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VAT and the cloud p#1/Billboards & section 199 p#4/ R&D credit p#5

In focus

This quarter we take a closer look at how VAT applies to national and international cloud computing with detailed case studies and a summary of the main jurisdictions where US suppliers may have VAT obligations. We also examine how the IRS is looking at outdoor advertising and what that may mean to your company's section 199 deductions. Our final focus is on innovation and how intellectual property could save your company money with research and development tax credits.

VAT and the cloud: Common pitfalls for US-headquartered businesses

In brief

The value added tax (VAT), including the goods and services tax (GST) and other similar consumption tax systems, has been implemented in more than 150 countries around the world. At the same time, cloud computing has also become a global phenomenon. As a result, many businesses are struggling to understand the VAT implications of the cloud services they are providing or receiving. This article summarizes some of the common challenges that US-headquartered companies face internationally.

"The ultimate VAT treatment will depend on a number of variables including type of service being provided, type of customer and place of establishment of the supplier."

How does VAT apply to cloud computing?

Generally speaking, any transaction involving the cloud, such as electronic storage and webhosting, would be viewed as a supply of services in most VAT jurisdictions. Services can, depending on the jurisdiction, be subject to VAT in the country where:

- the supplier of the services is established (i.e., is incorporated or has a fixed establishment);
- the recipient of the services is established; or
- the services are performed or "used and enjoyed."

The ultimate VAT treatment will depend on a number of variables, including type of service being provided, type of customer (B2B, B2C), and place of establishment of the supplier.

Domestic cloud transactions

Where services are delivered over the cloud, and the supplier and the customer are located in the same jurisdiction, the VAT treatment is generally straightforward. When the seller is established and VAT-registered in a VAT jurisdiction, VAT is simply added to the price. If the customer is VAT-registered, the seller is required to issue a VAT invoice that itemizes the VAT separately, thus enabling the customer to recover the VAT. If the customer is a private individual, the invoice might not separately itemize the VAT, which would be considered to be included in the price.

International cloud transactions

Where the supplier and the customer are located in different jurisdictions, the VAT treatment may vary, depending on whether:

- the supplier is located in a VAT jurisdiction;
- the customer is located in a VAT jurisdiction; and
- the customer is a business or a private individual.

We have summarized below the main juisdictions where a US supplier of cloud computing services without any presence may have VAT obligations:

The European Union (EU)

Provided that the supply falls within the definition of "electronically suppliedservices" (ESS) for EU VAT purposes, a US non-established business providing services to private consumers residing in the EU is liable to charge VAT to the customer at the rate applying in the country where the customer resides.

To account for the VAT, the business is required to either:

- Register and account for VAT in all countries where its customers reside; or
- Register for VAT through the special registration process for ESS in a country of its choice. The company may then account for VAT on all EU ESS supplies in a single return.

Iceland

A US non-established business providing cloud computing services to private individuals residing in Iceland would generally be liable to register and charge 25.5% Icelandic VAT to its customers, provided that the ISK 1,000,000 (approx. $8,700) registration threshold is met.

Norway

A US non-established business providing cloud computing services to private individuals residing in Norway would generally be liable to register and charge 25% Norwegian VAT to the customers, provided the NOK 50,000 (approx. $9,000) registration threshold is met.

Switzerland

A US non-established business providing cloud computing services to private individuals residing in Switzerland would generally be liable to register and charge 8% Swiss VAT to the customers, provided the CHF 100,000 (approx. $114,000) registration threshold is met.

Case studies

Example 1

Facts: Company A is established in the United States. It provides online movie streaming services via the cloud to private consumers located throughout the EU.

VAT treatment: Company A is required to register for EU VAT, either in each country where its EU customers reside or through the simplified regime for ESS. Company A is also required to charge VAT to its customers at the applicable rate in the country where the customers reside, e.g. 15% to customers in Luxembourg, 19.6% to customers in France, and 25% to customers in Sweden.

Example 2

Facts: Company A, established in the United States, provides electronic storage services via the cloud to business customers established in Luxembourg (Company B) and the United States (Company C).

VAT treatment: Company A is not required to register for VAT or to charge any VAT to Company B because the EU VAT rules for B2B transactions shift the requirement to account for VAT from the supplier to the business recipient. Consequently, Company A should self-assess Luxembourg VAT of 15% on the services received. Provided Company B is a fully taxable business, it should be entitled to simultaneously recover the self-assessed VAT in the same VAT return, leading to no cash-flow costs for Company B. The services provided to Company C would be outside the scope of VAT, given that they are provided domestically in the United States. US sales and use tax should, however, be considered.

