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Working in the cloud

Tax considerations of cloud computing



Working in the cloud: tax considerations of cloud computing

“Cloud computing is borderless by its very nature. One thing is certain, however – the world’s taxing authorities have not issued definitive guidance for its taxation. Moreover, the business nature of the overall offering is also evolving, which creates further technical uncertainty, as well as timing uncertainty, as to when taxpayers can expect actual guidance. Companies are forced to make decisions based on current rules and interpretations across all relevant jurisdictions, but will likely nonetheless encounter tax surprises.”

Channing Flynn
*Global Technology Industry Tax Services Leader,
Ernst & Young LLP*

Overview

As a relatively new business model that is by nature borderless, cloud computing creates challenges for taxing authorities and uncertainties for businesses. Taxation can vary among jurisdictions, and both cloud service providers and cloud business users need to be aware of different revenue characterization and sourcing rules, reporting responsibilities, and sales and use tax issues.

Cloud computing is an approach to shared infrastructure in which large pools of systems are linked to provide IT services. Users are typically not aware of the underlying technologies used, including physical location of the related assets (servers, etc.), only that the resources they wish to purchase are available over the Internet, which is the backbone of the cloud.

Cloud computing is often borderless, but tax regulations and tax compliance requirements are not. That simple-sounding conflict can give rise to complex and potentially material or significant tax issues, mainly for cloud service providers (CSPs). To date, at least, in the evolution of cloud computing, most jurisdictions view CSPs as the responsible party for tax purposes regardless of any arrangements struck between CSPs and their users.

Sometimes CSPs are truly global “clouds,” providing limited or no transparency about where data is being processed and stored. More often, however, cloud service is provided by a group of interrelated but distinguishable data centers in different locations. It is important to understand this underlying point, because especially in the latter case, it means that both the CSP and the cloud user may be subject to all or some tax regulations in all of the jurisdictions through which the cloud network passes the user’s information.

“In general, under current rules the critical taxation issues in cloud computing are determining the character of CSP revenue and whether the CSP has a taxable presence (known as “nexus” in the tax world) in each of the jurisdictions in which the CSP does business,” explains Jeff Levenstam, Partner, Ernst & Young LLP International Tax Services group.

Both issues need to be separately sorted for income tax and indirect tax (sales, use or value-added tax) purposes as different rules may apply in different taxing jurisdictions and even for different taxes in the same jurisdiction. For tax compliance, the key issues are determining which regulations apply as a result of where a CSP’s data centers are located, as well as the level of support the CSP provides in meeting those compliance requirements. Other critical issues, such as transfer pricing (i.e., making decisions about the attribution of value or risk in a CSP model), and recent rules governing the disclosure of tax uncertainties, create even more ambiguity for taxpayers and the need for careful evaluation.²

¹ This discussion of tax issues related to cloud computing is a modified excerpt from an in-depth report on cloud computing, *Cloud computing issues and impacts*, Ernst & Young LLP, 26 May 2011. The longer report also includes an overview and brief history of cloud computing, as well as sections on pricing and business models, security, standards, accounting issues and regulatory compliance, among other topics.

² For an in-depth discussion of transfer pricing issues related to cloud computing, see “Can Clouds Change Shapes? Transfer Pricing Considerations for Cloud Computing,” Ernst & Young LLP’s Anne Welsh, Curt Kinsky, Nick Ronan and Mark Klitgaard, *Tax Notes International Magazine*, 10 October 2011.

Cloud computing – general tax considerations

“One challenge in dealing with cloud computing taxation issues is that CSP business models are developing much more rapidly than the global taxing jurisdictions can respond with guidance,” explains Drew Alltizer, Partner, Ernst & Young LLP Business Tax Advisory Services.

For example, the CSP must determine whether its revenue is characterized as revenue from a sale of software, as a license of software, as a service, or as a bundled package with both a sale or license and a service component.

US federal tax considerations

Within the US, there are some key tax considerations that may pertain to cloud computing activities. For example, Section 199 provides a tax deduction for domestic production if taxpayers meet certain requirements. To determine whether this deduction applies, the CSP should consider whether it produces computer hardware or software in the US. If so, and if the CSP earns revenue from the transfer of that hardware or software, then the CSP might be entitled to a Section 199 deduction.

