

Cloud Computing

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Vered Kirshner, Tax Partner, PwC Israel

Omri Yaniv, International Tax Partner , PwC Israel

Agenda

- Cloud Computing in General
- Federal Income Tax
- International Income Tax

Cloud Computing in General

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Cloud Computing: What is it?

A style of computing where scalable and elastic IT-enabled capabilities are delivered as a service to external customers using internet technologies.

- Gartner Research

That was a mouthful...

What does this mean practically?

- A user of IT can now procure an IT capability as a web service
- The IT service *can* reside off premise, hosted by a third-party provider
- This service is elastic – can be dynamically scaled up/down, turned on/off
- Service is shared with other users, providing efficiency for provider
- Ultimately, the architecture, the delivery, and the consumption have all changed from the traditional model
- And payment for usage moves to subscription or on-demand

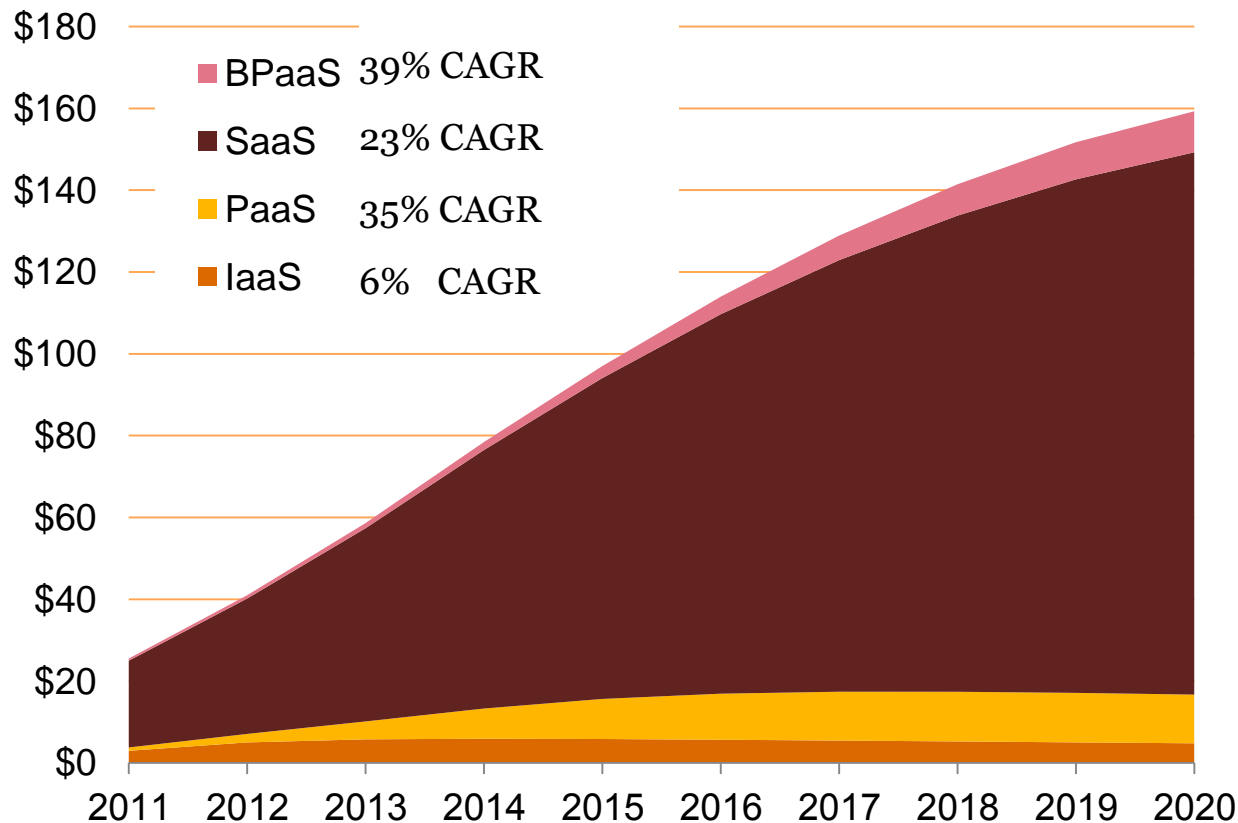
Cloud Computing: Delivery Models

<i>IaaS Infrastructure as a Service</i>	<i>PaaS Platform as a Service</i>	<i>SaaS Software as a Service</i>
On-demand server, storage, and network resources: <ul style="list-style-type: none">• Amazon EC2 & S3• Rackspace	Hosted application environment for building and deploying cloud applications: <ul style="list-style-type: none">• Force.com• Google AppEngine• Microsoft Azure	Applications, typically available via the browser: <ul style="list-style-type: none">• Google Apps• Salesforce.com
