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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
  - FDII considerations

Introduction

Cloud Computing Model Overview

- Cloud computing is based on a virtual network
  - Shared pool of configurable computing resources used to service multiple customers
  - Servers can be located anywhere and networks of servers (frequently spread across various locations) are used to deliver services to customers
  - On-demand self-service access for customer base
- Flexibility for cloud customers
  - Provides flexibility to scale computing needs up and down based on changing needs
  - Lower infrastructure costs for customers – cloud service provider makes the capital investment which is leveraged by multiple customers
  - Reduced risk of obsolescence for customers

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

Growth of Cloud Computing

Table 1. Worldwide Public Cloud Service Revenue Forecast (Billions of U.S. Dollars)

	2017	**2018**	**2019**	**2020**	**2021**
Cloud Business Process Services (BPaaS)	42.2	46.6	50.3	54.1	58.1
Cloud Application Infrastructure Services (PaaS)	11.9	15.2	18.8	23.0	27.7
Cloud Application Services (SaaS)	58.8	72.2	85.1	98.9	113.1
Cloud Management and Security Services	8.7	10.7	12.5	14.4	16.3
Cloud System Infrastructure Services (IaaS)	23.6	31.0	39.5	49.9	63.0
Total Market	**145.3**	**175.8**	**206.2**	**240.3**	**278.3**

BPaaS = business process as a service; IaaS = infrastructure as a service; PaaS = platform as a service; SaaS = software as a service
Note: Totals may not add up due to rounding.

Source: Gartner (September 2018)

Growth of Cloud Computing

Table 1: Cloud Shift Proportion by Category

	2018	2019	2020	2021	2022
System infrastructure	11%	13%	16%	19%	22%
Infrastructure software	13%	15%	17%	18%	20%
Application software	34%	36%	38%	39%	40%
Business process outsourcing	27%	28%	29%	29%	30%
TOTAL	**19%**	**21%**	**24%**	**26%**	**28%**

Source: Gartner (August 2018)

Revenue Characterization Developments

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

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.”

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
  - Limited to companies with global revenue of at least £500 million (US $641 million)
  - UK government estimates that the digital tax could eventually raise £400 million annually

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 reaslise 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 – Tax on Low-Tax Offshore Entities

- "Under the proposal, there will be a UK income tax charge on the gross income realized by a foreign resident entity in respect of intangible property, or rights over that property, that is used to generate UK sales revenues."
- "That includes the use of intangible property to support sales made directly by the foreign resident entity or a related party to UK persons."
- Effective April 2019
- Indirect rule to capture sales through related and unrelated parties
- Exception for foreign entities that are residents of jurisdictions that have income tax treaties with the UK that contain non-discrimination provisions
- The new tax will not apply where the tax on the income paid by the foreign entity is at least 50% of the UK income tax that would otherwise arise under the measure
- De minimis provision of £10 million UK sales

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-derived amounts" includes "an amount (whether of revenue or capital nature) in respect of the enjoyment or exercise of rights that constitute intangible property" and "the enjoyment or exercise of those rights … enables, facilitates or promotes UK sales (directly or indirectly)"
- "UK sales" is defined as "any services, goods or other property" provided in the UK or to persons in the UK

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 provision of cloud services

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 business, pending OECD consensus on the matter
  - Not law – “[T]his paper is merely a guide as to how principles might operate.”
  - Comments due November 30, 2018

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?

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 targeted advertising, these businesses rely heavily on user data, and intangible assets to process that data.
  - Intermediation services, sometimes referred to as "platforms", match buyers and sellers on websites or apps. Notes the OECD definition of "intermediation services" excludes websites operated by businesses to supply their own goods or services to customers (e.g., airline sites for booking flights).

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."
- Raises questions regarding adoption of a longer-term virtual PE approach
- States any approach should limit any interim provision to businesses above a certain revenue threshold – outlines a number of options
- Emphasizes the need for any interim provision to be temporary, pending the development and adoption of a multilateral solution.

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

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

Applicable Taxpayer under the BEAT

- Three requirements:
  - A corporation other than an RIC, REIT, or S corporation
  - At least $500 million in average annual gross receipts over the preceding 3 taxable years
  - A “base erosion percentage” for the taxable year of 3% or more (2% for banks and registered securities dealers)
- Aggregation rule: All US and foreign corporations in the same group (using a 50% control test) are included for the above test
- Staying below the 3% threshold turns off the BEAT!

