The Sky’s the Limit – Cloud-Based Services in an International Perspective

In this article, the author further considers various international taxation issues arising from the continued and increasing use of cloud-based computing services.

1. Introduction

Cloud computing, often referred to simply as "the cloud," is the delivery of on-demand computing resources over the Internet. It represents a fundamental change in the way information technology (IT) services are developed, deployed, scaled, updated, maintained and paid for. Cloud-based services are growing in popularity in both the business sector and among final consumers. Companies that seek greater IT efficiency and reduction of their capital costs are moving to the cloud. Consumers choose cloud-based applications to store their digital content that they wish to share and access on multiple devices.

As cloud-based services are usually provided for in a cross-border scenario, the provisions of international tax law, especially of tax treaties, are of particular relevance to parties engaged in cloud transactions. The aim of this article is to review, on the basis of a case study, some of the most common international tax issues that providers of cloud-based services face.

2. The Cloud – A New Trend with a Long History

Cloud computing provides flexible and real-time access to a shared pool of computing resources, such as servers, storage and applications, via the Internet. It represents a convergence of two major IT trends: (1) efficiency, whereby the power of computers is utilized more efficiently through highly scalable hardware; and (2) software resources, and business agility, whereby IT resources can be used as a competitive tool through the rapid deployment of applications that respond in real time to user requirements.

Three cloud service models can be distinguished. First, as a service (SaaS) provides applications that run on the cloud eliminating the need to install them on the customer computer. Second, platform as a service (PaaS) is a service targeting developers and facilitates the development of applications by providing operating system support and software development frameworks. Third, infrastructure as a service (IaaS) comprises resources, such as processing, storage and network, which can be virtualized and delivered as a service.

Although cloud computing is seen as a recent IT trend, its origins date back to the late 1950s, when companies used large powerful computers called mainframes. As mainframe technology was expensive, companies could not afford to purchase a new computer for each user. Instead, they developed “time-sharing” methods which allowed multiple users to share access to data and central processing unit time. Another major event in the cloud computing history was the development of the Advanced Research Projects Agency Network (ARPANET), the first decentralized communication network that connected US research and government institutions. The ARPANET transformed into the Internet, i.e. a worldwide decentralized and self-maintaining system of computer networks, capable of rapidly transmitting packets of data without direct human involvement or control.

In 1997, the term “cloud computing” was first used by Professor Chellappa to describe a new “computing paradigm where the boundaries of computing will be determined by economic rationale rather than technical limits alone.” In the late 1990s, companies began to gain a better understanding of cloud technology and its usefulness in providing services to customers. Salesforce.com became one of the first major movers in the cloud arena, pioneering the concept of delivering enterprise-level applications to end users via the Internet. In the 2000s, cloud computing established its position as a mainstream technology tool and a new cost-efficient business model.

3. The Facts of the Case Study

Income tax issues arising in a cloud business model are discussed on the basis of the following case study.

Service provider P supplies a bundle of services to customer C using the cloud business model. Those services include access to a tax information database, accounting software and a file storage system where customer data, i.e. electronic invoices, commercial documentation and accounts, is recorded. All the applications are developed by provider P using cloud computing solutions.

References

1. The term “cloud” is used as a representation of the Internet and an abstraction of the underlying infrastructures involved.
2. Examples of cloud-based applications for individuals include popular services, such as Gmail, Hotmail, Dropbox, Instagram or Facebook.
3. For a more detailed description, see A. Bal, Tax Implications of Cloud Computing – How Real Taxes Fit into Virtual Clouds, 66 Bull. Int’l Taxn. 6 (2012), Journals IBFD.
5. The first known academic usage and definition of the term cloud computing appears to be provided by Prof. Chellappa in a presentation entitled Intermediaries in Cloud-Computing, given at the INFORMS meeting in Dallas in 1997. See www.bus.emory.edu/ram.
oped and regularly updated by P, and run on his IT infrastructure. The file storage system also supports a back-up system meaning that data is replicated in a separate data centre abroad, so that it can be retrieved in case of fire, flood or other disaster. In addition, P provides technical assistance regarding the use of cloud applications in the form of a troubleshooting database with answers to frequently asked questions, such as log-in issues or password retrieval, and a service desk that can be contacted 24 hours per day.

P is resident of Country P and the equipment that he uses for his business operations is located both in Country P and abroad. Country P taxes its residents on a worldwide basis. C is resident in Country C. Under its domestic tax law, Country C regards income generated by non-resident service providers from services provided to its residents as sourced within its territory and taxes it accordingly. Countries C and P have concluded a tax treaty based on the OECD Model (2010). In order to avoid double taxation of its income, P seeks to invoke treaty protection.

In the context of cross-border business operations of the cloud provider, the following two questions must be examined:

(1) what is the income characterization of payments made by C to P for the cloud-based services (see section 4.); and
(2) what are permanent establishment (PE) risks of the cloud provider, taking into account the recent developments aiming at extending the PE definition to “virtual presence” (see section 5.).

