Regulations regarding digital content and cloud transactions

KPMG analysis and observations

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Contents

Introduction

The U.S. Department of the Treasury and IRS (collectively, "**Treasury**") on January 10, 2025, released final regulations (TD 10022, 90 FR 2977) regarding the classification of digital content ("**Final Digital Content Regulations**") and cloud transactions ("**Final Cloud Regulations**") (together, the "**2025 Final Cloud Regulations**"), as well as proposed regulations (REG-107420-24, 90 FR 3075) regarding the source of income from cloud transactions (the "**2025 Proposed Cloud Regulations**"). Both the 2025 Final Cloud Regulations and the 2025 Proposed Cloud Regulations were published in the Federal Register on January 14, 2025.

Background and Overview

Treasury first issued proposed regulations addressing the classification of cloud transactions and other transactions involving digital content on August 14, 2019 (REG-130700-14, 84 FR 40317) (the "**2019 Proposed Cloud Regulations**"). Read *TaxNewsFlash*. The 2019 Proposed Cloud Regulations contained rules intended to address questions regarding the classification of cloud transactions and modernize certain aspects of the rules governing transactions involving computer programs under Treas. Reg. § 1.861-18 (the "**Software Regulations**"). The 2019 Proposed Cloud Regulations also proposed a special sourcing rule that would have turned off application of the "title passage" rule under sections 861(a)(6) and 862(a)(6) when copyrighted articles are sold through an electronic medium, requiring taxpayers instead to determine the location of download or installation of the copyrighted article onto the end-user's device. The 2019 Proposed Regulations, however, did not provide guidance related to the sourcing of income from cloud transactions more broadly.

Consistent with the approach in the 2019 Proposed Cloud Regulations, the 2025 Final Cloud Regulations extend the classification rules in the existing Software Regulations to transfers of digital content other than computer programs. With respect to the proposed sourcing rule for sales of copyrighted articles through an electronic medium, the 2025 Final Cloud Regulations similarly reject application of the "title passage" rule but instead of sourcing based on the location of download or installation by the end user, the 2025 Final Cloud Regulations source income from those sales based on the billing address of the purchaser. The 2025 Final Cloud Regulations also provide a *per se* rule that cloud transactions are the provision of a service, replacing the multi-factor service versus lease test in the 2019 Proposed Cloud Regulations.

The 2025 Proposed Cloud Regulations represent Treasury's first attempt to provide guidance regarding the sourcing of income from cloud transactions and, in substance, would adopt an approach that takes into account the location of the service provider's assets, both tangible and intangible, and personnel responsible for providing the cloud transaction.

Applicability

2025 Final Cloud Regulations

The 2025 Final Cloud Regulations generally apply to tax years beginning on or after January 14, 2025 (i.e., the date they were published in the Federal Register). The regulations, however, permit early application in their entirety to tax years beginning on or after August 14, 2019, and all subsequent tax years, pursuant to an election. Taxpayers who choose to avail themselves of the early application election must apply the Final Digital Content Regulations *and* Final Cloud Regulations consistently in all subsequent years, provided that all taxpayers treated as related under sections 267(b) and 707(b) also consistently apply the rules in such years. The early application election is only available to relevant years for which the statute

of limitations for assessment and collection under section 6501 is otherwise open and where the application would not require a taxpayer to change its method of accounting as a result of the election.

KPMG observation

Following the 2019 Proposed Cloud Regulations, the 2025 Final Cloud Regulations apply to digital content and cloud transactions prospectively only. While the regulations allow for early adoption, in practice, certain taxpayers may be constrained from doing so due to inability to bind all related parties or as result of a procedural impediment *(e.g.,* the election would result in a change of method of accounting or the statute of limitations is otherwise closed for an early application year).

2025 Proposed Cloud Regulations

The 2025 Proposed Cloud Regulations would apply to tax years beginning on or after the date the final regulations are published in the Federal Register. The 2025 Proposed Cloud Regulations do not include reliance language.

KPMG observation

Because there is no express reliance language, consistent with Treasury's established policies and guidance, it appears taxpayers generally may not rely on the 2025 Proposed Cloud Regulations.

