intangible property factor used in the Proposed Regulations, but then reallocate U.S. source income and foreign source income among different cloud transactions. This reallocation could be based on the personnel factor and the tangible property factor, as illustrated in the following example.

> Example 7. Reallocation rule. FP, a foreign corporation, provides cloud services to customers in Country X through its Country X employees. Through employees in a U.S. branch, FP provides cloud services in the same product line to customers in the United States. In a taxable year, FP earns $1,000 from a cloud transaction with a single Country X customer (the "**Country X cloud transaction**"), which it treats as foreign source income that is not effectively connected income. FP also earns $1,000 from a single U.S. customer, which it treats as U.S. source effectively connected income (the "**U.S. cloud transaction**"). FP's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel ……..……$160
> Country X R&E personnel…….$120

equal $25, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $25, with the U.S. source portion equal to $0. Accordingly, USP's Apportionment Fraction with respect to the Country X cloud transaction would be $0/$50. Thus, $0 of USP's gross income from the Country X cloud transaction ($500 multiplied by $0/$50) would be U.S. source income and $500 ($500 minus $0) would foreign source income.

[194] Because FDRE pays a $70 royalty to USP, $430 of the gross income from the Country X cloud transaction would be foreign branch category income and $70 would be general category income. *See generally* Treas. Reg. § 1.904-4(f)(2)(vi). Furthermore, FDRE would likely be entitled to a $70 deduction for Country X tax purposes for the royalty payment, such that the foreign branch category would be aligned with the Country X tax base. Final regulations could be coordinated with the existing rules for attributing gross income to foreign branches, such that the source of gross income reattributed from a foreign branch under Treas. Reg. § 1.904-4(f)(2)(vi) would be subject to the domestic corporation's Apportionment Fraction rather than a foreign branch's Apportionment Fraction. On the other hand, Country X may impose a royalty withholding tax on FDRE's royalty and view that royalty income as appropriately sourced to Country X given that it is a payment for the right to use intangible property in Country X.

Personnel factor
U.S. direct service personnel……$35
Country X direct service personnel……...$35

Tangible property factor
U.S. server lease……...$25
Country X server lease……$25

FP's Apportionment Fraction would be $80/$200 with respect to its Country X cloud transaction and $140/$200 with respect to its U.S. cloud transaction. Therefore, under the Proposed Regulations, $400 of FP's gross income from its Country X cloud transaction would be U.S. source income and $600 would be foreign source income. $700 of its gross income from its U.S. cloud transaction would be U.S. source income and $300 would be foreign source income.[195]

Under a source reallocation approach that reallocated U.S. and foreign source income among transactions by reference to the other factors, the U.S. source portion of the Country X cloud transaction could be allocated to the U.S. cloud transaction in exchange for foreign source income. In each case, this reallocation would be capped by reference to the gross income available to be re-sourced. Under this approach, $300 of FP's U.S. source income from the Country X cloud transaction would be converted to foreign source (but $100 would remain U.S. source). Correspondingly, $300 of USP's foreign source income from its U.S. cloud transaction would be treated as additional U.S. source income, such that all $1,000

[195] With respect to its Country X cloud transaction, FP's intangible property factor would equal $140, with the U.S. source portion of the intangible property factor equal to $80. FP's personnel factor would equal $35, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $25, with the U.S. source portion equal to $0. Accordingly, FP's Apportionment Fraction with respect to the Country X cloud transaction would be $80/$200. Thus, $400 of FP's gross income from the Country X cloud transaction ($1,000 multiplied by $80/$200) would be U.S. source income and $600 ($1,000 minus $400) would foreign source income. With respect to its U.S. cloud transaction, FP's intangible property factor would equal $140, with the U.S. source portion of the intangible property factor equal to $80. FP's personnel factor would equal $35, with the U.S. source portion of that factor equal to $35. The tangible property factor would equal $25, with the U.S. source portion equal to $25. Accordingly, the numerator of FP's Apportionment Fraction with respect to the U.S. cloud transaction would be $140 (that is, the sum of $80, $35, and $25) and the denominator would be $200 (the sum of $140, $35, and $25). Thus, $700 of FP's gross income ($1,000 multiplied by $140/$200) would be U.S. source income and the remainder ($300) would be foreign source income.

(the sum of $700 and $300) of its income from the U.S. cloud transaction would be U.S. source.

This reallocation methodology would represent a middle ground between our recommended approach and the Proposed Regulations' current approach because it would produce the same amount of U.S. source income and foreign source income as the Apportionment Fraction in the Proposed Regulations but allocate U.S. source income first to transactions with direct service delivery personnel and tangible property located in the United States. As a result, while double taxation and double non-taxation would continue to result from the intangible property factor's aggregate approach within product lines, it would be reduced relative to the outcomes in the Proposed Regulations.

