the applicant or privilege holder. The extension request must be made by email and received by the Executive Director, Trade Policy and Programs, Office of Trade, CBP Headquarters, at *ecommerce@cbp.dhs.gov,* within the 30-day period. The denial of an application or the revocation of a waiver, does not preclude a party from reapplying for the privilege in the future.

■ 13. Amend § 143.26 by revising paragraph (b) and adding paragraph (c) to read as follows:

§ 143.26 Party who may make informal entry of merchandise.

* * * * *

(b) *Shipments valued at $800 or less.* Except for merchandise subject to paragraph (c) of this section, a shipment of merchandise valued at $800 or less which qualifies for informal entry under 19 U.S.C. 1498 and meets the requirements in 19 U.S.C. 1321(a)(2) (see §§ 10.151, 10.152, 10.153, 143.23(k), 145.31, 145.32, 148.51, and 148.64 of this chapter) may be entered, using reasonable care, by the owner, purchaser, or consignee of the shipment or, when appropriately designated by one of these persons, a customs broker licensed under 19 U.S.C. 1641.

(c) *Exception for the enhanced entry process.* A shipment of merchandise valued at $800 or less, which qualifies for informal entry under 19 U.S.C. 1498 and the administrative exemption under 19 U.S.C. 1321(a)(2)(C), may be entered under § 143.23(l), using reasonable care, by the owner or purchaser of the shipment, an express consignment operator or carrier in possession of the shipment (see § 128.1(a) of this chapter), or when appropriately designated by the owner, purchaser, or consignee of the shipment, a customs broker licensed under 19 U.S.C. 1641 (see part 141, subpart C). When a party eligible to file the entry transmits the entry information required under §§ 143.23(l)(1)(iv)(A) through (D) and 143.23(l)(2)(iv) through (v) of this part, and receives any of that information from another party, CBP will take into consideration how, in accordance with ordinary commercial practices, the transmitting party acquired such information, and whether and how the transmitting party is able to verify this information. When the transmitting party is not reasonably able to verify such information, CBP will permit the party to transmit the information on the basis of what the party reasonably believes to be true.

PART 145—MAIL IMPORTATIONS

■ 14. The authority citation for part 145 and the specific authority citation for §§ 145.31 and 145.32 continue to read as follows:

Authority: 19 U.S.C. 66, 1202 (General Note 3(i)), Harmonized Tariff Schedule of the United States, 1624.

* * * * *

Section 145.31 also issued under 19 U.S.C. 1321;

Section 145.32 also issued under 19 U.S.C. 1321, 1498;

* * * * *

■ 15. Revise § 145.31 to read as follows:

§ 145.31 Importations not over $800 in value.

The port director may pass free of duty and tax, without preparing an entry as provided for in § 145.12, packages containing merchandise having an aggregate fair retail value in the country of shipment of not over $800, subject to the requirements set forth in §§ 10.151 and 10.153 of this chapter. Such merchandise may alternatively be entered under § 143.23(l) of this chapter, in which case all required information must be transmitted to CBP no later than the date the merchandise departs from the country of posting.

§ 145.32 [Amended]

■ 16. Amend § 145.32 by removing the word ''shall'' and adding in its place the word ''may''.

Robert F. Altneu,

Director, Regulations & Disclosure Law Division, Regulations & Rulings, Office of Trade, U.S. Customs and Border Protection.

[FR Doc. 2025–00551 Filed 1–13–25; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107420–24]

RIN 1545–BR21

Source of Income From Cloud Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed rules for determining the source of income from cloud transactions for purposes of the international provisions of the Internal Revenue Code. These proposed rules would generally affect taxpayers who earn gross income from engaging in cloud transactions.

DATES: Written or electronic comments and requests for a public hearing must be received by April 14, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–107420–24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the ''Comments and Requests for a Public Hearing'' section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:01:PR (REG–107420–24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:01:PR (REG–107420–24), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Christopher E. Fulle at (202) 317–5367 or Michelle L. Ng at (202) 317–6989 (not toll-free numbers); concerning submissions of comments and requests for a public hearing, contact the Publications and Regulations branch at (202) 317–6901 (not a toll-free number) or by email to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

The proposed regulations are issued under the express delegation of authority under section 7805 of the Internal Revenue Code (Code). Section 7805(a) directs the Secretary of the Treasury or her delegate to prescribe all needful rules and regulations for the enforcement of that section and others in the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Background

Proposed regulations published in the **Federal Register** (84 FR 40317) in 2019 (REG–130700–14) (the 2019 proposed regulations) set forth proposed rules for identifying and classifying cloud transactions, and the preamble to the 2019 proposed regulations requested

comments on rules for sourcing income from cloud transactions. Comments received addressed the necessity of developing specific rules for sourcing gross income from cloud transactions and provided recommendations on the content of such rules. This notice of proposed rulemaking, which is being published with the final regulations for identifying and classifying cloud transactions (TD 10022) (the 2024 final regulations) that are being published in the Final Rules section of this same issue of the **Federal Register**, proposes rules for sourcing gross income from cloud transactions.

Explanation of Provisions

I. Source of Gross Income From Cloud Transactions

A. Overview of Comments Received

The Treasury Department and the IRS received more than a dozen comments in response to the request for comments on administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865. Comments were split almost evenly with regard to whether specific sourcing rules are needed in this area, with a narrow majority expressing support for such guidance. Of this majority, several comments recommended that services income from cloud transactions be sourced according to the location of the assets and personnel used in providing the service. A number of these comments explained that this approach would align with the result in *Piedras Negras Broadcasting Co.* v. *Comm'r,* 43 B.T.A. 297 (1941), *nonacq.,* 1941–2 C.B. 22, *aff'd,* 127 F. 2d. 260 (5th Cir. 1942), in which the income of a radio broadcasting corporation was determined to be foreign source because its broadcasting facilities and employees were located in Mexico, even though the corporation broadcasted programs primarily to listeners located in the United States and received almost all of its income from advertisers located in the United States. Other comments voiced the need for specific rules for sourcing income from cloud transactions, but did not recommend a particular sourcing approach, with one comment suggesting that the location of the cloud service provider's assets and personnel and the location of the end-user could be evaluated in developing the rules. Another comment proposed that given the challenges of sourcing cloud transactions when the operations, employees, and customers are dispersed, the sourcing rules could provide taxpayers with the option to source the income to the place where the contract is executed. While almost half of the comments received stated that regulations for sourcing income from cloud transactions are unnecessary because existing statutory, regulatory, and case law provides sufficient guidance, an overwhelming majority of those comments recommended that if issued, the regulations should take into account the location of the assets and people that contribute to the delivery of the cloud service.

