

Alert | Cross-Border Tax Planning



January 2025

New IRS Regulations Address Cross-Border Cloud Computing and Digital Infrastructure Transactions

Go-To Guide

- IRS issues final regulations classifying cross-border cloud transaction income as service income, including for purposes of sourcing such income for U.S. federal tax purposes.
- Proposed regulations introduce a three-factor test for sourcing cloud transaction income based on location of intangible property, personnel, and tangible assets.
- In light of the new rules, U.S. and non-U.S. businesses engaging in cross-border cloud computing and digital infrastructure transactions should carefully consider the location of their personnel, intangible property (including R&D activity), and tangible property that contribute to the generation of income from such transactions to optimize their tax planning and tax efficiency.
- Proposed regulations also include anti-abuse provisions that seek to prevent artificial reduction of U.S. federal income tax liability in a manner inconsistent with the regulations' purpose.
- Final regulations refine definitions of cloud transactions and digital content transactions, replacing de minimis rule with predominant character test.

On Jan. 10, 2025, the IRS released two sets of regulations under Section 861 of the Internal Revenue Code. The **Final Regulations** treat income from cloud transactions as income from services and clarify definitions of cloud transactions and digital content transactions for U.S. federal income tax purposes.

The **Proposed Regulations** provide a mathematical formula to determine the source of income from cloud transactions, based on the location of the taxpayer's employees and assets (both tangible and intangible).

The Final Regulations took effect Jan. 14, 2025. The Proposed Regulations will not become effective until the IRS adopts final rules.

Impact on US and Non-US Businesses

The new regulations impact businesses across all industries, due to the widespread use of digital and cloud-based transactions. As mentioned in our **August 2019 GT Alert**, before the Proposed Regulations, the rule for sourcing income in connection with cloud transactions for U.S. federal tax purposes was unclear, and sourcing of such income was determined under the general rules under Section 861 and Section 862 of the Internal Revenue Code.

As discussed in more detail below, the Final Regulations and Proposed Regulations provide welcome guidance on how to analyze whether and what portion of income derived by non-U.S. businesses from providing on-demand network access (cloud transactions) in the United States would be sourced to the United States for U.S. federal income tax purposes, and would therefore generally be subject to U.S. tax.

This guidance is also relevant to U.S. businesses engaging in cloud transactions outside the United States because the sourcing of their income from such transactions would affect their ability to claim foreign tax credits in the United States for foreign income taxes imposed on such income.

Under the Proposed Regulations, if finalized as proposed, income from cloud transactions would be considered U.S.-sourced (and would therefore generally be subject to U.S. tax) to the extent that the non-U.S. business' personnel, intangible property, and tangible property contributing to the generation of such income are located or performed within the United States. Factors such as the customers or executing agreements' locations would not be relevant for purposes of such determination.

In light of the new final and proposed regulations, U.S. and non-U.S. businesses engaging in cross-border cloud computing and digital infrastructure transactions should carefully consider the location of their personnel, intangible property (including R&D activity), and tangible property that contribute to the income generation from such transactions to optimize their tax planning and tax efficiency.

Cloud Transactions as Service Income

The Final Regulations define a cloud transaction as *"a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar sources"* and classify income from cloud transactions solely as income from the provision of services for U.S. federal income tax purposes. This differs from the 2019 Proposed Regulations, which classified income from cloud transactions either as income from the provision of services or from the lease of property based on nine factors enumerated in those regulations.

Proposed Three Factor Sourcing Test

For purposes of sourcing income from cloud transactions between U.S. source income and non-U.S. source income for U.S. federal income tax purposes, the Proposed Regulations follow the general sourcing rule that applies to service income, i.e., sourcing based on where the services are performed.

Under the Proposed Regulations, to determine the source of income, the location of the cloud services generating the cloud transaction income would be determined based on the location of the following three factors, to the extent they contribute to generating that income:

1. **Intangible property:** The intangible property factor reflects the contribution of intangible assets, such as software, algorithms, and research, to the performance of cloud services. It includes research and experimentation expenses, royalties, and amortization for intangible assets used in the service. This factor is sourced based on the location of employees involved in research and experimentation related to the cloud transaction, and expenses are allocated among transactions based on their relative income. The IRS aims to use practical proxies like compensation and research expenditures to avoid complexities in tracing intangible property's direct contribution.
2. **Personnel:** The personnel factor accounts for the contribution of employees who directly engage in providing cloud services, such as technical staff and immediate managers overseeing operations. It excludes those in strategic, sales, or administrative roles. Compensation for these employees is allocated based on the time they spend working on cloud transactions. The portion of this factor attributed to U.S. sources is determined by the location of the employees performing these activities, ensuring that only those directly involved are included in the calculation.
3. **Tangible Property:** The tangible property factor includes the value of physical assets, like servers and networking equipment, used in cloud transactions. It is calculated by including depreciation and rental expenses for property directly supporting the service. The U.S. portion of this factor is based on the location of the tangible property. Depreciation is computed without considering accelerated tax deductions, reflecting the true economic life of the property used in providing the cloud service.

