



Taxing the Cloud

Presented to TAGLaw and TAG Tax.

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Outline of topics

- > *International tax concepts*
- > *Recent developments*
- > *How is the Cloud different*
- > *Issues raised*
- > *Path forward*

International Tax Concepts

International Tax Concepts

Concept	Meaning
Permanent Establishment	Commonly used to define when a company has enough presence to require it to file income tax returns
Transfer Pricing	Required by law. The pricing of goods, services and intangibles that are transferred between related parties (more than 50% common ownership)
Indirect Tax	Duties, and VAT that is included in the price of a product or service. VAT is generally "recoverable", meaning it can be charged through or refunded
DTA	Double Tax Agreement: serves to reduce or eliminate source taxation
Character of Income	<p>The character of income often determines its taxation for withholding tax or other tax at source:</p> <ul style="list-style-type: none">➤ Sale of goods➤ Capital gain➤ Service➤ Rent or royalty

Rules of the road

Goal	Plan
Control Tax Footprint Avoid too many legal entities, but design structure to allow for global growth	Services tend to create tax presence. Payroll tends to create the need to form a taxable entity. Working from a central hub and using technology to monitor adaptive trials controls footprint
Contract directly with third parties and reduce the use of intercompany invoices whenever possible	Intercompany transactions attract transaction taxes. <ul style="list-style-type: none">- Reduce touch-points- Reduce the need to document intercompany transactions
Structure transactions with to reduce friction costs	<ul style="list-style-type: none">- Royalties generally attract withholding taxes.- Service Fees can create other tax costs

Recent developments

OECD – Report on Base Erosion on Profit Shifting (BEPS)

