U.S. International Tax Planning in the Cloud

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"The Cloud"

- Means of sourcing certain IT functions virtually
- End user accesses through web browser or mobile app
- Software and data stored remotely on servers
- Steve Jobs: "Keeping these devices in sync is driving us crazy…. We are going to demote the PC to just be a device."
- Examples:
  - iCloud, Webmail, Lexis/Westlaw, Online Banking

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Outline of Presentation

- Income Characterization
- Income Sourcing
- U.S. Taxable Presence (including Agency Principles)
- Tax Treaties

U.S. Federal Income Tax Treatment of Cloud Computing

- No specific rules dealing comprehensively with tax treatment of income from cloud computing
- Treasury/IRS generally has applied existing rules from other contexts instead (e.g., source rules under 861, 862)
- Character and source of cloud-related income thus not always clear

Character Issues

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Character Issues

–Factual analysis of transaction and rights of the parties should determine the character of the transaction. *See Boulez,* 83 T.C. 584

–Classification of transactions involving computer programs are governed by Treas. Reg. Section 1.861-18

–Lease vs. Services character- *See* Section 7701(e)

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Treas. Reg. Sec. 1.861-18

- Guidance on tax classification of transactions involving computer programs
- Copyright Rights vs. Copyright Articles
- Copyright Right if any of the following four rights are transferred to the customer:
  – Right to make copies for distribution to public
  – Right to prepare derivative computer programs based on the software
  – Right to make public performance of the software
  – Right to publicly display the software

1.861-18 Regs., cont'd.

- Copyright Article:
  – Transferee acquires only a copy of the software, but no copyright rights
  – Copy of computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device

1.861-18 Regs., cont'd.

- Copyright Rights
  - Sale or exchange if transfer of all substantial rights, based on facts and circumstances
  - Otherwise treated as license generating royalty income

- All substantial rights
  - Section 1235
  - All copyright rights
  - Term equal to remaining life of copyright
  - Exclusive rights within relevant territory

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1.861-18 Regs., cont'd.

- Copyright Articles
  - Sale or exchange if benefits and burdens of ownership have been transferred, based on facts and circumstances
  - Otherwise, treated as lease generating rental income

- Benefits and burdens, per examples in Reg.
  - Perpetual rights (vs. interest terminating at end of subscription period)
  - Right to reproduce/copy (but not distribute to public)
  - Right to re-sell
  - Risk of loss

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Section 7701(e)- Services vs. Lease

- Non-exclusive list of 6 factors supporting Services characterization:
  - <u>Physical Possession</u>- Customer does not take physical possession of software
  - <u>Control</u>- Customer does not have control over access to software
  - <u>Economic or Possessory Interest</u>- Customer not responsible for maintenance costs, or risk of loss limited to ability to access software
  - <u>Substantial Risk of Non-Performance</u>- Customer does not bear risk of non-performance (e.g., software failures)
  - <u>Concurrent Use</u>- Customer does not have exclusive access to the software
  - <u>Contract Price in Excess of Rental Value</u>- Payments for access to software substantially exceed rental value of software without any charge for services

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Tension Between Regs. and 7701(e)?

- Difficulty in determining whether Cloud software subscriptions constitute leases (generating rental income) or performance of services (generating services income)
- Regs. also make clear that "[n]either the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative" of the U.S. federal income tax characterization. Treas. Reg. Section 1.861-18(g)(1).

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Bundled Transactions

–Under Treas. Reg. Section 1.861-18, a transaction involving a computer program that includes both the transfer of a copy of a computer program and another type of transaction are treated as separate transactions, so long as neither transaction is "de minimis"

–*See also Tidewater v. U.S.*, 565 F. 3d 299 (5th Cir. 2009) (customers were given control over aspects of the use of a chartered vessel, but the vessel crew retained operational control. Fifth Circuit takes an "all or nothing" approach and characterizes the transaction based on its predominant character, as a lease)

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Example 1

- FC, in non-treaty jurisdiction, develops software and uses unrelated US server to deliver software to clients electronically through website
- Assume no copyright rights are transferred and FC has no US office or employees and is not ETB
- Clients buy right to download software onto client hard-drive one time and use software for 1 month subscription period in exchange for fixed fee
- At end of 1 month period, all client rights terminate
- Clients cannot sublicense software