The Proposed Regulations outline a formula to determine the U.S.-sourced portion of gross income from cloud transactions. This formula involves multiplying the gross income by a fraction. The denominator of this fraction is the sum of the three factors (intangible property, personnel, and tangible property), regardless of their location. The numerator is the sum of the portions of these factors that are located or performed within the United States.

A taxpayer is allowed to aggregate substantially similar cloud transactions and source the gross income from those transactions as if they were one transaction, but prohibits aggregation if it materially distorts the source of income. However, the Proposed Regulations' sourcing rule would apply on a taxpayer-by-taxpayer basis. Therefore, when calculating the gross income of an entity that provides cloud services, only the assets and personnel of that entity are considered.

The Proposed Regulations also include a general anti-abuse provision, under which if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability in a manner inconsistent with the regulations' purpose, the IRS would adjust the source of the taxpayer's gross income to reflect the location where the cloud transactions is performed.

The Proposed Regulations are not final Treasury regulations and, in the absence of an actual reliance provision within them, taxpayers cannot rely upon them. Nonetheless, they provide guidance and insight into the IRS's directional thinking regarding sourcing income from transactions involving cloud computing and digital infrastructure. Further, income from cloud transactions characterized as services income may be re-sourced under the provisions of an income tax treaty if the taxpayer qualifies for the treaty's benefits. This re-sourcing could be particularly significant for foreign tax credits, offering additional considerations for cross-border tax planning.

Digital Content Transactions

The Final Regulations define a digital content transaction as a transaction that constitutes a transfer of digital content or the provision of modification or development services or of know-how with respect to digital content. The definition of digital content remains unchanged but is refined to include “*content that is not protected by copyright law solely because the creator dedicated the content to the public domain.*” The Final Regulations replace the de minimis rule with a predominant character rule for characterizing transactions with multiple elements. The “predominant character” is determined by the primary benefit of value received by the customer, and the rule would apply to both digital content transactions and cloud transactions.

Authors

This GT Alert was prepared by:

- [Pallav Raghuvanshi](#) | +1 212.801.2151 | Pallav.Raghuvanshi@gtlaw.com
- [Erez I. Tucner](#) | +1 212.801.9241 | tucnere@gtlaw.com
- [Connie Keng](#) | +1 212.801.2232 | Connie.Keng@gtlaw.com

Albany. Amsterdam. Atlanta. Austin. Berlin^ˆ. Boston. Charlotte. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Houston. Kingdom of Saudi Arabia^ˆ. Las Vegas. London^ˆ. Long Island. Los Angeles. Mexico City^ˆ. Miami. Milan^ˆ. Minneapolis. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Portland. Sacramento. Salt Lake City. San Diego. San Francisco. São Paulo^ˆ. Seoul^ˆ. Shanghai. Silicon Valley. Singapore^ˆ. Tallahassee. Tampa. Tel Aviv^ˆ. Tokyo^ˆ. United Arab Emirates^ˆ. Warsaw^ˆ. Washington, D.C. West Palm Beach. Westchester County.

This Greenberg Traurig Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice nor as a solicitation of any type. Please contact the author(s) or your Greenberg Traurig contact if you have questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer's legal qualifications and experience. Greenberg Traurig is a service mark and trade name of Greenberg Traurig, LLP and Greenberg Traurig, P.A. ˆGreenberg Traurig's Berlin office is operated by Greenberg Traurig Germany, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ˆOperates as a separate UK registered legal entity. ˆGreenberg Traurig operates in the Kingdom of Saudi Arabia through Greenberg Traurig Khalid Al-Thebity Law Firm, a professional limited liability company, licensed to practice law by the Ministry of Justice. +Greenberg Traurig's Mexico City office is operated by Greenberg Traurig, S.C., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. »Greenberg Traurig's Milan office is operated by Greenberg Traurig Santa Maria, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ˆGreenberg Traurig's São Paulo office is operated by Greenberg Traurig Brazil Consultores em Direito Estrangeiro – Direito Estadunidense, incorporated in Brazil as a foreign legal consulting firm. Attorneys in the São Paulo office do not practice Brazilian law. ∞Operates as Greenberg Traurig LLP Foreign Legal Consultant Office. ˆGreenberg Traurig's Singapore office is operated by Greenberg Traurig Singapore LLP which is licensed as a foreign law practice in Singapore. ^Greenberg Traurig's Tel Aviv office is a branch of Greenberg Traurig, P.A., Florida, USA. ¢Greenberg Traurig's Tokyo Office is operated by GT Tokyo Horitsu Jimusho and Greenberg Traurig Gaikokuhojimbengoshi Jimusho, affiliates of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ‹Greenberg Traurig's United Arab Emirates office is operated by Greenberg Traurig Limited. ~Greenberg Traurig's Warsaw office is operated by GREENBERG TRAUIG Nowakowska-Zimoch Wysokiński sp.k., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. Certain partners in GREENBERG TRAUIG Nowakowska-Zimoch Wysokiński sp.k. are also shareholders in Greenberg Traurig, P.A. Images in this advertisement do not depict Greenberg Traurig attorneys, clients, staff or facilities. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. ©2025 Greenberg Traurig, LLP. All rights reserved.