taxnotes® federal

Volume 188, Number 9 ■ September 1, 2025

Proposed Cloud Services Sourcing Rule: The Right Direction

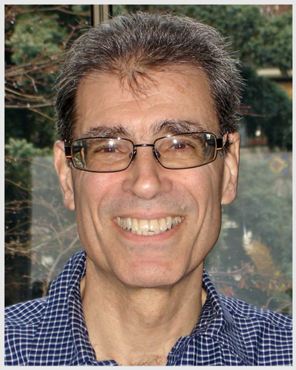
by Reuven S. Avi-Yonah, Jeffery M. Kadet, and Karen Sam

Reprinted from *Tax Notes Federal*, September 1, 2025, p. 1397

Proposed Cloud Services Sourcing Rule: The Right Direction

by Reuven S. Avi-Yonah, Jeffery M. Kadet, and Karen Sam

Reuven S. Avi-Yonah



Jeffery M. Kadet

Karen Sam

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law at the University of Michigan Law School. Jeffery M. Kadet is an adjunct lecturer of international tax at the University of Washington School of Law in Seattle. He was in private practice for over 32 years, working in international taxation for several major accounting firms. Karen Sam is an international tax consultant and fractional chief compliance officer.

In this article, the authors refute certain criticism of the proposed cloud services sourcing rules released in January, and they suggest important amendments for Treasury and the IRS to consider in implementing the final regulation.

I. Background

This past January, in conjunction with the issuance of a final regulation (T.D. 10022) that treats income from defined cloud transactions as income from services, Treasury and the IRS released a proposed regulation (REG-107420-24) on the sourcing of that income.[1] In 2019 a Treasury official had asked the tax community for feedback on whether specific cloud transaction sourcing rules were needed,[2] and the preamble to a 2019 proposed regulation asked for comments on "administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865."[3] The feedback was "split almost evenly with regard to whether specific sourcing rules are needed in this area, with a narrow majority expressing support for such guidance," the preamble to the 2025 proposed regulation explains.

In deciding that specific rules were needed, the preamble addresses the lack of existing guidance and the need for clarity and certainty for taxpayers and the IRS:

> Under the source rules of the Code, which were designed in the context of more traditional modes of commerce, gross income from the provision of services is sourced to the place where the service is performed. See sections 861(a)(3) and 862(a)(3). The Code does not provide guidance on how to determine the place of performance for specific types of service transactions, including cloud transactions.

---

[1] For a summary of the content of both T.D. 10022 and REG-107420-24, see Carrie Brandon Elliot, "Proposed Regs Clarify Source of Income From Cloud Transactions," *Tax Notes Federal*, July 14, 2025, p. 188.

[2] Kristen A. Parillo, "Treasury Wants Input on Need for Cloud Transaction Sourcing Rule," *Tax Notes Federal*, Sept. 23, 2019, p. 2139.

[3] Preamble to REG-130700-14, 84 F.R. 40317 (Aug. 14, 2019).

> Further, while section 863(b)(1) specifies that income from services rendered partly within and partly without the United States is treated as derived partly from each source, there is no statutory guidance prescribing how to source the services income, including income from cloud transactions, in such circumstances. 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.

Because of this need for guidance, Treasury and the IRS proposed a formula-based approach to sourcing this services income from cloud transactions. The approach reflects the existing statute and regulatory guidance, which focuses on the place where services are performed, as well as the distinctive attributes of cloud transactions. The preamble explains:

> 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. *See* 43 BTA at 297, *aff'd*, 127 F.2d at 260. 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). Similarly, the location where a contract for a cloud transaction is executed should not dictate the source of the resulting gross income because that location may not bear any connection to where the service is performed.

Based on this, the proposed regulation presents a formula that considers only three factors: (1) intangible property (which, as explained later, is mislabeled), (2) personnel, and (3) tangible property.