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Analysis

- No copyright rights transferred
- Any transfer is of copyright article
- No transfer of benefits and burdens of ownership, since client has limited time frame to use and cannot sublicense
- <u>Conclusion</u>: Per Reg. Sec. 1.861-18, income received by FC is rental income

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Analysis, cont'd

- Impact of Section 7701(e)?
  - Here, customer takes physical possession of software by downloading, and thereby controls its own access and bears risk of loss
  - Customer also bears risk of non-performance if hard-drive crashes
  - Customer has exclusive access to its copy of the software

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Analysis, cont'd

- Rental income is FDAP
- If rental income is foreign source, no US tax due
- If, however, rental income is US source under 861/862, US withholding tax liability arises
- Difficult compliance issues arise with FDAP income in these cases
- Unlikely US customers will withhold on purchase price, so FC has US reporting and payment duty
- Practically speaking, how does FC determine source in each case?

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Revised Example

- FC uses unrelated US server to deliver software to clients electronically
- Clients get temporary right to access software through the server (cannot download onto client hard drive) for 1 month in exchange for fixed fee
- Clients cannot sublicense software

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Analysis

- <u>Conclusion:</u> Section 7701(e) factors suggest Services characterization under revised facts
- Here, client does not take possession or control, has no risk of loss (other than ability to access software through server), does not have exclusive rights to software (server provides access to multiple users concurrently)

Query

- Is this distinction intended by IRS, such that mere fact of downloading software (with same bundle of rights) onto hard drive vs. accessing through server means difference in characterization between rental income and services income?
- Implications: varied sourcing and compliance obligations, and potentially different withholding tax rates under treaties if applicable (e.g., other income vs. royalties)

Example 2 – Bundled Offerings

- Non-U.S. software developer transfers a copy of software (Program X) to non-U.S. cloud service provider (CSP)
- CSP also obtains non-exclusive right for 1 year (less than remaining useful life of copyright) to sell Program X to unlimited number of users in Country Y and in the U.S.
- Customers download Program X onto their hard drives from CSP servers located in Country A. All customer rights to Program X terminate when subscription period ends
- In addition to the software, CSP also provides its customers with cloud-based computing power and data storage
- All of above is included in one monthly subscription fee
- Assume developer's classification of the income is "royalty" income (*See* Example 6 of the -18 Regs.)

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Example 2 – Bundled Offerings (cont.)

- How is the income of CSP characterized for U.S. federal income tax purposes, *i.e.*, is "unbundling" required?
- Under Treas. Reg. Section 1.861-18, treated as two separate transactions, so long as neither transaction is "de minimis"
- What is de minimis?
- If unbundling is required, how do we allocate the income?
  - *See also Tidewater v. U.S.*, 565 F. 3d 299 (5th Cir. 2009)
  - *See also* Treas. Reg. Section 1.199-3(i)(4)(i)(B)(6) for 5% de minimis test
  - Under Subpart F rules, general rule is that bundled transactions must be "unbundled". Treas. Reg Section 1.954-1(e)(2)
    - In rare circumstances, "predominant character" controls. Treas. Reg Section 1.954-1(e)(3)

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Query

- What is IRS/Treasury view on the unbundling issue? How do we know when unbundling is required and what is de minimis?
- Is IRS following *Tidewater* in 5th Cir. cases? How does IRS interpret *Tidewater* holding in Cloud context?

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Sourcing Issues

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Source of Income in Cloud Business Model

- The source of income from cloud offerings depends on its type and several other factors

- What is the source of the income from cloud offerings?
- Sales:
  - Sales are sourced where the title and risk of loss to copyrighted article transfers from seller to buyer. IRC §§ 861(a)(6), 862(a)(6)
- Rents:
  - Rents are sourced where the rented property is used. IRC §§ 861(a)(4), 862(a)(4)
  - Software physically located on end user's hard drive is "used" in the place where the computer is located
  - *Query*: *Where does use occur when software streams from server?*

Source of Income in Cloud Business Model (cont'd.)

