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Taxing the cloud
A foggy endeavour

The latest in our series on getting the most out of your cloud computing strategies

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Taxing the cloud

With a name as nebulous as 'The Cloud,' it isn't any wonder that applying multiple complex tax schemes to cloud services can quickly expand into a storm of issues for any business. Huge global opportunities lie in the cloud, as discussed in our earlier publications. But too often the potential tax repercussions of a cloud infrastructure strategy are overlooked or not sufficiently considered until it's too late. A company can be blindsided by unintended tax assessments.

The amorphous term 'cloud' is truly appropriate. Electronic services and applications provided on the cloud are drawn from providers everywhere; data is kept on remote servers located in distant locales; and end products can be consumed anywhere — one of the fundamental strengths of the entire system. However, it is exactly this strength that creates the complexity around taxing it (see chart on opposite page). So how do we apply tax rules to something that is difficult to define and even locate in today's digital environment? Where do we start?

Income tax: permanent establishment

Let's begin by looking at the international principle of permanent establishment since tax cloudiness often occurs when electronic transactions cross jurisdictional borders. International treaties generally include articles of permanent establishment that determine whether a taxpayer has a taxable presence in a particular country and the degree of the resulting taxation.

The Organisation for Economic Co-operation and Development (OECD) defines permanent establishment as a fixed place of business where an enterprise is wholly or partly conducted. However, it specifically does not include facilities used for storage, collecting information or conducting auxiliary activity. In most cases, under the OECD rules, the location of a server in a particular jurisdiction, by itself, will not give rise to a permanent establishment under a treaty. Under its Model Income Tax Treaty and subsequent commentary, the OECD concludes:

(1) a web site cannot, in itself, constitute a permanent establishment;

(2) web site hosting arrangements typically do not result in a permanent establishment for the enterprise that carries on business through the hosted web site;

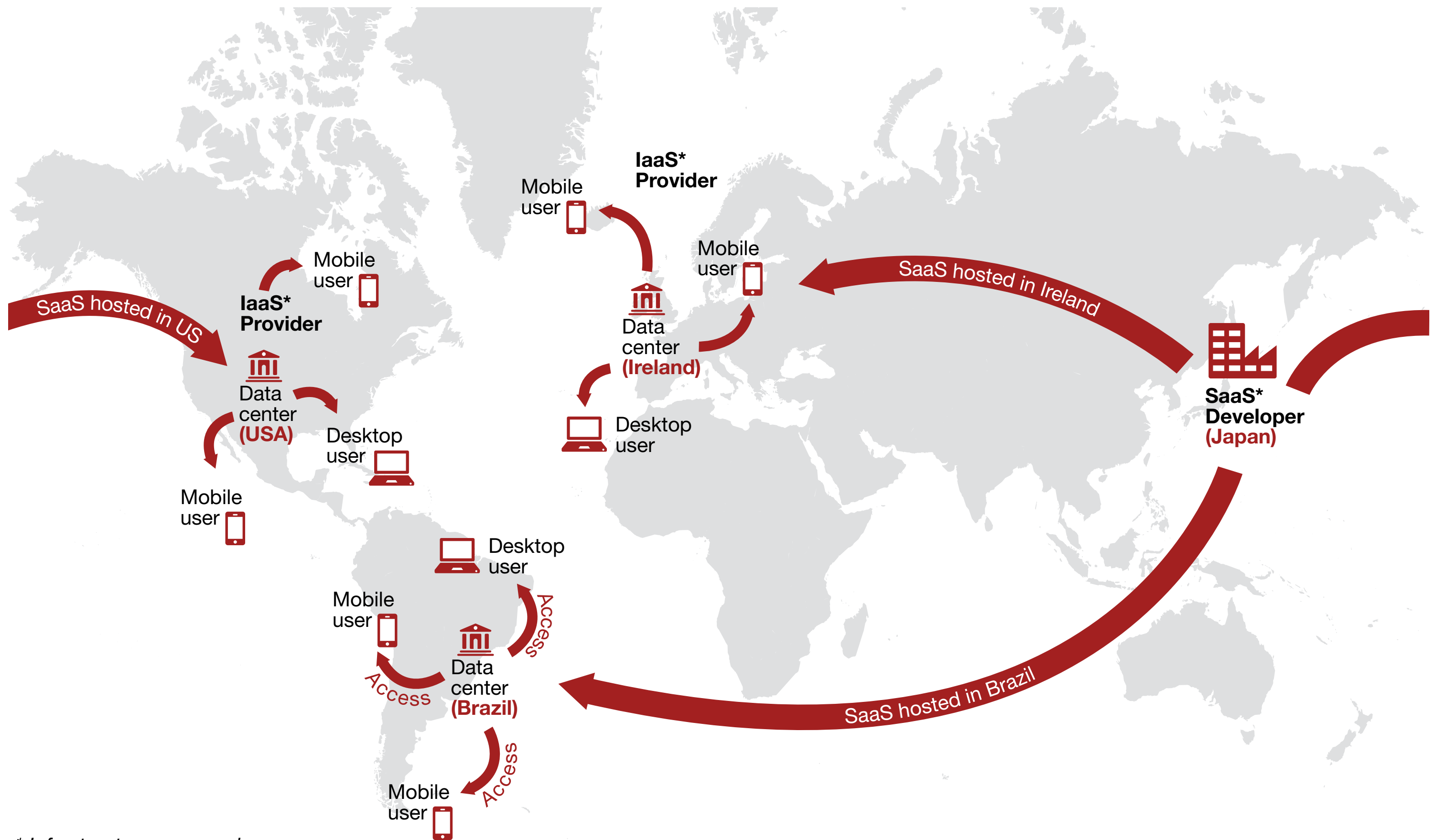
(3) except in very unusual circumstances, an internet service provider will not be deemed to constitute a permanent establishment for the enterprises to which it provides services; and