A major challenge faced by Treasury and the IRS was how this proposed formula should be applied to multinational groups when more than one group member is involved in conducting the activities and owning the assets that underlie the cloud services being provided to customers and clients. The preamble summarizes the comments on this issue:

> Many of the comments discussed whether the sourcing determination should be made by taking into account solely the assets and personnel of the taxpayer that recognizes the income from the performance of the cloud service (the taxpayer-by-taxpayer approach), or whether taxpayers should be required to look through to the activities and personnel of other related legal entities that contribute to the provision of the service (the unitary approach). Nearly all comments on this issue stated that income from cloud transactions should be sourced on a taxpayer-by-taxpayer basis.

Although "nearly all" commentators supported a taxpayer-by-taxpayer approach, two did not. One suggested an antiabuse rule that would apply a look-through or unitary approach in limited circumstances. The other argued that a unitary approach should be required, as the preamble explains:

> Another comment asserted that sourcing services income from cloud transactions on a look-through or unitary basis should be required, explaining that this approach more accurately reflects the economic realities of the transaction because it accounts for the contributions made by

> members of the multinational group to the provision of the service. That comment also expressed the concern that sourcing on a taxpayer-by-taxpayer basis could cause U.S. source income to be understated with respect to commonly-used structures in which the development, enhancement, maintenance, protection, and exploitation functions are performed primarily by U.S. entities but the services income is recorded by a foreign entity that contracts directly with the end-users to whom the cloud transaction is provided.

After considering these comments, Treasury and the IRS applied the taxpayer-by-taxpayer approach in the proposed regulation, with the preamble saying that this approach is "administrable and practical" and leads to "reduced complexity in tax compliance and enforcement." Presumably recognizing the potential for inappropriate sourcing results, the preamble says:

> This approach would not impede the IRS's ability to assert 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. Notwithstanding the above, the Treasury Department and the IRS will continue to study the implications of applying the taxpayer-by-taxpayer approach in the context of sourcing gross income from services generally, and may refine or propose revisions to the approach if they determine that this is 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.

Thus, while the proposed regulation adopts the taxpayer-by-taxpayer approach, that is not set in stone.

Because the three-factor formula has been detailed elsewhere,[4] there is no need to restate it here, except to the extent needed for the further discussion below. Interested readers are encouraged to read prop. reg. section 1.861-19(d), which is relatively short.

II. Countering Criticism

After releasing the proposed regulation, Treasury and the IRS received some critical comments (1) questioning the need for any cloud transaction sourcing rule at all, and (2) recommending that the intangible property factor (one of the three factors in the sourcing formula) be eliminated. We believe the criticisms of these two issues are without merit, likely reflecting the desires of the commentators, most or all of whom have economic interests in the outcome or represent persons that do.[5] We suspect those persons would largely like to continue the status quo, which allows maximum flexibility to minimize taxation through artificially high foreign tax credit limitations, maximize tax benefits through profit-shifting structures, and minimize the potential for shifted profits to be taxed as effectively connected income.[6]

Regarding the clear need for dedicated cloud transaction sourcing rules, we see three simple points:

- Cloud transactions represent a major economic sector.

[4] *See* Elliot, *supra* note 1.

[5] Unlike comments on REG-107420-24 by trade groups and some others, the New York State Bar Association Tax Section submitted overall favorable comments (likely reflecting its broad membership base) supporting the use of multifactor apportionment to determine source and the chosen three-factor formula in the proposed regulation. NYSBA Tax Section, "Comments on Proposed Regulations on Source of Income From Cloud Transactions," Rep. No. 1511 (Apr. 14, 2025). *See also* Jeffery M. Kadet, recommendations for 2025-2026 priority guidance plan, at 202-205 (May 17, 2025) (comments focusing on REG-107420-24 and T.D. 10022).

[6] If a U.S.-based multinational records gross income from cloud services within a foreign group member while a U.S. group member partially or wholly provides the services to the foreign group member's users and customers, there will be taxation on ECI if the foreign group member conducts a U.S. trade or business. The tax imposed is a direct corporate income tax on some or all of the foreign group member's income. This is in contrast to transfer pricing or recharacterizing adjustments that cause increased taxable income within a U.S. group member.

