

## Treasury Department Issues Final and Proposed Rules on Cloud Transactions, Other Digital Content

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On January 10, 2025, the US Department of the Treasury and IRS released final and proposed regulations that provide tax guidance for the digital economy.

The [final regulations](#) (TD 10022) define and provide a framework for the classification of “cloud transactions” and other transactions involving “digital content” for purposes of certain international provisions of the Internal Revenue Code (Final Regulations). These rules generally maintain the overall structure of the [2019 proposed regulations](#) on the same subject (2019 Proposed Regulations), but make a few important simplifying changes as discussed further below.

The [newly released proposed regulations](#) (REG–07420–24) build on the Final Regulations to provide rules for determining the source of income arising from cloud transactions (Proposed Source Rules).

The Final Regulations and Proposed Source Rules were issued under a section of the Code relating to the source of income, but also apply to a broad range of other international tax provisions listed in the Final Regulations – including, but not limited to, the base erosion and anti-abuse tax, related provisions on foreign derived intangible income and global intangible low-tax income, anti-hybrid rules, transfer pricing, and certain anti-basis importation provisions.

Finally, the Treasury Department and IRS issued [Notice 2025-6](#), requesting comments on the potential implications of applying the characterization rules for digital content and cloud transactions (as amended and added by the Final Regulations) to all provisions of the Code.

### Background

The Final Regulations (and, if adopted, the Proposed Source Rules) update and modernize rules dating from 1998 that classify “computer program” transactions for purposes of certain international tax rules (Prior Regulations). Under the Prior Regulations, a transaction involving a computer program is characterized in one of four possible ways:

1. A transfer of a copyright right in a computer program.
2. A transfer of a copy of a computer program (a “copyrighted article”).
3. The provision of services for the development or modification of a computer program.
4. The provision of know-how.

A transfer of a copyright right is further classified as either a sale or a license, depending on whether “all substantial rights” in the right have been transferred. Similarly, a transfer of a copyrighted article is further classified as either a sale or a lease, based on whether the benefits and burdens of ownership of the article have been transferred.

### The Final Regulations

As the Treasury Department and IRS acknowledged in the preamble to the 2019 Proposed Regulations, the Prior Regulations did not address “on-demand network access to computing resources, such as networks, servers, storage and software,” which have become increasingly prevalent business models since 1998. The Final Regulations attempt to fill this gap by addressing so-called “cloud computing transactions” – including software as a service (SaaS), platform as a service (PaaS), infrastructure as a service (IaaS), and other transactions, such as streaming digital content, access to certain databases and transactions involving mobile device applications. Further, the Final Regulations expand the Prior Regulations beyond “computer programs” to all “digital content” and make related modernizing changes.

### **Digital content**

The Final Regulations extend the four-category classification scheme from the Prior Regulations to all transactions involving “digital content.” Digital content is defined as “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 by copyright law solely due to the passage of time or because the creator dedicated the content to the public domain.”

A single transaction with multiple elements – at least one of which (if analyzed individually) is a digital content transaction – is classified entirely as a digital content transaction (falling into one of the four categories) if its “predominant character” reflects such classification. The “predominant character” is in turn based upon the “primary benefit or value received by the customer in the transaction.” This is a simplifying change to the 2019 Proposed Regulations, which generally required a separate classification to be made for each element.

The Final Regulations also provide a new sourcing rule for income arising from sales of copyrighted articles. For purposes of applying any source rule that is based (in whole or in part) on the location where a sale occurred, the sale of a copyrighted article through an electronic medium is deemed to take place at the billing address of the purchaser, subject to an anti-avoidance rule. The 2019 Proposed Regulations would have deemed such sales as occurring at the location of download or installation onto the end user’s device, but the Treasury Department and IRS determined that billing address is a more administrable proxy for place of sale.

### **Cloud transactions**

The Final Regulations provide a new set of rules that classify all “cloud transactions” as the provision of services. This is a notable departure from the 2019 Proposed Regulations, which classified a cloud transaction as either a lease or the provision of services based on a multifactor test.

A “cloud transaction” is defined as “a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources,” and specifically excludes the downloading of digital content onto a personal device. Examples of cloud transactions include streaming music from a digital library or using computing capacity on a company’s servers in exchange for monthly fees. As is the case for digital content transactions, a transaction with multiple elements is classified entirely as a cloud transaction (rather than being fragmented) if its “predominant character” is that of a cloud transaction. Although the Final Regulations characterize cloud transactions as services, they do not provide any guidance on the source of income from cloud transactions. This is addressed in the Proposed Regulations, as discussed below.