Store your data online with a third party cloud vendor, or utilize their compute power to process data.	Create a customer service application online, test it online, and deliver it to your employees via that same online platform.	Access your email online, use customer relationship management tools online, etc. Many typical desktop apps now accessed via web browser.

Cloud Computing: Market sizing

Global Public Cloud Market Size

2011 – 2020 Forecast (\$ Billions)



- Software as a Service (SaaS) accelerated early and quickly as ROI for SMB customers was readily apparent, and there were multiple use cases for consumers.
- There is growing interest today however in IaaS and PaaS, as capabilities have made these viable.
- In addition, the economic crisis and current normalization of growth have pushed this Cloud focus given the efficiencies and cost benefits.
- With growing press coverage, and increased M&A from large integrated Tech looking to round out Cloud offerings, users are taking notice.
- The cloud space is getting crowded though, and every vendor is looking for a way to bring its services to traditional IT buyers.

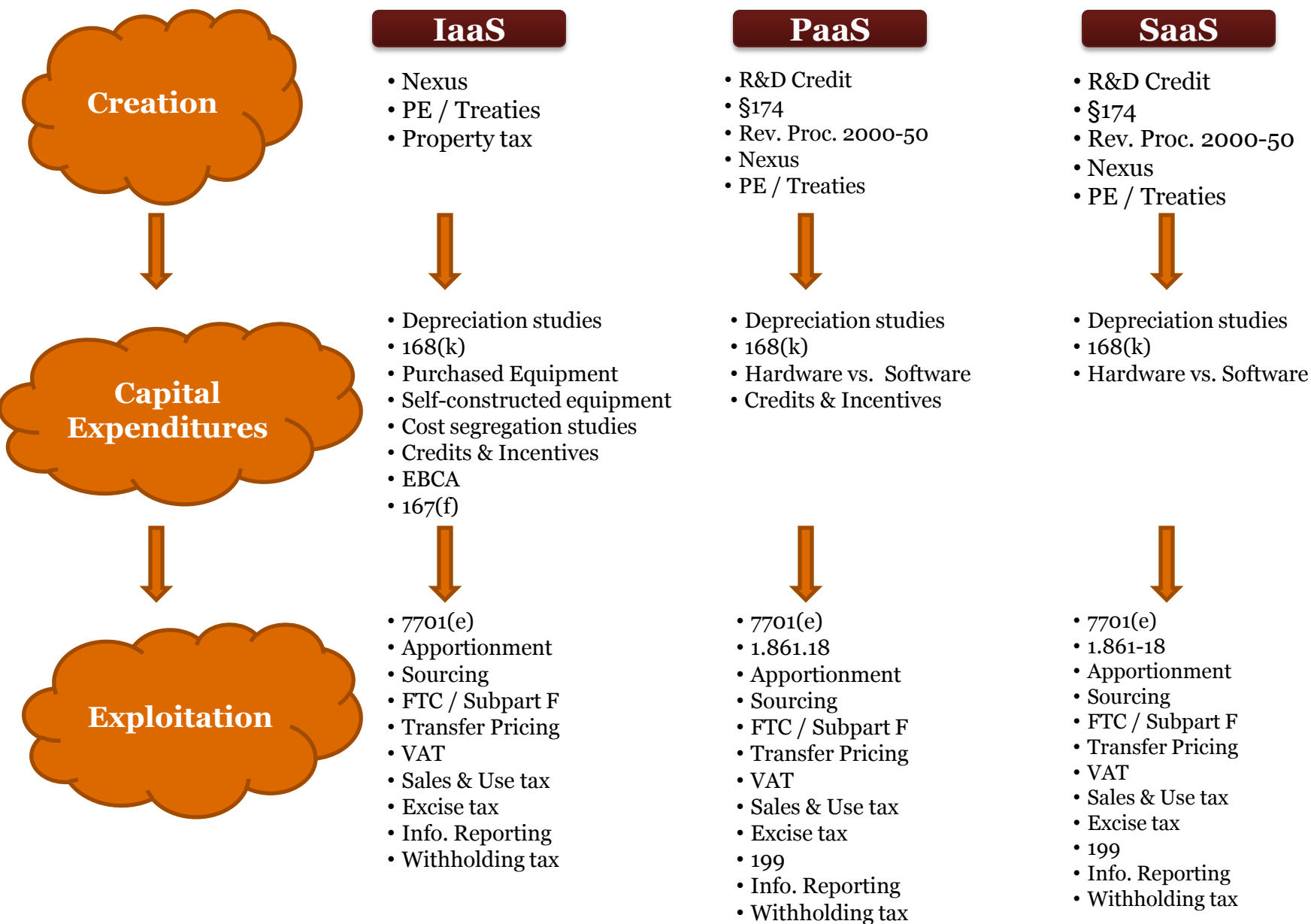
Data Source: Forrester – “Sizing the Cloud” April 2011