It should be noted that an approach to addressing the issues raised in this Part IV.D that relies entirely on the existence of a trade or business may not be appropriate. For example, the Proposed Regulations would determine source in part based solely on the location of servers and other property. Thus, under the Proposed Regulations, the mere location of servers and other tangible property would partially control source – and thus the allocation of taxing rights. In contrast, many jurisdictions (including, potentially, the United States) would not necessarily treat cloud service providers' use of a server in a jurisdiction as giving rise to a permanent establishment. For example, commentary to the OECD's model rules indicates that enterprises engaged in online retail would likely not have a permanent establishment in a jurisdiction merely by virtue of using servers located in that jurisdiction.[196] To address this, we recommend that final regulations deem the tangible property factor to be zero in two specific instances: (i) when the U.S. source portion of the intangible property factor and the U.S. source portion of the personnel factor would represent 100 percent of each factor and (ii) when the U.S. source portion of the intangible property factor and the U.S. source portion of the personnel factor would represent 0 percent of each factor. This would have the effect of preventing the bare presence of a server or other tangible property in a jurisdiction – with no other activity in the jurisdiction – from sourcing income to the jurisdiction.

E. Taxpayer-by-Taxpayer Approach

The Proposed Regulations determine the source of each taxpayer's services income from cloud transactions separately rather than combining related parties. The Preamble states that this is appropriate for a number of reasons: the approach is "administrable and practical[,]" it "allow[s] for appropriate deductions from that gross income in respect of amounts paid or accrued to affiliated or unaffiliated contributors to the provision of the cloud services[,]" it is "generally consistent with the current approach for sourcing other categories of income, including non-cloud

[196] OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary to Art. 5, pp. 151-54.

services income[,]" and the IRS would retain existing common law, statutory, and regulatory provisions to reflect the economic realities of the transaction.[197]

Nonetheless, the Preamble states that Treasury continues to consider whether this approach is appropriate, and could refine or revise the taxpayer-by-taxpayer approach if necessary "to adequately account for the interdependencies and collaboration across entities in a multinational group, and consequently, to ensure a fair and accurate representation of where services are performed."[198] In considering whether the Proposed Regulations adequately account for interdependencies and collaboration across related parties, several points are worth noting.

First, as discussed in Part IV.B, the Code's starkly different approaches to determining the source of services income and royalty income makes it difficult to identify a single appropriate source outcome in the context of cloud transactions. That is, when one taxpayer develops and licenses intangible property to a related-party service provider, neither a place-of-performance standard nor a place-of-use standard is unambiguously more appropriate as a theoretical matter in this context to determine the source of related parties' combined income. Aggregating the activities of related parties to eliminate the effects of related-party licensing may (or may not) yield more revenue,[199] but we do not believe that sound tax policy or the Code require it.

Second, a taxpayer-by-taxpayer approach is consistent with federal income tax principles that respect separate entity status of related persons and limit the attribution of one taxpayer's activities to another taxpayer absent an agency relationship, as set forth in *Moline Properties*, *National Carbide*, and *Bollinger*.[200] These broader principles have been applied by courts and the IRS in the context of the Code's international rules, and in particular in the context of determining the source of services income when some or all of the services income is subcontracted to related parties.[201]

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[197] 90 Fed. Reg. at 3077 (citing "common law principles, such as the economic substance doctrine, the step transaction doctrine, and the rules of agency, or existing statutory and regulatory provisions, such as the section 482 rules, to ensure that the Federal income tax consequences more properly reflect the economic realities of the transaction, including the contributions to a cloud transaction made by affiliates of the taxpayer.").

[198] *Id*.

[199] A principled approach to determining the place of performance would not be dependent on the Proposed Regulations' anticipated revenue effects. Moreover, as innovation outside the United States continues to advance, non-U.S. cloud service providers are likely to proliferate, making the revenue effects of the Proposed Regulations difficult to predict.

[200] *See* Part III.B.4.

[201] *Id.*

Third, treating members of a multinational group as a single taxpayer for these purposes would result in the same distortions – including an increase in double taxation and double nontaxation – that Part IV.D described with respect to the Proposed Regulations' impact on taxpayers with branches.

> Example 8. Inbound cloud service provider with a U.S. subsidiary. The facts are the same as in Example 4, except that FP operates in the United States through a wholly owned domestic corporation, USS (collectively with FP, the "**FP Group**"), rather than a branch. Thus, FP provides cloud services to customers in Country X through its Country X employees. In a taxable year, FP earns $1,000 from a cloud transaction with a single Country X customer (the "**Country X cloud transaction**"), all of which it treats as foreign source income under current law. USS provides cloud services in the same product line to customers in the United States. USS earns $1,000 from a cloud transaction with a single U.S. customer (the "**U.S. cloud transaction**"), all of which it treats as U.S. source income under current law. The FP Group's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel ……..…$150
> Country X R&E personnel…….$150
>
> *Personnel factor*
> U.S. direct service personnel……$30
> Country X direct service personnel……...$30
>
> *Tangible property factor*
> U.S. server lease……...$20
> Country X server lease…….$20
>
> If the Apportionment Fraction were applied by treating the FP Group as a single taxpayer, the FP Group's Apportionment Fraction would be $75/$200 with respect to its Country X cloud transaction and $125/$200 with respect to its U.S. cloud transaction. Therefore, $375 of FP's gross income from its Country X cloud transaction would be U.S. source income, with the remaining $625 treated as foreign source income. Furthermore, $625 of USS's gross income from its U.S. cloud transaction would be U.S. source income, with the remaining $375 being treated as foreign source income.[202]

Thus, a broad-based single entity approach for multinational groups would increase double taxation and double non-taxation. Unlike FP's U.S. branch in Example 4, USS would provisionally be subject to U.S. federal income tax on its $375 of foreign source income, although that foreign

[202] *See supra* note 177.

source income may allow USS to claim a credit for foreign income taxes imposed on other unrelated income.