4. Income Characterization

4.1. Mixed contracts

A meaningful and accurate discussion of the characterization of income from cloud-based services requires a thorough understanding of the particular transactions at issue and must begin by reviewing the contractual terms. The evaluation should consider, in particular, any references to intellectual property rights and the rights to use the underlying infrastructure. It is important to note that the terms “cloud computing”, “SaaS”, “PaaS” and “IaaS” can cover a wide variety of different transactions.

Contracts for cloud-based services are usually complex and include a bundle of services, for example, data storage, access to information, data processing or technical services. The Commentary on Article 12 of the OECD Model (2010) states that the total amount of the consideration payable under mixed contracts should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment, and an appropriate tax treatment should be applied to each apportioned part. However, if one element constitutes “by far the principal purpose of the contract” and the other element is “only of an ancillary and largely unimportant character”, the whole amount paid should be treated as relating only to the primary element. Everything that is economically treated as a unity should also be treated as a unity for tax purposes.

The rules for mixed contracts are clear in theory. In practice, it may be difficult to distinguish the principal and auxiliary elements and to apply the tax treatment of the principal part to the remaining parts of the contract. The question of whether or not a contract must be split has important practical consequences. If one contractual element gives rise to withholding at source and that component constitutes the principal part, the whole payment is subject to withholding. If the contract can be split, withholding tax only applies to a part of the consideration.

In the case in question, the contract concluded between C and P encompasses at least four different services:

(1) access to the tax information database;
(2) use of the accounting software;
(3) storage of business records; and
(4) support services.

It could be argued that all of the services should be considered together, as the primary purpose of purchasing cloud-based services was for C the possibility to use the accounting software. The other components were just parts of the accounting package that C acquired.

If so, the entire payment would be subject to the rules applicable to the right to use the accounting program. However, on the other hand, the file storage system, the tax information database and the availability of customer service for 24 hours are not inherently linked to the provision of the accounting software. Those components could be purchased and the basis of separate contracts, which would justify the treatment of all services on an individual basis.

Whether or not the contract can be split depends on the relationship of the services with one another, the contractual terms and the approaches of the countries to mixed contracts. Sections 4.2. and 4.3. assume that all the services can be considered separately.

4.2. Applicable treaty provisions

As the provision of cloud-based services is impossible in the absence of software, the tax treatment of software transactions can be used as a starting point to qualify payments for such services. Extensive guidance on the characterization of payments for computer software is provided for in the Commentary on Article 12 of the OECD Model (2010). Those principles are also applicable to transactions involving other types of digital products.

According to the Commentary on Article 12 of the OECD Model, income from software transactions may be characterized as royalty (article 12 of the OECD Model), business income (article 7) or capital gains (article 13). The application of each of those articles results in different tax consequences, which are outlined below.

6. OECD Model Convention on Income and on Capital (22 July 2010), Models IBFD.
7. OECD Model Convention on Income and on Capital: Commentary on Article 12 para. 17 (22 July 2010), Models IBFD.
8. Id., para. 11.6.
Under article 12 of the OECD Model, “royalties” are defined as:
- payments of any kind for the use of, or the right to use, any copyright of literary, artistic or scientific work, or
- payments for information concerning industrial, commercial or scientific experience.

Payments for computer software are not explicitly mentioned in the definition of royalties. However, the Commentary on Article 12 of the OECD Model explains that research by the OECD among its member countries revealed that software rights are usually protected under copyright rules. Consequently, payments for the right to use software may fall within article 12 of the OECD Model.

Article 12 of the OECD Model allocates the exclusive right to tax royalties to the residence state of the taxpayer, whereas the source state is denied any taxing rights that it may have under its domestic law. Therefore, unless the provider of intellectual property has a PE in the source state, that state obtains no tax revenue from the royalty payments that are made in consideration for the right to use the intellectual property. This approach reflects the views of capital exporting developed countries. The UN Model is more sympathetic to capital importing countries and allows taxation of royalties in the source state by means of a withholding tax.

As royalties are paid “for the use of or the right to use” intellectual property, article 12 of the OECD Model does not apply to payments for the alienation of all rights attached to intellectual property. Such payments are not made for the right to use the underlying property, but, rather, for the rights themselves and may be characterized as capital gains (article 13 of the OECD Model). Capital gains, other than those from alienation of immovable property, business property of a PE, shares in real estate company, ships or aircraft, are taxed only in the residence state of the alienor.

Article 13 of the OECD Model does not seem to have a broad application in the field of cloud-based services, as such services do not involve any transfers of full rights to an asset. The customer obtains access to remotely operated highly standardized software and/or hardware that runs on the infrastructure of the cloud provider. The cloud provider does not lose control over its software.

Nor can article 12 of the OECD Model be applied to software payments that do not involve any copyright. The Commentary on Article 12 of the OECD Model distinguishes between transfers of the copyright in the program and transfers of a copy of the copyrighted program. Payments made for the transfer of partial rights in the copyright represent a royalty, as they allow exploiting the copyright in a manner that would otherwise be the sole prerogative of the copyright holder and would, without a licence, constitute an infringement of copyright. Examples of such arrangements include licences to reproduce and distribute the public software incorporating the copyrighted program or to modify and publicly display the program. In contrast, payments for transactions in which the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program qualify as business income in accordance with article 7 of the OECD Model. Business income is taxed on a net basis in the residence state of the taxpayer, unless the taxpayer has a PE abroad and the income is attributable to that PE.