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. Comments explained that the taxpayer-by-taxpayer approach is administrable and supported by the principles of *Miller* v. *Comm'r,* 73 T.C.M. 2319 (1997), *aff'd without published decision,* 166 F.3d 1218 (9th Cir. 1998), in which income that a foreign corporation received for performing research and development services was held to be foreign source notwithstanding that the performance of those services was subcontracted to certain related and unrelated entities, including a wholly-owned U.S. subsidiary. One comment suggested that a taxpayer-by-taxpayer rule for sourcing services income from cloud transactions could be supplemented with anti-abuse provisions requiring the income to be sourced on a look-through or unitary basis in limited circumstances. However, 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.

B. Need for Proposed Regulations

The development and advancement of cloud technologies has transformed both the value that businesses deliver to customers and the way that value is delivered, giving rise to cloud-based business models and cloud transactions. The 2024 final regulations classify a cloud transaction (within the definition of § 1.861–19(b)) as the provision of services. *See* § 1.861–19(c)(1). 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. 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.

The proposed regulations, which would establish specific sourcing rules that interpret the place of performance in the context of a cloud transaction, are therefore necessary to provide clarity and certainty to both taxpayers and the IRS. To determine the place of performance, the proposed sourcing rules would take into account the location of the employees and assets, including both tangible and intangible assets, that contribute to the provision of the cloud transaction. 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.

The proposed cloud transaction sourcing rules would apply on a taxpayer-by-taxpayer basis and therefore, in determining the gross income of an entity that recognizes the services income, would take into account solely the assets and personnel of the legal entity. The Treasury Department and the IRS agree that this approach is administrable and practical. By focusing on the economic contributions that the contracting entity makes to the performance of the cloud transaction, the taxpayer-by-taxpayer approach provides a clear, straightforward way of determining the source of gross income from the transaction, while allowing for appropriate deductions from that gross income in respect of amounts paid or accrued to affiliated or unaffiliated contributors to the provision of the cloud services, leading to reduced complexity in tax compliance and enforcement. This approach is also generally consistent with the current approach for sourcing other categories of income, including non-cloud services income such as gross income from certain sales of inventory that is sourced to the location of production activity under § 1.863–3(c)(1)(ii). Further, 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.

C. Explanation of Proposed Rules for Sourcing Gross Income From Cloud Transactions

The proposed regulations state that gross income from a cloud transaction is sourced as services income under section 861(a)(3) or 862(a)(3), as appropriate, according to where the service is performed. Proposed § 1.861–19(d)(1). The place of performance of a cloud transaction is established through a formula composed of a fraction that relies on three factors: the intangible property factor, the personnel factor, and the tangible property factor (within the meaning of proposed § 1.861–19(d)(2), (d)(3), and (d)(4), respectively). *Id.*

As discussed in detail in Parts I.C.1 through 3 of this Explanation of Provisions, the intangible property factor is intended to reflect the contribution of intangible property to the provision of the cloud transaction; the personnel factor is intended to reflect the contribution of certain employees to the provision of the cloud transaction; and the tangible property factor is intended to reflect the contribution of tangible property to the provision of the cloud transaction. Each factor is determined by taking into account certain worldwide expenses by the entity that, in the view of the Treasury Department and the IRS, properly represent the contributions made by or through the relevant personnel and assets to the performance of the cloud transaction. Together, these factors make up the denominator of the fraction. The numerator of the fraction is determined by summing up the portion of each factor that is from sources within the United States.

Under the proposed regulations, the gross income from a cloud transaction multiplied by the fraction yields the portion of the gross income that is from sources within the United States. Proposed § 1.861–19(d)(1). The portion of the gross income that remains is gross income from sources without the United States. *Id.*

1. Intangible Property Factor

a. Determination of the Intangible Property Factor

The Treasury Department and the IRS consider intangible property to be a significant contributor to the performance of cloud transactions. Intangible property, such as software, algorithms, data processing applications, and other proprietary technologies, often plays a crucial role in the performance of a cloud transaction, including by shaping the unique features of the service and ensuring the service's functionality, reliability, and delivery. This role of intangible property is becoming particularly important as cloud transactions are becoming increasingly automated, requiring less and less contribution from personnel and tangible property to deliver value to customers. In such cases, the intangible property itself may be the main force that is effectively performing the service. It would be difficult and burdensome, however, to ascertain the precise value or contribution of an item of intangible property to the performance of a cloud transaction given the challenges inherent in isolating the specific impact of various intangibles on the cloud transaction's overall performance. The Treasury Department and the IRS are of the view that certain research and experimental expenses, amortization, and royalties incurred during the taxable year in which the cloud transaction is performed could serve as an administrable proxy for reflecting the contribution of intangible property to the performance of the cloud transaction. These expenses serve as the foundation for the intangible property factor.

Specifically, the intangible property factor is the sum of specified research or experimental expenditures (as defined under section 174(b)) incurred during the taxable year that are associated with the cloud transaction as well as royalty and certain amortization expenses incurred during the taxable year to the extent they are for intangible property directly used to provide the cloud transaction (collectively, ''intangible property costs''). Proposed § 1.861–19(d)(2)(i). Intangible property costs include payments to third-party and related-party research and experimentation providers. Because specified research or experimental expenditures are used as a proxy for current use of existing self-developed intangible property, those expenditures are taken into account as they are incurred, regardless of whether and

when they are deductible, in order to match the timing of when compensation is paid to employees performing research or experimentation activities. As discussed in Part I.C.1.b. of this Explanation of Provisions, the intangible property factor is sourced based on this compensation; therefore the Treasury Department and the IRS are of the view that taking the specified research or experimental expenditures in the year when incurred provides an administrable rule that recognizes the economic contribution of the intangible property and avoids taxpayers having to trace section 174(a)(2)(B) amortization deductions back to the year in which incurred. However, royalty and amortization expenses are taken into account for the intangible property factor when deductible because that is the most administrable proxy for measuring the economic contribution existing licensed or acquired intangible property makes to a cloud transaction.

