

Understanding the international tax challenges of software as a service and cloud computing

Insights for technology companies October 2011

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The allure of on-demand computing — and some caveats

Software as a service (SaaS) and cloud computing are fundamentally changing not only companies in the technology industry, but also how companies in all industries do business. Technological advances and the economic pressures of a down economy have fueled a dramatic increase in SaaS and cloud computing. But while companies are enjoying substantial cost savings, whether as users or providers, they may not understand the international tax exposures created by these new delivery models. They may not know how to identify related tax savings opportunities. And they may be hurting their bottom lines.

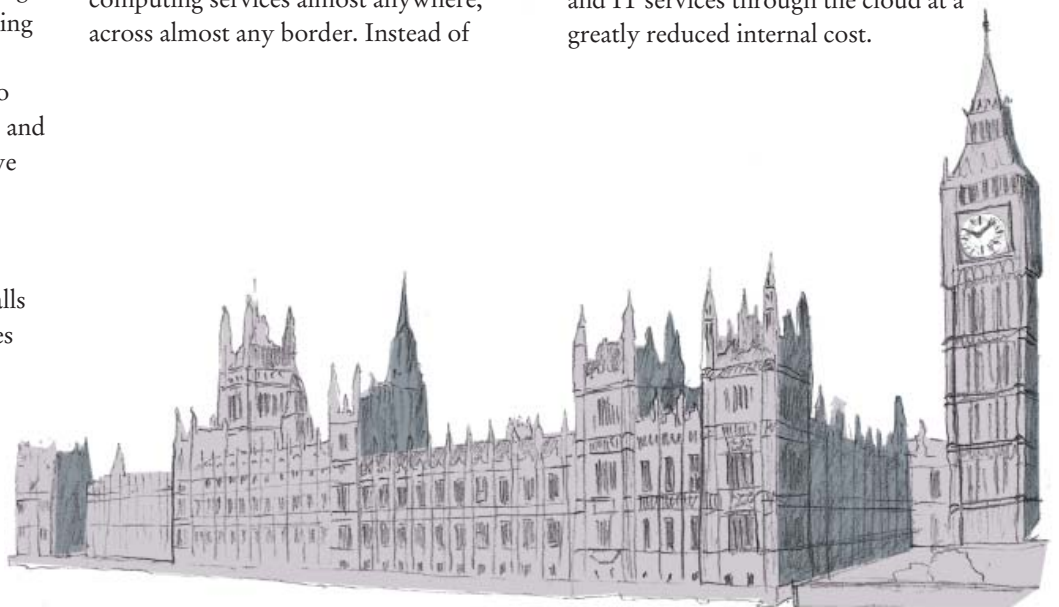
For that reason, before diving into SaaS and cloud computing, providers and users should perform a comprehensive analysis of their proposed business model. Consulting with qualified tax professionals as part of this analysis can help companies avoid costly pitfalls and gain insight into the opportunities presented by this new technology.

How SaaS and cloud computing are changing business

SaaS allows companies to move from licensing software and installing expensive hardware to entering into service contracts for the provision of software. As one might imagine, the potential for cost savings is tremendous, given that companies have historically spent millions of dollars on software, hardware and IT support teams.

While SaaS has changed how companies conduct business, cloud computing has changed where they transact business and how they access data, computing power and storage services. Cloud computing allows SaaS users to gain access to software and computing services almost anywhere, across almost any border. Instead of

maintaining their own IT infrastructure in a single location, companies pay SaaS providers to do this for them over a multistate and multinational network of servers known as a cloud or cloud computing. In other words, cloud computing permits the user to access software and computing power without being concerned about the underlying IT infrastructure. Using the cloud is similar to using electricity: Utility customers buy electricity through the local electrical grid without having to worry about how or where the electricity was generated. Instead of producing their own electricity, customers are billed by a utility company for the service of providing electricity. In the same way, users have access to data and IT services through the cloud at a greatly reduced internal cost.



Further, in a cloud computing environment, it may not be clear exactly where in the cloud the transaction is taking place and therefore which tax authority has jurisdiction. A SaaS provider's cloud may span several continents. For many reasons, such as security concerns and speed of accessibility, the location of the transaction may move through the cloud as the databases replicate to follow time zones. It does not require much imagination to comprehend just how difficult it can be for the tax authorities to make sense of cloud computing. As with a real cloud, they may be able to see the technological cloud, but they can't put their arms around it.

In today's world, the flow of goods and services is not always tangible.

Many countries are struggling to understand SaaS and cloud computing

While the on-demand characteristics of SaaS and cloud computing are a boon for global business, they present something of a conundrum for international tax authorities that are looking for the best way to tax these intangible and often hard-to-categorize services. Historically, countries have developed their own tax laws to define and tax tangible forms of doing business, including the provision of services and the transfer of assets or goods. The power to levy these taxes has been based on the existence of a place of business or the provision of services within the territorial confines of that country. A country's income taxes, value-added tax (VAT) and even its import taxes are all predicated on the tangible flow of goods and services.