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Federal Income Tax

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Cloud Life Cycle



Classification

One of the main struggles in taxing cloud computing services is how to classify the transaction—to answer the question “What are you selling?”

- Is it software?
- Is it information services?
- Is it data processing services?
- Are you leasing tangible personal property?
- None of the above?

Characterization/Classification

- Uncharted territory
 - Existing guidance difficult to apply to new landscape
 - Goal of consistency:
 - Similarly situated taxpayers
 - Federal/International/State characterization
- Possible characterizations of cloud computing transactions:
 1. Services
 2. Lease
 3. Rental
 4. Sale
 5. License

Transaction Characterization

The characterization of a transaction will determine its tax consequences.

Existing guidance:

- Section 7701(e) – “Predominant Nature” of transaction
- Treas. Reg. § 1.861-18
- Sale vs. License
 - Section 1235 – patents
 - Section 1253 – trademarks

Transaction Characterization

Section 7701(e) – leasing/renting vs. services

- Six *factors* to determine whether a service contract should be treated as a lease of property:
 1. The service recipient is in physical possession of the property;
 2. The service recipient controls the property;
 3. The service recipient has a significant economic or possessory interest in the property;
 4. The service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract;
 5. The service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and
 6. The total contract price does not substantially exceed the rental value of the property for the contract period.

Transaction Characterization

Section 7701(e) – leasing/renting vs. services

- *Tidewater Inc. vs. U.S.* (5th Cir. 2009):
 - The Fifth Circuit articulated a balancing test to weigh each of the factors set forth in section 7701(e).
 - The court noted that the statute does not give guidance as to the weight given to each factor – thus, it is in the court's discretion.
 - In *Tidewater*, the court determined that the critical issue was whether the customer has control of the property.

Transaction Characterization

U.S. Software Regulations (Treas. Reg. § 1.861-18)

Scope:

