April 14, 2025

Internal Revenue Service
CC:PA:01:PR (REG-107420-24)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: National Foreign Trade Council Comments on the Source of Income from Cloud Transactions Proposed Regulations (REG-107420-24)

The National Foreign Trade Council (the "NFTC") is writing to provide comments on REG-107420-24, "Source of Income From Cloud Transactions" (the "Proposed Regulations"), released by the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") on January 14, 2025.

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, accounting for over $6 trillion in revenue and employing nearly 6 million people in the United States. Our members support establishing and maintaining international tax norms that provide certainty to enterprises conducting cross-border operations.

Overview & General Comments

The Proposed Regulations propose a novel formula to determine the "place of performance" for sourcing gross income from cloud transactions, which are categorized solely as the provision of services. Under the proposed framework, the place of performance would be established using a novel formula based on a fraction that considers three key factors: intangible property ("IP"), personnel, and tangible property—elements that Treasury and the IRS identify as critical to delivering cloud transactions. The denominator of the fraction represents the sum of these three factors, while the numerator is determined by summing the portion of each factor attributable to sources within the United States. By applying this fraction to the total gross income from a cloud transaction, the resulting amount represents the U.S.-sourced portion of the income, with the remainder treated as foreign-sourced.

Additionally, the proposed sourcing rule would apply individually to each taxpayer, disregarding the activities and personnel of any related or unrelated entities involved in the provision of the service. The rule would also permit taxpayers to aggregate substantially similar cloud transactions and source the gross income from those transactions collectively, unless the taxpayer knows or reasonably should know that such aggregation would materially distort the source of the income. However, the Proposed Regulations do not define "substantially similar" or "materially distort," though an example in the Preamble suggests that distinct cloud transactions across different product lines may qualify as substantially similar.

Lastly, the Proposed Regulations include a general anti-abuse rule, which would allow the IRS to adjust the sourcing of a taxpayer's income if transactions are structured with a principal purpose of reducing U.S. tax liability in a manner inconsistent with the regulations' intent. The stated objective of the regulations is to source gross income from cloud transactions based on the location where the transaction is actually performed.

We appreciate the opportunity to provide comments on the Proposed Regulations. NFTC comments are limited in scope and may not represent all of the concerns of our members or the broader business community. The Proposed Regulations may introduce opportunities for structuring transactions, but also add significant complexity. Therefore, we request that Treasury withdraw and subsequently revisit the Proposed Regulations.

If the Proposed Regulations are not withdrawn, this complexity could be mitigated by incorporating reasonable alternatives suggested by NFTC and others during the comment period. Treasury should consider refinements that balance the need for administrability with the objective of accurately reflecting the economic reality of these transactions.

Specific Comments

NFTC appreciates the challenges of drafting these Proposed Regulations and recognizes the incorporation of promising elements. However, many aspects should be revised to address the issues outlined below.

Evaluating the Adequacy of Current Source Rules for Services

In evaluating whether the Treasury's premise is correct—specifically, that *Piedras Negras Broadcasting Co. v. Comm'r*, 43 B.T.A. 297 (1941) is outdated (as stated in section 1.C.1.a of the Preamble)—it is important to consider arguments both for and against this position. One argument against the premise is that the increasing automation of digital content does not necessarily devalue the role of physical presence or assets in cross-border transactions. Additionally, many other principles of law are based on physical presence and thus establish sovereignty and jurisdiction. We caution against uprooting those principles, especially through regulations.

While technology facilitates digital services, certain business operations still require a strong physical presence or local infrastructure to be effective, which can impact the source determination. Thus, the claim that assets or people are less valuable due to automation may not fully capture the complexity of digital services and their interactions with local markets.

Simplifying the Application of New Sourcing Rules: Practical Considerations and Challenges

One of the principal problems with the Proposed Regulations is that taxpayers should not be required to create entirely new datasets for each employee in order to comply. The administrative expense of collecting and updating such information would be high, especially for multinational companies with operations throughout the U.S. and the world. Taxpayers should be allowed to utilize available data wherever possible to reduce compliance without undue complexity.