Example 3

Facts: Company A sets up a new subsidiary, LuxCo, in Luxembourg to service the EU market. LuxCo provides online movie streaming services via the cloud to private consumers located throughout the EU.

VAT treatment: Because LuxCo is established in an EU country, it is not required to charge VAT at the rate applying in the customer's country. Instead, specific EU VAT rules apply to B2C transactions involving ESS which are provided by locally established businesses. LuxCo should, therefore, charge VAT at the rate applying in the country where the company is established, 15% in this case. However, effective January 1, 2015, EU-established entities will also be required to charge VAT based on the rate applying in the country where its EU customers are residing.

Example 4

Facts: Company D is a US company and provides data management services to US business customers. The US business customers require Company D's services to enable their own customers, which are located in the EU, to access software, websites and other intangibles from the Internet. In order for Company D to provide such services to its business customers and decrease any latency issues associated with accessing data over the Internet from servers located only in the United States, Company D will import its own servers into foreign jurisdictions and locate them at collocation facilities operated by third parties.

VAT treatment: Because Company D is importing its own servers into various VAT jurisdictions, it will incur local import VAT at the time of import at the rate of the country of import (EU rates range from 15%-27%). Depending on the country of import and the company's local VAT registration status, this VAT may be recoverable. In addition, depending on the location of the collocation facility, the service provider may charge Company D local VAT for the lease of the racking space in the country in which the server is located. Again, this VAT may be recoverable, depending on the country and/or the VAT registration status of Company D. It should be noted that the owning of servers in a foreign jurisdiction could lead to permanent establishment issues for Company D.

IRS clarifies which outdoor advertising displays qualify for section 199 deduction

One of the criteria for the Section 199 domestic production activities deduction is that gross receipts from the production activity must be from qualifying property. Such property includes tangible property other than land, real property described in Treas. Reg. Sec. 199-3(m)(3), or other specified property. When considering whether gross receipts from outdoor advertising displays qualify for Section 199, it is critical to determine whether the displays are tangible or real property.

"...certain outdoor advertising displays... constitute an inherently permanent structure ... and therefore must be considered real property in the context of Section 199."

Recently, the IRS concluded in CCA 201302017 (Nov. 29, 2012) that certain outdoor advertising displays (specifically, traditional wooden billboards and modern steel billboards) constitute an inherently permanent structure under Treas. Reg. Sec. 1.263A-8(c)(3) and therefore must be considered real property in the context of Section 199. As such, the ruling found that gross receipts generated from traditional wooden billboards would be considered as arising from real property and thus not eligible for the Section 199 deduction.

Notably, the IRS in this CCA did not address *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975), acq., 1980-1 C.B. 1, wherein the tax court found that outdoor advertising signs constitute tangible property in the context of an investment tax credit. The court in *Whiteco* enumerated six factors to be considered in applying the permanency test to determine whether property (other than items of the nature of machinery) should be classified as tangible or real property.

Ruling facts and IRS analysis

In this CCA, the taxpayer rents advertising space to customers on various billboards that it constructs and maintains, including mobile billboards, traditional billboards, and modern billboards. Mobile billboards are attached to the sides of trucks and relocated frequently. Traditional billboards are attached to wooden structures or poles set into the ground. Modern billboards are mounted onto steel frames or poles that are bolted or welded to a concrete or steel foundation. The traditional and modern billboards often require building permits and the use of construction machinery to install them, and they are used on land leased for a period of time ranging from 30 days to 20 years, often renewing automatically.

Real property for the purpose of Section 199 includes buildings, inherently permanent structures, inherently permanent land improvements, oil and gas wells, and infrastructure. The IRS looked to the definition of an "inherently permanent structure" under Treas. Reg. Sec. 1.263A-8(c)(3), which is property that is (i) affixed to real property and (ii) that will ordinarily remain affixed for an indefinite period of time. This regulation does identify "inherently permanent advertising displays" as an example of an "inherently permanent structure."

