



**34th Annual TEI-SJSU High Tech Tax Institute**

# Keep Your Head in the Clouds

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## Agenda

- Introduction
- Revenue Characterization Developments
  - German Software Decree
  - UK
  - India: MasterCard Case
  - Australia
  - Malaysia
- Impact of Select U.S. Tax Reform Provisions on Cloud Structures
  - BEAT implications
  - FDI considerations

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# Cloud Computing Model Overview

- Three broad service models used to describe cloud computing market
  - Infrastructure-as-a-Service (“IaaS”)
  - Platform-as-a-Service (“PaaS”)
  - Software-as-a-Service (“SaaS”)
- Dominant international tax characterization of cloud service payments as “business profits,” subject to taxation in the location where the service is performed
  - OECD Article 12 commentary

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# Growth of Cloud Computing

**Table 1. Worldwide Public Cloud Service Revenue**

The chart displays worldwide public cloud service revenue from 2010 to 2019. The data is presented as a bar chart with a blue background and white bars. The x-axis represents the years from 2010 to 2019, and the y-axis represents revenue in billions of dollars. The revenue shows a significant increase over the period, starting around \$10 billion in 2010 and reaching approximately \$100 billion by 2019. The chart is heavily distorted with digital noise and artifacts, making the data difficult to read.

Year	Revenue (Billions of Dollars)
2010	~10
2011	~15
2012	~25
2013	~40
2014	~60
2015	~80
2016	~100
2017	~120
2018	~140
2019	~160

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# Growth of Cloud Computing

Table 1: Cloud Spend Proportion by Category

Category	2018	2019	2020	2021	2022
Software	55%	58%	60%	62%	65%
Infrastructure	13%	15%	18%	20%	22%
Security	10%	12%	14%	16%	18%
Other	12%	15%	18%	20%	25%

# German Software Decree



- Inconsistent treatment of SaaS transactions by local tax offices, resulting in difficulty in getting withholding tax exemption certificates
- Withholding tax on payments “for the provision of the use of, or the right to use, rights, in particular copyrights” if either (1) the rights are exploited in Germany, or (2) the recipient has a fixed place of business or a permanent representative in Germany
- Decree requires “comprehensive rights to use the software for commercial exploitation.”
  - No WHT on payment from German customer to foreign SaaS provider
  - WHT still applies to payment from German reseller of SaaS, even if services are provided from outside Germany

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# UK – Background



- In the Autumn Budget 2017 the UK announced its intent to extend the types of income on which non-resident persons are liable to UK income tax.
  - Signaled intent to tax royalties and other payments for certain rights that are used to support UK sales and are realized in a “no tax” or “low tax” jurisdiction.
- On December 1, 2017, HM Revenue & Customs (“HMRC”) and HM Treasury published a consultation addressing potential changes to the UK withholding tax rules and invited comments on the proposed approach
  - Consultation closed February 23, 2018
- On October 29, 2018 the UK government released its responses/conclusions based on the consultation
  - Signaled intent to continue to pursue multinational action to “ensure that profits are taxed where value is created.” In the interim, the UK will pursue unilateral action “where the international tax framework is not working effectively and not being updated.”

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## UK – Digital Tax

- On October 29, 2018, the UK announced that Prime Minister Theresa May's government would introduce a 2% tax on UK digital sales
  - Effective April 2020
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## UK – Tax on Low-Tax Offshore Entities



- New Proposed Tax on Low-Tax Offshore Entities - announced October 29, 2018
  - Decision not to pursue changes to the withholding tax rules
  - “The objective of the measure continues to be targeting multinational groups that realise income from UK sales in low-tax offshore jurisdictions where intangible property is held.”
  - “Rather than achieving that through an extension of the UK withholding tax, and in response to concerns that were expressed about that approach, the government now proposes to directly impose UK tax on low-tax offshore entities that realise the income that a multinational group receives from UK sales in respect of intangible property.”