Fourth, section 482 generally ensures that related parties within a multinational group must transact at arm's length. When related parties within a multinational group subcontract for related-party *services*, a unitary approach could inflate U.S. or foreign source income by reference to the location of the subcontracted services.[203]

> Example 9. Subcontracted services. FP, a foreign corporation, owns all of the stock of A and B, domestic corporations that are not members of the same consolidated group. A provides cloud services to a third-party customer, earning $100 of gross income from the transaction in a taxable year. In connection with the transaction, A pays $40 to B, whose U.S.-based personnel act as direct service delivery personnel in connection with A's cloud transaction. Assume that B is appropriately characterized as a subcontractor and not as A's agent. B pays $30 to its direct service delivery personnel in connection with the services provided to A. A's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> U.S. R&E personnel……..……..…….$20
> Foreign R&E personnel……...…$10
>
> *Personnel factor*
> U.S. direct service personnel……..…..……...……$0
>
> *Tangible property factor*
> U.S. server lease…...…..……..…….....$10

[203] Contract R&E raises unique considerations due to the fact that R&E expenditures are allocated and apportioned to all gross intangible income under Treas. Reg. § 1.861-17.

Under the Proposed Regulations, the gross and net income of A and B would be as follows:[204]

	A		B		A + B	
	U.S. source	*Foreign*	*U.S. source*	*Foreign*	*U.S. source*	*Foreign*
Gross income	$ 75.00	$ 25.00	$ 40.00	$ -	$ 115.00	$ 25.00
Expenses	$ 60.00	$ 20.00	$ 30.00	$ -	$ 90.00	$ 20.00
Net income	**$ 15.00**	**$ 5.00**	**$ 10.00**	**$ -**	**$ 25.00**	**$ 5.00**

If A and B were treated as a single taxpayer, the combined A and B factors would be as follows:

Intangible property factor
U.S. R&E personnel……..……..…….$20
Foreign R&E personnel……...…$10

Personnel factor
U.S. direct service personnel……..…….....……..…$30

Tangible property factor
U.S. server lease…...…….....…….....$10

[204] With respect to its cloud transaction, A's intangible property factor would equal $30, with the U.S. source portion of the intangible property factor equal to $20. A's personnel factor would equal $0. The tangible property factor would equal $10, with the U.S. source portion equal to $10. Accordingly, the numerator of A's Apportionment Fraction with respect to the cloud transaction would be $30 (that is, the sum of $20, $0, and $10) and the denominator would be $40 (the sum of $30, $0, and $10). Thus, $75 of A's gross income ($100 multiplied by $30/$40) would be U.S. source income and $25 would be foreign source income. A incurs expenses of $80 (the $40 of expenses taken into account in its Apportionment Fraction, plus the $40 service fee paid to B), which A allocates to its gross income from the cloud transaction and apportions by reference to gross U.S. and foreign source income. *See generally* Treas. Reg. §§ 1.861-8 & 1.861-8T. Because B's service personnel perform services within the United States, all $40 of B's gross income is U.S. source income. The compensation paid to its service delivery personnel is deducted from this amount to reach $10 of net U.S. source income. *Id.* Finally, note that this Example 9 includes a number of simplifying assumptions, including that there are no other relevant expenses, there is no other gross intangible income recognized by A for purposes of Treas. Reg. § 1.861-17, and expenses are apportioned on the basis of gross income. Furthermore, the example ignores the capitalization of R&E expenditures (or assumes that previously capitalized amounts amortized in the current year equal current R&E expenditures).

Based on these facts, the gross and net income results in that case would be as follows:[205]

	A		B		A + B	
	U.S. source	*Foreign*	*U.S. source*	*Foreign*	*U.S. source*	*Foreign*
Gross income	$ 85.71	$ 14.29	$ 40.00	$ -	$ 125.71	$ 14.29
Expenses	$ 68.57	$ 11.43	$ 30.00	$ -	$ 98.57	$ 11.43
Net income	**$ 17.14**	**$ 2.86**	**$ 10.00**	**$ -**	**$ 27.14**	**$ 2.86**

Arguably, this result assigns too much weight to the location of B's direct service personnel. On a separate entity basis, B's income is entirely U.S. source and subject to U.S. tax. If A and B were treated as a single taxpayer, the location of B's personnel would be taken into account twice, causing more of A's gross income to be treated as U.S. source. One approach to addressing this effect would be to apply a limited single taxpayer approach that only redetermined the source of A's gross income to the extent necessary to ensure that A and B's net U.S. source income equals the amount of net U.S. source income A would have recognized if A and B were a single taxpayer. This approach would effectively give A credit for net U.S. source income recognized by B. Rules implementing this approach would likely be complex.

Separately, the fundamental difference between the Code's source rules for royalties and services means that related-party *licenses* may result in different outcomes. These differences are more prevalent when a U.S. person licenses intangible property to be used outside the United States or when a foreign person licenses intangible property to be used in the United States. In situations when core intangible property is licensed to a related party but would never or very rarely be licensed to an unrelated cloud service provider, the outcomes present even greater tax policy concerns.