First, the IRS argued that traditional billboards and modern billboards are affixed to real property, given that the boards are connected to poles set in the ground and secured in place by concrete or bolts, and thus meet the first test. Second, the IRS analyzed whether the billboards would ordinarily remain affixed for an indefinite period of time. It argued that traditional billboards and modern billboards were constructed to stay connected to real property for an indefinite period of time in order to perform their intended function (i.e., advertising). The IRS indicated that the use of construction machinery and equipment, as well as the expense and extra time of getting a building permit and building to withstand severe weather conditions, are indications that the billboards are considered to be attached and used on the real property for an extended period of time. In its argument, the IRS stated that a short lease term, for example, 30 days, is irrelevant because the permanency of a structure is not determined in hindsight.

The ruling's characterization of billboards

Given that traditional billboards and modern billboards meet both parts of the test for an inherently permanent structure, the IRS concluded in this CCA that they are real property for the purposes of the Section 199 deduction, and therefore do not meet the definition of qualifying production activity under Section 199(c)(5)(A).

Conversely, the IRS affirmed that a mobile billboard is intended to be moved frequently, and thus is not affixed for an indefinite period of time, and does not meet the definition of an inherently permanent structure.

The impact to EMC companies

The ruling of this CCA, that traditional and modern billboards are real property, represents adverse guidance for EMC companies either currently or anticipating claiming Section 199 benefits on revenues generated from these types of billboards. While this CCA is instructive in determining whether outdoor advertising displays are tangible property, one should note that IRS had announced that it would apply the six criteria set forth by the tax court in Whiteco on a case-by-case basis, as well as that outdoor advertising displays would not be categorically treated as either tangible personal property or inherently permanent structures (see Rev. Rul. 80-151, 1980 C.B. 7). As such, despite this CCA not specifically addressing Whiteco, a taxpayer should consider those enumerated factors and other guidance in assessing whether an outdoor advertising display could be considered tangible personal property, and therefore eligible for the Section 199 deduction.

Current developments warrant a fresh look at domestic and global research incentive tax planning

In brief

Many countries have followed the lead of companies worldwide and focused on innovation as one of the key elements of economic well-being. This has resulted in new products, increases in wages through the creation and advancement of jobs, and a strong desire to not only create but also to own intellectual property.

US R&D tax credits

"... extension of the research credit ..., and other recent developments, creates a need for a fresh look at the positions of EMC companies on expenditures qualifying for the research credit."

The recent extension of the research credit retroactive to January 1, 2012, and other recent developments, create a need for a fresh look at the positions of EMC companies on expenditures qualifying for the research credit.

In light of the modifications to the research tax credit surrounding the treatment of acquisitions and dispositions, as well as the allocation of the credit and recent case law, it may be prudent to consider the impact on current positions and to review processes for identifying and documenting credit-eligible costs.

Note: The IRS has recently issued Notice 2013-20, providing interim guidance on the allocation of research credits among corporations in controlled groups. The new guidance reflects recent legislative changes made by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013. For tax years beginning after December 31, 2011, in lieu of the allocation formula in Reg. Sec. 1.41-6(c), controlled groups are to allocate credits among group members in proportion to each member's contribution of qualified research expenditures (QREs) to the controlled group's total QREs for the tax year. This is simpler than the methodology in Reg. Sec. 1.41-6(c). The IRS intends to revise Reg. Sec. 1.41-6 and the related examples consistent with the allocation methodology described in Notice 2013-20.

In addition to the two-year extension of the credit contained within the fiscal cliff legislation, recent court decisions surrounding (i) adequate documentation, (ii) oral testimony, (iii) the use of estimates in determining qualified research expenses, manufacturing process improvements, and the related cost components, (iv) cost center accounting, and (v) internal use software demonstrate how the IRS and the tax court have focused on how R&D credit costs and support are accumulated. The lack of resolution in the IRS field examination of research credit issues has resulted in a significant backlog of cases at Appeals. Recently, Appeals has begun sending cases that have not been fully developed back to field exam teams to have the appropriate information presented and evaluated. In light of the difficulty of closing cases in the field, the IRS Large Business & International Division (LB&I) has embarked on restructuring efforts with a change in procedures directed to field examination teams, and several research credit-related items on Treasury's guidance plan. One such effort has resulted in a long-awaited, taxpayer-favorable development: on December 7, 2012, LB&I Commissioner Heather Maloy issued a memorandum to all LB&I employees regarding the examination of research credit claims in the pharmaceutical sector.