(4) a place where computer equipment, such as a server, is located may in certain circumstances constitute a permanent establishment, but requires that the functions performed at that place go beyond what is preparatory or auxiliary.[1]

While the model treaty provides some guidance, its usefulness is limited to businesses with complicated cloud models since most determinations have to be done on a case by case basis. For example, whether the use of a server in a particular locale gives rise to a permanent establishment depends upon how core that server is to the taxpayer's business and is specific to the taxpayer's attributes. In recent years, the OECD has worked to address the complexities that arise when applying the principles of permanent establishment to electronic transactions. In October 2012, the OECD released proposed amendments to 'auxiliary activity' within the Model Treaty, potentially allowing for additional activities to create permanent establishment.

1 The OECD commentary may be persuasive to a finder of fact in many instances, but member countries and their courts are not bound to abide by it.

An example of how Software as a Service (SaaS) might move around the world



* *Infrastructure as a service.*

It is also important to remember that the OECD Model Treaty is not binding, but rather provides a model for bilateral or multilateral treaties. It is these bilateral or multilateral treaties and local tax laws that govern cross border transactions. For example, in the services income context, vigilance is particularly important. Some countries are more aggressive in terms of characterizing services payments as royalties or some other type of income subject to withholding rather than as business profits earned by an enterprise outside the local jurisdiction. Businesses must be aware of these differences in order to avoid tax pitfalls.

Treaties and Local Laws

When establishing international operations, it is critical that businesses be familiar with treaties and local laws and may want to consult with tax advisors having local country expertise. Many electronic transactions may present novel fact patterns that local tax authorities may have not considered previously, or businesses may simply have to contend with an aggressive jurisdiction thirsty for tax revenues. A certain level of advocacy may be necessary to settle the tax treatment in a local jurisdiction, even in the planning stages.

Let's look at the United States as an example. Under the U.S.'s effectively connected income ('ECI') rules, certain types of foreign source income can be taxed in the U.S. if a company has a fixed place of business in the U.S. that is an 'essential element' in producing the income. Among the types of foreign source income that can be taxed are rents and royalties for the use of intangible property such as patents, copyrights and formulas and sales of inventory property—making some cloud services potentially taxable depending on how they are characterized. In such circumstances, companies should consider whether a treaty's permanent establishment article can be applied to their situation, providing for a favorable application of U.S. ECI rules.

Jurisdictional Tax Issues

In addition to country level taxes, businesses providing cloud services must also be concerned about local jurisdictional tax issues. Continuing with the U.S. example, a business may be subject to tax at the U.S. state tax level even if, under U.S. tax treaties with other countries, the business has no federal obligations. Increasingly states are taking the position that companies that derive revenue from within their respective markets have a filing obligation or 'nexus' despite a lack of physical presence in the state. This could be a game changer for companies that attempted to isolate their physical presence in order to limit their taxable nexus with other jurisdictions. Under one argument being used by several states, an 'economic nexus' is created when a business meets certain sales, property or payroll thresholds—a concept known as factor presence.

Indirect tax

As if the complexity around income taxes is not enough, the indirect tax issue can often be even more challenging, with rules varying from country to country.

More than 150 countries have a Value Added Tax (VAT) imposed on the sale of goods and services. Businesses generally collect the tax, adding it to the price of their products and passing the cost directly on to the consumer.

However, if a business is unaware that a particular transaction is subject to a VAT, or the amount of that VAT, before it has established its pricing structure, it can result in a significant hit to its profit margin. The revenue impact could be as high as 20 percent in countries such as Sweden and Norway, where the standard VAT rate is 25 percent.[2] Global companies doing business in Europe are currently confronting this type of profit threat because of a significant pending change in VAT rules for cloud services in the European Union (EU).