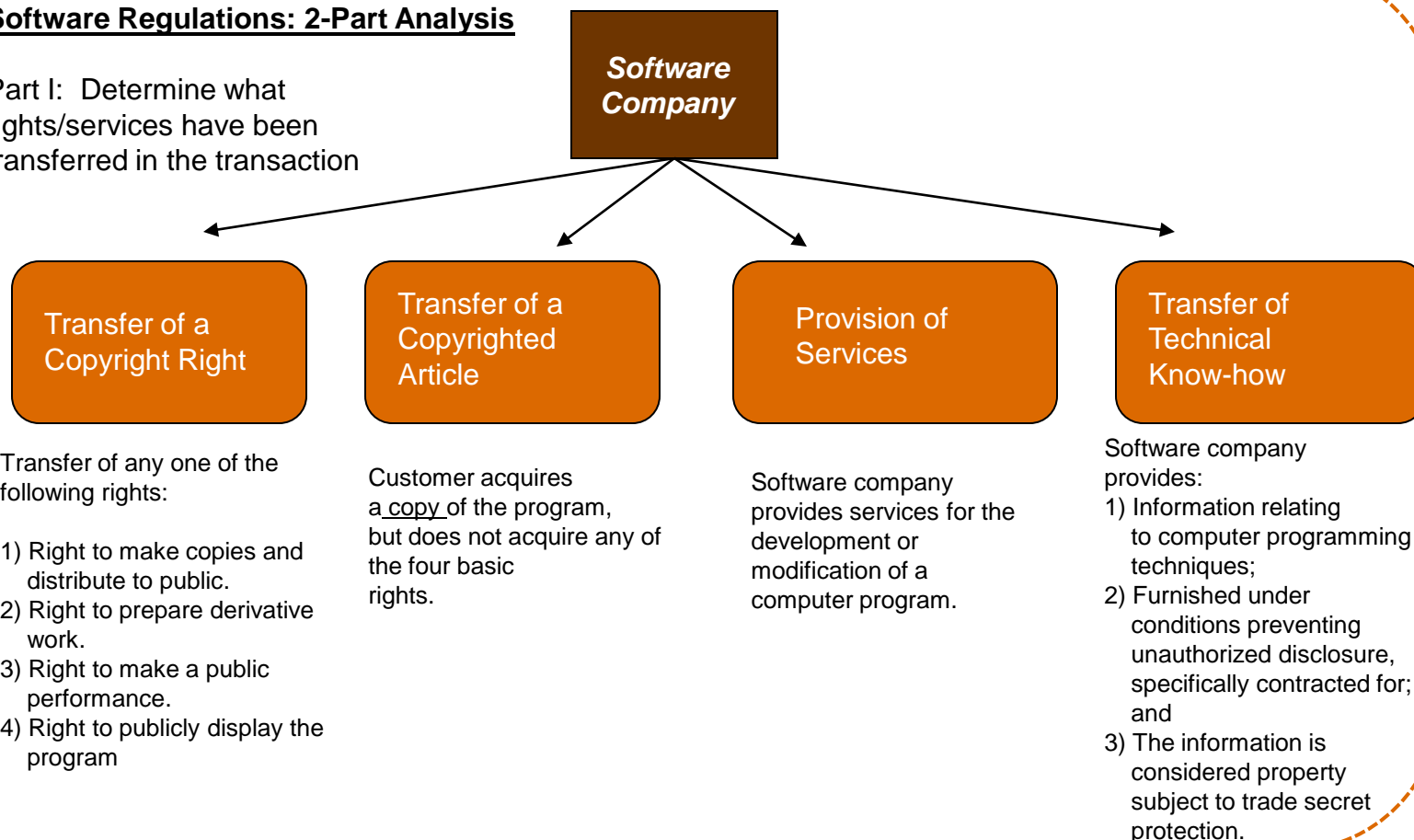
- Treas. Reg. § 1.861-18 applies for purposes of classifying transactions relating to “transfers” of **“computer programs”**.
- Categorizes the transfers of computer programs into four transaction categories (i.e. Copyright Right, Copyrighted Article, Service & Know How) and then characterizes each of the transactions (i.e. Sale, Lease, License) based on a set of criteria.
- In the absence of specific rules governing other ecommerce and cloud computing transactions, Treas. Reg. § 1.861-18 may provide a useful analogy (although not controlling authority).

Transaction Characterization

U.S. Software Regulations (Treas. Reg. § 1.861-18)