UK –



## UK – Tax on Low-Tax Offshore Entities

- Applicable to Cloud services?
  - Schedule in the draft legislation is entitled “Offshore Receipts in Respect of Intangible Property”
- Tax applies to any “UK-derived amounts” realized by a taxpayer during any taxable year
- “UK-U95

## India: MasterCard Case

- MasterCard Singapore provides services to banks in India
- Indian Authority for Advance Ruling found a PE multiple ways
  - MIP devices at banks considered “at the disposal” of Singapore
  - MasterCard network is FPOB at the disposal of Singapore
  - Bank premises are at the disposal of Singapore
  - Indian affiliate is a FPOB PE of Singapore
  - Employees visiting India create a services PE
  - Indian affiliate is a dependent agent that may exercise contracting authority
- Expansive interpretation of PE rules has implications for cross-border 09.2 20

## Australia

- Australian Treasurer’s May 2018 announcement of the federal budget signaled continued monitoring of international developments and approaches of other countries to determine Australia’s approach
  - Speculation that Australia would pursue either a digital PE approach or introduce a digital services tax
- In October 2018 Australia Treasury released a discussion paper entitled “The digital economy and Australia’s corporate tax system”
  - Outlines the impacts of the digital economy
  - Seeks input to enable Australia to design an “interim measure” to tax digitized



# Australia



- Background of the Proposal

- First announced by Australia's Treasurer, Scott Morrison (the current Prime Minister)
- Original estimate of \$200M/yr of additional tax revenues
- Originally raised in the context of a political discussion of reducing corporate tax rates in response to U.S. reform and the need to make Australia more competitive
- Is Australia viewing a digital tax as a mechanism to increase tax on multinationals a means for funding a local tax cut?
  - BEAT inspired?

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# Australia

- Discussion Paper's "Appendix" outlines the "design considerations for an interim measure"
  - Is this the outline of the leading proposals?
  - Important implications for cloud businesses
- The Appendix notes that a number of countries tax the view that an interim digital tax could focus on businesses providing internet advertising or digital intermediation services.
  - Internet advertising can be supplied remotely without the supplier. Yet, to deliver

## Australia

- The Appendix states that “[T]he OECD suggests that countries may consider excluding from the definition of digital intermediation platforms the provision of financial services, e-sales, cloud computing, transactions involving physical goods and the provision of non-intermediary services. Extending an interim measure to digital intermediation platforms may raise further challenges, given no country has yet implemented such a measure on these businesses.”

## Malaysia




- Change in Malaysian Tax Act of 1967 that characterize all payments “in respect of software” as giving rise to royalties that are subject to Malaysian withholding tax (effective as of January 17, 2017)
- Unclear as to the meanings of the phrase “in respect of software”
  - Cloud services all contain some element of services delivered via software applications
  - Software is typically not downloaded by the client in a cloud-based model
  - What is the intended breadth of “in respect of”?
    - Should this be determined based on a predominate character test?
  - What was intended with respect to “software”?
    - Did the Malaysian government intend this to apply to typical software model, where the customer download a software copy?

# Impact of Select U.S. Tax Reform Provisions on Cloud Structures


# Base Erosion and Anti-Abuse Tax (BEAT)

- New section 59A is an alternative minimum tax imposed on US corporate taxpayers making “base erosion payments”
- 10% tax on “modified taxable income” (5% in 2018, 12.5% after 2025)
- Key concepts
  - Applicable taxpayer
  - Base erosion percentage
  - Base erosion tax benefit
  - Base erosion minimum tax
- For payments in tax years beginning after December 31, 2017



## Base Erosion Percentage

- Ratio of base erosion tax benefits to:
  - Total deductions
  - Plus other base erosion tax benefits that are not deductions
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## Base Erosion Tax Benefit

- General Rule
  - Any deduction for a payment to a foreign related party
  - In case of a payment to acquire property from a foreign related party, amortization/depreciation with respect to such property
  - Reinsurance premiums paid to a foreign related party
- Special Rule for Surrogate Foreign Corporations
  - Any reduction in gross receipts (e.g., COGS) for a payment to:
    - a foreign related party that becomes a SFC after November 9, 2017, or
    - a foreign person that is a member of the same expanded affiliated group as such SFC

# Base Erosion Tax Benefit Exceptions

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# Base Erosion Minimum Tax

- The BEAT tax equals the excess of
  - Modified taxable income  $\times$  the BEAT tax rate, over
  - Regular tax liability + R&D credits + limited \$38 credits
- Modified taxable income equals
  - Regular taxable income
  - Plus base erosion tax benefits
  - Plus base erosion percentage  $\times$  NOL deduction under §172

# BEAT Example

Regular taxable income	2,000	R&D service fee	800
Research and development credit	2,450	50% of interest payments	150
Low margin services	4,500	Low margin services	200
Interest subject to 15% WHT	450	Other deductions	21,900
Denominator of base erosion percentage	10% of modified taxable income	NOL carryforward	500
Other deductions	23,700	Total deductions	23,700
Regular tax liability	370	Adjusted tax liability	30
Base erosion percentage	10%	Adjusted tax liability	30
Regular tax liability	370	Adjusted tax liability	30