Base Erosion Percentage

- Ratio of base erosion tax benefits to:
  - Total deductions
  - Plus other base erosion tax benefits that are not deductions
  - Minus deductions under sections 172, 245A, and 250
  - Minus payments for certain excluded services and qualified derivatives

$$\frac{Base\ Erosion\ Tax\ Benefits}{Deductions + Other\ Benefits - Excluded\ Deductions}$$

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

- Payments that reduce gross receipts (e.g., COGS) other than to a SFC
- Payments at cost for low-margin services
  - Services qualify for the services cost method (without regard to the business judgment rule)
  - Amount limited to the cost, without a mark-up
- Payments for qualified derivative contracts
- Payments subject to withholding tax at full statutory rate
  - Exception prorated if withholding tax imposed at a lower rate

Base Erosion Minimum Tax

- The BEAT tax equals the excess of
  - Modified taxable income × 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 × NOL deduction under §172

BEAT Example

Regular Income Tax

Gross income	25,700
Payments to foreign related parties	
R&D service fee	800
Low margin services	200
Interest subject to 15% WHT	300
Other deductions	21,900
NOL carryforward	500
Total deductions	23,700
Taxable Income	2,000
21% income tax	420
Tax credits	(50)
Regular tax liability	370

Base Erosion Tax Benefits

Base erosion tax benefits	
R&D service fee	800
50% of interest payments	150
Reinsurance payments	1,500
	2,450
Denominator of base erosion percentage	
Total deductions	23,700
Reinsurance payments	1,500
Low margin services	(200)
NOL carryforward	(500)
	24,500
Base erosion percentage	10%

Base Erosion Minimum Tax

Modified taxable income	
Regular taxable income	2,000
Base erosion tax benefits	2,450
NOLs x base erosion percentage	50
	4,500
10% of modified taxable income	450
Regular tax liability	370
R&D credits, etc.	30
Adjusted tax liability	400
Base erosion minimum tax	50

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?
- What costs can be capitalized under section 263A as COGS?
- What options are there to net inbound and outbound payments?
- Disregard payment to related party if ultimately to a third-party?
- NOL carryover multiplied by which year's base erosion percentage?
- When are payments to or from partnerships base erosion payments?

BEAT Planning Ideas

- Stay under the 3% base erosion percentage threshold!
- Defer deductions to delay impact of the BEAT
- Make prepayments before effective date of the BEAT or in first year
- Break out payments for SCM services
- Use cost sharing or restructured contractual relationships to net flows
- Check foreign subs into the US to eliminate base erosion payments
- Create direct third-party transactions with the US
- Invert flows to turn outbound payments into inbound payments
- Convert US licensee into buy-sell distributor

FDII and the Cloud

The FDII Deduction of § 250 – Overview

- Section 951A triggers a GILTI gross income inclusion for U.S. shareholders of certain foreign corporations
- Section 250 provides two levels of tax relief for domestic corporate taxpayers:
  - a <u>deduction</u> based on the corporation's GILTI income inclusion; &
  - a <u>deduction</u> based on the corporation's "foreign derived intangible income" ("FDII")
- Regulatory guidance is pending

The FDII Deduction of § 250 – Overview

- Section 250(a)(1) provides domestic corporate taxpayers with a deduction for the 8 taxable years beginning after 12/31/17 and before 1/1/26 equal to the following:
  - 37.5% x FDII, and
  - 50% x (§ 951A GILTI inclusion + § 78 gross-up attributable to GILTI)
- For taxable years beginning after 12/31/25 the § 250(a)(1) deduction percentages are reduced to:
  - FDII: 21.875%
  - GILTI: 37.5%
- Deduction limited to C-corps that are not RICs or REITs
- Deduction not in excess of current year income

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 12/31/17 and before 1/1/26:
- GILTI:
  - 10.5% 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 is owned is 13.125%
  - As foreign taxes on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rates range between 10.5% and 13.125%
- FDII
  - 13.125%