[205] With respect to its cloud transaction, A's intangible property factor would equal $30, with the U.S. source portion of the intangible property factor equal to $20. A's personnel factor would equal $30 (taking B's direct service personnel compensation into account), with the U.S. source portion of the intangible property factor equal to $30. The tangible property factor would equal $10, with the U.S. source portion equal to $10. Accordingly, the numerator of A's Apportionment Fraction with respect to the cloud transaction would be $60 (that is, the sum of $20, $30, and $10) and the denominator would be $70 (the sum of $30, $30, and $10). Thus, $85.71 of A's gross income ($100 multiplied by $60/$70) would be U.S. source income and $14.29 ($100 minus $85.71) would be foreign source income. A incurs expenses of $80 (the $40 of expenses taken into account in its Apportionment Fraction, plus the $40 service fee paid to B), which A allocates to its gross income from the cloud transaction and apportions by reference to gross U.S. and foreign source income. *See generally* Treas. Reg. §§ 1.861-8 & 1.861-8T. Because B's service personnel perform services within the United States, all $40 of B's gross income is U.S. source income. The compensation paid to its service delivery personnel is deducted from this amount to reach $10 of net U.S. source income. *Id.*

Example 10. Related-party licensing (domestic provider). USP owns all of the stock of FS, a controlled foreign corporation. FS provides cloud services to a third-party customer, earning $1,000 of gross income from a single cloud transaction in a taxable year. In connection with the transaction, FS pays USP $80 for the right to use USP's intangible property in connection with FS's cloud transaction. FS's relevant expenses for the taxable year are as follows:

Intangible property factor
Foreign R&E personnel……...……..……..…….$20
Royalty…….……...…$80

Personnel factor
Foreign direct service personnel……..…….……...……...……..……$10

Tangible property factor
Foreign server lease…...…..……..……$10

Under the Proposed Regulations, all $1,000 of FS's gross income would be foreign source income, and all $80 of USP's gross income would similarly be foreign source income.[206] In contrast, assume that if USP and FS were treated as a single taxpayer, the combined intangible property factor would include $40 of USP's compensation paid to R&E personnel located in the United States. Presumably, the $80 royalty paid by FS to USP would be eliminated from the intangible property factor, such that the intangible property factor would equal $60 (that is, $20 of FS's R&E expenditures plus $40 of USP's R&E expenditures) and the U.S. source portion of the combined intangible property factor would be $40. In that case, $500 of FS's gross income would be U.S. source, with the remaining $500 being treated as foreign source.[207]

[206] FS's intangible property factor would equal $100, with the U.S. source portion of the intangible property factor equal to $0. FS's personnel factor would equal $10, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $10, with the U.S. source portion equal to $0. Accordingly, the numerator USP's Apportionment Fraction with respect to the U.S. cloud transaction would be $0 and the denominator would be $120 (the sum of $100, $10, and $10). Thus, $0 of USP's gross income ($1,000 multiplied by $0/$120) would be U.S. source income and all $1,000 would be foreign source income.

[207] FS's intangible property factor would equal $60, with the U.S. source portion of the intangible property factor equal to $40. FS's personnel factor would equal $10, with the U.S. source portion of that factor equal to $0. The tangible property factor would equal $10, with the U.S. source portion equal to $0. Accordingly, the numerator USP's Apportionment Fraction with respect to the U.S. cloud transaction would be $40 and the denominator would be $80 (the sum of $60, $10, and $10). Thus, $500 of USP's gross income ($1,000 multiplied by $40/$80) would be U.S. source income and the remaining $500 would be foreign source income.

Example 10 illustrates that by providing services to customers through a foreign affiliate, a domestic corporation could reduce U.S. tax liability.[208] Under one view, this distinction could be viewed as inviting inappropriate manipulation, which could be prevented through the adoption of a single entity approach. A contrary view would be that this example illustrates the fundamental problem – which is particularly acute in the context of technology-enabled services – of the Code's different source rules for royalties and service fees.

F. Partnerships

1. Treatment as an Entity or Aggregate

The taxation of partnerships under the Code involves a blend of aggregate and entity concepts,[209] and the Code's international rules adopt different approaches with respect to different types of income.[210] Within the Code's sourcing rules, partnerships are treated differently depending on the context. For example, the source of interest income is determined by reference to the payor of the interest.[211] When a partnership pays interest, the source of the interest depends on the residence of the partnership making the payment rather than residence of its partners.[212] On the other hand, an aggregate approach applies in the case of gain from the sale of personal property. Subject to several exceptions, the source of gain from the sale of personal property is determined by reference to the residence of the seller.[213] When a partnership sells personal property, the resulting gain is determined by reference to the residence of its partners.[214]

Gain or loss from sales of inventory property is not subject to the residence-of-the-seller rule. The source of income from the sale of purchased inventory generally depends on where the

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[208] If a portion of FS's income were U.S. source income, the resulting GILTI or subpart F income inclusion would be U.S. source unless the income were resourced under an applicable income tax treaty. *See* I.R.C. §§ 904(h)(2) & 951A(f). As a result, the inclusion would be subject to tax and no amount of foreign income tax deemed paid with respect to that income (or other income in the same separate limitation category) could be credited against that income. As a result, double taxation similar to that described in Part IV.D would result.