2025 Final Cloud Regulations

A. Final Regulations under Treas. Reg. § 1.861-18 with respect to Transfers of Digital Content

Consistent with the 2019 Proposed Cloud Regulations, the Final Digital Content Regulations broaden the application of the Software Regulations to include digital content, defined as a computer program or any other content (e.g., books, movies, and music in digital format) that is either protected by copyright law or not protected by copyright law solely due to the passage of time or because the content was dedicated to the public domain. Additionally, the Final Digital Content Regulations also update the list of Code sections for which the Final Digital Content Regulations apply, including sections 59A, 245A, 250, and 267A, and chapter 4 (e.g., sections 1471 through 1474).

KPMG observation

Concurrent with the 2025 Final Cloud Regulations, Treasury also issued Notice 2025-6 requesting comments on whether the 2025 Final Cloud Regulations should apply to all provisions of the Code.

Consistent with the Software Regulations, a transaction that involves a transfer of digital content is treated as: a transfer of a copyright right, a transfer of a copy of the digital content (i.e., a copyrighted article), the provision of services for the development or modification of digital content, or the provision of know-how relating to development of digital content. A copyright right includes the right to make a public performance of digital content and the right to display digital content to the public. Following the 2019 Proposed Cloud Regulations, however, the Final Digital Content Regulations provide an exception for performance or display for purposes of advertising and, thus, would not treat the public performance or display of digital content *solely* for advertising purposes as a transfer of a copyright right.

Whereas the Software Regulations treated a transaction involving more than one category of transfer of digital content as separate transactions and required separate classification of each transaction except to the extent it was *de minimis*, the Final Digital Content Regulations instead adopt a predominant character rule. Under this new rule, a transaction with multiple elements (one or more of which would be a digital content transaction if considered separately) is classified in its entirety based on the predominant character of the transaction. Moreover, a transaction that consists of both digital content transactions and cloud transactions, as defined in Treas. Reg. § 1.861-19(b), discussed below, will be classified solely as either a digital content transaction or a cloud transaction based on the predominant character of the transaction. In general, the predominant character of a transaction is determined by ascertaining the primary benefit or value received by the customer in the transaction.[1] If the primary benefit or value received by the customer in the particular transaction is not reasonably ascertainable, the 2025 Final Cloud Regulations would determine the primary benefit of a transaction based on how a typical customer uses or accesses the digital content. If data on how typical customers use or access the digital content is not available, the predominant character is determined by examining other factors, including how the transferor or provider markets the transaction, the relative development costs of each element, and the relative price paid in an uncontrolled transaction for one or more elements of the transaction. A taxpayer is not required to develop any of the data specified in the regulation that it does not already develop in the course of its business.

KPMG observation

The use of a transaction's predominant character is intended to provide simplicity to the classification of digital content and cloud transactions and represents a significant departure from the approach under the Software Regulations and the 2019 Proposed Cloud Regulations, which would have bifurcated a transaction to separately classify the digital content transaction and cloud transaction (or a digital content transaction with multiple elements), except to the extent either is a *de minimis* aspect of the overall transaction or arrangement.

The Final Digital Content Regulations also include significant updates to existing examples along with the addition of new examples. Several of the examples specifically address new types of business models that are now common.

For instance, Example 20 in the Final Digital Content Regulations addresses a business model in which an online platform operator offers the sale of applications as an agent on behalf of application developers. The facts assume that the platform operator and application developer have established an agency relationship under general tax principles and, while the transaction between the platform operator and the application developer consists of additional other elements, in applying the predominant character rule, the analysis concludes that the primary benefit or value received by the application developer in the transaction is the platform and agency services the platform operator provides. As a result, the entire transaction between the platform operator and application developer is characterized as a transaction for platform and agency services and *not* a digital content or cloud transaction.