- Services:
  - Services are generally sourced based on where the services are performed. IRC §§ 861(a)(3), 862(a)(3), *Piedras Negras Broadcasting*, 127 F.2d 260 (5th Cir. 1942)
  - Where are services performed in a cloud business model?
  - On the end user's computer when he or she accesses the hosted software?
  - On the server which hosts the software?
  - Where the performance of management or people functions necessary to hosted software occurs?
  - Minimal substance of, or participation by, the payer in the overall transaction likely to lead to consideration of the activities of unrelated service providers (third party server)
  - Look to where the servers are located if there are limited or no "people functions" in providing the services (may be multiple places of performance)? See OECD Model Treaty
  - Assess degree to which third party servers direct non-U.S. customers to appropriate servers

Sourcing of Royalties

   – <u>Sourcing of Royalties</u>

- Royalties for patents, copyrights, and trademarks are sourced based on "place of use."
- Conflicting authorities exist—further complicated with difficult "cloud computing" facts.
  - More clarity for copyright royalties (*e.g.,* Rev Rul 72-232)
  - FSA 200222011 muddies the water for software royalties
  - Patent authorities are mixed
- Possible relevant facts include: server location, customer billing address, customer location at time of use, technical support function, sales force, etc.

   – Conclusion:

- For copyright royalties, place of consumption seems supportable.
- For patent royalties, may want to look at most economically significant functions.
- In every case, may also consider multi-factor sourcing.

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Example – Source of Income from Cloud Offering

- A foreign-based software developer transfers a hard copy of software (Program X) to U.S. cloud service provider (CSP)
- CSP downloads Program X onto its own server
- CSP pays developer a fixed fee for 1 year license with renewal option
- License permits CSP to distribute Program X to the public
- CSP sells monthly access to Program X to customers located in the U.S. and in foreign Country Y in exchange for fixed fee
- Customers access the program from servers located in Country A and the U.S.
- Classification of developer's income is "royalty" income (See Example 6 of -18 Regs.)

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Example – Source of Income from Cloud Offering (cont'd.)

- What is the source of the developer's royalty income?
  – Possibilities include: (i) place of copying/installing; (ii) location of servers (i.e., U.S. or Country A); (iii) billing address of customer; (iv) physical location of user at time of use; (v) location of personnel providing key services.
- Should there be a single source or multiple locations?
- If multiple locations, how should the royalty income be allocated to such locations?
- If application of the law to cloud based transactions is unclear, how are withholding agents supposed to comply with their withholding obligations?

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Revised Example – Source of Income from Cloud Offering

- A foreign-based software developer sells cloud-based access to its software (Program X) to customers located in the U.S. and Foreign country Y
- Customers can access Program X only through the cloud; cannot download copy; do not receive hard copy
- Customers pay developer a fixed fee for 1 year of use
- Customers access Program X from servers located in Country A and the United States
- Developer's income is classified as services income (per Section 7701(e))

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Revised Example – Source of Income from Cloud Offering (cont'd.)

- What is the source of the developer's services income?
  - Possibilities include: (i) place of copying/installing; (ii) location of servers (i.e., U.S. or Country A); (iii) billing address of customer; (iv) physical location of user at time of use; (v) location of personnel providing key services.
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Issues with U.S. Taxable Presence/ U.S. Trade or Business

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U.S. Taxable Presence

– If income from cloud offerings is earned through foreign subsidiaries/affiliates, U.S. federal income tax may apply to income of a foreign corporation that is effectively connected with a U.S. trade or business.

– When is a foreign cloud provider engaged in U.S. trade or business?

– Generally a facts and circumstances analysis; foreign persons can be engaged in a U.S. trade or business ("U.S. T/B") through their own activities or activities conducted through an agent (express or implied). IRC § 864(b)

– Must be substantial, continuous and regular activity (typically a low threshold)

  • Could foreign affiliates have a U.S. T/B if U.S. based servers accept cloud subscription orders from customers on their behalf (agency principles)?

  • Could owned or leased third party servers in the U.S. give rise to a U.S. T/B because foreign affiliates and/or U.S. employees manage or operate the servers?

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U.S. Taxable Presence, Cont'd.