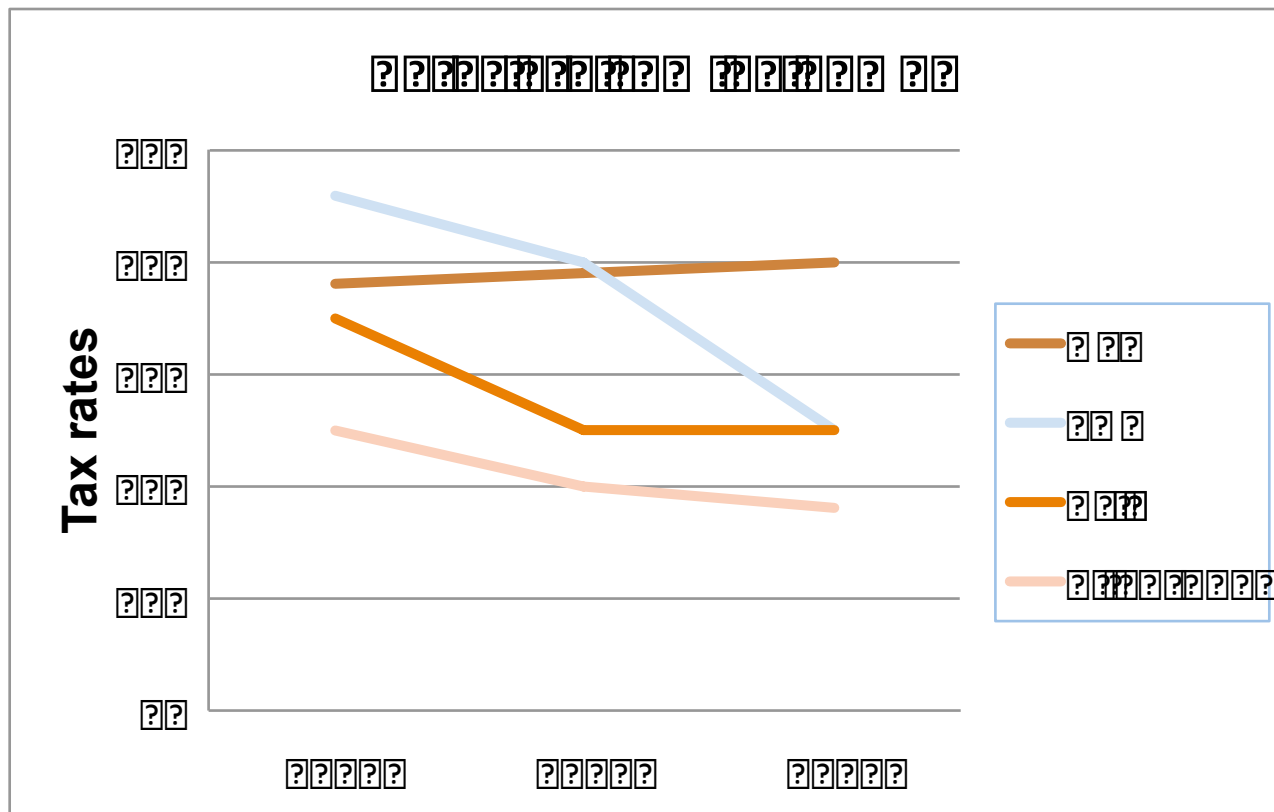
OECD – Report on Transfer Pricing

UK Commons Public Accounts Committee blasts Big 4 “Extraordinary Structures”

Administrations Budget Proposal 2014

What to expect in 2013

Trends in tax rates



OECD - BEPS

Surprisingly insightful

Many well known structures are analyzed

General view the intangible migrations are causing base erosion

- Tone: although structures are legal, transfer pricing is being misused

Not interested in an apportionment formula or allocation model

OECD – Transfer Pricing report

Roadmap to transfer pricing issues

Reiterates the concerns of BEPS report

Lists factors which might highlight transfer pricing abuse

- existence of companies in low tax jurisdictions is a risk elevator
- large pooling of profits in a low tax location
- significant intercompany transactions
- recurring and non-recurring
- focus on IP transfers
- the **Battle of Documentation**

How is it the Cloud different?

The Business Model

The Cloud provides customers a pay-to-play model for large information applications. It also relieves the customer of having to maintain up to date systems and software.

It also is, as a wise CIO friend once put it, "placing your most mission critical information into the hands of a perfect stranger and hoping it all works out."

How is it the Cloud different?

- Contract can be with a customer in China.
- Company contracting may be in Singapore
- Company providing IT servers may be in Bangalore
- Software development may be in US and Ireland
- Billing may be done out of Singapore, or from a local agent in China

HOW DOES THIS GET TAXED?

How is it the Cloud different?

The Tax Issues

Character of income

Service?

Sale of goods?

Royalty?

Rent of property?

Service

Source of income

Where is it taxable?

The old model – sell, install, maintain

Sales of software

- > Regional hub sells software, usually for an upfront license fee. Perpetual or time limited
- > Copyrighted article = goods

Local company installs and configures software on customer site

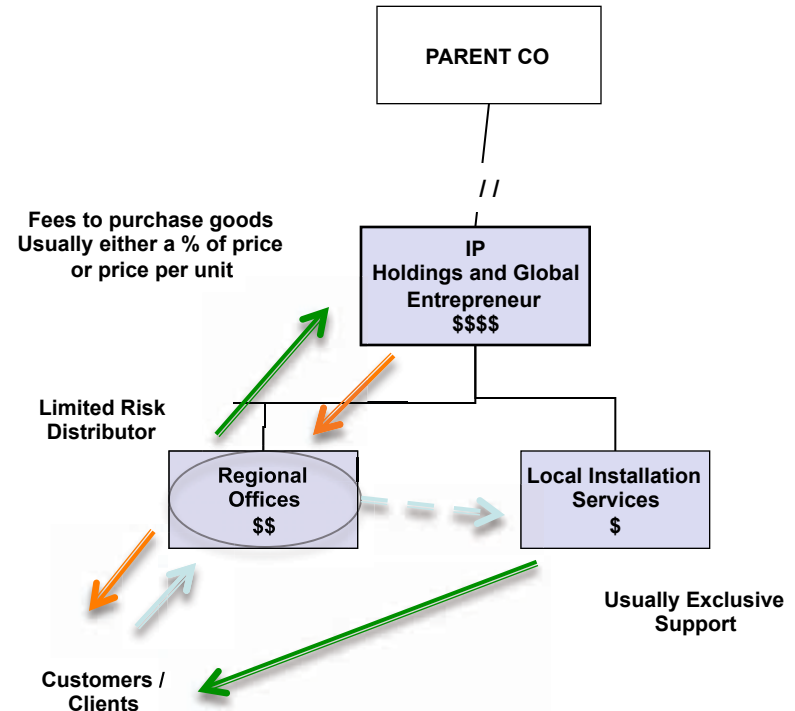
- > Usually paid based on a rate card
- > Subcontractor to Regional Sales

Regional Sales can be two things

- > Most common: distributor of copyrighted articles
- > Optional: licensed agent.

