Entertainment, Media and Communications Tax Newsletter

A PwC Industry Publication

June 2011

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State tax issues in considering private vs. public clouds

As more and more businesses consider using cloud computing, the focus in 2011 appears to be not only if and when to move to a cloud, but also whether to choose a public or private cloud. To make an informed decision about which cloud infrastructure to use, EMC companies should understand the advantages and disadvantages of both, why a business may want to choose one over another, and the various state tax treatments for either option. There are also federal and international tax issues to consider, but they are beyond the scope of this article.

Cloud deployment models

According to the National Institute of Standards and Technology (NIST), there are four distinct cloud infrastructure deployment models: private clouds, public clouds, community clouds, and hybrid clouds. A private cloud infrastructure operates solely for a single organization. It may be managed by the organization or a third party and may exist on or off premises. A public cloud infrastructure is made available to the public or a large industry group and is owned by an organization selling cloud services. A community cloud infrastructure is shared by several organizations, and a hybrid cloud infrastructure is a composition of two or more clouds (private, community, or public). For purposes of this discussion, we focus solely on the distinctions between public and private cloud infrastructures; however, many of the same issues also apply to community and hybrid clouds.

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Private vs. public clouds

Using a private cloud has several advantages and disadvantages. According to a 2010 Harris Interactive study funded by Novell, security concerns are one of the leading barriers to the switch to cloud computing. The survey found that 91% of the more than 200 information technology (IT) leaders at enterprise organizations are concerned about security in the cloud, and 50% say it is the primary barrier to implementing a cloud. However, 83% of the respondents also say that private clouds offer most of the benefits of public clouds without the security and compliance concerns of public clouds. Further, 86% say data is more secure in a private cloud, and 81% cite the difficulty in maintaining regulatory policies as a factor in choosing between a private and a public cloud. Therefore, the level of security that comes with having dedicated resources under the complete control of one user is a major advantage to a private cloud. A second benefit of private clouds is that they offer the highest level of customization to a customer's needs. However, these two benefits must be weighed against the higher cost of using a private cloud rather than a public one. Another advantage — or, depending on the viewpoint, a disadvantage — is that all of the decision-making resides with the company setting up the private cloud.

Like private clouds, public clouds also have advantages and disadvantages. As mentioned above, public clouds consist of network resources that are hosted off premises and shared with other public users. Their greatest advantages lie in their scalability and lower cost. However, because a public cloud consists of shared assets, it has minimal capability for customization, and the end user has no say in how and which resources are deployed. Additionally, security is dependent on the provider. Therefore, when deciding which public cloud to use, the security protocols of potential providers must be evaluated thoroughly. To address this concern, many providers offer certifications as to their security levels. It should be noted that turning over security of a company's data to a third party often requires additional certification by a company's auditors and/or applicable regulators.

State tax issues

Though there are many technical and cost/benefit advantages and disadvantages for using either private or public clouds, often tax benefits, and more often tax consequences, are overlooked until after a cloud strategy has been implemented. As a result, a company can be blindsided by unintended tax assessments and a surprisingly expanded state tax footprint. Therefore, an analysis of state tax consequences should be conducted by any EMC company moving into the cloud space, preferably before implementing a strategy.

For both public and private cloud offerings provided by a third party, a major tax challenge lies in the tax classification of the cloud service. Is the offering a taxable or nontaxable service? Is it data processing or information services? Is it the sale or lease of tangible personal property? While a significant number of states have addressed cloud services from a software delivery model (software as a service or SaaS), very few states have addressed cloud classification from an infrastructure delivery model (infrastructure as a service or IaaS) standpoint.

Further, when using a private rather than a public cloud, there are more state tax considerations. For example, in the case of a private cloud provided by a third party, a taxpayer must determine whether the use of specifically assigned assets transforms what appears to be a service transaction — the purchase of computing power — into the lease of tangible personal property. In many states, service transactions generally are not subject to sales and use taxes; however, the lease of tangible personal property is subject to tax. Of greater consequence is the possible nexus implication that may result if the transaction is determined to be a lease of tangible personal property. Having the presence of leased property in a state can create both income and sales and use tax nexus in the state where the assets are located.