- Cloud transactions are starkly different from traditional services performed by individuals — the brief, people-focused source rule now in reg. section 1.861-4 is simply not sufficient.
- There must be one sourcing rule to create a level playing field so that similarly situated taxpayers are taxed consistently.

To explain why the intangible property factor is an appropriate part of the proposed formula, we first consider whether the label "intangible property factor" is part of the problem.

This label implies that the location where intangible property was created should be a factor in where cloud services income is sourced. Some of the critics may have jumped on this implication because the existing law and regulations on the source of services income focus solely on where services are performed and not where any intellectual property underlying those services was created.[7]

For example, consider a lawyer who was educated at Harvard Law School and obtained several advanced degrees in international and European law in England and the Netherlands. When he performs his lawyerly services in New York using the technical knowledge he gained on the east side of the Atlantic for a client located in Japan, the resulting services income is U.S.-source because he performed his services within the United States. Neither the location where he gained his technical expertise and professional qualifications nor the location of the client is relevant to the source determination.

So in the context of cloud services, it would be a problem if the proposed rule were to have an intangible property factor that included the location where that property (for example, software, copyrights, and business model) underlying the service being provided was created. That would clearly be inconsistent with the underlying law and existing regulations.

Despite the implication of the intangible property factor label, the details of the proposed regulation make clear that the location where intangible property was created is not a factor in where cloud services income is sourced. Rather, this factor should be relabeled to something like "intangible property maintenance expenses."

What is included in this factor that makes the label so misleading and makes its real content appropriate to include in the proposed three-factor formula?

The factor includes three components: (1) certain limited research and development expenditures, (2) certain amortization, and (3) relevant royalty expenses.

Because the amortization and royalty components represent *period* costs for a taxpayer's rights underlying the services being performed, there should be no question that those expenses are appropriately included in the base for the mislabeled intangible property factor.

Regarding which R&D expenditures are included, prop. reg. section 1.861-19(d)(2)(i) specifies: "the taxpayer's specified research or experimental expenditures (as defined in section 174(b) and regardless of whether and when the expenses are deductible) *for that taxable year that are associated with cloud transactions in the same product line as the cloud transaction performed*" (emphasis added).[8]

Before any taxpayer earns substantial income from cloud services in a new product line, there is usually a significant period (often years) during which planning, software development, and other activities take place. Because that is the norm, and because only R&D expenditures of the *current* tax year[9] within the *specific product line*[10] are included in the intangible property factor, the included expenditures will not represent development of the rights that underlie the services being

[7]Sections 861(a)(3) and 862(a)(3) and reg. sections 1.861-4 and 1.862-1.

[8]Because P.L. 119-21, enacted July 4, 2025, added new section 174A and amended section 174(b), this reference in the proposed regulation will require an appropriate amendment when the final regulation is promulgated.

[9]Although including R&D expenditures of only the current tax year is a reasonable approach, there is an alternative that would provide more accuracy at the cost of slightly more administrative complexity. Instead of using just the current year's R&D expenditures in the factor, the cumulative of those expenditures for the product line from the date that the product line first earned significant services income from cloud transactions could be used. By measuring only from the time of significant income, the prior R&D expenditures that created the intangible property underlying the product line would be fully excluded from the intangible property factor. Only the accumulation over time of later relevant expenditures would be included.

[10]Because of this "same product line" limitation, the R&D expenditures that create new service products will not be included within the intangible property factor for any existing cloud service product line.

Summary Results

	Corp A		Corp B		Total Unitary	
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
Gross Income Results						
Example 15 — With cost-sharing arrangement	800.0	0.0	612.8	187.2	1,507.9	92.1
Example 15 — With license and no CSA	800.0	0.0	0.0	800.0	1,507.9	92.1

performed. Rather, they will primarily represent things such as new features added to an existing cloud service, tweaks, bug fixes, and regular updates and security patches. The preamble emphasizes this point: "Specified research or experimental expenditures [of the current year] are used as a proxy for current use of existing self-developed intangible property."

R&D expenditures on those items represent period costs of maintenance and enhancements that, like period amortization and royalty costs, should undoubtedly be included in the mislabeled intangible property factor.