Customer considerations:

- > High upfront costs
- > Can be hard to maintain



The Old Model – we know this

What is it?	Sourcing	PE and Transfer Pricing
Sale of software	<ol style="list-style-type: none">1. If the sale is for an "article" that is copyrighted and (1) the software is usable as is, for the most part, (2) the buyer has no right to reproduce, and (3) the license is perpetual then the sale is equivalent to the sale of goods2. Sourced by where TITLE PASSES. Usually at the point of delivery.3. Can be subject to VAT as an imported good or imported service.	<ol style="list-style-type: none">1. Can apply Article V protections2. Sales pricing model like that of a distributor – limited or full risk.

The Old Model – we know this

What is it?	Sourcing	PE and Transfer Pricing
Installation and Maintenance	<ol style="list-style-type: none">1. Services are sourced to where they are PERFORMED.2. For VAT sometimes Services are sourced to where delivered, but this is for very rare cases.	<ol style="list-style-type: none">1. Services are much harder to protect under Article V2. More value gets trapped locally for transfer pricing3. Harder to commoditize services
Payments for Intangible Property: - Code - Marketing intangibles (brand, name, customer relationship)	<ol style="list-style-type: none">1. Sourced to where the IP is being used and taxed at source.2. In LRD model, each unit sold is considered a sale of "copyrighted article" and effectively considered a sale of goods. Generally with delivery DDU. Invoicing is from local to local and remittance is from local to IP owner.	<ol style="list-style-type: none">1. Can be a hot area for transfer pricing because comparables can be hard to find. Best if using the Limited Distributor Model2. If characterized as a royalty payment it can be subject to source withholding tax of 10-30%.<ul style="list-style-type: none">- Treaties make a big difference here- Sometimes conceding withholding tax is solution to exchange control problems.

Tax Rate on Structure

Entity	Income	Portion paid on	Portion taxable	Tax rate	ETR
Regional	100%	90%	10%	35%	3.5 %
Installer	5%	0	5%	30%	1.5 %
IP Holding and Global	90%	5%	85%	5%	4.5 %
					9.5 %

This is an illustrative example

This example assumes funds will remain outside the US. If funds are returned to the US, either through (1) dividends, (2) redemption of stock or (3) loans from controlled foreign corporations, under the US system the effective tax rate would be 35% or more.

The Cloud

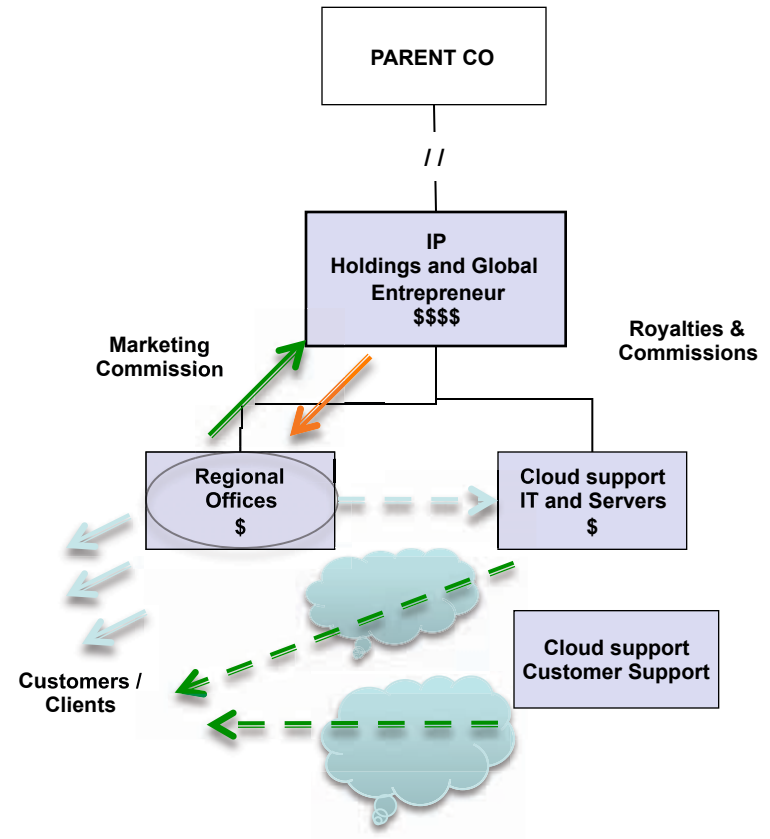
Regional office is face to market

- > This is the face to market and the company that invoices the customer
- > Regional office might be set up in Singapore, Dubai or Ireland. Regional office would bill on behalf of IP Holdings.
- Pay 98% and charge 2% has administration fee
- If necessary can structure as a royalty