In addition to the classification complications and possible nexus issues involved with cloud transactions, providers, purchasers, and states struggle with the difficulties of sourcing cloud transactions for both income and sales and use tax purposes. If the service is determined to be a lease of tangible personal property, the transaction would be sourced for income and sales and use tax purposes based on the location of the servers on both the provider and purchaser side of the transaction. For the provider, if the transaction is determined to be a taxable service, the transaction would be sourced on a cost of performance or market basis for income tax purposes, depending on the state's apportionment formula. For sales and use tax purposes, the service would be sourced where it is performed or where it is received, based on state law for both the provider and the purchaser. Unfortunately, with cloud computing, either location may be difficult or impossible to determine. To further complicate matters, the income tax classification of a transaction may be different from its sales tax classification.

Finally, many states are offering credits and incentives to companies setting up data centers or server farms within their borders. A company setting up its own private on-premises cloud should be aware of these credits and incentives and negotiate with local jurisdictions before deciding on a location for its private cloud. However, in the case of off-premises private clouds or public clouds, such tax benefits may not be available.

Conclusion

EMC companies considering a move into a cloud infrastructure must choose between using a public or private cloud. Both private and public clouds have advantages and disadvantages including tax ramifications that should be evaluated before a company moves onto the cloud.

PwC addresses section 199 "shrink back rule" for telecommunications industry in letter to IRS

On March 9, 2011, PwC submitted a comment letter to the Internal Revenue Service (IRS) and Department of the Treasury on behalf of AT&T Inc., Qwest Corporation, and Verizon Communications Inc., addressing whether and to what extent the so-called "Shrink Back Rule" in Section 199 applies to transactions involving telecommunication products and services.

The letter addresses a Treasury and IRS priority guidance project that is intended to address specific issues under Section 199 that potentially will affect the telecommunications industry. In this regard, the letter notes the uncertainty among some telecommunications companies and practitioners regarding how to apply the Shrink Back Rule to transactions providing telecommunication products and services to customers, and how to determine whether such transactions should be categorized as a service, a lease/rental, or as a combination thereof.

Much of the uncertainty centers on the "either/or" characterization of a transaction under Section 7701(e) as either a service or a lease/rental for federal income tax purposes and whether such characterization also applies for purposes of Section 199.

In this regard, the letter states that Section 199 and its legislative history clearly refutes the "either/or" characterization that may apply for other federal income tax purposes and specifically requires taxpayers to apply the Shrink Back Rule and treat transactions providing telecommunication products and services to customers as a combination of a service and a rental, and to apportion the revenue stream associated with the transaction between the service and rental aspects based on transfer pricing principles.

The letter urges the Treasury and the IRS to issue guidance consistent with this position. Although it is anticipated that such guidance will be issued in the relatively near future, there is no specific time table.

IRS clarifies repair deduction rules for wireline and wireless telecommunications industries

On April 4, 2011, the IRS released three revenue procedures, which are the culmination of the wireline and wireless telecommunications Industry Issue Resolution (IIR) process for depreciation and repairs. These three revenue procedures are intended to reduce controversy and increase certainty for depreciation and repair issues for certain wireline and wireless telecommunication assets. The guidance in these procedures is available for assets used in the wireline and wireless telecommunications industry for depreciation or repairs purposes only.

The first of the three revenue procedures, Rev. Proc. 2011-22, provides safe harbor recovery periods for wireless telecommunication assets. Rev. Proc. 87-56 generally provides depreciation recovery periods for tangible assets. Because this revenue procedure has not been updated since 1987 and there have been many changes in the telecommunications industry, many questions have arisen related to the proper depreciation recovery period for wireless telecommunications assets. The safe harbors provided Rev. Proc. 2011-22 are intended to answer some of these questions and reduce controversy.