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%

Section 250 Mechanics

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

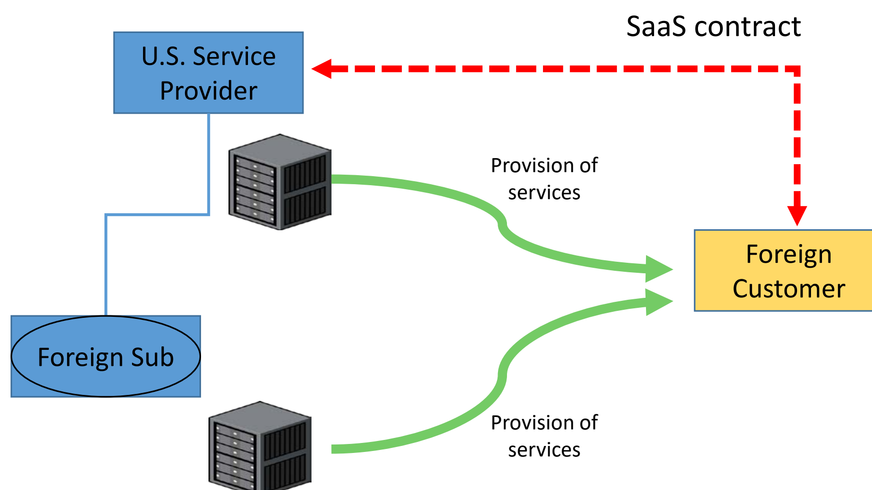
$$FDII = Deemed\ Intangible\ Income \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

Deduction Eligible Income

$$FDII = Deemed\ Intangible\ Income \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

- "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;
  - Any domestic oil and gas extraction income; and
  - Any foreign branch income

Section 250 – Foreign Branch Income Exclusion



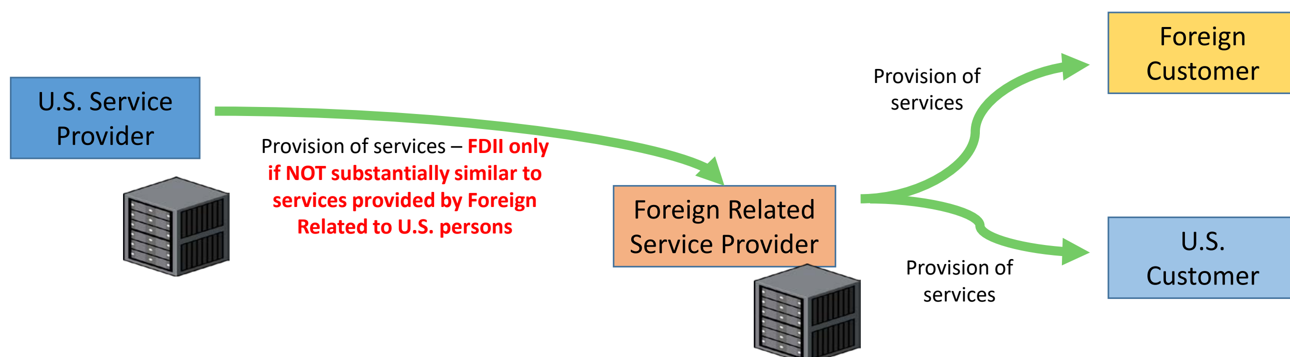
Foreign Derived Deduction Eligible Income

$$FDII = Deemed\ Intangible\ Income \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

- "Foreign Derived Deduction Eligible Income" is defined at §250(b)(4) as the taxpayer's Deduction Eligible Income derived in connection with:
  - Property sold by the taxpayer to any person who is not a U.S. person, provided the property is for "foreign use;" and
  - Services provided by the taxpayer to "any person, or with respect to property, not located within the United States"
- Must be established to the satisfaction of the Secretary
- Is there a foreign use/consumption test for services?

Foreign Derived Deduction Eligible Income

- Related party exception for services - §250 The provision of services to a foreign related party <u>will not qualify as FDII</u>, <u>unless</u> the service is not substantially similar to services provided by such related party to U.S. persons



Deemed Intangible Income

$$FDII = Deemed\ Intangible\ Income \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

- "Deemed Intangible Income" is defined as the excess (if any) of a domestic corporation's deduction eligible income over its "deemed tangible income return"

Deemed Intangible Income = Deduction Eligible Income – Deemed Tangible Income Return

- The "Deemed Tangible Income Return" is defined as an amount equal to 10% of the corporation's QBAI

Deemed Intangible Income = Deduction Eligible Income – (10% × QBAI)

- In short, the Deemed Intangible Income calculation is equal to the corporation's Deduction Eligible Income less a fixed 10% return on the adjusted bases of the corporation's active trade or business assets

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