But in today's world, the flow of goods and services is not always tangible. Although the Internet has been around for years, few countries have changed their tax laws to address e-commerce. Even when those laws are changed, they typically cover only the simplest of intangible transactions.

SaaS and cloud computing: Paving the way

What can savvy executives do to prepare for the adoption of SaaS or cloud computing?

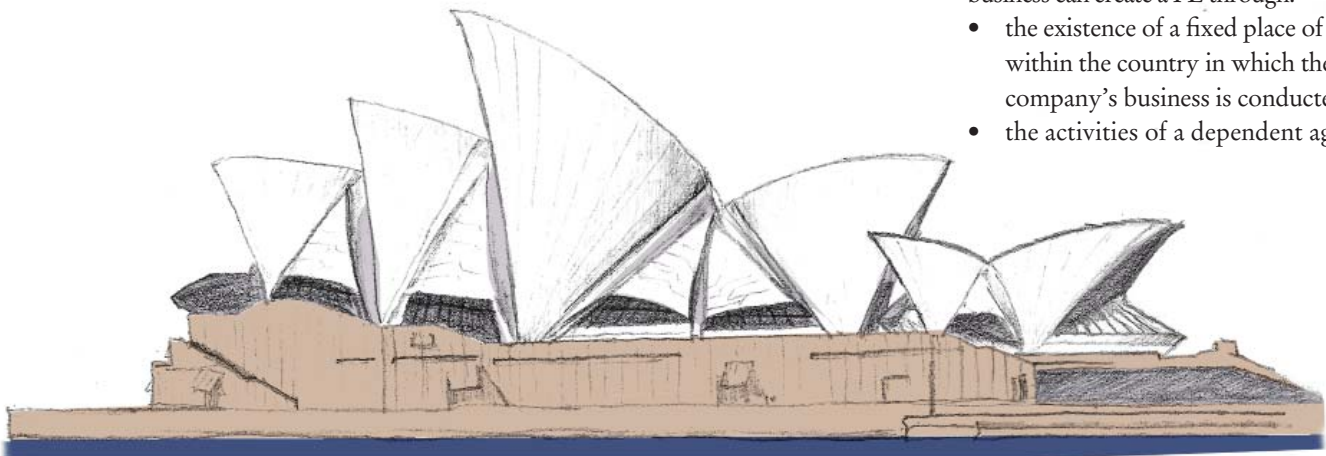
The following recommendations provide a framework that businesses can use to help identify tax savings opportunities and reduce liabilities.

Understand the risk of creating a taxable presence or permanent establishment.

Generally, to be liable for income tax in a particular country, one needs to create a taxable presence in that country or earn revenue that falls under the purview of the country's withholding tax regime. Generally, if the relevant country is party to a treaty, the taxable presence will fall under the permanent establishment (PE) clause. Partly because of the economic downturn, countries have become more aggressive in asserting the existence of a PE, thus causing a rise in the number of PE controversies.

The Organisation for Economic Co-operation and Development (OECD) has taken a close look at the application of PE concepts to e-commerce. Under most treaties and the OECD Model Tax Convention, a business can create a PE through:

- the existence of a fixed place of business within the country in which the company's business is conducted, or
- the activities of a dependent agent.





With regard to SaaS and cloud computing, the tax authorities are considering the ability of a computer server to create a fixed place of business for either a SaaS provider or a SaaS user. In addition, they are thinking about whether a SaaS provider might be a dependent agent of a SaaS user.

The commentary appended to the OECD Model Tax Convention stipulates that owning computer hardware signals the presence of a fixed place of business. However, if the activity the company performs while using the equipment is of a preparatory or auxiliary nature, then a PE is generally not created. In the realm of e-commerce, it can be difficult to determine the scope and nature of all of the activities taking place. If a PE is formed, then the authorities will apply transfer pricing methodologies and allocate profit to the PE on which tax will be assessed. On the other hand, if a company such as a user of SaaS or cloud

computing does not lease or own the server hardware, then it is likely that a PE does not exist. It may be easier for users of SaaS or cloud computing to fall under this exception than it is for providers. But as we have seen, countries do levy taxes on the provision of services, and activities that involve SaaS or cloud computing may not be exempt from those taxes.

Recently, the tax authorities' more aggressive enforcement approach has made it imperative for technology companies to engage in comprehensive planning that helps them minimize their tax exposure. With proper tax planning, users of SaaS and cloud computing may be able to avoid creating a PE in some countries. For providers that own the cloud infrastructure, the proactive use of transfer pricing and the proper placement of substance, functions and risks can lower the amount of profit allocated to PEs in high-tax countries while raising the amount of profit allocated to low-tax countries.

Develop a supply chain strategy that is tax-efficient and aligned with the company's commercial objectives.

