

Cloud computing and International Taxation

OECD current view and future work



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This article focusses on a specific highly digitalised business model-cloud computing. It briefly provides for an overview of the nature of cloud computing transactions and discusses the possible international tax implications of such transactions. The article concludes with a brief overview of the OECD future work as described in its report of 31 May 2019.

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I. Introduction

This article aims to provide for a high-level summary of the points discussed during my presentation in Bergamo (Italy) on 21 September 2018. The purpose of the presentation was to create awareness surrounding the international corporate tax issues that could arise for cloud computing transactions based on the international tax rules (as provided by the Organisation for Economic Cooperation and Development [OECD] and amongst others its commentaries to the 2017 OECD Model Tax Convention on Income and on Capital [OECD MC] [1]) applicable at the time of the presentation. During this latter, only the most important issues were highlighted and they are by no means exhaustive.

In addition, since the OECD has meanwhile issued a programme of work to develop a consensus solution to the tax challenges arising from the digitalization of the economy[2], this article will also briefly touch upon this programme.

[1] OECD, Model Tax Convention on Income and Capital, cond. vers., Paris 2017.

[2] OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20, Inclusive Framework on BEPS, Paris 2019, <https://urlly.it/332qh> (consulted on 05.10.2019).

II. Cloud computing: what is it?

Cloud computing is an IT method which enables users to access from any computer data or services that are stored on remote servers. The main idea of cloud computing is to be able to access remotely stored information from any device worldwide. A typical example of companies using cloud computing are email service providers like Google (Gmail) or Microsoft (Outlook). A user only needs a computer, an Internet connection and his log-in details in order to view his emails[3].

Although cloud computing technology can be used in a business-to-consumer (B2C) context (e.g. emails), this article will focus on its application in a business-to-business (B2B) context where cloud computing services are provided for a fee. The most known cloud computing service providers in a B2B context are most probably Amazon (i.e. AWS services) and Microsoft (i.e. Azure). These providers offer services such as the storage of data, analytics of data and access to and use of accounting software (or any other type of software). Most of the time, cloud computing service providers offer a package of different services to their clients.

III. International tax issues

From an international tax perspective, the digitalization of transactions has led to different issues. Firstly, digitalization has led to the development of new types of transactions, which did not exist before the development of the Internet (e.g. cloud computing transactions).

Consequently, it is not always clear how the profits from these transactions need to be characterized from an international tax point of view (e.g. business profits, royalties, other). Secondly, digital companies no longer require any physical presence in a market State in order to provide their services to customers located in that State. From an international tax perspective, the rules concerning permanent establishments (PE) are no longer adequate to determine a fair allocation of taxing rights between the States concerned.

[3] ALEXANDRA BAL, Tax Implications of Cloud Computing, How Real Taxes Fit into Virtual Clouds, Bulletin for International Taxation 2012, p. 335.

A. Characterization issues

There are in theory three main categories for taxation purposes in which profits arising from cloud computing transactions could fall: royalties (art. 12 OECD MC); capital gains (art. 13 OECD MC) or business profits (art. 7 OECD MC).

In practice, the characterization between royalties and business profits will be the most relevant. Cloud computing transactions are least likely to be characterized as capital gains because full ownership of the goods (*i.e.* software) is not transferred to the customer. Customers usually gain access to software and are able to use it but they do not obtain full ownership[4].

Whether or not cloud computing transactions are royalties or business profits will depend on whether copyright rights are being transferred between the service provider and the customer. The term "copyright" needs to be understood from a tax point of view. The OECD suggests that there is no transfer of copyright rights unless the customer obtains the possibility to commercially exploit the rights. If there is no commercial exploitation possible, the fee obtained for the transaction will not be characterized as a royalty but as business profits[5]. A case-by-case analysis is therefore necessary to determine the correct characterization. Should the fee for a particular cloud computing service be categorized as a royalty, withholding tax could be applicable at source depending on the provisions of the relevant double tax treaty.

B. Permanent establishment

Assuming however that cloud computing transactions have to be characterized as business profits, the question then arises on how the profits resulting from those transactions need to be allocated between the States concerned in a cross-border *scenario*. According to existing OECD rules, a State cannot tax business profits of a non-resident company unless it has a PE in that State.

A PE can be obtained in two ways: by having a fixed place of business in the non-resident State (further referred to as the "market State"[6]) through which the business is wholly or partially carried on; or by having a dependent agent in the market State (*i.e.* agency PE)[7].

Since cloud computing service providers do not have the need to employ personnel in the market State in order to conduct

their activities there, it is unlikely that they would have PE's in those States. In a first instance, it is clear that the agency PE rule cannot apply. The OECD clearly states that the agent needs to be a "person"[8]. Secondly, because there are no premises or personnel in the market States, a fixed place of business can also not be considered to exist unless a server is located there provided that it can effectively be considered as a fixed place of business[9]. This will not be an easy exercise since it is in practice difficult to determine what activities are performed by the server and whether or not these activities are of a preparatory or auxiliary nature[10]. In addition, even if this could be determined, the existing rules on profit allocation would not allow a significant amount of profit to be attributed to the server[11].

III. Future work: OECD developments

To mitigate the issues arising from the digital economy (some of which are described briefly above), the OECD issued a program of work to develop a consensus solution in this respect on 31 May 2019[12].