The Proposed Regulations assume the ability of taxpayers to possess finely granular information of how each and every worker spends their time, which is not feasible. Businesses may not have systems in place that can track time spent by each and every employee on various tasks and activities, especially in an

off-site or blended work setup. The Proposed Regulations should account for the practical limitations of the taxpayers in gathering such amounts of detailed information.

To alleviate these concerns, we suggest permitting reasonable grouping of similar employees by cost centers, business lines, job titles, or roles, or other similar metrics as a more practical solution. This would enable companies to more efficiently assign resources and activities, without demanding overly specific individual-level information, but still adhering to the intent of the sourcing rules. A similar approach was taken by the IRS in the 2017[1] and 2020[2] guidance relating to calculating the Section 41 credit, allowing taxpayers to utilize classifications already performed for financial statement purposes. Grouping by business lines and cost centers would provide for similar administrative ease without material distortions.

The Proposed Regulations provide a transaction-by-transaction structure; however, allowing taxpayers to group "substantially similar" transactions together would be more desirable. Transactions within the same business unit or product line may qualify as "substantially similar," enabling uniform and uncomplicated application of the rules. The Proposed Regulations provide language that is problematic in that it does not provide a proper definition of "substantially similar," thus enabling the potential for subjectivity and dispute.

The collateral effects in the implementation of these new rules must be considered. For instance, decisions regarding the place of performance for Subpart F income need to be specially addressed, so that they dovetail with the new sourcing system. The computation of U.S. source income in controlled foreign corporations ("CFCs") could also be impacted by these reforms, and hence, there needs to be clarification on how these will interact with the new regulations.

Another significant issue is the potential extendability of U.S. extraterritorial withholding tax impacts to end-user consumers of foreign resellers in certain situations. This has widespread implications for the global distribution of digital products; NFTC requests clarity on extraterritorial withholding taxes so as not to create unexpected tax impacts on foreign customers.

Lastly, the Proposed Regulations contemplate costs included in the tax bases of sourcing income that may be applicable to "cloud" and "non-cloud" transactions alike. The question of how to apportion costs and whether it would make sense to apply the same apportionment on gross income to both types of transactions needs to be considered because it might result in inconsistencies or inefficiencies in cross-border transaction tax treatment.

Taxpayer-by-Taxpayer Approach

NFTC suggests the Proposed Regulations adopt a "taxpayer-by-taxpayer" approach for the sourcing rules, with every regarded legal entity treated as an individual taxpayer. This approach would provide certainty in the sourcing of Foreign Source Income ("FSI") by making cloud-related transactions determined at the regarded legal entity level. We request Treasury consider rules on intercompany ("I/C") transactions, especially in consolidated groups, because such transactions may require a more advanced treatment.

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[1] LB&I-04-0917-005, "Guidance for allowance of the Credit for Increasing Research Activities under I.R.C Section 41 for taxpayers that expense research and development costs on their financial statements pursuant to ASC 730"
[2] LB&I-04-0820-0016, "Guidance for Allowance of the Credit for Increasing Research Activities Under I.R.C. Section 41 for Taxpayers That Expense Research and Development Costs on Their Financial Statements Pursuant to ASC 730"

Consolidated groups should be treated as a single "taxpayer" for these purposes, which would simplify the application of the sourcing rules to related entities.

The Intangible Factor

NFTC recognizes that intangible property and its development are fundamental to the lifecycle of cloud services, much like they are for many products across various industries. However, we have concerns, expressed in other fora as well, that the location where intangibles are developed should not influence the sourcing of income derived from cloud services utilizing those intangibles. For example, the sale of inventory property is sourced to the location of the purchaser, regardless of where the R&D and design work were performed. Similarly, ordinary personal services are sourced to the location where the service is performed, notwithstanding where the service line offering was designed or developed.

Significant R&D efforts are undoubtedly required to develop products and services capable of being provisioned with minimal personnel involvement. The location of these R&D activities is not dispositive and does not equate to the location where the service itself is delivered. Under long-standing tax norms, service sourcing has been determined by where the service is performed or provided. The Proposed Regulation acknowledges that these rules "establish specific sourcing rules that *interpret* the place of performance in the context of a cloud transaction" (emphasis added). Introducing an entirely new factor into this framework would not be an interpretation of existing law but rather the creation of a new one.