Software Regulations: 2-Part Analysis

Part I: Determine what rights/services have been transferred in the transaction

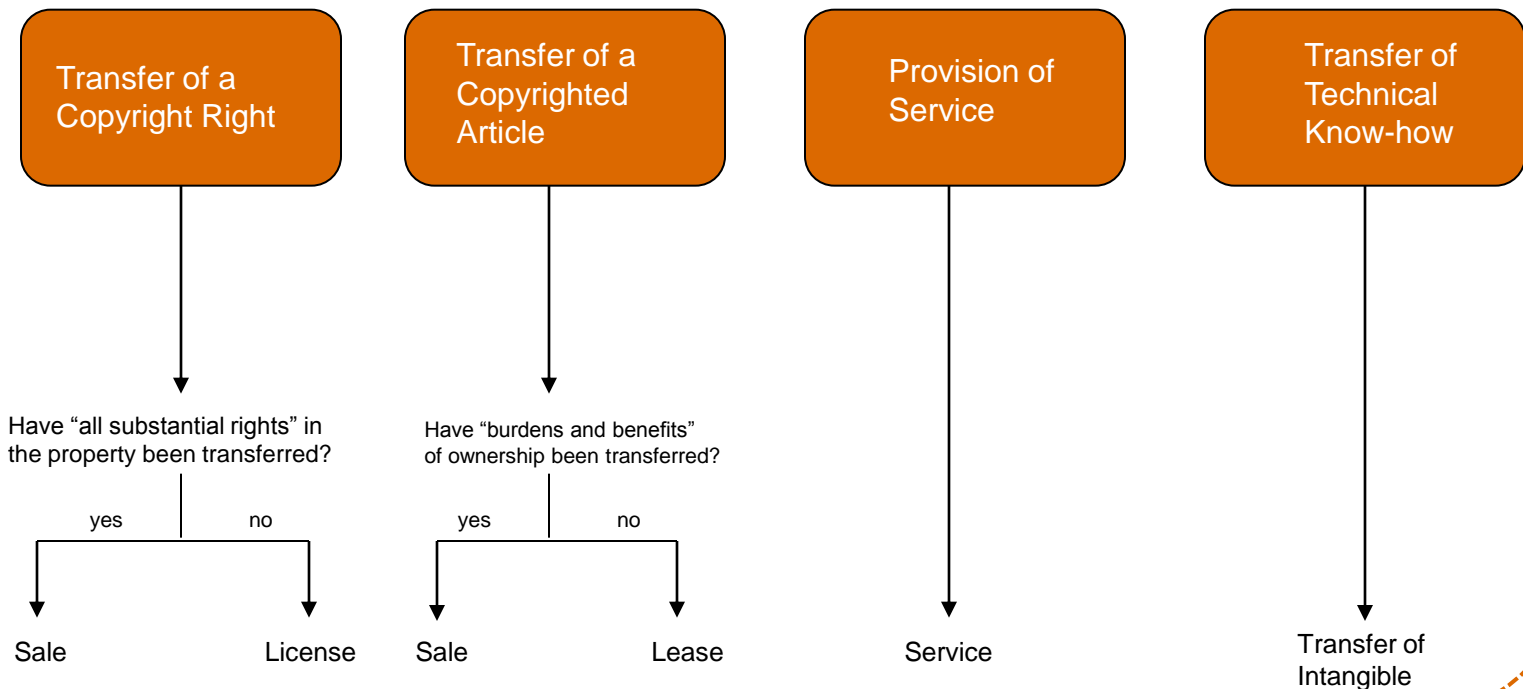


Transaction Characterization

U.S. Software Regulations (Treas. Reg. § 1.861-18)

Software Regulations: 2-Part Analysis

Part II: Determine **character** of the transaction



International Income Tax

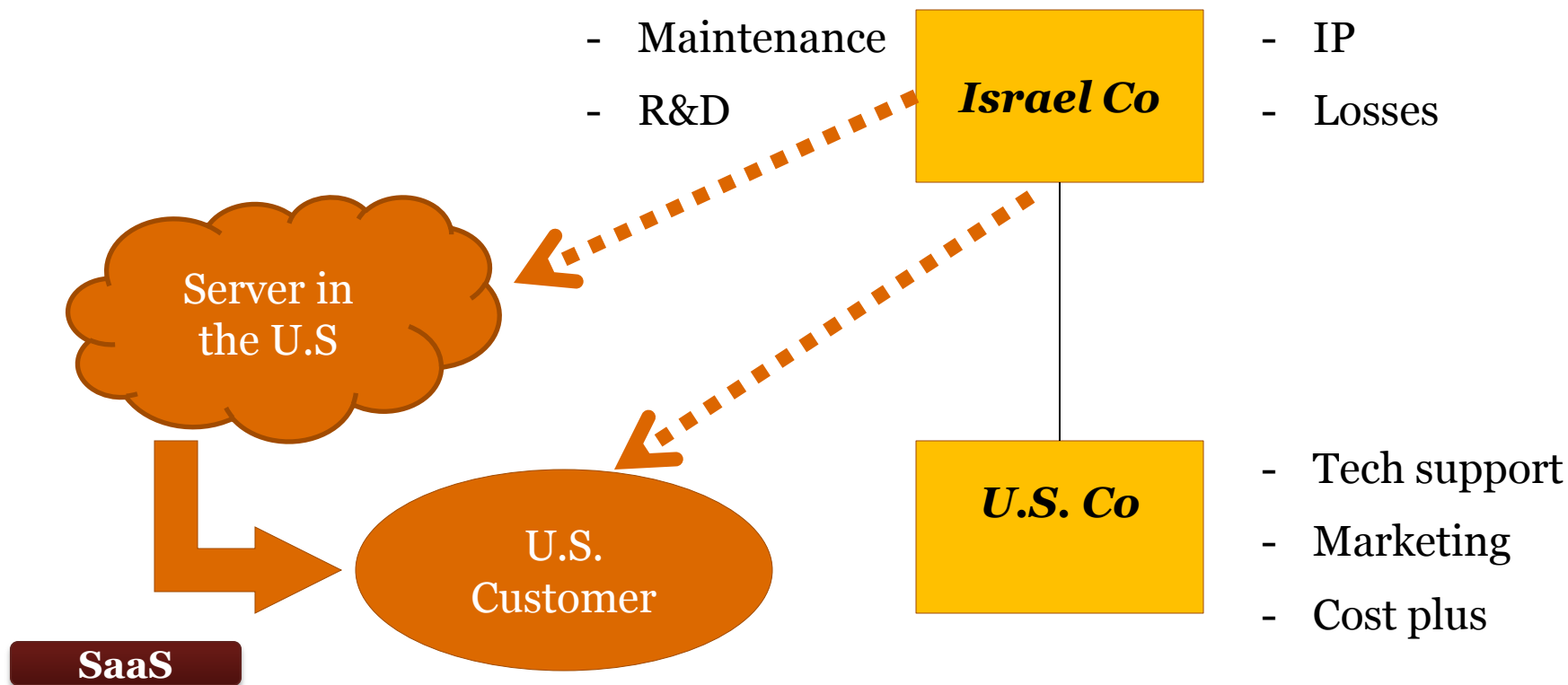
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Scenario 1 – Inbound Israeli Company doing business in the U.S.