By comparison, Examples 23 and 24 in the Final Digital Content Regulations deal with the sale of copyrighted articles (either through digital downloads or digital keys) pursuant to a reseller arrangement. In particular, where a reseller receives from the owner of a copyrighted article *only* the limited right to distribute the copyrighted article and subsequently resells the copyrighted article to customers, the transactions are "functionally and economically equivalent to back-to-back" transfers of copyrighted articles.[2]

Another business model, discussed in Example 22, involves customer access to digital content that is monetized either through advertising or through subscription fees. In Example 22, customers are able to stream digital content via Corp A's website, either for free with ads or through a paid subscription with no

[1] Treas. Reg. § 1.861-18(b)(3)(i).
[2] Treas. Reg. § 1.861-18(h)(23).

ads, and Corp A contracts with third-party digital content creators to provide content to Corp A's website. Corp A earns revenue from the subscriptions as well as from third-party advertisers who pay when customers access digital content on Corp A's website. While the example addresses the subscription fees from customers (treated as a cloud transaction) and the transaction with content creators (a transfer of copyright rights), the example does not address the transaction with advertisers because, according to the preamble, even though the ads are viewable online, "the advertising services are likely not cloud transactions because there is no on-demand network access to computer hardware, digital content, or similar resources provided by the platform to the advertisers."[3] The preamble does, however, acknowledge that specific fact patterns with respect to advertising arrangements may differ.

KPMG observation

Example 22 suggests that income from separate transactions, each of which is classified as service income, may be subject to different sourcing rules and may result in different sources of income to a single taxpayer. In that example, Corp A earns service income from subscription fees paid by customers to view video content on Corp A's website (a transaction that *is* a cloud transaction) and also earns services income from the provision of advertising services (a transaction that is *not* a cloud transaction) by showing advertisements to users who view the video content for free. Each transaction generates service income that is connected with the platform for viewing video content online, but only the cloud transactions would be subject to the proposed sourcing rule for cloud transactions in the 2025 Cloud Proposed Regulations. Income from the advertising services would generally be sourced under the rules in sections 861(a)(3) and 862(a)(3), i.e., based on place of performance of the services.

Finally, the Final Digital Content Regulations contain a special limited scope sourcing rule. Under the Software Regulations, income from transactions that are classified as sales of copyrighted articles are sourced under sections 861(a)(6), 862(a)(6), 863, or 865(a), (b), (c), or (e), where appropriate. The 2019 Proposed Cloud Regulations introduced a sourcing rule for the sale of copyrighted articles transferred through an electronic medium that would have deemed the sale to occur at the location of the download or installation onto an "end-user's" device. The Final Digital Content Regulations instead adopt a rule that, for purposes of Treas. Reg. §1.861-7(c), sources income from the sale of copyrighted articles that are electronically transferred based on the billing address of the purchaser.[4] This sourcing rule is further subject to a newly added anti-abuse rule, whereby if a transaction is arranged in a specific manner for a principal purpose of tax avoidance, the special sourcing rule based on billing address does not apply. Instead, all of the relevant facts and circumstances are taken into consideration and the sale will be treated as having occurred where the "substance of the sale occurred."[5] For this purpose, the relevant facts and circumstances include the place where the copyrighted articles will be used, the place where negotiations and execution of the agreement occurs, and the terms of the agreement.

KPMG observation

In response to concerns over the ability of sellers to artificially elect the source of income, the Final Digital Content Regulations adopt a sourcing rule that moves away from the "place of sale" or "title passage" rule for sales of a copyrighted article through an electronic medium. The 2019 Proposed Cloud Regulations proposed a rule based on the location of the download or installation on the end user's device. The final sourcing rule instead is based on the billing address of the purchaser. It appears these changes (i.e., the use of billing address and "purchaser" rather than "end user") are intended to make the final sourcing rule more administrable. Taxpayers will thus not be required to

[3] 90 FR 2977, 2983.
[4] Treas. Reg. § 1.861-18(f)(2)(ii).
[5] *Id.*

determine the "end-user" of a copyrighted article or the place of installation or download of the copyrighted article, both of which may require information that is difficult for taxpayers to obtain and verify. Importantly, the Final Digital Content Regulations clarify that the new sourcing rule in Treas. Reg. § 1.861-18(f)(2)(ii) generally applies for purposes of sections 861(a)(6) and 862(a)(6) but does not apply for purposes of section 863(b) (governing the sale of inventory property *produced* in whole or in part by a taxpayer).