In computing the intangible property factor, the Treasury Department and the IRS recognize that some specified research or experimental expenditures may not be directly traceable to a single transaction because intangible property developed through research and experimentation conducted in a taxable year may not be monetized in cloud transactions until a future year. In light of this, and consistent with the approach taken for allocating and apportioning deductions for such expenditures, the proposed regulations provide that the specified research or experimental expenditures to be taken into account with respect to a cloud transaction from which the gross income is being sourced are those associated with all cloud transactions provided in that taxable year that are in the same product line as the cloud transaction. *Id.; cf.* § 1.861–17(b) (recognizing that research and experimentation is an inherently speculative activity, which when successful ultimately results in the creation of intangible income, and allocating expenditures for such activity to gross intangible income earned in the year of the expenditure). The Treasury Department and the IRS are of the view that the current-year approach in the proposed rules serves as a workable, reliable, and appropriate proxy for existing intangible property in the same product line. Under the proposed regulations, cloud transactions are considered to be in the same product line if they are within the same Corresponding Index Entry under a North American Industry Classification System (NAICS) code number. Proposed § 1.861–19(d)(8). The proposed regulations also include a consistency requirement to prevent taxpayers from changing Corresponding Index Entry and NAICS code numbers absent a change in facts. *Id.* The intangible property factor focuses on work done in the same product line as the cloud transaction to balance between specificity and practicality. The factor aims to capture the contribution of intangible property to the performance of a cloud transaction, so a factual relationship between the specified research or experimentation expenditures and the cloud transaction being tested needs to exist. At the same time, the Treasury Department and the IRS are aware that it is not necessarily possible to precisely determine the product or products that will benefit from a research and experimentation process at an early stage. To prevent duplication, the proposed regulations require expenses that would be included in the intangible property factor for multiple cloud transactions in a taxable year to be allocated among those transactions (taking into account the aggregation rule described in Part I.C.4 of this Explanation of Provisions) based on the relative gross income earned from each transaction. Proposed § 1.861–19(d)(2)(i). Any intangible property costs that support cloud transactions in general but that do not relate to any specific cloud transaction should be allocated in the same manner.

b. Determination of the Portion of the Intangible Property Factor From U.S. Sources

Once the intangible property factor is determined, the portion of this factor that is attributable to sources within the United States must be identified for inclusion in the numerator. Given the non-physical nature of intangible property, its location when used in providing a service may be challenging to ascertain. Under the proposed rules, the portion of the intangible property factor that is from sources within the United States is determined based on the extent to which certain of the taxpayer's employees perform services in the United States, determined by leveraging the principles of § 1.861–4(b)(2)(ii)(E) (relating to sourcing compensation from labor or personal services on a time basis). The employees considered for this purpose are those whose primary function is to perform research and experimentation activities associated with cloud transactions in the same product line as the cloud transaction the gross income of which is being sourced. Proposed § 1.861–19(d)(2)(ii). The proposed regulations provide that the employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time. Proposed § 1.861–19(d)(5). In order to account for amounts paid to third-party research and experimentation providers, amortization, and royalties, the fraction determined by the compensation that has been paid to the research and experimentation personnel is applied to the total research and experimental expense determined under § 1.861–19(d)(2)(i). *See* proposed § 1.861–19(d)(2)(ii).

The Treasury Department and the IRS are of the view that the location of research and experimentation personnel is a logical and accurate proxy for the location of intangible property that contributes to the performance of a cloud transactions for a number of reasons. First, the research and experimentation personnel contribute to the creation, design, and refinement of the intangible property either through their own efforts or by managing and facilitating research and experimentation work carried out by third parties. Therefore, the value of the intangible property used to provide the cloud transaction depends on their personal efforts and expertise. Additionally, while intangible property does not have a physical form that can be easily located, the place where research and experimentation personnel operate is tangible and verifiable. Relatedly, taxpayers generally know or should know the location of their research and experimentation personnel, and thus, relying on the location of these personnel would avoid a burdensome compliance process that might otherwise be required to determine the location of intangible property used to provide cloud transactions. For similar reasons, in determining gross income of a taxpayer, the rule does not look to research and experimentation personnel other than those of the taxpayer, and uses the taxpayer's own personnel as a proxy for all research and experimentation personnel working on the relevant intangible property.

The determination of which research and experimentation employees should be taken into account focuses on the employees whose primary function is the performance of research and experimentation activities, without limiting the analysis to nonmanagerial employees or first-line managers who undertake these activities. This is because research and experimentation typically involves contributions from personnel across various levels of the organization, including senior

leadership and technical staff, as an idea for a product or service moves from concept to design, implementation, and testing. Accordingly, focusing solely on nonmanagerial employees or first-line managers could result in missing key contributors to the research and experimentation activities associated with a cloud transaction, including individuals within the organizational structure who oversee or engage in higher-level experimentation efforts.