Generally, the safe harbor recovery period provided in the revenue procedure is the same for a group of similar assets located at a mobile telephone switching office (MTSO) or cell site. For example, cabling between an MTSO, a cell site, and the public switched telephone network is depreciated over 15 years. MTSO computer-based switching and related equipment, as well as dedicated heating, ventilation, and air-conditioning equipment, is depreciated over five years. Significantly, a cell tower is treated as property with no class life that is depreciated over seven years, while the tower's foundation is treated as a land improvement depreciated over 15 years. Certain other equipment is also treated as property with no class life that is depreciated over seven years.

A wireless telecommunications taxpayer that is currently using a longer or shorter recovery period than the safe-harbor recovery period may wish to change to a more accelerated or less controversial recovery period. Generally, a change to the safe harbor method for a wireless telecommunications carrier is made automatically under Rev. Proc. 2011-14.

The second and third revenue procedures released as part of the IIR process, Rev. Proc. 2011-27 and -28, provide two alternative safe harbors that wireline or wireless telecommunications carriers may use to determine whether an expenditure is a deductible repair or a capital improvement. One safe harbor is the network asset maintenance allowance method, and the other is the unit of property method. Because these revenue procedures are part of the repairs IIR process it is unlikely that the repairs regulations, when published in final form, will substantially modify these two safe harbors. Additionally, a wireline or wireless telecommunications carrier may generally change to the network asset maintenance allowance or unit of property method under the automatic consent provisions of Rev. Proc. 2011-14.

Network asset maintenance allowance method

Under the network asset maintenance allowance method, a fixed percentage of a taxpayer's repair and maintenance expenditures is currently deductible. The percentage is 12% for wireline telecommunications assets and 5% for wireless telecommunications assets. Repair and maintenance expenditures for purposes of this computation are determined by reducing a taxpayer's financial accounting capitalized asset additions by asset acquisitions defined in Section 1060, assets acquired in a transaction to which Section 338(h)(10) applies, and certain other adjustments under Section 1011.

Taxpayers that adopt the network asset maintenance allowance method are required to adopt the method for all of their network assets and may not apply the safe harbor on an asset by asset basis. In addition, a taxpayer must attach an annual schedule to its tax return showing the computation of the allowance.

Units of property method

The second safe harbor relates to the determination of the appropriate unit of property for purposes of determining when a repair and maintenance expenditure increases the value, substantially prolongs the life, or adapts the property to a new or different use.

Similar to the wireless depreciation revenue procedure, safe harbor units of property are generally based on groupings of similar assets located at a wire center or central office building for wireline telecommunications carriers or located at an MTSO or cell site for wireless telecommunications carriers. For example, towers, poles and mounted fittings within a wire center are a unit of property for a wireline telecommunications carrier; central office equipment at a central office building is a unit of property for a wireline telecommunications carrier; MTSO equipment at an MTSO is a unit of property for a wireless telecommunications carrier; and transmission equipment, radio equipment, antenna tower, and tower foundation at a cell site are each separate units of property for a wireless telecommunications carrier.

Unlike the network asset maintenance allowance safe harbor, a taxpayer may selectively choose the assets for which it will use the safe harbor unit of property. Additionally, if a safe harbor unit of property is adopted for repairs purposes, the taxpayer must use the safe harbor for all similar property.

For more information, please do not hesitate to contact

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Recommended reading:

Global entertainment and media outlook: 2011-2015

http://www.pwc.com/us/en/industry/entertainment-media/publications/global-entertainment-media-outlook.jhtml

2010 North American wireless industry survey

http://www.pwc.com/us/en/industry/communications/publications/2010-North-American-wireless-industry-survey.jhtml

Point of View: Wireless Customer Profitability

http://www.pwc.com/US/en/point-of-view/wireless-customer-profitability.jhtml

Communications Review: A journal for telecom, cable, satellite, and Internet executives

http://www.pwc.com/communicationsreview

EMC Perspectives: Technical accounting guidance for entertainment and media companies

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