– Generally, courts have found that the economic activities necessary to create a U.S. T/B generally involve a geographically relevant asset or activity combined with human intervention or people functions:

  · The mere purchase of services from an independent service provider (that provides such services within the United States) should not constitute a U.S. T/B for a foreign principal

  · However, if the service provider constitutes an agent of the foreign principal, the service provider may cause the foreign principal to have a U.S. T/B. Even an "independent" contractor does not necessarily insulate the foreign principal from being attributed to the independent contractor's U.S. T/B, but there is less risk that the activities are imputed

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Agency Issues

- Do arrangements with third parties constitute agency relationships, service provider arrangements, or "other"?
- No agency relationship where
  - (i) there is no agency agreement,
  - (ii) parties did not intend for agency, and
  - (iii) no representations of agency to 3rd parties.
  - *Bollinger*, *Moline Properties*, *Miller*
- Conduct consistent with principal-agent relationship will be viewed as such —regardless of contractual limitations. *Inverworld*.

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Effectively Connected Income

- If a foreign cloud provider has a U.S. T/B, is its U.S. source income deemed to be effectively connected income ("ECI")?
- Income from performance of services in the U.S. generally is ECI and subject to U.S. federal income tax. Section 882.
- Special rules apply, depending upon whether income is U.S. source or foreign source.
- U.S.-based assets and activities determine whether a foreign corporation's U.S. source income is ECI. See Section 864(c)(2), Treas. Reg. Section 1.864-4(c)(3).
- In addition, the branch profits tax of 30% may apply, but may be reduced by a tax treaty. Section 884.
- Tax treaties may minimize the risk of a U.S. taxable presence, provided foreign company qualifies for treaty benefits (discussed on later slide).

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Example

- FC develops and sells its software to customers through its website, in exchange for a fixed fee.
- FC hires hosting service ("host"), an unrelated U.S. company, to handle all operation and maintenance of the website.
- Some customers are located in the U.S.
- FC pays host fixed monthly fee for its hosting and related services.
- *Query: Does unrelated hosting service constitute agent that may cause FC to be ETB?*

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Taxation of ECI vs. FDAP

- If foreign cloud provider has U.S. T/B, ECI taxed at graduated rates on net basis. Section 882(a).
- If foreign cloud provider does not have U.S. T/B , its U.S. source FDAP income is subject to 30% gross basis withholding tax, unless reduced or eliminated by treaty. Section 881.
- In some cases, where no treaty is available, may be advantageous to cause U.S. T/B classification to take deductions.
  - Section 882(c) permits deduction of expenses allocable to ECI
  - Consider filing protective return where no U.S. T/B is thought to exist, to preserve potential deductions

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Treaty Issues

Treaty Issues

– If a foreign cloud provider has a taxable presence under U.S. domestic law, a tax treaty may reduce or eliminate U.S. tax, although risk created by U.S. servers may not be eliminated.

- OECD Commentary to Article 5 notes that having a server at FC's "disposal" may give rise to PE

– Generally, a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. Activities carried on by a person, whether related or unrelated to an enterprise, may create a PE for an enterprise if such persons are dependent agents. This includes persons, whether or not employees of the enterprise, who are not independent agents, and who have the ability to bind the enterprise.

- Use of third party server may not cause dependent agency relationship to the extent third-party provider is legally and economically independent and does not otherwise act for the foreign client or on behalf of its foreign affiliates

Commentary to Article 5, OECD Model

- An Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property.
- A web site, therefore, does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" as far as the software and data constituting that web site is concerned.
- On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

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Commentary to Article 5, cont'd.
ISP/Hosting Arrangements

- Although the fees paid to an ISP may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location.
- In such a case, the enterprise does not even have a physical presence at that location, since the web site is not tangible.
- In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement.

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ISP/Hosting Arrangements, Cont'd.

– However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) <u>and</u> operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met. (OECD Commentary to Article 5)

- Thus, merely leasing servers from an unrelated party (Amazon) may not constitute a PE absent indicia of management and/or operational activity

- However, leasing coupled with operation of the server may constitute a PE

– If there is a PE based on a fixed facility or dependent agent, the profit attribution treaty article must be considered. Consider options to attribute a functional or routine return to U.S. servers based on U.S. or OECD based transfer pricing principles.

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