U.S. federal income tax issues

- U.S. trade or business/permanent establishment (PE);
- What constitutes a PE? – Website hosting, ISP, Server (owning, maintaining);
- Acting through an agent;
- Characterization of transaction– service, sale, lease;
- Classification/Sourcing of income from U.S. activities.

Scenario 1 – Inbound Israeli Company doing business in the U.S.



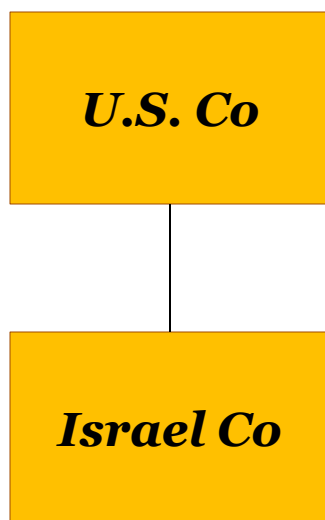
OECD Developments

OECD published commentary in 2000 on Article 5 of the Model Treaty re: e-commerce transactions, concluding generally that:

- A website does not in itself constitute a PE.
- Website hosting arrangements typically do not result in a PE.
- ISP generally not a PE for the enterprises to which it provides services.
- Maintaining/owning a server in a country (or having direction and control), by itself, will not necessarily give rise to a PE.
- If functions performed on the server are an *essential and significant* part of the taxpayer's commercial activity, *i.e.*, they are core to the taxpayer's business, the server may give rise to a permanent establishment.
- **U.S. Views** - No clear answers. Generally follows the OECD guidelines. Care should be taken if the transaction involves the supply of digital goods from a server located in the United States.