Given the above, calls for elimination of the intangible property factor are misplaced and should be disregarded.

III. Suggested Improvements

The Treasury and IRS drafters of the formula approach for sourcing cloud services income in prop. reg. section 1.861-19(d) should be applauded. That said, there are some improvements we hope they will consider for the finalized regulation.

A. Adopt a Unitary Approach

Because the proposed regulation reflects a taxpayer-by-taxpayer approach, the three-factor formula reflects only the taxpayer and its agents. Amounts paid by them to independent contractors would be ignored. A unitary approach, by contrast, would include amounts not only from the group member taxpayer (including any agents) that has recorded revenue but also amounts from the books and records of other group members that were involved in or contributed to the provision of the cloud services, even if they putatively act as independent contractors. See the appendix for a brief explanation of how a unitary approach might work.

The issue of which approach should be required in the sourcing regulation is important because multinational groups often conduct their worldwide centrally managed businesses through multiple group members, specifically taking advantage of the separate entity application of tax laws. With cloud services, a foreign group member will often contract with foreign customers and users, thereby recording the gross revenue from those customers and users. However, the actual services are partially or wholly provided to them by a U.S. group member. (The U.S. group member is also providing the cloud services to its own U.S.-based customers and users.) In that typical case, the proposed taxpayer-by-taxpayer approach causes nonsensical sourcing results. This is because the bulk of the relevant assets and expenses associated with performing the cloud services are in the United States and thus left out of the foreign group member's three-factor formula calculation.[11] They are included only in the U.S. group member's source calculation for revenue from U.S. customers and users.

The table provides summary results from an example in which the numbers for Corp A (the U.S. parent) and Corp B (a foreign group member)

[11]For several detailed examples of how a taxpayer-by-taxpayer approach can produce nonsensical sourcing results, see Kadet, "Sourcing Cloud Transactions Economically — The Right Way," *Tax Notes Federal*, June 6, 2021, p. 1555; and Kadet comments on REG-107420-24 and T.D. 10022 (Mar. 19, 2025). This comment letter includes considerable additional discussion supporting the unitary approach, as well as an examination of other relevant issues concerning both T.D. 10022 and REG-107420-24. For example, it discusses the relevance, or lack thereof, of *Miller v. Commissioner*, T.C. Memo. 1997-134, *aff'd without published decision*, 166 F.3d 1218 (9th Cir. 1998).

are significantly different.[12] Applying the taxpayer-by-taxpayer approach to the arrangement, which involves a license, results in $800 of U.S.-source income in the hands of Corp A and $800 of foreign-source income in the hands of Corp B. However, when the calculation is done on a unitary basis, the split is $1,507.90 U.S.-source income and $92.10 foreign-source income.[13]

A taxpayer-by-taxpayer approach works perfectly when there's a single taxpayer entity that conducts the taxpayer's worldwide cloud service business, which is probably the case for most small and midsize businesses. Those businesses would not be inconvenienced if the final sourcing rule requires a unitary approach for relevant multinational groups.

We explain some reasons for these different sourcing results below.

In the typical multinational structure, a foreign group member will be making two types of relevant payments to U.S. group members. The first type secures rights to the intangible property that underlies the services. These will be royalty payments if there's a licensing arrangement or intangible development cost payments if there's a cost-sharing arrangement governed by reg. section 1.482-7.

When a foreign group member makes a royalty payment, the sourcing is based on the location of the foreign group member's R&D personnel.[14] Since that foreign group member will normally have no R&D personnel in the United States, 100 percent of the royalty will be foreign source.

When there's a cost-sharing arrangement, a participant's payments toward developing cost-shared intangibles "will be considered the payor's costs of developing intangibles at the location where such development is conducted."[15] This is essentially a look-through characterization rule that will cause the foreign group member to have some amount of U.S.-source intangible property factor.