2. Personnel Factor

a. Determination of the Personnel Factor and the Portion From U.S. Sources

The Treasury Department and the IRS are of the view that while the underlying technology and infrastructure are important in providing a cloud transaction to customers, the employees who manage, operate, and maintain these systems are also fundamental to the provision of the service. Accordingly, the efforts of personnel employed by the taxpayer who directly contribute to the provision of the cloud transaction must be taken into account in sourcing gross income from that cloud transaction. To properly reflect the contribution of these personnel to the provision of the cloud transaction, the personnel factor is composed of the compensation paid to the taxpayer's employees whose primary function is to directly contribute to the provision of the cloud transaction. *See* proposed § 1.861–19(d)(3)(i). However, to avoid double counting income, compensation that is paid to research and experimentation personnel described in proposed § 1.861–19(d)(2) is excluded. *Id.*

As explained in Part I.C.1.b of this Explanation of Provisions, an employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time. Proposed § 1.861–19(d)(5). The proposed regulations provide a rule to account for situations in which an employee's primary function is to directly contribute to more than one cloud transaction. In those cases, all of the employee's compensation must be allocated among those cloud transactions based on the relative amount of time the employee spends contributing to each transaction. Proposed § 1.861–19(d)(3)(i). To illustrate the application of these rules, if an employee spends 30 percent of their working time on Cloud Transaction 1, 30 percent of their working time on Cloud Transaction 2, and 40 percent of their working time not on cloud transactions, that employee's primary function would be working on cloud transactions because a majority of their working time (60 percent) is spent on cloud transactions. Consequently, all of this employee's compensation would be allocated among Cloud Transaction 1 and Cloud Transaction 2 based on the relative amount of time the employee spends contributing to each of the two cloud transactions. However, where an employee contributes to multiple cloud transactions simultaneously, their compensation must be allocated among those transactions based on the relative gross income earned from each transaction because it would be impossible to use a time-based allocation in such cases. *Id.*

Similar to the determination of the numerator of the intangible property factor, which is the portion of that factor from sources within the United States, the proposed regulations provide the numerator of the personnel factor, which is the portion of that factor from sources within the United States, is equal to the part of the personnel factor that is paid for services performed in the United States using the principles of § 1.861–4(b)(2)(ii)(E). Proposed § 1.861–19(d)(3)(ii).

b. Direct Contribution to the Provision of the Cloud Transaction

The proposed regulations set forth rules that define which employees are considered to directly contribute to the provision of the cloud transaction and which employees are not considered to do so. Under proposed § 1.861–19(d)(3)(iii), personnel directly contribute to the provision of a cloud transaction to the extent they personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are managers who directly support or immediately supervise such technical or operational personnel. Proposed § 1.861–19(d)(3)(iii) provides a non-exhaustive list of the functions that fall within the meaning of ''technical and operational activities.'' These functions are the conduct of scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction; the provision of monitoring, diagnostics, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security; the management of the cloud transaction's infrastructure; the delivery of end-user support with respect to the cloud transaction; and the conduct of any similar functions. *Id.* Further, under proposed § 1.861–19(d)(3)(iv), personnel are not considered to directly contribute to the provision of the cloud transaction to the extent they conduct business strategy, leadership, legal or compliance, marketing, communications, sales, business development, finance, accounting, clerical, human resources or administrative duties, or similar functions.

Proposed § 1.861–19(d)(3)(iii) and (iv) are intended to identify the individuals that generally have the hands-on, day-to-day involvement in the software, infrastructure, and processes that enable the cloud transaction to be provided to the customer and to function as intended. The Treasury Department and the IRS are of the view that the individuals who personally perform the technical and operational work and the immediate managers who direct and supervise that work are essential to the performance of the service, and therefore, their contributions must be included. By contrast, employees in higher-level management or executive positions who are responsible for setting the strategic direction of the business and making high-level decisions are too far removed from the hands-on, day-to-day work that ensures the delivery of any particular cloud transaction to the customer. Therefore, while their roles are important to the overall business, they do not directly contribute to the provision of the transaction itself and are not accounted for as part of the personnel factor. The Treasury Department and the IRS are of the view that this distinction properly interprets the statutory requirement to source gross income from a service to the place where the service is performed.

3. Tangible Property Factor

a. Determination of the Tangible Property Factor and the Portion From U.S. Sources

Cloud transactions depend on physical infrastructure and hardware, such as servers and networking equipment. For this reason, the Treasury Department and the IRS are of the view that tangible property that directly supports the provision of a cloud transaction must be taken into account in determining the source of gross income from a cloud transaction. Under the proposed regulations, the tangible property factor, which is intended to represent the contribution of the tangible property to the performance of the cloud transaction, is the sum of the depreciation and rental expense for the taxable year for tangible property owned or leased by the taxpayer, to the extent the property is directly used to provide the cloud transaction. *See* proposed § 1.861–19(d)(4)(i). To eliminate double counting, the proposed regulations

require any depreciation or rental expense that would be included in the tangible property factor for multiple cloud transactions in a taxable year to be allocated among those transactions based on the relative gross income earned from each transaction. The portion of the tangible property factor that is from sources within the United States and comprises the numerator is equal to the part of the tangible property factor attributable to property located within the United States.

b. Determination of the Depreciation Expense

For purposes of computing the tangible property factor, depreciation expense for a taxable year is determined by dividing the adjusted depreciable basis (as defined in § 1.168(b)–1(a)(4)) of the tangible property by the applicable recovery period as though the alternative depreciation system in section 168(g)(2) applied for the entire period the property has been in service. Proposed § 1.861–19(d)(4)(iii). The Treasury Department and the IRS are of the view that the determination must be made without taking into account tax incentives intended to accelerate the recovery of costs in order to provide an allocation of depreciation that more closely reflects the asset's actual economic life. Thus, the proposed regulations explicitly state that the depreciation expense is computed without regard to the election to expense certain depreciable property under section 179 and without regard to any additional first-year depreciation provision (for example, section 168(k)).

4. Aggregation Rule

The proposed regulations include an aggregation rule, set forth in proposed § 1.861–19(d)(7), that is intended to enhance the administrability of these regulations and to alleviate the compliance burden on taxpayers associated with the regulations. The rule allows a taxpayer to aggregate substantially similar cloud transactions and source the gross income from those transactions as if they were one transaction. However, the rule also prohibits a taxpayer from aggregating substantially similar cloud transactions if the taxpayer knows, or has reason to know, that doing so would materially distort the source of gross income from any cloud transaction.

For example, assume a cloud provider offers two distinct but substantially similar cloud transactions, Service 1 and Service 2, that are not in the same product line (within the meaning of proposed § 1.861–19(d)(8)). Further, assume the cloud provider incurs significantly more research and experimentation costs associated with Service 2 as compared to those incurred for Service 1, and all of the research and experimentation personnel of the cloud provider are located in the United States at all times. This leads a significantly larger percentage of the income from Service 2 to be sourced within the United States as compared to that of Service 1. Aggregating Service 1 and Service 2 would cause a materially larger amount of gross income from Service 1 to be sourced within the United States than if the income were sourced without aggregating Service 1 with Service 2. Therefore, under the proposed regulations, the cloud provider cannot aggregate Service 1 and Service 2 to source the gross income from these transactions.