### **Effective date**

The Final Regulations generally apply to all taxable years beginning on or after January 14, 2025. However, a taxpayer may elect to apply the Final Regulations to all taxable years beginning on or after August 14, 2019, so long as all persons related to the taxpayer do so consistently and certain other requirements are met. In order to comply with the Final Regulations, some taxpayers may be required to change their accounting method, for which the consent of the IRS would be required.

## The Proposed Source Rules

Under the Proposed Source Rules, the source of service income arising from a cloud transaction is determined through a three-factor formula based on the location of the assets and personnel used by the taxpayer in the transaction. The formula aggregates expenses incurred with respect to the transaction by reference to an “intangible property factor,” a “personnel factor” and a “tangible property factor.” These factors are intended to reflect, respectively, the contribution of intangible property, certain employees and tangible property to the transaction. This is a departure from long-standing rules on the source of income, which generally have been based solely on where services are physically performed.

To arrive at the US-source portion of the gross income from a particular cloud transaction, gross income is multiplied by a fraction, the numerator of which is the sum of the US portion of expenses for each factor, and the denominator of which is the sum of the worldwide expenses for each factor. The formula applies on a taxpayer-by-taxpayer basis, and thus the assets and personnel of related taxpayers that may contribute to the transaction generally are not taken into account.

### The three-part formula

The three parts of the formula are described below:

**Intangible property factor.** Rather than attempt to value various intangibles, the Proposed Source Rules use an expense-based factor that is considered an “administrable proxy for reflecting the contribution of intangible property.” The intangible property factor is the sum of (1) current-year research or experimental expenditures (whether or not deductible in the current year) incurred with respect to cloud transactions in the same product line and (2) current-year amortization (other than capitalized research or experimental expenditures) and royalty expense for intangible property to the extent directly used to provide the cloud transaction. The US-source portion of the factor generally is based on the proportion of compensation paid to employees located in the United States (relative to the amount paid to employees worldwide) “whose primary function is to perform research and experimentation activities associated with cloud transactions in the same product line.”

**Personnel factor.** The personnel factor generally is the total current-year compensation paid to employees “whose primary function is to directly contribute to the provision of the cloud transaction, other than compensation taken into account in the intangible property factor.” The US-source portion of the factor is based on the amount of such compensation paid for services performed in the United States.

**Tangible property factor.** The tangible property factor is the sum of current-year depreciation and rental expense for tangible property owned or leased by the taxpayer, to the extent such property is directly used to provide the cloud transaction. The US-source portion of the factor is based on the amount attributable to such property located in the United States.

Once the factors have been calculated, the taxpayer adds together the US portion of each and divides that total by the sum of all three. That yields a percentage representing the portion of the income attributable to US personnel and property (tangible and intangible), which is then multiplied by the gross income arising from the cloud transaction to arrive at the US-source total.

For administrability, taxpayers generally can aggregate “substantially similar cloud transactions” when calculating the source of income, and there are special rules that allocate assets and personnel among multiple cloud transactions to avoid double-counting.

### Proposed effective date

The Proposed Source Rules would become effective when final regulations are published. Pending finalization, the Treasury

Department and IRS have requested comments from the public on all aspects of the Proposed Source Rules. In particular, comments have been requested on whether there are other administrable ways to determine the portion of the intangible property factor from sources within the United States, whether companies presently track research or experimental expenditures by product line, and whether there is a practicable way to link the contribution of intangible property developed in one year to a cloud transaction provided in a later year, among other topics.

## Conclusion

The Final Regulations and Proposed Source Rules together represent a significant advancement in the guidance available to taxpayers when navigating the treatment of cloud and other digital transactions. As mentioned above, however, these rules apply only to certain international provisions of the Code. In [Notice 2025-6](#), the Treasury Department and IRS have requested comments on the potential implications of the application of these characterization rules (as amended and added by the Final Regulations) to all provisions of the Code, with particular attention to the possible impact on various depreciation and amortization rules, the timing of income inclusions under Section 451, real estate investment trusts, and the calculation of gain and loss, among other areas.

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