The work is divided in two Pillars. Pillar One aims at resolving the fundamental international tax issues (*i.e.* review of nexus and profit allocations rules) arising from the digitalization of the economy, whereas Pillar Two aims at resolving remaining BEPS issues. In the framework of this article only Pillar One will briefly be discussed as Pillar Two falls outside the scope.

In the context of Pillar One, two alternative approaches have been suggested for determining nexus in a market jurisdiction and three new approaches have been brought forward regarding profit allocation. It is interesting to note that the new approaches regarding profit allocation are highly driven by a demand for simplicity and deviate significantly from the arm's length principle. It is also clear that all of the proposed approaches are designed to allocate more taxing rights to the market States.

While the new proposals still remain relatively vague, an overview of the main ideas are provided below.

A. Proposal for new nexus rules

The OECD proposes to develop a concept of "remote taxable presence" (*i.e.* taxable presence without traditional physical presence) and a new set of criteria to determine when such a remote presence exists. This can be achieved in two ways: (i) either by amending the definition of a PE rule; or (ii) by developing a standalone rule establishing new nexus separate

[4] ALEXANDRA BAL, *The Sky's the Limit, Cloud-Based Services in an International Perspective*, Bulletin for International Taxation 2014, p. 517.

[5] OECD MC (footnote 1), Commentary on Article 12, §13.1; GARCIA HEREDIA, *Software Royalties in Tax Treaties: Should Copyright Rights Be Reconsidered in the OECD Commentary on Article 12?*, Bulletin for International Taxation 2005, Pp. 230-231; GARY SPRAGUE/OZZIE SCHINDLER, *Another Step Towards Uniformity, Relative Consensus of the OECD TAG on Income Characterization of E-commerce Transactions*, Tax Management International Journal 2001, pp. 270-271; OLIVER HEINSEN/OLIVER VOSS, *Cloud Computing under Double Tax Treaties: A German Perspective*, Intertax 2012, pp. 585-586; Global Tax Treaty Commentaries, Article 12, IBFD, Latest update 10 July 2017, section 5.1.3.1.3.

[6] Also to be considered as the State in which activities are carried on.

[7] Article 5 OECD MC.

[8] Article 5 OECD MC.

[9] See for more information: OECD MC (footnote 1), Commentary on Article 5, § 123; See also BAL (footnote 3), p. 336.

[10] OECD MC (footnote 1), Commentary on Article 5, § 124, § 126 and § 128; ARTHUR COCKFIELD/WALTER HELLERSTEIN/REBECCA MILLAR/CHRISTOPHE WAERZEGGERS, *Taxing global digital commerce*, Wolters Kluwer, 2013, pp. 117-118.

[11] See for more information: BAL (footnote 3), pp. 336-337; More recently also confirmed in general terms in OECD, 2010 Report on the Attribution of Profits to a Permanent Establishment, OECD Publishing, Paris 2010, p. 26, § 66.

[12] OECD (footnote 2).

from the PE concept^[13]. The new concept of “remote taxable presence” would provide jurisdiction to tax to a market State when economic activities are being conducted in that State even in the case where no physical presence exists.

B. Proposal for new profit allocation rules

Once nexus is established, the programme of work discusses how profits could be allocated to different jurisdictions.

A first approach concerns the Modified Residual Profit Split Method (MRPS method). This method would be designed to allocate to the market jurisdictions a portion of a Multination Enterprise's (MNE) group non-routine profits. The idea would be that the non-routine profits allocated to the market jurisdictions would reflect the value created by the group in those jurisdictions^[14]. This method therefore seems to adhere to the value creation principle.

A second approach concerns the Fractional Apportionment Method. This method is quite similar to the MPRS method except that, if this method would to be used, a portion of the overall profits of an MNE (without making a distinction between routine and non-routine profits) would be allocated to the market jurisdictions. The profits would be allocated on the basis of a formula^[15].

A final suggestion that is made is the use of Distribution-Based Approaches. The idea behind these approaches is to allocate to the market jurisdictions an amount of profit of an MNE (routine and non-routine) related to marketing, distribution and user-related activities^[16].

The Programme of Work acknowledges that many questions need to be answered before any of the above methods could be implemented. For example, the amount of profit in scope needs to be determined as well as the proper allocation keys and the interaction of the new rules with existing transfer pricing rules and situations on which withholding taxes could be applicable^[17].

IV. Conclusion

It is clear that the current OECD rules are not designed to deal with highly digitalized business models such as cloud computing. Since many cloud computing transactions are fairly new, characterization issues could arise that would affect their tax treatment (*e.g.* royalty vs. business profits). In addition, cloud computing service providers do not have any physical presence in the States where they operate making it almost impossible for market jurisdictions to tax these activities. The concept of a server PE is not adequate to deal with this issue and servers are not necessarily located in the market jurisdictions.

The new rules proposed by the OECD will most likely affect cloud computing service providers since the new approaches are designed to be generally applied. However, since many questions still remain unanswered, it is not yet possible to determine what the exact consequences will be.

[13] OECD (footnote 2), p. 18.

[14] OECD (footnote 2), p. 12.

[15] OECD (footnote 2), p. 14.

[16] OECD (footnote 2), p. 15.

[17] OECD (footnote 2), pp. 12-16.