5. Anti-Abuse Rule

In order to prevent taxpayers from circumventing the purpose of the proposed regulations—to attribute the source of gross income from a cloud transaction to the place where the transaction is performed—the proposed regulations would provide an anti-abuse rule. That anti-abuse rule, included in proposed § 1.861–19(d)(9), would provide that 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 purpose of the proposed regulations, appropriate adjustments will be made so that the source of the taxpayer's gross income reflects the location where the cloud transaction is performed.

II. Request for Comments

Comments are requested on all aspects of the proposed regulations, including the following topics:

(1) whether there are appropriate and administrable ways to determine the portion of the intangible property factor from sources within and without the United States other than by relying on the location of research and experimental personnel;

(2) whether and to what extent companies presently track specified research or experimental expenditures by product line;

(3) whether there is a practicable and verifiable way to precisely link the contribution of intangible property developed in one year to a cloud transaction provided in a later year;

(4) whether relative gross income is an appropriate allocation method in cases in which the same cost or expense would be included in a factor for multiple cloud transactions during a taxable year;

(5) whether additional operating costs incurred with respect to tangible property directly used in the provision of the cloud transaction, such as electricity costs associated with cloud transactions, should be included in the tangible property factor, and if so, how to capture the costs that contribute to the performance of the cloud transaction in an administrable manner; and

(6) whether a special rule is needed to source the gross income of resellers of cloud transactions, for example, whether assets and employees other than those described in the proposed regulations better reflect the reseller's role in the cloud transaction.

Proposed Applicability Date

The regulations are proposed to apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these regulations as final regulations in the **Federal Register**.

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Paperwork Reduction Act

This proposed rulemaking does not impose or revise any information collections subject to 44 U.S.C. Chapter 35.

III. Regulatory Flexibility Act

The Regulatory Flexibility Act requires consideration of the regulatory impact on small businesses. It is hereby certified that these proposed regulations, if adopted, will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

These proposed regulations would set forth specific rules for sourcing income from cloud transactions. Specifically, the proposed regulations provide guidance on sourcing such income based on three factors that are broadly consistent with existing case law on sourcing income from analogous transactions. Although data are not readily available to estimate the economic impact of the proposed regulations, the Treasury Department and the IRS project that any economic impact of the proposed regulations

would be minimal for businesses regardless of size. This is because the proposed regulations adopt an approach that is broadly consistent with the general principles of existing law and reflect current industry practice. Therefore, the proposed rules are not expected to materially alter taxpayer behavior and therefore the Treasury Department and the IRS expect no material economic impact.

For the reasons stated, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required. Notwithstanding the above, the Treasury Department and the IRS invite comments on the impact the proposed rules would have on small entities.

IV. Section 7805(f)

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

V. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. Executive Order 13132: Federalism

Executive Order 13132 (entitled *Federalism*) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. The proposed regulations do not have federalism implications, do not impose substantial direct compliance costs on State and local governments, and do not preempt State law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. All comments will be available at *www.regulations.gov*.

A public hearing will be scheduled if requested in writing by any person that timely submits comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Christopher E. Fulle and Michelle L. Ng of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.861–19, as added in a final rule published elsewhere in this issue of the **Federal Register**, effective January 14, 2025, is amended as follows:

■ a. Revise the section heading and paragraph (a);

■ b. Redesignate paragraphs (d), (e), and (f) as paragraphs (e), (f), and (g), respectively;

■ c. Add new paragraph (d);

■ d. For each paragraph listed in the following table, remove the language in the ''Remove'' column and add in its place the language in the ''Add'' column.

Paragraph	Remove	Add
newly redesignated (e), first sentence	paragraph (d)	paragraph (e).
newly redesignated (e)(2)(i), first sentence	paragraph (d)(1)(i)	paragraph (e)(1)(i).
newly redesignated (e)(2)(ii), first sentence	paragraph (d)(1)	paragraph (e)(1).
newly redesignated (e)(5)(i), first sentence	paragraph (d)(4)	paragraph (e)(4).
newly redesignated (e)(6)(i), first sentence	paragraph (d)(5)(i)	paragraph (e)(5)(i).
newly redesignated (e)(6)(ii)(A), first sentence	paragraph (d)(5)(ii)	paragraph (e)(5)(ii).
newly redesignated (g), first sentence	paragraph (e)	paragraph (f).

■ e. Add paragraphs (e)(12) and (13); and

■ f. Revise newly redesignated paragraph (f).

The revisions and additions read as follows:

§ 1.861–19 Classification of, and source of gross income from, cloud transactions.

(a) *In general.* This section provides rules for classifying and sourcing gross income from cloud transactions (as defined in paragraph (b) of this section). The rules of this section apply for purposes of Internal Revenue Code sections 59A, 245A, 250, 267A, 367, 404A, 482, 679, and 1059A; subchapter N of chapter 1; chapters 3 and 4; and sections 842 and 845 (to the extent involving a foreign person), and apply with respect to transfers to foreign trusts not covered by section 679.

* * * * *

(d) *Source of income from a cloud transaction*—(1) *In general.* Gross income from a cloud transaction is sourced as services income under section 861(a)(3) or 862(a)(3), as appropriate, according to where the service is performed. The place of performance of the cloud transaction is based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section. To determine gross income from a cloud transaction from sources within the United States, gross income from the cloud transaction is multiplied by a fraction, the numerator of which is the sum of the portion of each of the intangible property factor, personnel factor, and tangible property factor that is from sources within the United States

as calculated in paragraphs (d)(2)(ii), (d)(3)(ii), and (d)(4)(ii) of this section, and the denominator of which is the sum of the intangible property factor, personnel factor, and tangible property factor as calculated in paragraphs (d)(2)(i), (d)(3)(i), and (d)(4)(i) of this section. See paragraph (e)(12) of this section (*Example 12*). Any remaining gross income from a cloud transaction is gross income from sources without the United States.