IP Holdings may contract software development to center in India or Indonesia

- > Low cost high skill labor
- > Tax holidays
- > Singapore / India treaty makes Singapore an attractive party to own and run India

Customer interacts with servers and support outside the country



The Cloud – we know this

- ✓ *No comprehensive rules dealing with income from cloud computing.*
- ✓ *Tax authorities generally applies rules from other contexts (e.g. source rules)*
- ✓ *Character and source of cloud income not always clear.*
- ✓ *No taxable presence in US / Treaty may reduce or eliminate US Tax.*

The Cloud – what is it?

What is it?	Answer	PE and Transfer Pricing
Not clear:		
1. Sale of services that are preformed outside the country?	1. The most likely answer is that it is a payment for services that are performed from outside the country.	1. The way it is defined in the contract and the way it is invoiced may be very significant in answering "what is it" – service, data, goods?
2. Subscription for data?	2. Could also be the sale of data services	
3. Sale of software?		
4. A royalty to use IP?		

The Cloud – what is it?

What is it?	Sourcing	PE and Transfer Pricing
If service where is it "sourced" – considered delivered.	1. Services are sourced to where they are PERFORMED, but is that (1) where the server is (2) where the support office is (3) where the developers are?	1. If services they would be generally be considered to be delivered outside the country of the paying customer. 2. How do we handle for VAT ? An imported service with reverse charge ? 3. Have we just commoditized services?
Payments for Intangible Property: - Code - Marketing intangibles (brand, name, customer relationship)	1. Sourced to where the IP is being used and taxed at source.	1. Can be a hot area for transfer pricing because comparables can be hard to find. Best if using the Limited Distributor Model 2. If characterized as a royalty payment it can be subject to source withholding tax of 10-30%. - Treaties make a big difference here

The Cloud – can it expand my tax footprint?

What is it?	Tax footprint	PE and Transfer Pricing
When do you create a taxable presence in the local country?	Does hosting by a third party create a taxable presence for the non-resident Cloud provider?	<ol style="list-style-type: none">1. Consider OECD Discussion Draft on PE – Art V.<ul style="list-style-type: none">- Are assets at the disposal of non-resident?- Is unrelated server provider reporting all income?

The Cloud – sale of goods or royalty for use?

Character Issues: Reg. §1.861-18

classification of transactions involving computer programs.

What is it?	Defined	Character
Copyright Right	Customer acquires right to (1) make copies for public distribution; (2) Prepare derivative computer programs based on software; (3) right to make public performance of software; or (4) right to publicly display software.	Sale or exchange if customer acquires “substantially all of the rights.” Otherwise, license / royalty. Based on facts and circumstances.
Copyright Article	Customer acquires (1) only a copy of the software, but not copyright rights; or (2) copy of software from which work can be reproduced / communicated either directly or with aid of machine or device.	Sale or exchange if “benefits and burdens of ownership” transferred. Otherwise, lease / rental income. Based on facts and circumstances.

The Cloud – Services

Character Issues: IRC §7701(e)

Non-exclusive list of factors supporting Services characterization

What is it?	Characteristics (Non-Exclusive List)
Services	<ol style="list-style-type: none">1. <u>Physical Possession</u>: Customer does not take physical possession of the software.2. <u>Control</u>: customer does not have control over access to software.3. <u>Economic or possessory interest</u>: Customer not responsible for maintenance costs, or risk of loss limited to ability access software.4. <u>Substantial risk of Non-Performance</u>: Customer does not bear risk of non-performance (e.g., software failures).5. <u>Concurrent use</u>: Customer does not have exclusive access to the software.6. <u>Contract price in Excess of Rental Value</u>: Payments for access to software substantially exceed rental value of software without any charge for services.

The Cloud – bundling

Bundled Transactions

- ✓ More business models bundle, IP, service, data and product.
- ✓ Transaction involving a computer program that includes both (1) a transfer of a copy of a computer program and (2) another program are treated as separate transactions, so long as neither transaction is de minimis.
- ✓ See also *Tidewater v. U.S.*, 565 F.3d 299 (5th Cir. 2009): Customers given control over other aspects of use of chartered vessel but crew retained operational control. Fifth Circuit takes all-or-Nothing approach and characterizes transaction as a “lease” based on its predominant character.