Generally speaking, transactions involving the cloud are considered services, as opposed to goods, in most countries, including the EU. While goods are generally only subject to VAT in a country if they are in that country at the time of the sale, the situation for services is much more complicated. A supply of services can be subject to VAT where the supplier is located, where the recipient is located, and/or where the services are performed, depending on the jurisdiction and the type of service performed. Whether the recipient is a taxable business or an individual makes a big difference on who is responsible for collecting the tax and at what rate.

The VAT rates and accounting requirements are different for cloud services provided by businesses to private individuals. In addition, these rules are changing significantly in the coming years, sparking concerns about profit margins and pricing structures. Currently, EU-based businesses that sell most cloud services to private individuals are allowed to collect VAT at the rate of the country the supplier business is located. That means that many cloud service providers, including the EU affiliates of global companies, have located in Luxembourg, which has the lowest standard VAT rate in the EU, at 15 percent. Starting January 1, 2015, these companies will instead have to pay the VAT rate of the country where their individual customers are located, which is as high as 25 percent in some countries.

> Compounding the complexity is the difficulty service providers face in ***defining their product.*** Is it a taxable or nontaxable service? It is a data processing or information service? Is it the sale or lease of tangible personal property?

It is important to note that the above is true only for services classified by the EU as electronically supplied services (ESS), which include most, but not all, cloud services. Cloud services not defined as ESS are taxed differently still.

The coming change puts EU businesses on a level playing field with non-EU businesses providing services to private individuals in the EU. Currently, when non-EU businesses provide ESS to private individuals residing in the EU, the transaction is still subject to the VAT rate in the country where the customer is located. Unlike in business-to-business transactions, the non-EU supplier must account for the VAT by registering and accounting with each EU country it serves, or in a single country through a special process.

2 Example: A U.S.-based company with no presence in the EU sells online games to a Swedish private individual for $10. That sale is subject to 25 percent Swedish VAT, which is presumed to be included in the price. The U.S. company will have to pay the VAT due to the revenue authorities out of the $10 received, leaving revenue of only $8 ($8 x 1.25 = $10), instead of the of the anticipated $10.

The above paragraphs describe the complexities of VAT collection on cloud services in just the EU. Each of the more than 100 other countries that have VAT have similarly complicated rules that vary based on the location of the supplier and provider and how the service is defined. All can have a significant impact on the bottom line price of a cloud service for a buyer.

Like the VAT in Europe, the taxation of electronic transactions in U.S. states is also changing. The U.S. has no federal sales and use tax. Instead, states and municipalities are allowed to establish their own sales and use taxes. However, under federal law, each state can only require retailers with a physical presence in their particular state to collect and remit sales tax.

Financially strapped states looking to increase sales tax revenue are increasingly finding new ways to meet the physical presence requirement. One of the primary ways they have done so is through what is known as 'click-through nexus.' Click-through nexus provisions vary state-to-state, but generally require out-of-state and global businesses to collect and remit sales taxes by declaring they have a physical presence in the state since they have an online tie to an in-state business or individual. The argument for physical presence is that the in-state entity helps facilitate the global retailer to sell its goods over the internet, typically by placing on its website a link to the retailer's website, hence the name click-through. The in-state entity then receives commissions from sales generated through the link.

In addition to click-through nexus, some states are expanding their definition of physical presence to include anyone in the state deemed to be helping build an out-of-state or global retailer's market in the state. For example, a third-party distribution center could create nexus.

And any legal challenges could soon become moot. The U.S. Congress is considering new legislation that would allow states to require global retailers to collect sales tax for sales made in their states, regardless of whether they have a physical presence. Congress has been debating this issue for years, but one bill, the Marketplace Fairness Act of 2013, is finally showing promise. The U.S. Senate passed it in 2013, but it still requires approval from the House of Representatives. Under the legislation, all online retailers that make over $1 million in U.S. sales, regardless of where the retailer is located, would be required to collect and remit sales tax to states that require it. If enacted, the tax would be collected from consumers based on where the item is shipped.

The takeaway

Almost by definition, cloud services are based on global computing networks that defy borders. This makes determining how they should be taxed — a system traditionally based on physical location — an enormously complicated task.

Is a product still taxed based on the location of its servers if no people actually work where those servers are located? If a jurisdiction taxes a service at the point of use, what happens if the service is free at the point of use or the product is used in various jurisdictions?

Compounding the complexity is the difficulty service providers face in defining their product — is it a taxable or nontaxable service? It is a data processing or information service? Is it the sale or lease of tangible personal property?

Many of these questions can only be answered on a case-by-case basis, through the evaluation of particular circumstances.

To have a deeper conversation about how this subject may affect your business, please contact:

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