(2) *Intangible property factor*—(i) *Total.* For purposes of paragraph (d)(1) of this section, the intangible property factor with respect to any cloud transaction performed by the taxpayer in a taxable year is equal to the sum of 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 and the taxpayer's amortization (other than amounts capitalized under section 174(a)(2)(A) and amortized under section 174(a)(2)(B)) and royalty expense for intangible property for the taxable year to the extent directly used to provide the cloud transaction. If the same cost or expense would be included by a taxpayer in the intangible property factor for more than one cloud transaction during a taxable year, such cost or expense is allocated among each such cloud transaction based on the relative gross income earned from each cloud transaction.

(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 of the taxpayer's employees 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 § 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 property factor described in paragraph (d)(2)(i) of this section.

(3) *Personnel factor*—(i) *Total.* For purposes of paragraph (d)(1) of this section, the personnel factor with respect to a cloud transaction performed in a taxable year is equal to the sum of the total compensation paid to all of the taxpayer's employees in that taxable year whose primary function is to directly contribute to the provision of the cloud transaction, excluding compensation amounts that are paid to research and experimentation personnel described in paragraph (d)(2) of this section. If, however, an employee's primary function is to directly contribute to multiple cloud transactions, then all of such employee's compensation is allocated among the cloud transactions that the employee directly contributes to as part of their primary function based on the relative amount of time the employee spends contributing to each cloud transaction. If an employee contributes to multiple cloud transactions simultaneously, then that employee's compensation is allocated among those cloud transactions based on the relative gross income earned from each cloud transaction.

(ii) *Portion from sources within the United States.* With respect to a cloud transaction, the portion of the personnel factor described in paragraph (d)(3)(i) of this section that is from sources within the United States is equal to the part of that factor paid for services performed in the United States, as determined using the principles of § 1.861–4(b)(2)(ii)(E) (relating to sourcing income from labor or personal services on a time basis).

(iii) *Personnel considered to directly contribute to the provision of the cloud transaction.* Personnel are considered to directly contribute to the provision of the cloud transaction to the extent they personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are a manager who directly supports or immediately supervises such technical or operational personnel. Such technical or operational activities are the conduct of scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction; the provision of monitoring, diagnostics, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security; the management of the cloud transaction's infrastructure; the delivery of end-user support with respect to the cloud transaction; and the conduct of any similar functions.

(iv) *Personnel not considered to directly contribute to the provision of the cloud transaction.* Personnel are not considered to directly contribute to the provision of the cloud transaction to the extent they conduct business strategy, leadership, legal or compliance, marketing, communications, sales, business development, finance, accounting, clerical, human resources or administrative duties, or similar functions.

(4) *Tangible property factor*—(i) *Total.* For purposes of paragraph (d)(1) of this section, the tangible property factor with respect to a cloud transaction performed in a taxable year is equal to the sum of the depreciation expense for that taxable year for tangible property owned by the taxpayer and rental expense for that taxable year for tangible property leased by the taxpayer, in each case to the extent directly used to provide the cloud transaction. If any depreciation expense or rental expense would be included in the tangible property factor for more than one cloud transaction during the taxable year, such depreciation expense or rental expense is allocated among the cloud transactions based on relative gross income earned from each cloud transaction.

(ii) *Portion from sources within the United States.* The portion of the tangible property factor described in paragraph (d)(4)(i) of this section from sources within the United States is equal to the part of that factor attributable to property located within the United States.

(iii) *Determination of depreciation expense.* For purposes of paragraph (d)(4) of this section, depreciation expense for a taxable year is determined by dividing the adjusted depreciable basis (as defined in § 1.168(b)–1(a)(4)) of the tangible property by the applicable recovery period as though the alternative depreciation system set forth in section 168(g)(2) applied for the entire period that such property has been in service, without regard to the election to expense certain depreciable property under section 179 and without regard to any additional first-year depreciation provision (for example, section 168(k)).

(5) *Primary function.* For purposes of this section, an employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time.

(6) *Employee.* For purposes of this section, the term employee has the meaning given to it in § 31.3121(d)–1(c) of this chapter.

(7) *Aggregation rule.* For purposes of applying this paragraph (d), a taxpayer may aggregate substantially similar cloud transactions unless it knows or

has reason to know that doing so would materially distort the source of gross income from any cloud transaction.

(8) *Product line.* For purposes of this section, a product line is defined as all products within the same Corresponding Index Entry under a North American Industry Classification System (NAICS) code number. Once a taxpayer selects a Corresponding Index Entry and NAICS code number for the first taxable year for which this section applies, it must continue to use that Corresponding Index Entry and NAICS code number in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in Corresponding Index Entry and NAICS code number is appropriate.

(9) *Anti-Abuse Rule.* The purpose of this paragraph (d) is to attribute the source of the taxpayer's gross income from a cloud transaction to the location where the cloud transaction is performed. Therefore, 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 purpose of this paragraph (d), appropriate adjustments will be made so that the source of the taxpayer's gross income reflects the location where the cloud transaction is performed.

(e) * * *

(12) *Example 12: Sourcing gross income from a cloud transaction*—(i) *Facts.* (A) Corp A provides customers on-demand network access to Program Y in exchange for a monthly fee. All of the transactions with customers are substantially similar to one another. Customers must be connected to the internet to access the functionality of Program Y.

(B) Corp A has employees whose primary function (as determined under paragraph (d)(5) of this section) is to conduct research and experimentation associated with developing new versions of Program Y and other products in the same product line (as determined under paragraph (d)(8) of this section). Corp A paid $160x in compensation to such employees, of which $80x was paid for services performed within the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). Besides employee compensation, Corp A spent an additional $200x for research and experimentation costs associated with developing new versions of Program Y and other products in the same product line. Corp A did not take any amortization deductions with respect to intellectual property used to provide Program Y.

(C) Corp A paid $400x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of Program Y to customers, of which $100x was paid for services performed in the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section).