Another fundamental problem with the intangible factor is the extensive and burdensome data collection it necessitates. Gathering information about the activities of individual employees would require tracking their R&D contributions and determining how much of their time is spent on specific NAICS code categories. This process would need to be performed annually, making it an enormous administrative challenge. Since such data is not typically collected for any other business purpose, there are no existing systems to leverage when working to comply with this requirement.

Additionally, the inclusion of an intangible factor undermines one of the stated purposes of Example 10 in Treas. Reg. §1.861-19(d)(10). The preamble to that regulation acknowledges concerns that some jurisdictions classify income earned by resellers of services, such as software-as-a-service, as royalties subject to withholding tax. In response, Example 10 was introduced to clarify that a reseller's transactions with customers constitute the provision of services rather than royalty payments. However, incorporating an intangible factor into sourcing cloud services income contradicts this objective, as it reinforces the argument that such income is derived from intangible property rather than service provision.

We also highlight the inconsistency between the proposed intangible factor and the source rules for royalties, which source revenue generated by the use of IP to the place of use or right to use that IP. The Proposed Regulations provide that the source of services is not to the place of performance, which may impart use of IP, but rather to the place of development of IP. For example, a U.S. taxpayer that licenses IP to a third party for rights to use that IP in the U.S. will have U.S. source royalty income. The same U.S. taxpayer that sells the third-party cloud services may have some foreign source income due to contract R&D performed by foreign employees of its disregarded entities. This is a surprising result.

Given these concerns, we recommend removing the intangible factor from the Proposed Regulations. Consistent with historical precedent, service sourcing should continue to rely on the location of personnel and assets, rather than introducing a new and impractical standard.

Tangible Property Factor

The inclusion of a Tangible Property Factor in the sourcing rules should be reconsidered, especially concerning data hosting costs. Specifically, there should be clarification as to whether data hosting costs should be treated similarly to rent or depreciation for tax purposes. The source of the income should also be considered in the case of withholding taxes paid by customers and when customers of foreign cloud sellers utilize U.S. data centers. The Proposed Regulations suggest that all payments made for third-party (or related-party, at least outside the consolidated group) data hosting should be excluded from the formula, as they seem irrelevant to the determination of source income. This creates potential disparities, particularly where taxpayers have the ability or choose to either own or subcontract cloud infrastructure. There is also a need to further clarify the treatment of rent expenses, as the language in the proposal is not clear on how these expenses should be calculated. Under U.S. Generally Accepted Accounting Principles ("GAAP"), rent expense is calculated on a straight-line basis, which is similar to what is required for tax depreciation. However, for purposes of the proposed rules, rent expense is tied to cash payments, which could fluctuate due to rent escalation clauses.

The Personnel Factor

Similar to the intangible factor, the personnel factor necessitates rigorous tracking of employee time, requiring businesses to determine whether and to what extent employees worked on cloud transactions and where that work occurred. While tracking this data for individual employees is theoretically possible, collecting and managing it on a global scale would be both impractical and prohibitively expensive. This challenge is exacerbated by the fact that taxpayers currently have no obligation to collect data on whether and to what extent employees worked on cloud transactions for tax or business purposes. Furthermore, the fluid nature of cloud services delivery and workforce composition makes compliance with this requirement even more burdensome.

To mitigate these challenges, we would recommend implementing a rebuttable presumption to establish the location and transactions associated with in-scope employees. For location, the rebuttable presumption is that 100% of an employee's time is allocated to the employee's country of employment. This is in line with standard industry practice to hire into local entities with the expectation of local delivery. For transactions, the rebuttable presumption is that 100% of an employee's time is allocated to the cloud transaction (or aggregated transactions) that align to the employee's organization, which can be determined based on existing business data, such as cost center or reporting line. This is in line with standard industry practice to hire for roles scoped to support specific business lines. As both are rebuttable presumptions, taxpayers may instead choose to provide data sufficient to prove out of the role on an employee-by-employee basis.