Learning point

- ✓ In crafting contracts with customers intercompany affiliates, we can control the terms to bundle, or unbundle, services and to define the type of product, or service the customer, or group affiliate, is receiving for payment.

The Cloud – where is it taxable?

Sourcing of Income in Cloud Based Model

Source depends on Character

Source of Income from Transactions in the Cloud depends on its Character and several other factors.

What is it?	Where is the Source?
Sales	where title and risk of loss to copyrighted Article transferred from Seller to Buyer.
Rents	where rented property used.
Services	where services performed.
Royalty	Place of use, consumption, most economically significant functions.

The Cloud – ?

Outstanding Issues

- Where are services performed in cloud-based model?
 - On the user's computer when he / she accesses the software?
 - On the Servers that host the software?
- Where the performance of management of people functions necessary to host the software occurs?
 - Minimal participation by Payer, then consider other providers.
 - Minimal people functions, Look to location of Servers.

Learning point

- ✓ We can define the point of delivery and the rights and "product" the customer is receiving in the contract or work-order.
- ✓ Can't we define the terms?

The Cloud – taxable presence

US Taxable Presence

- If income from cloud offerings is earned through foreign subsidiaries / affiliates, US federal income tax may apply to income of a foreign corporation that is effectively connected to a US trade or business.
- Tax law was founded on assumptions relating to physicality of business. In early law, the Tax Court found that a Mexican based, US owned, radio station, which had all of its customers in the US, and which broadcast through-out the US, all the way to Canada, did not have a taxable presence in the US, not effectively connected income because all of its broadcasting assets were in Mexico. *Piedras Negras Broadcasting Co.*, 43 BTA 297 (1941) (Mexican radio station broadcasting into US did not have US trade or business).
- Query: The rules are based on a physical world, not a virtual one.

The Cloud – we know this

US Taxable Presence, Cont.

- Facts and circumstances analysis. Foreign persons can be engaged in US trade or business through its own activities or those conducted through an agent. Must be substantial, continuous, regular activity.
- Generally, courts have found that the activities necessary to create a US trade or business involve a geographically relevant asset or activity combined with human intervention or people functions.
 - Mere purchase of services from independent service provider should not constitute a us trade or business.

Learning point

- ✓ Having US ECI usually requires three things (1) some physical presence and (2) people doing something, to (3) make some profit at some point
- ✓ In a Cloud world this we don't fit the traditional model

The Cloud – we know this

US Taxable Presence, Cont.' d

Generally, income from the performance of **services in the US** is effectively connected income (“ECI”). Special rules may apply, depending on whether the income is US source or foreign source. US based assets / activities determine if foreign corporation’s US source income is ECI.

The Cloud – treaty

Treaty Issues – Treaty Can Cut off Tax Presence

- If foreign cloud provider has a taxable presence under US domestic law, a tax treaty may still render that presence insufficient to create US income tax liability (it does not cut off indirect tax or property tax).
- Risk created by US servers may not be eliminated. *OECD Commentary to Art. 5* (having a server at “disposal” may give rise to PE).
 - OECD commentary tends to favor the existence of a physical place of business "at the disposal" of the non-resident enterprise.
- PE generally a fixed place of business through which business of enterprise is wholly or partly carried on.
 - Dependent Agents: Activities carried on by a dependent agent may create a PE for an enterprise.
- Use of a third party server may not cause dependent agency relationship to extent (1) third-party provider is legally and economically independent and (2) does not otherwise act for the foreign client or on behalf of its foreign affiliates.

The Cloud – treaty

Commentary to OECD, Art. 5

- PE usually requires physical presence in the country. We know that without any other activity, a website does not constitute a PE.
- A server may constitute a PE but only if the server is at the foreign corporation's "disposal". If enterprise owns (or leases) and operates the server, it may have a server at its disposal and, therefore, a PE. However, fees paid to ISP for disk space (i.e., hosting arrangement) generally do not constitute PE.
- Mere leasing of a server from an unrelated party probably does not constitute a PE, absent management or operations activity. However, leasing coupled with operation of the server may constitute a PE.
- Interaction with Art. 7 – If a server or switch created a PE, it is unlikely much profit could be aligned to it on the principle the transmitting data is not a high value service.