(D) Corp A hosts Program Y on servers it owns that are located both within and without the United States. These servers are used only to host Program Y. Corp A deducted $140x for depreciation expense attributable to these servers, $80x of which was attributable to the servers located within the United States, and $60x of which was attributable to the servers located without the United States. These depreciation deductions are in accordance with the rules of section 168(g)(2).

(E) Corp A earned $800x of gross income from providing customers access to Program Y. Corp A does not know or have reason to know that any of the costs, functions or assets described in this paragraph are disproportionately allocated to certain transactions or groups of transactions among all of the transactions that generated $800x of gross income.

(ii) *Analysis.* (A) Under paragraph (b) of this section, each transaction between Corp A and a customer is a cloud transaction because Corp A provides on-demand network access to Program Y. Under paragraph (c)(1) of this section, each cloud transaction is classified as the provision of services. Under paragraph (d)(7) of this section, because all of these transactions are substantially similar and Corp A does not know or have reason to know that there is any disproportionate allocation of costs, functions or assets among them, all of the transactions may be considered in the aggregate for purposes of applying paragraph (d) of this section.

(B) Under paragraph (d)(1) of this section, the source of Corp A's $800x of gross income from providing access to Program Y to customers is determined based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section.

(C) Under paragraph (d)(2) of this section, the intangible property factor is equal to $360x because Corp A paid $160x in compensation to employees whose primary function was to conduct research and experimentation associated with developing new versions of Program Y and other products in the same product line, and incurred $200x in other research and experimentation costs associated with developing new versions of Program Y and other products in the same product line. $80x/$160x of such compensation, or 50%, is paid to employees for research and experimentation services performed with respect to Program Y and other products in the same product line in the United States. Corp A's $360x intangible property factor is multiplied by the same quotient to determine that $180x is from sources within the United States pursuant to paragraph (d)(2)(ii) of this section.

(D) Under paragraph (d)(3) of this section, the personnel factor is equal to $400x because Corp A paid $400x in compensation to employees whose primary function was to directly contribute to the provision of Program Y to customers and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Pursuant to paragraph (d)(3)(ii) of this section, $100x of the personnel factor is from sources within the United States because Corp A paid $100x in compensation to employees for services performed in the United States that directly contributed to the provision of Program Y to customers.

(E) Under paragraph (d)(4) of this section, the tangible property factor is equal to $140x because Corp A deducted $140x in depreciation expense for tangible property directly used to provide Program Y to customers under the method described in section 168(g)(2). $80x of the tangible property factor is from sources within the United States because this amount of the $140x depreciation expense is attributable to tangible property located within the United States.

(F) The sum of the intangible property factor ($360x), the personnel factor ($400x), and the tangible property factor ($140x) is equal to $900x. The sum of these factors from sources within the United States is $360x ($180x with respect to the intangible property factor, $100x with respect to the personnel factor, and $80x with respect to the tangible property factor). Accordingly, Corp A's $800x of gross income from providing Program Y to customers for the taxable year is multiplied by the quotient of $360x/$900x pursuant to paragraph (d)(1) of this section to determine that $320x is from sources within the United States. Pursuant to paragraph (d)(1) of this section, the

remaining $480x ($800x − $320x) is from sources without the United States.

(13) *Example 13: Sourcing gross income from multiple cloud transactions*—(i) *Facts.* (A) The facts are the same as in paragraph (e)(12) of this section (*Example 12*), except that Corp A also provides customers on-demand network access to software platform Z in exchange for a monthly fee, and Corp A hosts software platform Z on the same servers it uses to host Program Y (which generate more depreciation than in *Example 12*). All of the transactions for software platform Z customers are substantially similar to one another. Customers must be connected to the internet to access the functionality of software platform Z.

(B) Corp A has employees whose primary function (as determined under paragraph (d)(5) of this section) is to conduct research and experimentation associated with developing new versions of software platform Z and other products in the same product line. The software platform Z product line is not the same as the Program Y product line under the definition in paragraph (d)(8) of this section. Corp A paid $200x in compensation to such employees, all of which was paid for services performed in the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). Corp A also has employees whose primary function as determined under paragraph (d)(5) of this section is to conduct research and experimentation associated with developing functionality for new versions of both Program Y and software platform Z. Corp A paid $100x in compensation to such employees, all of which was paid for services performed in the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). Corp A did not have any other research and experimentation costs associated with software platform Z.

(C) Corp A paid $100x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of software platform Z to customers, and that entire amount was paid for services performed in the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Corp A also paid $80x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of both Program Y and software platform Z to customers, and that entire amount was paid for services performed in the United States as determined in accordance with the principles of § 1.861–4(b)(2)(ii)(E). These employees spent half their time contributing to software platform Z transactions and half their time contributing to Program Y transactions. None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section).

(D) Corp A hosts software platform Z on servers it owns that are located both within and without the United States. These servers are used to host both Program Y and software platform Z. Corp A deducted $180x for depreciation expense attributable to these servers, $120x of which was attributable to the servers located within the United States, and $60x of which was attributable to the servers located without the United States. These depreciation deductions are in accordance with the rules of section 168(g)(2).

(E) Corp A earned $800x of gross income from providing customers access to software platform Z. Corp A does not know or have reason to know that any of the costs, functions or assets described in this paragraph are disproportionately allocated to certain transactions or groups of transactions among all of the transactions that generated $800x of gross income.

(ii) *Analysis.* (A) Under paragraph (b) of this section, each transaction between Corp A and a customer for software platform Z is a cloud transaction because Corp A provides on-demand network access to software platform Z. Under paragraph (c)(1) of this section, each cloud transaction is classified as the provision of services. Under paragraph (d)(7) of this section, because all of these software platform Z transactions are substantially similar and Corp A does not know or have reason to know that there is any disproportionate allocation of costs, functions or assets among them, all of the software platform Z transactions may be considered in the aggregate for purposes of applying paragraph (d) of this section.

(B) Under paragraph (d)(1) of this section, the source of Corp A's $800x of gross income from providing access to software platform Z to customers is determined based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section.