The second type of payment that a foreign group member will be making to a U.S. group member is for the latter's operation of the internet-based platform and its delivery of the service directly to the foreign group member's customers and users. This reflects the fact that the foreign group member often plays little or no part in operating the platform through which the cloud services are provided. Although the foreign group member directly contracts with its customers and users for the cloud services, it often can't perform those services itself. It conducts only routine marketing and sales, customer support, logistics, and other similar functions and must rely on a U.S. group member to conduct and deliver the cloud services.[16]

It seems certain that multinationals commonly treat those amounts paid by a foreign group member to a U.S. group member as payments to an independent contractor and not as payments to an agent.

Under the taxpayer-by-taxpayer approach, only the U.S. group member includes the tangible asset and personnel costs in its three-factor source computation. Because of this approach and the independent contractor characterization, the foreign group member excludes these payments to the U.S. group member for providing the cloud services to its customers and users from its own source computations. This causes artificially high foreign-source income in the hands of the foreign group member.

As the table shows, the illogical sourcing results caused by these two types of payments can be corrected only by a unitary approach that combines the numbers from all relevant group members involved in providing cloud services.

Some major taxpayers should clamor for a unitary approach because they repatriated their intellectual property back to the United States to transform what would otherwise have been foreign income treated as global intangible low-taxed income (net controlled foreign corporation tested income for tax years beginning after December 31, 2025) into income qualifying for the foreign-derived intangible income benefit

[12]For the full details of this example, see Kadet comments, *supra* note 11.

[13]This summary differs slightly from the original in the comment letter, *id.*, to reflect a minor arithmetical correction.

[14]*See* prop. reg. section 1.861-19(d)(2)(ii).

[15]Reg. section 1.482-7(j)(3)(i).

[16]This situation is reflected in Example 10 in reg. section 1.861-19(d)(10).

(foreign-derived deduction-eligible income for tax years beginning after December 31, 2025). A unitary approach should allow these multinationals to report increased levels of foreign-source income.

While a full unitary approach would be best, there is some question whether Treasury and the IRS have sufficient statutory authority to adopt it.[17] If it were determined that current statutory authority is insufficient to implement a full unitary approach, the final regulation should adopt a look-through rule that would apply to all intercompany payments — that is, all royalties, service fees, and other payments (no matter how designated) paid by a taxpayer to a related person to compensate for rights to relevant intangibles and the conduct of any activities or functions that provide or support the taxpayer's provision of cloud transactions to its customers and users. The look-through rule should reduce or eliminate some of the absurd results illustrated in the table.

B. Amend Structure of Intangible Property Factor

The structure of prop. reg. section 1.861-19(d)(1)-(4) requires taxpayers to first determine the U.S.-source portion of their gross income from cloud transactions. Then, under the last sentence in prop. reg. section 1.861-19(d)(1), the remainder becomes the foreign-source portion.

The structure of the intangible property factor (prop. reg. section 1.861-19(d)(2)) is problematic and can add to the nonsensical results that can occur under the taxpayer-by-taxpayer approach. (The structure of the intangible property factor would work fine if a unitary approach were adopted.)

For a U.S. multinational, a foreign group member earning cloud transaction services income will usually have few if any research and experimentation personnel as defined in prop. reg. section 1.861-19(d)(2)(ii). And the foreign group member will almost never have any U.S.-based R&E personnel. Yet the foreign group member may still have significant "total" intangible property factor amounts under prop. reg. section 1.861-19(d)(2)(i) because the factor includes not only certain R&D expenditures but also certain amortization and royalty payments.

Assume that a foreign subsidiary (FS) of a U.S. parent has a total intangible property factor of $1,000. Also assume it has no R&E personnel. Under the structure of prop. reg. section 1.861-19(d)(1) and (2), FS will first determine its U.S.-source portion of the intangible property factor. Under the formula, that will result in a zero U.S.-source factor since FS has no R&E personnel in the United States. That means that in the prop. reg. section 1.861-19(d)(1) computation, there will be zero U.S.-source intangible property factor in the numerator of the formula and $1,000 in the denominator. This will be the result regardless of where the U.S. parent's R&E personnel are located.

Again, the application of a unitary approach would cure this problem.