[209] Willis, Postlewaite & Alexander, *Partnership Taxation*, § 1.03 (2025).

[210] *See generally* Gregory Featherman, *Tax Issues Raised by the Use of Cross-Border Partnerships*, Tax Notes Federal, Volume 174, 337 (Jan. 17, 2022); Robert J. Staffaroni, *Partnerships: Aggregate v. Entity and U.S. International Taxation*, 49 Tax Lawyer 55 (1995).

[211] I.R.C. §§ 861(a)(1) & 862(a)(1)

[212] *See* I.R.C. § 861(a)(1)(B) & Treas. Reg. § 1.861-2(a)(2).

[213] I.R.C. § 865(a).

[214] I.R.C. § 865(i)(5).

sale takes place.[215] In contrast, the source of gain or loss from the sale of inventory produced by a taxpayer ("**produced inventory**") is determined solely on the basis of the production activities with respect to the inventory.[216] Gain from the sale of inventory produced within the United States is generally U.S. source income and gain from the sale of inventory produced without the United States is generally foreign source income.[217] In general, this determination is made by reference to the taxpayer's production assets.[218] When a taxpayer's production assets are located both within and without the United States, foreign source income is determined by multiplying the gross income by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States.[219] The remaining income is treated as U.S. source income.[220]

For this purpose, a partnership is generally respected as an entity separate from its partners.[221] A general anti-abuse rule provides an example of a transaction that would be within scope: the acquisition of domestic production assets by a related partnership (or a subsidiary of a related partnership) with a principal purpose of reducing U.S. tax liability by claiming that the taxpayer's income from sales of inventory is subject to the place-of-sale rule rather than the produced inventory rule.[222]

2. Interaction with the Proposed Regulations

In the context of the Proposed Regulations, the treatment of a partnership as an entity or aggregate affects both a partnership's gross income and a partner's gross income. Thus, two related questions arise. First, should the source of cloud services income be determined at the partner level or the partnership level? Second, should a partner take into account its share of partnership-level expenses in computing the three factors (and their respective U.S. source portions) in computing

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[215] *See* I.R.C. §§ 861(a)(6) & 862(a)(6); Treas. Reg. § 1.861-7(c). This rule is often referred to as the "title passage" rule.

[216] I.R.C. § 863(b)(2); Treas. Reg. § 1.863-3(b).

[217] *Id*.

[218] Treas. Reg. § 1.863-3(c).

[219] Treas. Reg. § 1.863-3(c)(2).

[220] *Id*.

[221] An exception applies when inventory property is distributed from, or contributed to, a partnership. Treas. Reg. § 1.863-3(f)(2). A separate dual sourcing rule under section 863(b)(2) applies when the foreign corporation itself manufactures the inventory property outside of the U.S. and then sells such property within the United States in a sale subject to section 865(e)(2). *See supra* note 13. Such income is apportioned as partly foreign source income and partly U.S. source income. *See* Treas. Reg. § 1.865-3.

[222] Treas. Reg. § 1.863-3(c)(3).

the partner's Apportionment Fraction? If the answer to the first question is that the source of income from cloud transactions should be determined at the partnership level, then the answer to the second question should be that partners should disregard their share of a partnership's expenses. This would be consistent with treating partnerships as entities. If the answer to the first question is that partners should determine the source of their distributive share of cloud services income at the partner level, then a partner should take into account its share of partnership-level expenses. This approach would treat a partnership as an aggregate.

We recommend the adoption of an entity approach to partnerships for this purpose. Determining a partner's share of underlying expenses presents administrative challenges, particularly if the Proposed Regulations' current-year expense approach is retained. For example, limited partners in a partnership may not be able to obtain the information necessary to determine whether expenses relate to a particular cloud transaction, product line, or location. To the extent that a partner could obtain the necessary information, it would often be shortly before the partner's own income tax return must be filed. Apart from the administrative concerns, as a factual matter, there will often be no factual connection between expenses incurred by a partnership and its partners' cloud transactions, and vice versa.

Moreover, to the extent that our recommendations limiting the distortions associated with branches are not adopted, the treatment of partnerships as an entity would allow taxpayers structural alternatives that would mitigate the Proposed Regulations' impact on taxpayers with branches outside their countries of incorporation.

Finally, this approach is consistent with existing Treasury regulations addressing gain from the sale of produced inventory, which also apply a formulaic approach (using tax basis rather than expenses). Consideration could be given to whether partnerships may be used to manipulate the Apportionment Fraction (a concern that motivated an anti-abuse rule in the regulations regarding produced inventory). The existing partnership anti-abuse regulations may provide adequate protection against any identified abuses.[223]

G. Consolidated Groups

1. Relevant Single Entity Principles

An affiliated group of corporations may elect to file a U.S. federal income tax return on a consolidated basis.[224] Section 1502 provides that the Secretary of the Treasury (the "**Secretary**")

[223] *See* Treas. Reg. § 1.701-2.

[224] I.R.C. § 1501. An affiliated group of corporations that elects to file a consolidated return is referred to as a "**consolidated group**." Treas. Reg. § 1.1502-1(h).

shall prescribe regulations for a consolidated group to clearly reflect the U.S. tax liability of the consolidated group and to prevent avoidance of such tax liability.

