

Taxation of Electronic Commerce – Issues In Cloud Computing

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Characterization and Server/PE Developments

Cloud Revenue – United States

Character of Income

- Threshold issue for U.S. and non-U.S. tax purposes**
- Depending on the particular transaction, leading possibilities include:**
 - Sale**
 - License**
 - Lease**
 - Services**
- U.S. Treasury/IRS seeking public comments**
- Treas. Reg. §1.861-18: Similar principles adopted by other countries (e.g., Singapore).**

Character – Treas. Reg. § 1.861-18

- Transfer of a copyright right (sale or license)**
- Transfer of a copyrighted article (sale or lease)**
- Provision of services in developing a computer program or provision of know-how relating to programming techniques (scope of services transactions subject to -18 is very limited)**
- Preamble explains that “functionally equivalent transactions should be treated similarly”**
- Rules apply “irrespective of the physical or electronic or other medium used to effectuate a transfer”**

Character – Section 7701(e) Services vs. Lease

- Referenced in OECD e-commerce report**
- Factors favoring a services characterization:**
 - Customer not in “physical possession” of property**
 - Customer does not “control” the property**
 - Customer does not have a significant economic or possessory interest in the property**
 - Service provider bears risk of nonperformance**
 - Service provider uses the property concurrently to provide services to persons other than the Customer**
 - Payments for access to software substantially exceed rental value of software without any charge for services**
- ?**

Source of Income

- **Services: Place of performance**
 - Where are cloud services performed (e.g., where software developer developed the software and other necessary people functions are performed, where the server hosting the software is located, where the customer accesses the software)?
- **Rents/Royalties: Place of use**
 - Where is software used
- **Sales: Sourced where title and risk of loss passes**
 - Where does the risk of loss pass in an electronic download?

Applying Subpart F

Category of Revenue	Applicable Subpart F Provision
Sale of copyrighted article	Foreign base company sales income
Sale of copyright right	Foreign personal holding company income
License of copyright right	
Lease of copyrighted article	
Transfer of know-how	
Services	Foreign base company services income

Subpart F Concerns with Cloud Services

- Hosting in the US pushes the CFC over the 80% cost threshold for substantial assistance
 - Move hosting offshore
 - Direct contract with third-party providers of power, bandwidth, and data center services
- Performing services a related party was obligated to perform (*i.e.*, on behalf of)
- Structuring for same-country performance of services
 - Where are cloud services performed?
 - Attribution of activities: see *Miller* and *Le Beau Tours*

Cloud Revenue – Non-U.S.

Non-U.S. Characterization Cases - *eBay*

- *eBay International AG v. ADIT* (2012)**
 - eBay International AG operated India-focused websites that allowed Indian users to buy and sell goods and services**
 - The Indian tax authorities characterized user fees that eBay International received from Indian users as fees for technical services, which were subject to Indian withholding tax**
 - The Income Tax Appellate Tribunal in Mumbai (ITAT (Mumbai)) observed that Indian law defines fees for technical services to mean “any consideration . . . for the rendering of any managerial, technical or consultancy services”**

Non-U.S. Characterization Cases – eBay (Cont'd)

- The ITAT (Mumbai) ruled that the user fees did not constitute fees for technical services because the Indian websites were “platform[s] for doing business” and did not provide managerial services to Indian users; represented a “standard facility,” the use of which did not constitute availment of a technical service; and did not allow Indian users to consult with eBay International**

Non-U.S. Characterization Cases - *Pinstorm*

- ***Pinstorm Technologies Pvt. Ltd. v. ITO (2012)***
 - Pinstorm purchased key word advertising from Google Ireland on behalf of Pinstorm's Indian clients
 - The case turned on whether Pinstorm's payments were for the right to use industrial, commercial, or scientific equipment and thus constituted royalties
 - The ITAT (Mumbai) ruled that the payments did not constitute royalties because Google Ireland posted the advertisements of Pinstorm's clients, and Pinstorm did not have the right to and in fact did not access the Google portal
 - *Pinstorm* followed a similar decision of the ITAT (Mumbai) in *Yahoo India Pvt. Ltd. v. DCIT (2011)*

Non-U.S. Characterization Cases – *Right Florists*

- *ITO v. Right Florists Pvt Ltd (2013)***
 - An Indian florist made payments to Google and Yahoo for online advertising**
 - The Income Tax Appellate Tribunal in Kolkata (ITAT (Kolkata)) ruled that Google and Yahoo did not have Indian fixed place of business PEs because the servers on which the websites were hosted were not located in India**
 - The ITAT (Kolkata) also ruled that the florist neither paid equipment royalties to Google or Yahoo under the ITAT (Mumbai)'s decisions in *Pinstorm* and *Yahoo* nor paid fees for technical services – i.e., managerial, technical, and consultancy services – because the services were entirely automated and did not involve human intervention**