KPMG observation

The final sourcing rule will not apply, however, if a transaction is arranged for a principal purpose of tax avoidance. The Final Digital Content Regulations do not define "principal purpose," but new Example 26 provides helpful guidance of what may constitute a "principal purpose" of tax avoidance. In this example, a parent company, Corp A, negotiates the purchase of a copyrighted article with a third party but Corp A's foreign subsidiary purchases the copyrighted article and then distributes it to Corp A. Because the foreign subsidiary did not act as a procurement hub in its ordinary course of business and did not use the copyrighted article, the example concludes that the purchase of the copyrighted article through the foreign subsidiary was arranged for a principal purpose of tax avoidance. By contrast, in Example 25, the foreign subsidiary similarly purchased a copyrighted article from a third party and distributed it to other affiliates of Corp A, except that in this example the foreign subsidiary acted as a procurement hub in its ordinary course of business. Although the income of the third-party seller from the sale of the copyrighted article was foreign source based on the billing address of the foreign subsidiary, the example concludes that because the foreign subsidiary is a procurement hub that regularly purchases products for distribution, there was no evidence of tax avoidance and therefore the anti-abuse rule did not apply. Notably, the foreign subsidiary in Example 25 did not itself use the copyrighted article and acted only as the purchaser and distributor to affiliated entities.

B. Final Regulations under Treas. Reg. § 1.861-19 with respect to Cloud Transactions

The 2025 Final Cloud Regulations, in a significant simplification from the 2019 Proposed Cloud Regulations, classify all "cloud transactions" as a provision of services for purposes of the same enumerated code sections noted above for the Final Digital Content Regulations.

KPMG observation

The 2019 Proposed Cloud Regulations would have classified a cloud transaction as either provision of a service or as a lease of property, in its entirety, based on the factors in section 7701(e). Although theoretically possible to find a lease under these factors, the examples in the proposed regulations all resulted in characterization of the transactions as provision of services, and many commenters noted that, in practice, it was hard to conceive of a fact pattern involving a cloud transaction that would properly be considered a lease of property.

For these purposes, a cloud transaction is defined as 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."[6] By contrast, no cloud transaction arises from "network access to download digital content for storage and use on a person's computer or other electronic device," which is governed by the Final Digital Content Regulations.

[6] Treas. Reg. § 1.861-19(b).

If a transaction has multiple elements, including cloud and non-cloud elements, it is classified as a cloud transaction in its entirety if that is the predominant character of the transaction under the predominant character rules discussed above—that is, based on the "primary benefit or value" to the customer.[7]

KPMG observation

As discussed above, the prior Software Regulations under Treas. Reg. § 1.861-18 would have classified a transaction consisting of more than one category (e.g., a transfer of a computer program and the provision of services for the development of a computer program) as separate transactions with different potential characterizations except to the extent *de minimis*. The 2019 Proposed Cloud Regulations similarly would have characterized transactions involving both a cloud transaction and a transfer of digital content as separate transactions unless one of the transactions was *de minimis*. By contrast, the Final Digital Content Regulations *and* Final Cloud Regulations depart from this approach and characterize a transaction based on its predominant character. Nevertheless, the predominant character test does not eliminate the need to determine whether there is more than one transaction, and even where there is one transaction it may present challenges when there are two or more equally important benefits or value-drivers that suggest different uses or benefits to the customer. However, in practice, it may be easier to determine predominant character, including potentially looking to a "typical customer" in a "similar arrangement," as compared with the prior *de minimis* exception, for which the 2019 Proposed Cloud Regulations provided no specific guidelines. In addition, the Final Digital Content Regulations *and* Final Cloud Regulations provide a list of specific factors in a prioritized order to consider when determining the predominant character where it is not readily ascertainable.

There are a number of updated and new examples in the Final Cloud Regulations that demonstrate how the rules apply, including application of the predominant character rules.