The memo directs LB&I employees not to challenge the amount of QREs claimed by taxpayers in the pharmaceutical sector that arise during Stage 1 (discovery and preclinical stage) or Stage 2 (clinical trial stage) of the four-stage pharmaceutical development process, as long as the taxpayer has provided a Certification Statement regarding those QREs. The research undertaken in Stage 1 and Stage 2 is often referred to as "core R&D."

Note: While the memorandum applies only to examinations of taxpayers in the pharmaceutical sector, the IRS is expected to use it as a model for examinations of core R&D in other industry sectors, including EMC.

In addition to the restructuring noted above, an effort to further develop a more robust examination process has resulted in LB&I designing and implementing peer reviews of CIC examinations, as well as implementing new procedures to improve the process. These reviews focus on key components of the quality exam process, including interviews and discussions with exam team members and taxpayers.

Note: LB&I recently terminated the "issue tiering" program. Previously listed issues such as R&D, which was a Tier 1 initiative, will be supported by the newly organized Issue Practice Groups (IPGs) and Issue Practice Networks (IPNs). As part of the change, the IRS has withdrawn all prior Industry Director Directives (IDDs) addressing the affected issues.

One final domestic item to keep in mind is that most state credits, unlike the federal credit, are permanent. Some states have also made significant changes to their credits or enacted new credits that benefit taxpayers. For example, there have been several recent developments that could affect taxpayers claiming credits in the state of California, including Franchise Tax Board (FTB) efforts to improve examination of the research credit (the FTB recently held an interested parties meeting to solicit input from taxpayers and practitioners).

Global return on research investments

The important role innovative companies play in their national economies has led to the enactment of tax incentives and grant programs to encourage additional research investments by businesses. Many companies seeking worldwide effective tax rate relief are taking advantage of the various jurisdictions that offer research incentives in the form of tax credits, "super" deductions, or cash grants. Some jurisdictions also will provide relief in the form of reduced tax on income associated with technology-based intellectual property. Consideration of these tax incentives — along with the impact of transfer pricing, green initiatives, intellectual property protection, and capital investments — is critical to maximizing the return on investment. Some countries have recently updated or implemented some sort of incentive, and a select few are below.

Australia

In July 2011, the Australian regime was revised to eliminate the "super-deduction" to a two-tiered credit regime. In addition to this improvement, taxpayers may also capture costs paid to activities performed on Australian soil but reimbursed by offshore companies within the same group, regardless of where the IP is owned. While this shift from the super-deduction to the credit has been lauded as a significant step in providing taxpayers a stronger return on their R&D investment, Australia continues to seek ways to further improve their regime. On February 17, 2013, Treasurer Wayne Swan announced that the Australian government is amending tax rules to better target the provision of research and development tax incentives so that more small and medium-size businesses can take advantage of R&D tax benefits.

Brazil

By providing two benefits, an R&D deduction and an R&D credit, Brazil offers a potential reduction in taxable income of up to 34% for technological innovation projects. The R&D deduction provides an additional 60%-100% deduction for technical innovation and provides full depreciation on assets placed in service for purposes of technical innovation in the year of acquisition, plus accelerated amortization for intangible assets. The R&D credit in Brazil offers a 50% reduction in corporate excise tax that may be otherwise payable on machines, equipment, or spare parts/tools used in R&D. The taxpayer may also take advantage of the following R&D tax incentives:

- 50% federal VAT (IPI) reduction in the acquisition of new equipment related to R&D activities
- Accelerated amortization for certain R&D equipment
- 0% income tax WHT on the cross-border remittances for the registration of trademarks and patents
- Government subsidies to fund part of the remuneration of certain researchers

Canada

The Canadian Scientific Research and Experimental Development (SR&ED) credit, which is permanent, remains broader than the US R&D credit. Qualifying SR&ED expenses include salary and wages, materials, contract payments, leases, overhead, and capital expenditures. There is no restriction on eligible SR&ED contracts (100% of amount to be claimed). There is a 100% write-off for eligible SR&ED capital equipment and full credit. Unused SR&ED tax credits can be carried back three tax years and forward 20 tax years.

Proposed changes cover both the SR&ED credit and provisional credits, which in some cases may provide greater benefits than the SR&ED. Canada is seeking to create an Industrial Research and Innovation Council to provide a consistent vision for the national and provincial credits. The objective is to provide a clear business innovation mandate while also making government programs more effective. In addition, Canada is seeking to simplify SR&ED by easing the qualification for some cost classifications, redirecting tax credit funds toward growth initiatives, implementing simpler compliance rules, increasing accountability, and alternative methods of rewarding innovation through direct funding.