Alternatively, the CSP might qualify for the deduction if customers access online software produced by the CSP in the US for a fee, as long as similar software has previously been available to customers in the marketplace via download or diskette.

In addition, the research credit under Section 41 imposes various restrictions on the eligibility of research expenditures for software designed for a taxpayer’s own use. New uses of cloud services may affect the definition of “internal use software” for purposes of the Section 41 research credit.

Finally, CSPs need to be aware of the sourcing rules for electronic services income for purposes of the US federal income tax.

Cross-border considerations

CSP multinationals must consider several issues when operating in the cloud. Currently, CSP revenue characterization is regulated inconsistently around the globe, and even state-by-state within the US. The Organisation for Economic Co-operation and Development (OECD), a peer group of 34 countries that provides a forum for governments to seek solutions to common issues, has issued a general statement that CSP revenue is more akin to revenue from a service. However, the OECD’s guidance is non-binding; each country adopts its own laws and regulations, and the reality is that some characterize CSP revenue as a service while others treat it as a software sale or lease. This non-uniform treatment of CSP revenue is also seen at the US state level. “Making the distinction has significant and complex ramifications for all CSPs in terms of an overall tax mitigation strategy – especially US multinationals operating abroad or other multinationals operating in jurisdictions with similar worldwide taxing systems,” says Jeff.

Questions to consider

Cloud business user

- ▶ Have I adequately considered tax nexus and the related compliance issues in the selection of my CSP, and are they clearly documented in our agreement? Are the filing and tax responsibilities clearly identified among the parties?
- ▶ How will I monitor CSP adherence to agreed-upon compliance duties?
- ▶ How will the relationship with my CSP adapt to changing tax statutory and regulatory requirements?

Cloud service provider

- ▶ Is my tax strategy aligned with my business model and flexible enough to change as required?
- ▶ Where do I have tax nexus?
- ▶ What are the revenue characterization and sourcing rules for each jurisdiction in which I operate? Do I have tax risk with respect to these issues?
- ▶ Am I aware of all potential domestic and global incentives to supplement cloud service provider expansion plans?
- ▶ What level of independent assurance am I willing to offer my customers?

“In most jurisdictions, the CSP itself is likely ultimately responsible for reporting and remitting indirect taxes such as sales and use taxes, even if an agreement states that it is the responsibility of the cloud user. Taxpayers are advised to carefully understand the rules and requirements and put in place at the outset the appropriate processes to manage tax risks.”

Drew Alltizer

Partner

Business Tax Advisory Services, Ernst & Young LLP



From a US multinational's federal income tax perspective, the revenue characterization question also impacts whether the income of its foreign subsidiaries is eligible for deferral from current taxation in the US, as different rules (including different exceptions) apply to services income versus licensing or leasing income. The revenue characterization is also extremely important for US state and local sales and use tax purposes, since services are generally not subject to such taxes, although various US states are starting to identify exceptions.³ As of March 2012, nearly half of all states that impose a sales and use tax apply that tax to digital goods. While the states continue to search for new sources of revenue, it is expected that this number will continue to grow.

Similarly, outside the US, certain nations subject services to value-added tax (VAT), goods and services tax (GST) or other forms of indirect taxation.

Once a CSP has determined revenue characterization, the CSP must determine where it has a taxable presence or nexus for both income and sales or use taxes so as to properly comply with regulations in the appropriate jurisdictions.