Regulations addressing intercompany transactions (the "**intercompany transaction regulations**") provide rules for taking into account items of gain, deduction, and loss of consolidated group members from intercompany transactions.).[225] The purpose of the intercompany transaction regulations is to "clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)."[226] Under a matching rule,[227] the separate entity attributes of intercompany items of a selling member ("**S**") and the corresponding items of a buying member ("**B**") are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. S's items of income, gain, deduction or loss from an intercompany transaction are its "intercompany items," while B's items from the transaction are referred to as its "corresponding items."[228] The attributes of an intercompany item or corresponding item are all of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income.[229]

2. Interaction with the Proposed Regulations

In certain circumstances, the intercompany transaction regulations may have the effect of redetermining the source (and section 904 category) of members' intercompany items and corresponding items so as to produce the same result that would occur if the members were divisions of a single corporation. An example ("**Example 14**") illustrating the application of the matching rule for purposes of determining the source of gain from the sale of produced inventory.[230] Example 14 demonstrates that, when S produces inventory and sells the inventory to B, which performs further production functions with respect to the inventory, the matching rule requires a redetermination of the source of gain on S's intercompany item (from S's sale to B) and B's corresponding item (from B's sale to a third party).[231] Example 14 further demonstrates that in reaching this result, the rules for determining the source of produced inventory (Treas. Reg. § 1.863-3), including the formula for apportionment of production activities by reference to the basis

[225] Treas. Reg. § 1.1502-13.

[226] Treas. Reg. § 1.1502-13(a)(1).

[227] Treas. Reg. § 1.1502-13(c).

[228] Treas. Reg. § 1.1502-13(b)(2) & (3).

[229] Treas. Reg. § 1.1502-13(b)(6).

[230] Treas. Reg. § 1.1502-13(c)(7)(ii)(N); *see also* Treas. Reg. § 1.904-4(f)(4)(xv) (Example 15).

[231] Treas. Reg. § 1.1502-13(c)(7)(ii)(N)(1)(ii).

of production assets, must be applied by treating the consolidated group as a single entity.[232] It would be reasonable to conclude that a similar outcome would apply if S and B were engaged in the cloud services business.

> Example 11. Cloud service providers in a consolidated group. P is the parent of a consolidated group that includes S and B. B provides cloud services to a third-party customer, earning $100 of gross income from the transaction in a taxable year. In connection with the transaction, S licenses intangible property to B for $20, all of which would be U.S. source income. S and B's relevant expenses for the taxable year are as follows:
>
> *Intangible property factor*
> B: Country X R&E personnel.....……..……...……$20
> B: Royalty payment... .....$20
> S: U.S. R&E personnel……..……..…….$20
>
> *Personnel factor*
> B: U.S. direct service personnel…….…….……...……$5
>
> *Tangible property factor*
> B: U.S. server lease….……..…….....$5
>
> On a separate entity basis, $80 of B's gross income from cloud services would be foreign source income and $20 would be U.S. source income.[233] On a single entity basis, applying the Apportionment Fraction as though members of the P group were a single entity, $60 of B's gross income would be U.S. source income and $40 would be foreign source income.[234] Thus, under Treas. Reg. § 1.1502-13(c)(1)(i),

[232] Treas. Reg. § 1.1502-13(c)(7)(ii)(N)(1)(i) & (ii).

[233] B's intangible property factor would equal $40, with the U.S. source portion of the intangible property factor equal to $0 ($40 multiplied by $0/$20). B's personnel factor would equal $5, with the U.S. source portion of that factor equal to $5. The tangible property factor would equal $5, with the U.S. source portion equal to $5. Accordingly, B's Apportionment Fraction with respect to the cloud transaction would be $10/$50. Thus, $20 of B's gross income from the Country X cloud transaction ($100 multiplied by $10/$50) would be U.S. source income and $80 ($100 minus $20) would be foreign source income.

[234] If B and S were divisions of a single corporation, the combined intangible property factor would equal $40, with the U.S. source portion of the intangible property factor equal to $20 ($40 multiplied by $20/$40). (If S and B were divisions of a single corporation, no regarded royalty would be paid, such that the intangible property factor likely would not include B's $20 royalty payment to S.) The personnel factor would equal $5, with the U.S. source portion of that factor equal to $5. The tangible property factor would equal $5, with the U.S. source portion equal to $5. Accordingly, B's Apportionment Fraction with respect to the cloud transaction would be $30/$50. Thus, $60 of B's gross income from its cloud transaction ($100

it may be appropriate to treat an additional $20 of B's gross income from its cloud transaction as U.S. source income.[235]

On the other hand, the Proposed Regulations aggregate certain expenses associated with transactions in a particular product line, whether or not the expenses are directly related to a particular transaction. Consolidated group members may incur costs that would be taken into account as part of the intangible property factor for cloud transactions in the same product line without entering into intercompany transactions. As a result, the intercompany transaction regulations would be inapplicable in certain cases, producing results that are inconsistent with a single entity approach.