Scenario 2 – Outbound U.S. Company doing business abroad

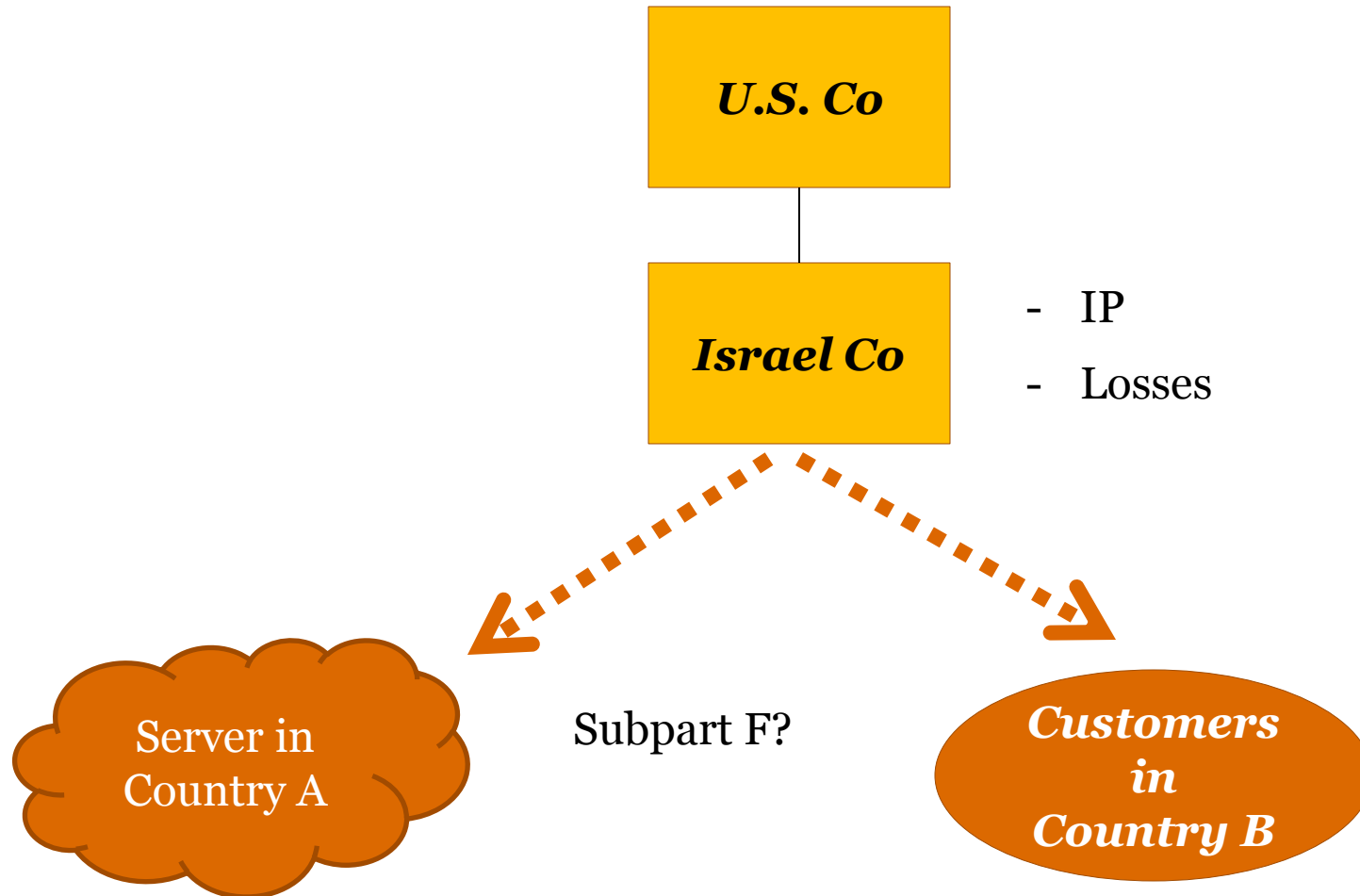
Subpart F considerations:



- Potentially applicable subpart F categories include, but are not limited to:
 - ***Service Income:*** Foreign base company services income;
 - ***Rental/Royalty Income:*** Foreign personal holding company income;
 - ***Sales Income:*** Foreign base company sales income.
- Also, the acquisition of IP itself could give rise to deemed dividend treatment (section 956).

Scenario 2 – Outbound

U.S. Company doing business abroad



Scenario 2 – Outbound U.S. Company doing business abroad

Subpart F considerations

- Selected rules for characterizing income for Subpart F purposes:
 - ***Substance over form*** -
For subpart F (section 954) purposes.
 - ***Separate transaction rule*** –
A single transaction may contain more than one character components (for example, sale and services components), each of which may have its own separate consequence for subpart F purposes.
 - ***Predominant character rule*** –
Portion related to FPHCI: for example, certain rents and royalties, “is always separately determinable and thus must always be segregated from other income and separately classified.”

Other International Tax Issues to Consider

1. VAT and other indirect tax issues
2. Transfer pricing
3. Withholding tax

Indirect Tax Considerations for Cloud Computing

- Classification of Service Offerings
- Sourcing
- State Sales & Use Tax
- Billing and Multiple Points of Use

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Thank you!

Vered Kirshner, Tax Partner, PwC Israel

03-7954849

vered.kirshner@il.pwc.com

Omri Yaniv, International Tax Partner, PwC Israel

03-7954474

omri.yaniv@il.pwc.com

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