# BEAT Regulatory Authority

- Treasury shall issue guidance necessary or appropriate to carry out the provisions of section 59A, and as needed to prevent the avoidance of the purposes of section 59A, including through:
  - the use of unrelated persons, conduit transactions, or other intermediaries, or
  - transactions or arrangements designed to
    - characterize payments otherwise subject to the BEAT as not subject to the BEAT, or
    - substitute payments not subject to the BEAT for payments otherwise subject to the BEAT



## Observations and Questions on the BEAT

- NOL utilization and tax credits, including FTCs, can trigger BEAT tax
- Outbound payments that give rise to subpart F or GILTI double-taxed
- Does the SCM exception apply if mark-up not separately invoiced?
- What besides COGS might qualify as a reduction in gross receipts?





# FDII and the Cloud



## The FDI Deduction of § 250 – Overview

- Section 250(a)(1) provides domestic corporate taxpayers with a deduction



## The FDII Deduction of § 250 – The Big Picture

- Under a 21% U.S. corporate tax rate, the effective tax rates on GILTI and FDII for taxable years beginning after 12/31/15:
- GILTI:
  - 13.125% GILTI rate
  - Due to 80% limit on FTCs for GILTI per § 960(d), the minimum foreign tax rate at which no U.S. residual tax will be owned is 16.406%
- FDII
  - 16.406%

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## Section 250 Mechanics

- FDII is an approximation of the domestic corporation's taxable income from exploiting intangible property outside the U.S.
- FDII formula:

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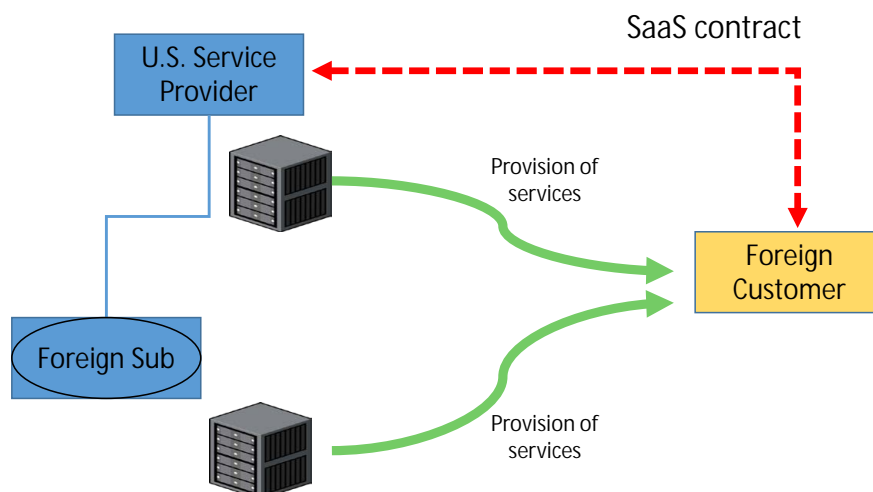
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# Deduction Eligible Income

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- “Deduction Eligible Income” means the excess (if any) of the gross income of the corporation over the deductions properly allocable to such income, determined without regard (excluding) the following categories of income:
  - Subpart F inclusions;
  - GILTI inclusions;
  - Financial services income (as defined in § 904(d)(2)(D));
  - Dividends received from CFCs;
  - A4(e7.156 07Tw 2)-46mestic oil7Tw 2d ga156 07Tw -7/4(edx)-6ic20.8(ac0.9(m)1(ic)3(i

# Section 250 – Foreign Branch Income Exclusion



# Foreign Derived Deduction Eligible Income

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- “Foreign Derived Deduction Eligible Income” is defined at §250(b)(4) as the (oTextF1.8( )TJO Tc 0 Tw (\$Tj[(2)0.6(5)0.5(0)0x(c)48m(p9(t)-1a)6(c5(





## Will FDII Survive WTO Challenge?

- DISC and FSC revisited?
- On December 11, 2017 the Finance ministers from the five largest EU economies sent a joint letter to U.S. Treasury Secretary Mnuchin outlining concerns with respect to three proposed measures in the House and Senate bills – FDII was identified as problematic
  - “The proposed incentive [FDII] would subsidize exports compared with the domestic consumption. It could therefore face challenges as an illegal export subsidy under WTO Subsidies and Countervailing Measures Agreement rules.”
  - Asserts FDII is not compliant with BEPS consensus on accepted IP regimes