If this rebuttable presumption suggestion is not palatable, we recommend implementing a simplified personnel factor calculation or allowing a reasonableness standard. Hypothetically, in line with the predominant character standard in Treas. Reg. §1.861-19 (Classification of Cloud Transactions), if during the year an employee works on a large swath of projects, a majority of which are related to cloud transactions, we recommend their entire compensation should be allocated to the personnel factor, rather than only the portion of their income that is directly tied to cloud services. Alternatively, if an employee is primarily tied to a single cost center for cloud transactions, that employee's expense should be allocated under the personnel factor. Similarly, if an employee primarily works in one location, their entire annual compensation should be attributed to that location. We suggest a potential safe harbor to address these

concerns; for instance, if an employee spends a majority of their time on cloud transactions in a single location, their full compensation would then be included in the personnel factor.

The Proposed Regulations should also be modified to incorporate a reasonableness standard for data collection, supported by illustrative examples. For instance, in cases where a department engages in numerous cloud and non-cloud transactions across multiple locations, collecting individual employee time data would be excessively burdensome. Instead, a reasonable approach should allow a company to classify a group of employees as related to cloud transactions and a single location if the majority of their activities align accordingly. An example could demonstrate how a taxpayer, through internal interviews with a department head, reasonably determines that all employees under that individual's supervision contribute to a single cloud transaction in a single location.

In addition, we suggest clarifying the definition in §1.861-19(d)(3)(iii) of the Proposed Regulations on who qualifies as someone who "directly contributes to the provision of the cloud transaction." The definition should encompass a broader range of roles within an organization that contribute to the delivery of cloud services, such as IT specialists or data center employees.

Further, the interaction between the final examples in the proposed rules and the exclusion of sales and marketing activities should be addressed. There is concern that resellers, particularly CFC resellers, could inadvertently generate U.S.-source income due to the exclusion of sales and marketing activities from the sourcing of cloud revenues. This result would be incongruous with Example 10 in Treas. Reg. §1.861-19(d)(10), which affirmatively finds that a reseller with sales and marketing functions performs cloud services for its customers, not as an agent of Corp A.

By implementing these modifications as well as the prior suggestions, the Proposed Regulations would maintain their intended objectives while significantly reducing the administrative challenges they impose.

Alignment of New Sourcing Rules

The new sourcing rules in the Proposed Regulations should align with the global position that resellers do not obtain IP rights and, therefore, do not pay royalties. This consistency is crucial, as non-U.S. jurisdictions may seek to use these rules to increase locally taxable income of resellers or assert withholding tax on their transactions.

In addition, it is important that regulations uphold the principle that foreign subsidiaries do not act as agents for U.S. affiliates. This global stance helps ensure clarity in determining the appropriate tax treatment of foreign subsidiaries, reinforcing the notion that such entities operate independently and should not be subject to agency-like roles that could affect their tax obligations.

Such considerations are crucial to ensuring coherence in cross-border taxation rules and consistency with international tax conventions.

Characterization

In Treas. Reg. §1.861-19(d)(10), Example 10, a general fact pattern is described in which Corp A develops a product ("Program S") that it provides to customers via the cloud. Corp B, a CFC of Corp A, is granted "the right to sell access to Program S to Corp B's customers located in Corp B's country." While Corp B handles the purchase and sales process, including invoicing and collections, it does not

otherwise participate in providing access to customers. Instead, Corp A remains “responsible” for delivering access to Program S.

The example concludes that both the transaction between Corp A and Corp B, as well as the multiple transactions between Corp B and its customers, are cloud transactions. However, the analysis section offers little substantive reasoning and fails to adequately explain why both transactions fall under the cloud transaction classification.

NFTC suggests that Example 10 be revisited as it omits crucial details regarding the contractual relationships and the economic value distribution within the transactions—details necessary for a proper characterization under the predominant character standard and the “primary benefit or value” indicators. Identifying the correct customer in a transaction and determining the predominant character of the transaction depend on the contractual relationships between the parties. Example 10 fails as it disregards potential variations. It oversimplifies the analysis by assuming that the transaction does not have multiple elements, which is unlikely in real-world applications. In our view, the conclusion of Example 10 should only follow if the example includes two additional facts: One, Corp A is responsible for providing customers access to Program S at the direction of Corp B; and Two, Corp A does not have a direct contractual relationship with Corp B’s customers. We therefore recommend that Example 10 include these two additional facts.

Conclusion

Thank you for consideration of our comments. We are happy to answer any questions or clarify any of the comments raised; please contact Anne Gordon, Vice President of International Tax Policy (agordon@nftc.org).