Non-U.S. Characterization Cases – *ThoughtBuzz*

- *In re ThoughtBuzz Pvt. Ltd. (2012)*:
 - Indian users paid subscription fees for ThoughtBuzz to use its crawlers to monitor and compile online content about their brands, industries, and competitors
 - Users did not control the ThoughtBuzz software and were limited to accessing the uncopyrighted, non-proprietary content that ThoughtBuzz made available
 - The Indian tax authorities argued that the ThoughtBuzz crawlers were “store[s] of data based information” and that the users made royalty payments for “information concerning technical, industrial, commercial or scientific knowledge, experience, or skill”
 - The Indian Authority for Advance Rulings agreed

Non-U.S. Characterization Cases - *Wipro*

- *CIT v. Wipro Ltd. (2011)*:**
 - Wipro made outbound payments for access to a U.S. database maintained by the Gartner Group**
 - The Karnataka High Court concluded that accessing the Gartner database without a user agreement would have constituted copyright infringement**
 - The Karnataka High Court then held that Wipro paid for a “right to access” the database which amounted to a “transfer of [the] right to use the copyright held by . . . Gartner” and that Wipro’s payments represented royalties subject to Indian withholding tax**

Non-U.S. Characterization Cases - *Amadeus*

– *Amadeus* (2006)

- Iberia Airlines paid Amadeus to use the Amadeus computer travel reservation and distribution system, which provided information, communication, reservations, ticket issuance, distribution and related functions**
- The Spanish Supreme Court reasoned that the right to use a computer program represented a right to use intellectual property**
- The Spanish Supreme Court held that the payments made by Iberia to Amadeus for such use and access to the Amadeus computer program should be characterized as royalties, not income from services**

Server/PE

Fixed Place of Business

- Potential for permanent establishment
- When does enterprise have premises “at its disposal”?
 - Control over physical assets
 - Need personnel physically present at the server location?
 - Remote manipulation of software and data okay?
 - Remote monitoring of hardware okay?
- Do the preparatory/auxiliary activities exceptions apply (e.g., where a mirror server is used to reduce latency (access times) or to provide redundancy in case of a server malfunction)?
- Impact of BEPS and Action Items on PE and Digital Economy?

Fixed Place of Business – OECD Commentary

- A website, by itself, does not give rise to a PE because it does not constitute tangible property**
- However, a server on which the website is stored and through which it is accessed may result in a PE because it requires a physical location**
- Distinction drawn between computer equipment (which may result in a PE) and the “data and software which is used by, or stored on, that equipment”**

Fixed Place of Business – OECD Commentary (Cont'd)

- ISP arrangement does not typically result in a PE because the location of the server is not “at the disposal of” the foreign enterprise, even if the taxpayer can determine that its website should be hosted on a particular server at a particular location
- Foreign enterprise does not “own (or lease) and operate” the server
- Treatment of auxiliary/preparatory activities (e.g., advertising of goods or services and supplying information)

PE Issues Relating to Data Centers – Canada

- Recent Canadian published ruling that a data center owned and operated by a Canadian affiliate of a U.S. parent company does not constitute a PE for the U.S. parent (CRA document 2012-0432141R3).**
- Relevant facts:**
 - USCo derives income from advertising services (the advertisers' content is stored on the taxpayer's servers) and from developers (who sell their digital content through the taxpayer's website);**
 - Canco owns a data center and owns (or leases) the servers and equipment;**
 - USCo pays an arm's length fee to Canco for website and data hosting capacity, including for advertising content;**

PE Issues Relating to Data Centers – Canada (Con

- Canco employees are principally responsible for installation, operation, maintenance, and repair of the equipment in the data center;**
- Access to the data center is limited to Canco's employees;**
- USCo's employees have restricted access to the data center, are required to show identification, and are escorted during visits.**
- Small group of USCo employees authorized by Canco to visit the data center from time to time to inspect, maintain, etc.**
- **Applications and data hosted in the data center are managed remotely by USCo employees from outside Canada.**
 - Employees can monitor performance of hardware and software, install/uninstall applications, perform maintenance on hosted applications, and manage the software and data.**

PE Issues Relating to Data Centers – Canada

(Cont'd)

- Ruling supports the position that remote management of data and applications (without ownership or leasing of equipment) does not cause the server on which such data and applications are hosted to be “at the disposal” of the foreign enterprise.
- Ruling arises in the context of a *related party* owned or operated server.
- Services PE considerations: CRA agreed that USCo would not be considered to provide services within scope of treaty deemed PE rule.
- Broader implications of the ruling?
 - Welcome development in light of little existing guidance.
 - Are other countries likely to follow suit?

Server as PE – Other Foreign Rulings

- Australian published rulings:**
 - Ruling 79967 (online subscription service): PE – Taxpayer owned and operated servers, but no employees physically present; auxiliary/preparatory exceptions not applicable.**
 - TD 2005/2 (trading stock/merchandise to Australian customers through an unrelated ISP): No PE.**
- Japan: Equipment owned by a third party located at the Tokyo Stock Exchange premises and used by nonresident traders to effect trades on the TSE does not create a PE.**
- UK and Hong Kong take the position that, in general, a server (with or without a website) does not constitute a PE.**



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