If Treasury and the IRS are hesitant to apply a full unitary approach, they should consider amending prop. reg. section 1.861-19(d)(2)(ii) to read:

> (ii) *Portion from sources within the United States*. With respect to a cloud transaction provided in a taxable year, the portion of the intangible property factor from sources within the United States is determined using a formula based on the location of all employees of both the taxpayer and all persons related to the taxpayer (within the meaning of sections 267(b) and 707(b)) whose primary function is to perform research and experimentation activities associated with cloud transactions in the same product line in that taxable year (the research and experimentation personnel). The formula is as follows: applying the principles of reg. section 1.861-4(b)(2)(ii)(E) (relating to sourcing income from labor or personal services on a time basis), divide the sum of the total compensation paid to the research and experimentation personnel for services performed within the United States by the sum of the total compensation paid to the research and experimentation personnel, and multiply the resulting quotient by the intangible

[17] *See* Michael J. Graetz, "Sovereignty, Sins, and the Reassertion of Primary Taxing Rights by the United States," *Tax Notes Federal*, Feb. 24, 2025, p. 1399.

property factor described in paragraph (d)(2)(i) of this section.

With this amendment, the sourcing results under the taxpayer-by-taxpayer approach would be significantly improved.[18]

This amendment would also produce a fairer and more appropriate result for U.S. subsidiaries of foreign-based multinationals. If a U.S. subsidiary has only one employee constituting R&E personnel and they are located within the United States, that would likely overstate economically the amount of that U.S. subsidiary's U.S.-source income. On the other hand, if the U.S. subsidiary has no R&E personnel, its foreign-source income would be overstated.

C. Expand the Proposed Sourcing Rule

Reg. section 1.861-19(b) defines a cloud transaction narrowly, excluding many types of electronic medium-provided services income, one of which is advertising.[19] Lee A. Sheppard in a March article observed the irony that major internet-based services like advertising by companies such as Google are not included within the definition.[20]

This means that only cloud services falling within the narrow cloud transaction definition will be sourced using the proposed three-factor formula. While it appears clear that the very general sourcing guidance in reg. section 1.861-4 will apply to cloud services that fall outside the cloud transaction definition, good tax policy strongly suggests that the proposed formula approach should apply to *all* income from services conducted through electronic media.

One reason is that conceptually, in determining source, there is no reason to treat income from different types of services conducted through electronic media differently. Another reason is that the general sourcing guidance in reg. section 1.861-4 allows taxpayers that do not fall within the narrow cloud transaction definition broad latitude to develop their own income sourcing computations. Clearly, good tax policy requires that taxpayers earning a particular type of income source that income in the same manner. Only in this way can there be a level playing field among all relevant taxpayers. Given the size of this economic sector, this is an important and relevant issue.

Putting this expansion of the sourcing rule into effect could be accomplished by amending the definition in reg. section 1.861-19(b) to fully include all services conducted through electronic media. Or the existing sourcing rules in reg. sections 1.861-4 and 1.862-1 could be amended to simply reference the prop. reg. section 1.861-19(d) sourcing rule for relevant services income that is not already within the reg. section 1.861-19(b) definition. Such a cross-reference could perhaps also be inserted into regulations under section 863.

IV. Summary

Treasury and the IRS should be praised for the well-thought-out cloud transaction sourcing rule they have proposed. The rule, as drafted, is necessary, and the allocation factors included are relevant and appropriate. They also made

[18]The NYSBA Tax Section report, *supra* note 5, included several thoughtful recommendations that would generally make the sourcing results more theoretically accurate. One was to allocate between U.S.- and foreign-source within prop. reg. section 1.861-19(d)(2)(ii) based not solely on the location of R&E personnel but by using all relevant expenditures for which "there is a demonstrable and objectively determinable factual connection between an expense and a specific jurisdiction." We believe that any of those NYSBA recommendations could be considered for implementation in the final regulation. However, because a formulaic approach is by its nature meant to produce sourcing results that are fair to both the government and taxpayers, further refinements must be judged based more on their additional cost and inconvenience for IRS examiners and taxpayers rather than based on whether they provide arguably more theoretically correct results. This example regarding expenditures beyond solely the location of certain personnel, which is a relatively objective factor, would add not only considerable detail to the source calculation, but it would also add to the scope for disagreements between the IRS and taxpayers on what may be subjective determinations of when particular expenditures have a determinable factual connection with a specific jurisdiction.