In the context of SaaS and cloud computing, the development of a supply chain strategy involves identifying the user base for services and determining the necessary placement of hardware, software and functions. The company should keep in mind that the ownership and location of hardware may create a taxable presence in a given country. Once optimal locations have been decided upon, the company should assess the risk of creating a taxable presence or PE by analyzing relevant laws and treaties of countries where hardware would be located and SaaS and cloud computing would occur. This analysis should also address VAT implications and transfer pricing requirements with respect to each country. In performing this analysis, a company must gain a clear understanding of the activities to be offered or accessed through SaaS and cloud computing, and how those activities would be characterized and sourced by the relevant tax authorities for income tax and VAT purposes. Further, executives should think about how intellectual property (IP) rights will need to be shared within the company, among subsidiaries and across international borders, and the company should be aware of the tax implications of shared IP rights. Finally, the company should work with legal advisers to draft third-party contracts and intercompany agreements that support the chosen strategy, and use transfer pricing appropriately. The company should review all contracts that cover SaaS and cloud computing in order to know what is being provided and taxed in each location.

Know the VAT implications.

The concept of a PE varies from country to country and is defined in income tax treaties, while in the absence of a treaty the concept of taxable presence is defined under local law. If liability for tax is not created by means of a PE, a liability may still exist for VAT or withholding purposes. For instance, within the European Union (EU), the electronic delivery of software (e.g., when it is accessed via the cloud or downloaded) is deemed a service for VAT purposes.

Moreover, when the items are provided by a U.S. supplier that has no presence in the EU, the place of supply (i.e., where the items are taxed) is considered to be where the customer is located. Business customers can generally self-assess for the local VAT in their member states through the reverse-charge mechanism. However, if software is sold to private individuals, the U.S. supplier must register and charge VAT where the customer is located.

Instead of having to account for VAT separately in each of the 27 EU member states, the company may obtain a single EU registration number, and the relevant amount of VAT that is collected (15–25 percent, based on where the customer is located) is paid and reported on a single online return. If sales are a mixture of B2B and B2C, then VAT registration numbers should be requested from EU business customers (and retained as evidence) in order to distinguish these businesses from private individuals, to whom local VAT is charged.

These VAT requirements are not exclusive to software. They apply to almost all digitally or electronically supplied services for which the supplier is outside the EU — e.g., Web hosting; downloaded music and video games; and access to images, databases, information, virtual goods and e-books. Other jurisdictions outside the EU (e.g., Switzerland) have implemented similar rules with regard to taxation of digital services that are offered to private individuals.

Therefore, the company must know the character of its transactions in order to classify them for VAT and withholding purposes. The United States has complicated laws for determining whether a transaction is a license, rental, sale, or provision of service or know-how. The relevant country will need to consider whether accessing the cloud — including software or servers used for data storage — is the provision of a service, the transfer of software, or the provision of content or information. Making this assessment is not easy and usually involves a detailed review of specific facts and legal arrangements.

Decide how IP rights should be shared.

In addition to considering VAT implications, businesses must decide how IP rights should be shared among subsidiaries and across international borders, and must examine the tax implications of that sharing. Third-party contracts and intercompany agreements may be required to support the chosen strategy and, with regard to the latter, the method of transfer pricing that is used. (For a detailed discussion of financial, operational and compliance risks pertinent to the SaaS sector, see the Grant Thornton LLP survey *Issues and trends: Assessing and managing SaaS risk.*)



Analyze the delivery and use of SaaS and cloud computing under ASC 740-10.

For public companies, the tax pitfalls of SaaS and cloud computing are of real concern. Public companies are required under ASC 740-10 (formerly FIN 48) to account for uncertainty in income taxes. ASC 740-10 provides that a tax uncertainty may cause a contingency for which a reserve is necessary. Not only is this reserve required for U.S. income taxes, it's also mandatory for income taxes in foreign countries. Therefore, companies must assess how each foreign tax authority will treat, characterize and possibly tax their SaaS and cloud computing activities. This assessment can be a daunting task, but it is one that must be performed if costly restatements are to be avoided.

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The need to be proactive

Companies need to take the lead in understanding and planning their tax exposure based on their delivery or use of SaaS and cloud computing. Otherwise, they may find themselves shouldering a heavier tax burden than necessary. In today's depressed global market, many countries continue to deal with budget shortfalls and an eroding tax base. These pressures are causing them to be more aggressive in their audits, thus giving rise to more PE controversies than in the past. If a particular country concludes that a SaaS provider or user has created a PE, the tax authorities will allocate a certain amount of profit to that PE and will subject that profit to tax. In an ideal world, this increase in taxable income in one jurisdiction would be accompanied by a decrease in taxable income in another. In reality, though, the country on the losing end will generally not agree to the reduction in taxable income without a contest, which usually involves a lengthy competent authority process. There is no guarantee that a reduction in taxable income will be granted; therefore, the company may end up facing double taxation.



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