Nexus determination not only governs taxation and the amount thereof, but can also determine whether filings are required (irrespective of whether any tax is due). In the current environment, CSP multinationals are often surprised by the potential nexus questions and answers that arise in establishing current business models. This is especially true with respect to non-US multinationals operating virtually in the US, as well as US multinationals operating in large organized economic communities such as the EU.⁴

CSP multinationals may face different determinations for each jurisdiction where income is earned, resulting in double taxation, and should familiarize themselves with any treaties that might apply to change this. It also may be possible to try to obtain a ruling to gain certainty on the treatment or characterization, withholding tax implications, and overall taxability within a jurisdiction. There is, however, one positive element for CSPs in today's environment: since cloud services are often provided via a network of local data centers, and many localities offer constantly changing special tax and other cash incentives,

careful planning and working with local economic development agencies can create a competitive advantage for CSPs as they seek to build out data centers in the US and abroad. "Many different jurisdictions are eager for economic development, so they will offer abatements or holidays for sales tax or VAT or even reduced rates of overall income taxation based on profits derived from activities based in their jurisdictions," explains Drew. Current technology requires that CSPs rely on physical substance somewhere, so consideration of the jurisdiction(s) in which to locate this activity is paramount, including whether tax incentives may factor into the overall business decision as to where to locate the data centers. Obtaining special incentives for reduced operating costs (electricity savings, for example) can significantly contribute to the CSP's bottom line.

"Many cloud computing service arrangements are technological evolutions of existing online/internet service and software delivery models. Accessing the insight of an experienced advisor in this area is helpful to understand the complex rules and the issues involved, as well as the uncertainties and overall tax planning opportunities."

Channing Flynn

Global Technology Industry Tax Services Leader, Ernst & Young LLP



³ For an analysis of recent state sales and use tax developments involving cloud computing, see "Sales Tax Considerations With Regard to Bundling in the Clouds," Ernst & Young LLP's Mark Stefan and Mauricio Keene, *Journal of Multistate Taxation and Incentives*, August 2011.

⁴ The application of VAT to cloud computing services, specifically within the European Union, is discussed in greater detail in "Cloud Computing and VAT," Ernst & Young LLP's Corin Hobbs and Karen Christie, *Tax Notes International Magazine*, 13 June 2011.

⁵ Welsh, Kinsky, Ronan and Klitgaard, *supra*, note 2

Transfer pricing (generally defined as the intra-company allocation among various jurisdictions/entities of the overall profit elements within related-party transactions) is another key issue to consider in designing or subscribing to a CSP arrangement.⁵

Taxpayers are advised to consider and clearly identify where the risk and value functions exist in CSP arrangements to ensure that each jurisdiction's profits are determined and reported on an arm's-length basis (determined as if the intra-company entities were unrelated)

CSPs and overall service company arrangements

Many of the world's countries have entered into income tax or other related tax treaties that may govern certain elements of the tax profile for CSPs operating in cross-border arrangements including withholding tax or nexus determinations. Tax treaties are generally designed to offer tax savings or more relaxed rules for the signing parties; CSP multinationals should ensure that

they understand the tax treaty implications of their contemplated arrangements and comply with requisite compliance elements for obtaining benefits of various tax treaties.

Such issues will become an increasing concern for global multinational companies in all industries. As multinationals respond to their customers' requests for global service delivery, cloud computing models will play a critical role in how these companies build their service delivery models. Amy Ritchie, International Tax and Americas Tax Technology Leader says, "As multinational companies design service level models and consider how to move people and data to provide 24/7 service delivery in all time zones, consideration of cloud models is key. There is significant need among US multinationals to understand the complexities and opportunities inherent within global service delivery models, including how cloud arrangements are integrated within them."

Ernst & Young observations

Analyzing the underlying substance of the CSP's product offerings and customer contracts will assist appropriate revenue characterization.

Determining where and whether a CSP has a taxable presence is a necessary step in designing new business models or subscribing to a CSP offering.

The full range of tax implications for CSPs will continue to evolve.

CSPs should approach CSP design and tax compliance as a potential competitive advantage. One way to achieve this is through assurances on design models that help cloud users maintain compliance with all tax regulations in the jurisdiction in which they operate.

Conclusion

As cloud computing continues to expand, taxing authorities are looking to adjust tax regimes to capture the revenue streams involved. Businesses, whether CSPs or cloud business users, need to be aware of the challenges, opportunities and risks. They must also work to keep abreast of ever-evolving tax laws and regulatory requirements in different jurisdictions. Employing a forward-thinking tax strategy that takes these factors into account will give businesses a competitive advantage in this rapidly evolving area.

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