Example 12. Cloud service providers in a consolidated group. P is the parent of a consolidated group that includes S and B. S provides cloud services to a third-party customer, earning $100 of gross income from the transaction in a taxable year. B provides cloud services in the same product line to a different third-party customer, also earning $100. S and B engage in no intercompany transactions. S and B's relevant expenses for the taxable year are as follows:

Intangible property factor
S: U.S. R&E personnel…….……..…….$50
B: Foreign R&E personnel…….……..……...….$30

Personnel factor
S: U.S. direct service personnel…….....$15
B: U.S. direct service personnel…….…..……...……..….$15

Tangible property factor
S: U.S. server lease…….....$5
B: U.S. server lease……..…….....$5

On a separate entity basis, (i) $100 of S's gross income from cloud services would be U.S. source income and $0 would be foreign source income and (ii) $60 of B's income would be foreign source income and $40 would be U.S. source income.[236]

multiplied by $30/$50) would be U.S. source income and $40 ($100 minus $60) would be foreign source income.

[235] For simplicity, this example ignores the effects of the allocation and apportionment of expenses. Further adjustments may be necessary to achieve an appropriate result after considering those effects. In addition, adjustments to the treatment of the intercompany royalty payment may be necessary in certain instances. *See infra* note 239.

[236] S's Apportionment Fraction would equal $70/$70, such that all $100 of its gross income from the cloud transaction would be U.S. source income. B's intangible property factor would equal $30, with the U.S. source portion of the intangible property factor equal to $0 ($30 multiplied by $0/$30). B's personnel factor

Treated as a single entity, S and B would each earn $75 of U.S. source income and $25 of foreign source income.[237] Thus, on a separate entity basis, B and S collectively would earn more foreign source income ($60) than they would if the P consolidated group were treated as a single entity ($50). However, because neither S nor B engages in an intercompany transaction, the matching rule likely would not apply to redetermine the attributes of S or B's gross income.

Thus, absent further guidance, the application of the Proposed Regulations to consolidated groups would produce inconsistent results. We believe that the clear reflection of the taxable income of a consolidated group would be better served by treating all members of a consolidated group as a single corporation for purposes of determining the source of income from cloud transactions.[238] Related adjustments would likely be necessary to prevent distortions related to income and deductions associated with intercompany payments.[239]

This result would reduce inappropriate outcomes and eliminate traps for the unwary. It would also be consistent with a number of rules governing the interaction of the Code's international provisions and the consolidated group rules, including the determination of a consolidated group's foreign tax credit,[240] the determination of a consolidated group member's

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would equal $15, with the U.S. source portion of that factor equal to $15. B's tangible property factor would equal $5, with the U.S. source portion equal to $5. Accordingly, B's Apportionment Fraction with respect to the cloud transaction would be $20/$50. Thus, $40 of B's gross income from its cloud transaction ($100 multiplied by $20/$50) would be U.S. source income and $60 ($100 minus $40) would be foreign source income.

[237] S and B's combined intangible property factor before allocation between cloud transactions would equal $80, with the U.S. source portion of the intangible property factor equal to $50 ($80 multiplied by $50/$80). After the allocation of expenses to S and B on the basis of gross income from their respective cloud transactions, the intangible property factor with respect to each of S and B's cloud transactions would be $40 (that is, since each earns $100 of gross income, each would receive 50 percent of the expenses taken into account in the intangible property factor). The U.S. source portion of each intangible property factor would be $25 (that is, $40 of their respective intangible property factors multiplied by $25/$40). The other factors would remain unchanged, such that S and B would each have an Apportionment Fraction of $45/$60. Accordingly, B and S would each recognize $75 of U.S. source income and $25 of foreign source income (in each case, $100 multiplied by $45/$60).

[238] This single entity treatment should not go so far as to "collapse" partnerships whose only partners are members of a single consolidated group. Rather, we recommend that the single entity treatment apply solely for purposes of determining the source of gross income from cloud transactions directly earned by a member of a consolidated group.

[239] For example, in Example 11, B's deduction for its royalty payment could be allocated to U.S. and foreign source gross income in the same proportions as S's gross income for such royalty to better achieve a single entity outcome. *Cf.* Treas. Reg. § 1.861-11T(e)(2)(i).

[240] Treas. Reg. § 1.1502-4.

share of certain items for purposes of section 951A,[241] the treatment of section 959(b) distributions for purposes of section 951(a)(2)(B),[242] and the section 987 regulations.[243] Accordingly, we recommend that consolidated groups should be treated as a single taxpayer for purposes of applying the Apportionment Fraction.

H. Anti-Abuse Rule

The Proposed Regulations include a broad anti-abuse rule, providing that appropriate adjustments will be made if a taxpayer enters into, or structures, one or more transactions with a principal purpose of reducing its U.S. tax liability in a manner that is inconsistent with the purpose of attributing the source of the taxpayer's gross income from a cloud transaction to the location where the cloud transaction is performed.[244]

One may reasonably question whether an anti-abuse rule is appropriate in this context. As the Preamble observes, the IRS has a number of common law doctrines at its disposal to challenge potentially abusive transactions, including the economic substance doctrine, the step transaction doctrine, and agency theories. The anti-abuse rule, however, would further require taxpayers to determine whether an arrangement is consistent with the purposes underlying the Proposed Regulations. We believe that this would pose difficulties for taxpayers. The three factors taken into account in the Apportionment Fraction act as a proxy for, rather than a precise measure of, the place of performance in connection with a cloud transaction. This proxy-based approach is necessary in part because intangible property has no inherent location but as with any proxy, however well designed, will necessarily sometimes reach results that are somewhat arbitrary. For these reasons, there is no evidently correct "baseline" source outcome under general principles against which to evaluate a transaction and conclude that manipulation contrary to the purpose of the source rule has occurred.[245]

As discussed throughout this Report, the nature of the Apportionment Fraction is such that starkly different source outcomes may result from commercially similar transactions with different organizational structures and legal arrangements with related and unrelated parties. For example, a taxpayer that creates intangible property and licenses the intangible property would often be subject to a very different source outcome than a taxpayer that creates intangible property and uses it to provide a service. Although the Code's different approaches to determining source in those transactions are different, neither is self-evidently more appropriate from a tax policy perspective.