KPMG observation

In general, the examples focus on distinguishing between cloud transactions and those involving the transfer of digital content where both elements are present. There is a cloud transaction classified as a service, for example, when there is access to online software via an application, but a lease of a copyrighted article when there is offline software with limited online functionality. The examples also establish that whether there is a temporary or permanent download of digital content is not determinative; for example, even if a particular customer downloads digital content, the predominant character of the transaction can still be a cloud transaction if a typical customer streams, rather than downloads, content. Additionally, access to an online database with copyrighted materials is classified as a cloud transaction (and, therefore, a service) if the primary benefit for the customer is the access to the online database and proprietary search functions, as opposed to any particular content that may be downloaded.

The Final Cloud Regulations also provide an example (Example 2) that makes clear that a cloud transaction can include the provision of a server on the customer's premises, if the customer accesses the server through the provider's network and the monthly fee is based on the amount of computing power made available to the customer. By contrast, providing *only* the server, and not on-demand network access to computing capacity, would likely fall outside the definition of a cloud transaction, and would be classified under section 7701(e).[8]

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[7] Treas. Reg. §§ 1.861-18(b)(3), 1.861-19(c)(2).
[8] *Accord* Example 2, Treas. Reg. § 1.861-19(d)(2)(ii) (third sentence).

2025 Proposed Cloud Regulations

The 2019 Proposed Cloud Regulations did not provide guidance for sourcing income from cloud transactions, but instead requested comments regarding "administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865."[9] In response to comments requesting specific sourcing rules, the 2025 Proposed Cloud Regulations propose a multi-factored approach that would take into consideration the location of the taxpayer's employees and assets that contributed to the provision of the cloud transaction. In particular, the 2025 Proposed Cloud Regulations would look to the location of the taxpayer's personnel who perform core activities related to the cloud transaction, distinguishing activities such as development, management, and delivery of the service from other "ancillary" activities, such as marketing, sales, and contracting. The 2025 Proposed Cloud Regulations would also take into account the location of the service provider's assets, both tangible and intangible, to the extent that property is used to provide the cloud transaction. The location of customers, end-users, or contract execution, however, would be irrelevant.

Moreover, the 2025 Proposed Cloud Regulations would generally apply on a taxpayer-by-taxpayer basis, such that in determining the source of a service provider's income, only the assets and personnel of that taxpayer would be taken into account. The 2025 Proposed Cloud Regulations would likewise apply on a transaction-by-transaction basis, with special rules for service providers engaging in multiple cloud transactions. Specifically, the 2025 Proposed Cloud Regulations would permit taxpayers to aggregate substantially similar cloud transactions unless aggregation would "materially distort" the source of gross income resulting from the transactions.

KPMG observation

The approach for sourcing income from cloud transactions proposed by the 2025 Proposed Cloud Regulations is a functional one that incorporates many of the principles embodied in caselaw, including *Piedras Negras*[10] and *Miller*.[11] For example, similar to *Piedras Negras*, the 2025 Proposed Cloud Regulations would primarily consider the location of the key income generating assets and personnel directly responsible for deployment of the cloud transaction. Additionally, the taxpayer-by-taxpayer approach proposed in the 2025 Proposed Cloud Regulations appears to be consistent with the Tax Court's decision in *Miller*, in which the court concluded that income of a foreign corporation for performing R&D services gave rise to foreign source income, even though the performance of the services was subcontracted to related and unrelated parties, including a related U.S. affiliate.

To prevent taxpayers from circumventing the purpose of the proposed sourcing rule, which, as described in the regulations and preamble, is to "attribute the source of gross income from a cloud transaction to the place where the transaction is performed," the 2025 Proposed Cloud Regulations would include a broad anti-abuse rule. This anti-abuse rule would apply if the taxpayer has undertaken a transaction with "a principal purpose" of achieving a reduction in its U.S. tax liability in a manner inconsistent with the purpose of the sourcing rules, and would grant Treasury the authority to adjust the source of the taxpayer's income to better align the source of the taxpayer's income with the place of performance. The preamble to the 2025 Proposed Cloud Regulations also notes that statutory provisions (e.g., section 482), as well as common law doctrines (e.g., the economic substance doctrine, the step transaction doctrine, and the rules of agency) may apply, where appropriate, to ensure that the U.S. tax consequences "more properly reflect the

