



# TaxJourney

United States

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## Digital & Cloud Transactions: Treasury & IRS issue final regulations on digital content and propose cloud transaction sourcing rules

The Treasury and the IRS have issued final regulations under Section 861 (the “2025 final regulations”), addressing transactions involving “digital content” and certain “cloud transactions.” For these purposes:

- **Digital content** refers to computer programs or other materials—such as books, movies, and music—provided in digital format. This includes content protected by copyright law, or content that has entered the public domain due to the expiration of copyright protection or a creator’s dedication of the material to the public domain.
- **Cloud transactions** involve obtaining on-demand network access to computer hardware, digital content, or similar resources.

These regulations primarily affect taxpayers involved in digital content or cloud transactions. They will take effect for taxable years beginning on or after their publication date in the Federal Register, currently scheduled for January 14, 2025.

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The 2025 final regulations generally align with the framework established in the 2019 proposed regulations, incorporating several revisions. Key updates include:

1. Replacing certain de minimis rules with a “predominant character” rule for classifying transactions with multiple components.
2. Using the purchaser’s billing address, rather than the “place of sale,” “title passage,” or place of download, to source income from sales of copyrighted articles via digital platforms that are not governed by Section 863(b).
3. Characterizing all cloud transactions exclusively as services transactions, eliminating the multifactor “services vs. lease” test outlined in the 2019 proposed regulations.

In addition, Treasury and the IRS have published proposed regulations (Proposed Regulations) to clarify the sourcing of income from cloud transactions. These Proposed Regulations aim to provide taxpayers with greater certainty and facilitate IRS audits. Taxpayers earning gross income from cloud transactions will be impacted. Public comments on the Proposed Regulations are due within 90 days of their publication in the Federal Register, currently expected on January 14, 2025.

The Proposed Regulations introduce a taxpayer-specific approach for sourcing income from cloud transactions, focusing on the economic contributions made by intangibles, employees, and assets involved in performing the cloud transaction. They also outline a mathematical formula to determine the source of such income, factoring in:

1. The intangible property contribution,
2. The personnel contribution, and
3. The tangible property contribution.

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Finally, the IRS has released **Notice 2025-6**, soliciting comments on the potential implications of extending the characterization rules in Regulations 1.861-18 and 1.861-19, as amended by the 2025 final regulations, to all provisions of the Internal Revenue Code. Currently, the 2025 final regulations apply only to specific international provisions of the Code, as detailed within the regulations.

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The 2025 final regulations finalize Proposed Regulation 1.861-18, extending the income classification rules for computer programs to other forms of digital content and updating certain existing rules for characterizing income. Additionally, the final regulations finalize Proposed Regulation 1.861-19, offering guidance on how to characterize income from transactions involving on-demand network access to computer hardware, digital content, and similar resources.

The Proposed Regulations emphasize the need for specific sourcing rules to address the unique nature of income from cloud transactions. These regulations would take effect for tax years beginning on or after the publication of the final rules in the *Federal Register*.

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