(C) Under paragraph (d)(2) of this section, the intangible property factor is equal to $250x. Corp A paid $200x in compensation to employees whose primary function was to conduct research and experimentation associated with developing new versions of software Platform Z and other products in the same product line. Corp A also paid $100x in compensation to employees whose primary function was to conduct research and experimentation developing functionality for new versions of both Program Y and software platform Z, of which Corp A allocates $50x to software Platform Z and $50x to Program Y based on Corp A's relative gross income from Program Y and software platform Z transactions in the taxable year. $250x/$250x of such compensation, or 100%, is paid to employees for research and experimentation services performed in the United States with respect to software Platform Z and other products in the same product line. Corp A's $250x intangible property factor is multiplied by the same quotient to determine that $250x is from sources within the United States pursuant to paragraph (d)(2)(ii) of this section.

(D) Under paragraph (d)(3) of this section, the personnel factor is equal to $140x. Corp A paid $100x in compensation to employees whose primary function was to directly contribute to the provision of software platform Z to customers and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Corp A also paid $80x in compensation to employees whose primary function was to directly contribute to the provision of both Program Y and software platform Z (and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section)), and Corp A allocated $40x to software platform Z and $40x to Program Y based on the relative amount of time these employees spent contributing to Program Y and software platform Z transactions in the taxable year. $140x/$140x of such compensation, or 100%, is paid to employees for services performed in the United States that directly contributed to the provision of software platform Z to customers.

(E) Under paragraph (d)(4) of this section, the tangible property factor is equal to $90x. Corp A deducted $180x in depreciation expense for tangible property directly used to provide both Program Y and software platform Z transactions under the method described in section 168(g)(2), of which $120x is from sources within the United

States because this amount is attributable to tangible property located within the United States. Based on Corp A's relative gross income from Program Y and software platform Z transactions in the taxable year, Corp A reasonably allocates $90x to software platform Z, of which $60x is from sources within the United States and $90x to Program Y, of which $60x is from sources within the United States.

(F) The sum of the intangible property factor ($250x), the personnel factor ($140x), and the tangible property factor ($90x) is equal to $480x. The sum of these factors from sources within the United States is $450x ($250x with respect to the intangible property factor, $140x with respect to the personnel factor, and $60x with respect to the tangible property factor). Accordingly, Corp A's $800x of gross income from providing software platform Z to customers for the taxable year is multiplied by the quotient of $450x/$480x pursuant to paragraph (d)(1) of this section to determine that $750x is from sources within the United States. Pursuant to paragraph (d)(1) of this section, the remaining $50x ($800x − $750x) is from sources without the United States.

(f) *Applicability date*—(1) *In general.* Except as otherwise provided in this paragraph (f), this section applies to taxable years beginning on or after January 14, 2025. Paragraphs (d) and (e)(12) and (13) of this section apply to taxable years beginning on or after the date of publication of the Treasury decision adopting those paragraphs as final regulations in the **Federal Register**.

(2) *Early application.* Except for paragraphs (d) and (e)(12) and (13) of this section, a taxpayer can apply this section to taxable years beginning on or after August 14, 2019 and all subsequent taxable years not described in paragraph (f)(1) (early application years) if—

(i) The taxpayer also applies § 1.861–18 to the early application years;

(ii) This section and § 1.861–18 are applied to the early application years by all persons related to the taxpayer (within the meaning of sections 267(b) and 707(b));

(iii) The period of limitations on assessment for each early application year of the taxpayer and all related parties (within the meaning of sections 267(b) and 707(b)) is open under section 6501; and

(iv) The taxpayer would not be required under this section to change its method of accounting as a result of such election.

* * * * *

Douglas W. O'Donnell,

Deputy Commissioner.

[FR Doc. 2024–31373 Filed 1–10–25; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107895–24]

RIN 1545–BR20

Base Erosion and Anti-Abuse Tax Rules for Qualified Derivative Payments on Securities Lending Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the base erosion and anti-abuse tax imposed on certain large corporate taxpayers with respect to certain payments made to foreign related parties. The proposed regulations relate to how qualified derivative payments with respect to securities lending transactions are determined and reported. The proposed regulations would affect corporations with substantial gross receipts that make payments to foreign related parties.

DATES: Written or electronic comments and requests for a public hearing must be received by April 14, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG–107895–24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the ''Comments and Requests for a Public Hearing'' section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments submitted to the IRS's public docket. Send paper submissions to: CC:PA:01:PR (REG–107895–24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sheila Ramaswamy at (202) 317–6938; concerning submissions of comments, requests for a public hearing, and access to a public hearing, Publications and Regulations Section at (202) 317–6901 (not toll-free numbers) or by email to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

This document contains proposed additions and amendments to 26 CFR part 1 (Income Tax Regulations) under sections 59A and 6038A of the Internal Revenue Code (Code). The proposed additions and amendments are issued pursuant to the express delegations of authority to the Secretary of the Treasury (or her delegate) provided under sections 59A(i) and 6038A(b)(2). The proposed regulations are also issued under the express delegation of authority under section 7805(a) of the Code.

Background

I. Statutory Framework

The base erosion and anti-abuse tax (''BEAT'') of section 59A imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the taxable year. For taxable years after 2018 and before 2026, the base erosion minimum tax amount for the taxable year is the excess of ten percent of the modified taxable income of the applicable taxpayer minus the applicable taxpayer's regular tax liability under section 26(b) reduced (but not below zero) by certain credits. *See* section 59A(b)(1) and (2). To be an applicable taxpayer, generally the taxpayer must meet the following three requirements: (1) the taxpayer must be a corporation which is not a regulated investment company, a real estate investment trust, or an S corporation; (2) the taxpayer must have average annual gross receipts for the three-taxable-year period ending with the preceding taxable year that are at least $500 million; and (3) the taxpayer generally must have a base erosion percentage for the taxable year of at least three percent (or two percent for banks and registered securities dealers). *See* section 59A(e).

The applicable taxpayer determines its modified taxable income by computing its taxable income without regard to any base erosion tax benefit with respect to any base erosion payment or the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year. *See* section 59A(c)(1). Generally, a base erosion payment is any deductible amount paid or accrued by an applicable taxpayer to a foreign person as defined in section 6038A(c)(3)