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[241] Treas. Reg. § 1.1502-51.

[242] Treas. Reg. § 1.1502-80(j).

[243] Treas. Reg. § 1.1502-13(j)(9). *But see* Prop. Reg. § 1.1502-13(j)(10)(3) (generally overriding the matching rule in the context of the DCL regulations).

[244] Prop. Reg. § 1.861-19(d)(9).

[245] *Id*.

Consequently, it will be difficult (perhaps impossible) for taxpayers to determine (and IRS examiners to assess) whether a taxpayer's choice of structure or legal arrangements implicate the anti-abuse rule, particularly in the case of related-party transactions. This uncertainty would potentially undermine one of the Proposed Regulations' stated objectives of setting forth a clear and administrable rule.[246]

To address this, we recommend that final regulations not include an anti-abuse rule. If, however, an anti-abuse rule is retained in final regulations, it should include much more specific and administrable guidance as to outcomes, structures, and transactions that are considered abusive. One instance to which an anti-abuse rule might appropriately apply would be transactions in which related parties act as conduits or accommodation parties. Any such rule should, however, set out with specificity factors that are indicative of status as an accommodation party, such as a lack of employees, inadequate capitalization, the lack of dealings with third parties, and other factors. Treasury could also consider adopting mechanical presumptions; for example, if a taxpayer subcontracts with related parties for 95 percent or more of the intangible property, personnel, and tangible property used to provide a cloud service, the taxpayer could be presumed to be acting as a conduit.

It is questionable whether a taxpayer's choice of form (even if tax motivated in part) should be subject to an anti-abuse rule. For example, a domestic cloud services provider expanding into a new market or new product could form a subsidiary with the requisite direct service personnel and tangible property, while licensing existing critical tangible property to enable the affiliate to provide services. Alternatively, the cloud service provider could provide the services directly (or via a disregarded entity or true branch), recognizing services income directly. As discussed throughout this Report, a taxpayer faced with this choice would obtain starkly different source outcomes. On the one hand, this degree of electivity is troubling. On the other hand, it is arguably a function of the Code's different treatment of services income and royalty income, coupled with the respect afforded separate but related entities. Moreover, as a matter of horizontal equity, there should be no reason that a taxpayer should be prevented from restructuring its existing affairs to obtain results that could be obtained *ab initio*. We submit that it is inappropriate for an anti-abuse rule to leave taxpayers to grapple with these questions; if final regulations do include an anti-abuse rule, guidance as to these core issues should be included.

We further recommend that the final regulations provide guidance on, and specific examples of, structures and transactions that are ***not*** subject to the anti-abuse rule. Examples might include developing intangible property and licensing that intangible property to related or unrelated service providers in a bona fide license arrangement even if the choice of structure is, in in part, motivated by the source outcome under the rules.

[246] 90 Fed. Reg. at 3077.

I. Withholding

Throughout this Report, and in particular in Part IV.D with respect to branches, we have made recommendations that would reduce the instances in which cloud transactions between foreign persons would generate U.S. source income. Nonetheless, even if those recommendations are adopted in final regulations, they may not comprehensively eliminate situations that would result in withholding obligations. In those cases, burdensome compliance processes may interfere with legitimate third-party transactions. For example, a foreign or U.S. customer – whether that customer is an end-user or itself a business – would be unaccustomed to Chapter 3's withholding obligations in this context. Although the most likely outcome would be widespread, often inadvertent noncompliance, taxpayers that attempted to comply with the Code's withholding requirements (by recommending that its customers withhold, for example) would be disadvantaged vis-à-vis competitors with no U.S. presence.

To address those situations, we recommend that Treasury issue procedural guidance providing that no withholding is required under Chapter 3 of the Code when the cloud service provider is a foreign person. This procedural relief would not extend to the cloud service provider's substantive tax liability under the Code. Treasury could consider a number of safeguards, including limiting the relief to transactions between unrelated persons, and by requiring a certain specified percentage of the cloud service provider's income be foreign source income. For example, the guidance could provide that a cloud service provider is not eligible for relief if more than 80 percent of its income is U.S. source income. Alternatively, other factors, such as headcount, customers, or other measures of physical foreign presence, may be used. Consideration should be given to whether such relief would be appropriate with respect to foreign cloud service providers engaged in a U.S. trade or business or with a U.S. permanent establishment. Although those providers' greater nexus to the United States arguably makes such relief less appropriate, determining whether the related income is effectively connected income or business profits attributable to a U.S. permanent establishment may be difficult in certain circumstances.[247]

[247] *See supra* text accompanying notes 178-181.