[9] 84 FR 40317, 40321 (Aug. 14, 2019).
[10] *Piedras Negras Broad. Co. v. Comm'r*, 43 B.T.A. 297 (1941), *nonacq.*, 1941-1 C.B. 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942).
[11] *Miller v. Comm'r*, 73 T.C.M. 2319 (1997), *aff'd without published decision*, 166 F.3d 1218 (9th Cir. 1998).

economic realities of the transaction, including the contributions to a cloud transaction made by affiliates of the taxpayer."[12]

Factor-Based Sourcing Approach

The 2025 Proposed Cloud Regulations would source income from the provision of a cloud transaction pursuant to a formula consisting of three components: (1) the intangible property factor (the "**IP Factor**"), (2) the "**Personnel Factor**," and (3) the "**Tangible Property Factor**." After calculating the relevant factors, U.S. source gross income from the cloud transaction would be determined by multiplying the gross income from the cloud transaction by a ratio. This ratio is derived by dividing the sum of the U.S. associated expenses for each factor by the sum of the worldwide expenditures related to the three factors, as follows:

$$\text{U.S. Source Income} = \text{Gross Income from Cloud Transaction} \times \frac{\text{US Portion of Factors}}{\text{IP Factor} + \text{Personnel Factor} + \text{Tangible Property Factor}}$$

KPMG observation

The 2025 Proposed Cloud Regulations would first require a service provider to determine the sum of certain costs associated with its personnel and property responsible for the provision of the cloud transaction, under the theory that the expenditures incurred by the service provider with respect to the deployment of its key employees and assets are intended to serve as an administrable proxy for each factor's economic contribution to the provision of the cloud transaction. Thereafter, the 2025 Proposed Cloud Regulations would determine the U.S. source portion of such expenditures, with the resulting gross income from the cloud transaction that is associated with such portion giving rise to U.S. source income; the residual gross income not treated as from U.S. sources would be foreign source income.

IP Factor

The IP Factor is equal to the sum of the service provider's specified research or experimental ("**R&E**") expenditures (as defined in section 174(b)) that are associated with cloud transactions in the same product line as the cloud transaction performed, as well as the taxpayer's amortization and royalty expense for intangible property (together, "**Intangible Property Costs**"). The IP Factor also considers third-party and related party R&E costs.

KPMG observation

As highlighted in the preamble, the performance of cloud transactions often relies significantly on intangible property, such as software, algorithms, data processing applications, and other proprietary technologies. The IP Factor is intended to reflect the crucial role intangible property plays in the performance of a cloud transaction, particularly as reliance on intangible property has increased due to the continued automation of cloud transactions. Because of the difficulty in determining the exact value and contributions of intangible property to a cloud transaction, the 2025 Proposed Cloud Regulations would provide a proxy for the value of the intangible property, by considering costs associated with the acquisition and use of relevant intangible property. Furthermore, the treatment of R&E expenditures as a proxy for intangible property is intended to be consistent with Treas. Reg. 1.861-17(b)(1), which provides that the definition of intangible property includes intangible property, either created or acquired by the taxpayer, that is derived from R&E expenditures. Additionally, R&E expenditures are based on annual spend, without regard to whether such expenditures are deductible in the current tax year; whereas costs for amortization and royalties may only be taken into account

[12] 90 FR 3075, 3077.

for the tax year when deductible for tax purposes. Finally, to prevent duplication, intangible property expenses that would be included in the IP Factor for multiple cloud transactions are allocated among the cloud transactions based on the relative gross income earned from each transaction.

To determine the U.S. and foreign source of the IP Factor, the 2025 Proposed Cloud Regulations utilize the principles of Treas. Reg. § 1.861-4(b)(2)(ii)(E) to determine the extent to which a taxpayer's employees perform services in the United States. In this regard, the IP Factor is multiplied by the ratio of the compensation for personnel in the United States whose primary function is R&E associated with cloud transactions in the same product line over the worldwide compensation for all relevant R&E personnel. In this regard, an employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time.