The Cloud – indirect taxes

VAT / Duty and Excise Taxes

- The rules for sales to private consumers are different than the rules for sales to businesses registered in the EU.
- Business to Business → Sale outside Buyer's country
 - Seller gets the VAT ID of the Buyer
 - Seller can sell Zero Rated and recover input VAT
 - Buyer must bring into their country and pay VAT on import on a “reverse charge” basis
- Business to Consumer
 - Seller must register for VAT in every country where there is a Consumer purchaser of its digital products. *Services may be handled differently*
 - Seller charges VAT on the sale and includes it in the price to the Consumer
 - Seller generally remit VAT monthly

BEST PRACTICES

The Cloud

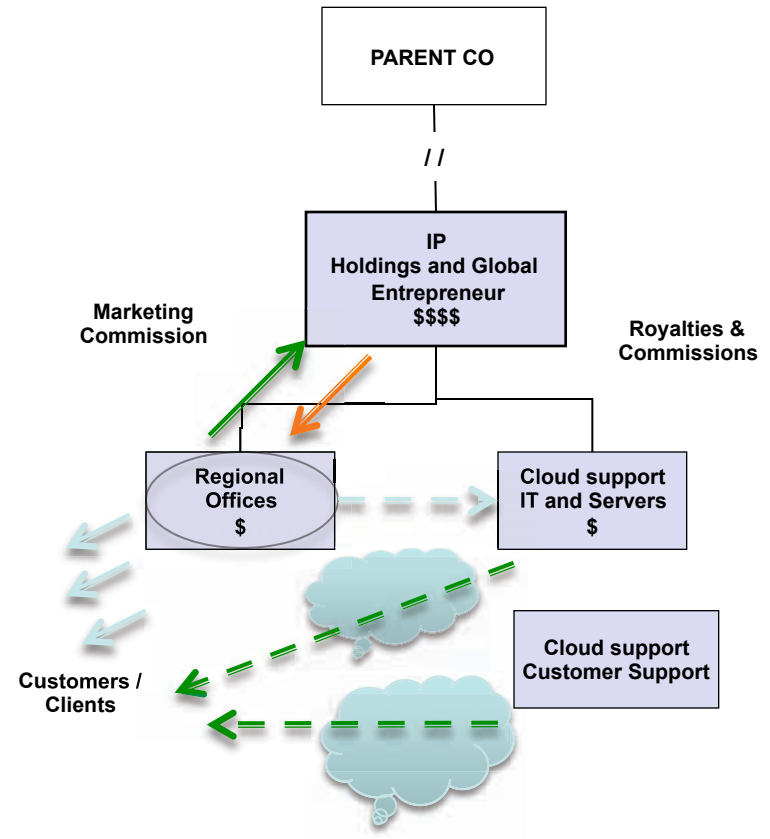
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The Cloud – operating model

Structuring

- Regional will invoice from Singapore where the IP is commercially owned.
 - Singapore does not have exchange control
 - Not a "tax haven"
 - Can get a very low tax rate on net income from IP
 - Company would have Regional Staff in Singapore to support office
- Regional license its IP from IP Holding Company.
 - Income to IP Holding is taxed at low tax rate
- Servers will be in India and Indonesia and owned by Affiliates and 3rd Party Server contractors.
 - Server companies will be paid by Regional for their service
- IP development will be funded by Regional Office.
- Company will have no physical presence in the country of the Customer

Tax Rate on Structure

Entity	Income	Portion paid on	Portion taxable	Tax rate	Effective Tax Rate
Regional	100%	98%	2 %	17%	0.3 %
IT Center	2 %	0	2 %	30%	0.6 %
IP Holding and Global	98%	2%	96 %	5%	4.8 %
					5.7 %