[19]Reg. section 1.861-19(b) provides: "*Cloud transaction defined*. A cloud transaction is a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in section 1.861-18(a)(2)), or other similar resources. A cloud transaction does not include network access to download digital content for storage and use on a person's computer or other electronic device." According to the preamble to T.D. 10022 (at Section III.B), advertising services fall outside this definition "because while the ads are viewable online, the advertising services are likely not cloud transactions because there is likely no on-demand network access to computer hardware, digital content, or similar resources provided by the platform to the advertisers (though specific fact patterns may differ)." The preamble mentions other types of cloud services that would normally fall outside the narrow definition (*e.g.*, sites and apps involving the gig economy, job recruiting, and travel).

[20]Sheppard, "Wetware Somewhere: The New Cloud Regulations," *Tax Notes Federal*, Mar. 17, 2025, p. 1949.

reasonable judgments in balancing theoretical accuracy with administrative simplicity.

As discussed above, there are important details that it is hoped will be considered in the preparation of the final sourcing regulation. These include requiring that sourcing results for multinationals be based on a unitary approach, renaming the mislabeled intangible property factor and adjusting it as described above, and expanding the coverage of the proposed three-factor formula approach to include all income from services conducted through electronic media.

V. Appendix

How a Unitary Approach Might Work

The sourcing of income under the prop. reg. section 1.861-19(d) three-factor formula as determined on a unitary basis would take into account the relevant information from multiple group members, effectively canceling out intragroup contractual arrangements and payments. However, federal taxation would continue to be applied on a separate entity basis.[21] As a result, U.S. taxation of U.S. group members and foreign group members would be applied to the income reported by each group member. To reflect the unitary nature of multinationals' cloud service businesses and the need for separate application of taxation to each entity, the percentages of U.S.- and foreign-source income as determined on the unitary basis would be applied to the income recorded within each group member.[22]

Example. Assume a multinational conducts a cloud service business through two group members: X, established in the United States, and Y, established in a foreign country. Under a cost-sharing agreement, each of X and Y owns the intangible property necessary to conduct the business's exploitation of that intangible property within its respective territory: the United States for X and the rest of the world for Y.[23] Management and other personnel responsible for the business's development, enhancement, maintenance, protection, and exploitation functions are primarily within X in the United States. Both X and Y have sales, marketing, and customer service personnel within their respective regions, as well as relevant tangible assets (for example, servers, data centers, and office equipment). X and Y are treated as a unitary group conducting one worldwide cloud service business.

Assume that, from applying the formulaic approach specified in prop. reg. section 1.861-19(d) on a unitary basis, it is found that 70 percent of the business's income is sourced in the United States and 30 percent is sourced outside the United States. When computing the relevant foreign-source income that will be used in X's FTC limitation calculation, 30 percent of X's own directly earned service income will be foreign source. Further, in applying section 904(h) for the source of specified types of income (for example, dividends, interest, income from qualified funds, subpart F, and GILTI inclusions (net CFC tested income for tax years beginning after December 31, 2025)), 30 percent of Y's directly earned service income will be foreign source and 70 percent will be U.S. source. If it is found that Y is engaged in a trade or business within the United States, 70 percent of its service income will be taxable as ECI.[24] ■

[21] Consolidated tax return filing for U.S. group members is, of course, a common exception to this separate entity application of taxation. However, the exception is irrelevant to the effects of the unitary approach to sourcing because pertinent foreign group members would never be included as members of the affiliated group of companies joining in the filing of consolidated U.S. tax returns.

[22] The income recorded within each group member would be after any IRS adjustments, such as section 482 intercompany pricing adjustments.

[23] This example could be changed to involve, instead of a cost-sharing arrangement, an intercompany license agreement under which X licenses relevant intangible rights to Y that allow Y to contract with customers in the rest-of-the-world territory for the provision of cloud services. That change of facts would not alter the results.

[24] *See* section 864(c)(3).