Personnel Factor

The Personnel Factor is equal to the sum of the total compensation paid to the service provider's employees whose primary function is to directly contribute to the provision of the relevant cloud transaction. This excludes compensation paid to R&E personnel because such amounts are already included in the IP factor. Where an employee directly contributes to multiple cloud transactions, the employee's compensation is allocated based on time spent contributing to the provision of each cloud transaction. The 2025 Proposed Cloud Regulations would provide that employees who provide services for the configuration, delivery, or maintenance of a cloud transaction, provide services with respect to the cloud service's delivery, or end-user support directly contribute to the cloud transaction.

KPMG observation

The Personnel Factor is intended to acknowledge the fundamental role of employees who manage, operate, and maintain systems vital to the provision of a cloud transaction. The 2025 Proposed Regulations would potentially impose additional compliance burdens by requiring taxpayers to accurately document and maintain an accounting of the time of all employees who directly contribute to a cloud transaction. Importantly, personnel who perform "ancillary" activities, such as sales and marketing, would not be considered for the Personnel Factor.

To source the Personnel Factor, a similar method to that described above for the IP Factor is used.

Tangible Property Factor

The Tangible Property Factor is equal to the sum of the service provider's annual depreciation and rental expense for tangible property owned or leased by the provider that is directly used in a cloud transaction.

KPMG observation

Although cloud transactions have an increasing dependency on intangible property, tangible property may still play a large role in the execution of these transactions. The Tangible Property Factor thus takes into account the taxpayer's tangible property, such as hardware used to deliver the cloud services (e.g., computers, servers, and networking equipment), that directly supports a cloud transaction. Consistent with the taxpayer-by-taxpayer approach, the Tangible Property Factor would not attribute the ownership of tangible property held by another taxpayer, except where the service provider leases such property.

For taxpayers that engage in multiple cloud transactions, the 2025 Proposed Cloud Regulations would require a taxpayer to allocate depreciation and rental expense to each transaction based on the relative gross income earned from each transaction. Under the proposed rules, depreciation expense would be

determined by dividing the tangible property's adjusted depreciable basis by the applicable recovery period, as though the alternative depreciation system applied for the entire period the property has been in service.

KPMG observation

The Tangible Property Factor is determined without regard to incentives that may accelerate the recovery of costs, such as a taxpayer's section 179 election (if taken), "bonus" depreciation, and any first-year depreciation. By eliminating such incentives from the Tangible Property Factor, the factor is intended to more accurately track an asset's actual economic life.

To source the Tangible Property Factor, the portion of the factor from sources within the United States is equal to the part of that factor attributable to property located within the United States.

Requests For Comment

The preamble generally requests comments on all aspects of the 2025 Proposed Cloud Regulations and, specifically, regarding the following topics, by April 14, 2025:

- Whether appropriate alternatives to determining the intangible property factor from U.S. and foreign sources exist;
- Whether and to what extent companies presently track R&E expenditures by product line;
- Methods to link the contribution of intangible property to cloud transactions occurring in years after the intangible property is developed;
- The appropriate allocation methods for costs and expenses included in a factor for multiple cloud transactions;
- The inclusion of additional expenses associated with cloud transactions in the tangible property factor and how to appropriately consider those costs in the tangible property factor; and
- Whether a special rule is needed to source the gross income of resellers of cloud transactions.

KPMG observation

As discussed, the 2025 Proposed Cloud Regulations would adopt a new, formula-based approach for sourcing income from the provision of cloud transactions. Treasury has requested comments on all aspects of these proposed rules, including many of the factors comprising the sourcing formula. Taxpayers currently engaged in cloud transactions should consider the practical implications of the 2025 Proposed Cloud Regulations, including how such transactions would be impacted by the proposed approach, if at all, and whether (and how) Treasury's proposal should be modified. Affected taxpayers should also consider providing comments, as appropriate. In particular, resellers of cloud transactions may want to consider commenting as to how the proposed sourcing rule should apply to them, particularly in light of the taxpayer-by-taxpayer approach and the fact that, as proposed, costs associated with sales and marketing employees would not be included in the factors.

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