Late development: On March 21, 2013, the Canadian Federal Minister of Finance released the majority government's budget. While there were no changes to the SR&ED program, the budget did introduce a new reporting requirement for SR&ED claims filed after January 1, 2014. Specifically, detailed information must be disclosed about SR&ED claim tax preparers and the related billing arrangements. Where a tax preparer has assisted with the preparation of a claim, the business number of each such tax preparer will be required, along with details about the billing arrangements, including whether contingency fees were used and the amount of fees payable. If a third-party tax preparer was not involved, the claimant will be required to certify this. A penalty of $1,000 will be imposed for each SR&ED claim for which the information about SR&ED claim tax preparers and billing arrangements is missing, incomplete, or inaccurate.

The budget also announced additional funding for the Canada Revenue Agency (CRA) to (i) extend outreach programs for first-time claimants, and (ii) focus more resources on reviews of SR&ED claims where the CRA believes the risk of non-compliance is perceived to be high and eligibility for the SR&ED program unlikely.

While claimants can expect additional CRA SR&ED outreach and audit activity, the 2013 federal budget confirms the federal government's ongoing support for SR&ED undertaken in Canada.

Ireland

The Irish credit shows some recent updates and looks to further improve the level of return on investment. With the recent changes, the credit was increased from 20% to 25% for R&D and manufacturing activities. The impact of this increase, along with the reduced corporate tax rate, provides an effective corporate deduction of 37.5% (25% + 12.5%). The Irish credit, much like the US credit, is incremental. However, the base amount has been updated to reflect the base year frozen at 2003 going forward. Ireland has also broadened its interpretation of qualified R&D to incorporate process R&D. Taxpayers can obtain additional benefit for capital expenditures and buildings that are not used "wholly" for the purpose of R&D. One of the very attractive features of the Irish regime is the ability to pay a decreased tax rate of 5% for IP-generated income through a "patent box," which provides a reduced corporate tax rate for related income.

In an effort to both attract and retain top-tier R&D talent, the Irish Finance Bill from February 2013 introduced even further improvements for start-up companies and reduced the level of qualifying commitment of employees from 75% to 50%, thus making the credit more generous by lowering those thresholds. As part of the Finance Bill, the Irish authorities are seeking consultation on other ways to improve the benefits and administration of the credit.

South Africa

The Republic of South Africa has introduced, effective October 2012, a 150% "super-deduction" on qualified expenditures, providing a net tax benefit of 14% for qualified expenses. South Africa also offers accelerated depreciation of capital expenses over three years (50% in year 1, then 30% and 20% in years two and three, respectively).

Obtaining the benefit requires pre-approval applications with the Department of Science & Technology.

United Kingdom

Much discussion has been focused on the change from the "super-deduction" to the "payable R&D expenditure credit" (also known as the "Above the Line Credit," or ATL). Under the new scheme, companies that qualify for the R&D credit will obtain cash benefit irrespective of their tax profile. If the company is paying tax, it will see its corporation tax bill offset by the amount of the credit. But where the credit cannot be offset against the company's corporation tax bill (for example, due to losses), the new scheme will allow the company to claim a cash payment from the Treasury.

The change will allow the benefit of the tax credit to be recorded in the company's accounts as profit before tax, rather than as a reduction in the tax charge, as is the case now. In addition, the change will provide an increased incentive to the individuals who control R&D budgets and will provide an incentive to more foreign multinationals to invest in R&D in the UK. Other incentives are available for small-medium enterprises (SMEs). Thresholds include employee, revenue, and asset limits. However, the benefits provide the ability to reinvest more easily.

The new R&D credit rate is increasing from 9.1% to 10%, which is great news for many businesses. The new credit is optional, with companies having the choice to either stay in the old R&D tax credit regime or claim the new R&D expenditure credit from April 1, 2013 (which is accounted for above the line).

The increased R&D credit rate means there is now a significant differential between the rate of relief available under the old regime of 6% (30% super-deduction at a 20% CT rate) compared with the new R&D credit with a net rate of 8% (10% less 20% tax). Companies will need to factor in this differential when deciding whether to elect into the new R&D credit.

The UK patent box regime is also in effect beginning April 2, 2013, with a 10% corporate tax rate and the benefit being phased in over four years.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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