This is an illustrative example

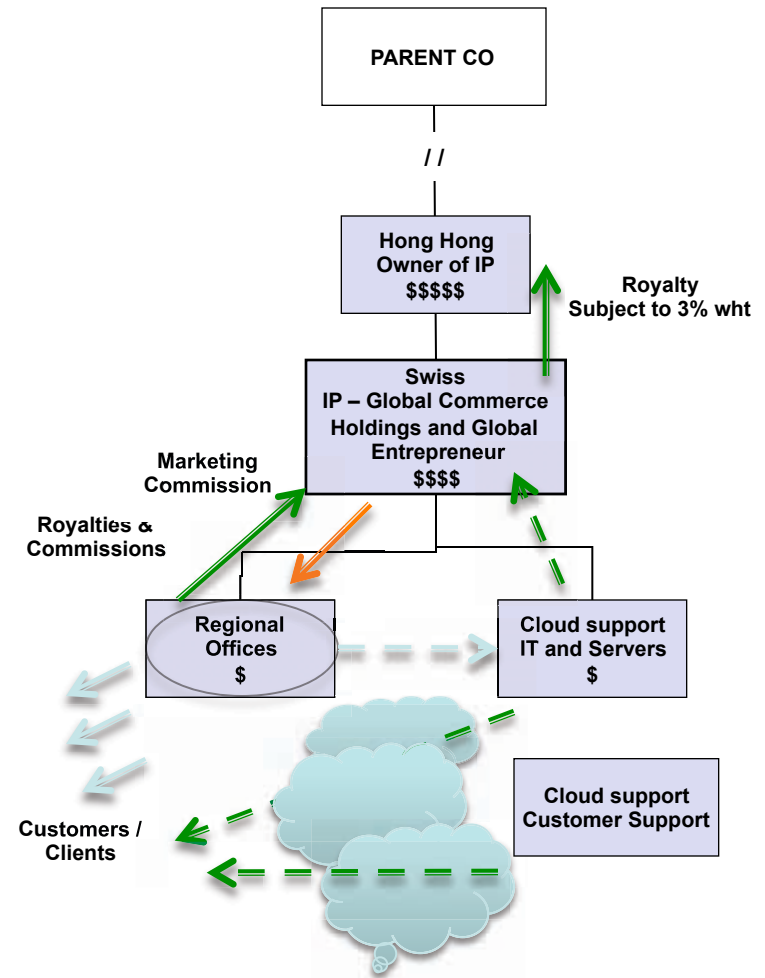
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The Cloud – Swiss / Hong Kong

Regional office is face to market

- > Similar Attributes to the general structure
- > Adding HK and Switzerland
- > Treaty was ratified October 21 2012 and becomes effective January 1 2013.
 - Nil withholding on dividends
 - Nil withholding on interest
 - 3% withholding on royalties

Strict substance requirements



Illustrates structure that becomes efficie as of Jan 1 2013 due to new treaty.

Tax Rate on Structure – Hong Kong / Swiss

Entity	Income	Portion paid on	Portion taxable	Tax rate	Effective Tax Rate
Regional	100%	98%	2%	17%	0.3 %
IT Center and Customer Support	2%	0	2%	30%	0.6 %
Swiss - Global Sales	98%	96% 3% withholding tax	4%	5%	0.2 %
Hong Kong IP Holding	96%	2%	94%	2.8% wht	2.8 %
					3.9 %

This is an illustrative example

This example assumes funds will remain outside the US. If funds are returned to the US, either through (1) dividends, (2) redemption of stock or (3) loans from controlled foreign corporations, under the US system the effective tax rate would be 35% or more.

Other options for structuring

Entity	Framework	Effective Tax Rate
Singapore / India	Singapore is the entrepreneur for global sales of SaaS. Outsource production to India.	5-10 %
Double Irish structure	A structure Google uses. Form 2 Irish companies. One becomes non-resident. It owns all IP and gets a large royalty from resident Irish company. All billing from Irish resident.	2-6 %
Luxembourg / Swiss	Luxembourg holds all IP and uses deductions from Preferred Equity Certificates and possibly the 80% exclusion for royalties on certain IP. Swiss bills and pays a royalty to Luxembourg	2-5%
Dubai	Zero tax rate. Not hard to staff. Good for a regional hub for Middle East, North Africa and Africa.	Nil
United States	US Centric models are also used	45%

This is an illustrative example

The Path Forward

Managing uncertainty

Suggestions

Take a proactive stance

You can define a lot of attributes in your contracts and files.

- Decide which position fits your facts
- what is the most manageable process?

Get your functional analysis right

Functions, risks and property ownership can be influenced by intercompany legal agreements. Take a hard look at how these should be crafted.

Indirect Tax

What is it? How it taxed for VAT and imports? These questions need careful consideration

DTA

Double Tax Agreement: serves to reduce or eliminate source taxation.
- Use them

Other

Export controls
Privacy rules
know your customer !!!

Questions?

This presentation is for discussion purposes only.

Thank you!

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