Article 7(4) of the OECD Model (2010) states that:

[where business profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

As articles 12 and 13 of the OECD Model deal specifically with royalties and capitals, the provisions of those articles override the rules in article 7 if the royalties and capital gains also constitute business profits. Therefore, the characterization for income from cloud-based services will be first examined on the basis of articles 12 and 13 of the OECD Model.

4.3. Cloud-based services
4.3.1. Accounting software

The accounting software is an application that records and processes accounting transactions. As it constitutes software within the definition provided by the Commentary on Article 12 of the OECD Model, the rules on the tax treatment of software transactions should be directly applicable. The fact that the software is not transferred to the customer, but, rather, runs on the IT infrastructure of the cloud provider, should not have any effect on the tax consequences as the OECD Commentary on Article 12 explicitly states that the method of delivery of a computer program is irrelevant. Although the OECD Commentary on Article 12 mentions two ways of software transfer, i.e. on a tangible medium or through downloading, the same should apply to making the software available on another party’s infrastructure. The OECD Commentary on Article 12 does not refer to this form of delivery, as the relevant paragraphs were first inserted into the Commentary on...
Article 12 of the OECD Model (2000) when cloud computing was not considered mainstream technology.\textsuperscript{18}

The answer to the question of which article applies to the provision of the accounting software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the software.\textsuperscript{19} As explained in section 4.2., the Commentary on Article 12 of the OECD Model distinguished between transfers of the copyright in the program and transfers of a copy of the copyrighted program.\textsuperscript{20}

In the case in question, the licence entitles C to mere use of the software for its own business purposes. He is not allowed to copy the program for distribution, to prepare derivative programs, to market it outside the company or to display it publicly. Thus, it can be concluded that C does not acquire any copyright in the software.

Although cloud-based applications are highly standardized, it is possible that, on request of the customer, the accounting software is adapted to fit within its business model. As such tailor-made software can only be used by a particular customer, the question arises as to whether or not the whole transaction may be regarded as a sale of all rights in the customized software that gives rise to a capital gain. The fact that the software still runs on the infrastructure of the cloud provider could be interpreted as the provision of IT capabilities for customers to operate their applications, i.e. IaaS. Whether or not the capital gain characterization can be assumed depends on the customer’s possibilities to use the software in the absence of the infrastructure of the cloud provider. If, in such circumstances, the customer does not have access to the accounting software, it cannot be regarded as the owner of all software rights.

\subsection*{4.3.2. Database}

Domestic law determines whether or not, and to what extent, the tax information database is protected by any intellectual property rights. In the European Union, the Directive on the Legal Protection of Databases has created new exclusive \textit{sui generis} right for database producers.\textsuperscript{21}

An electronic database may be protected by this \textit{sui generis} database right if there has been a substantial investment in obtaining, verifying or presenting its contents. Copyright protection may also apply if the database has originality in the selection or arrangement of the contents. In the United States, databases may be protected by copyright law as compilations if they are original in their selection, coordination and arrangement.\textsuperscript{22}

If the database is protected by intellectual property rights, the distinction between transfers of a right in the program and transfers of a copy of the program will have to be made. The observations outlined in section 4.3.1. apply accordingly. As C is not allowed to exploit the database commercially, but, rather, to use it for its own business purposes, the remuneration is likely to be classified as business profits. If the database is not subject to any copyright, or database right, protection, P supplies a service consisting in the access to a compilation of data which will not be covered by article 12 of the OECD Model, but, rather, by article 7.

In this context, it is pertinent to consider that the characterization of payments for the use of databases has been a contentious issue in some countries. For instance, in India, there have been conflicting rulings by courts and tribunals regarding the distinction between article 7 and 12 of the OECD Model.

In 2010, the Income Tax Appellate Tribunal (ITAT) in Mumbai decided on the characterization of remuneration for access to an online database in \textit{Gartner Ireland Ltd.} (2010).\textsuperscript{23} Gartner, a company incorporated and resident in Ireland, provided access to an online commercial database with research reports on the information technology sector to customers in India, where it did not have a physical presence. The subscribers could access Gartner’s data over the Internet, i.e. from Gartner’s server that was located outside India. Gartner classified its income from Indian subscription fees as business profits, which were not subject to tax in India under the India-Ireland Income Tax Treaty (2000).\textsuperscript{24} However, the tax officer classified the fees as taxable royalties. The ITAT ruled in favour of the taxpayer and held that income from subscription fees constituted business profits. In order to support its decision, the ITAT Mumbai referred to the decision of the ITAT Bangalore in \textit{Wipro Ltd} (2004),\textsuperscript{25} in which the same conclusion was reached.

However, three years later, in a case involving the same parties and the same tax treaty,\textsuperscript{26} the ITAT Mumbai held that payments for accessing a database are taxable in India as royalty. In order to support its decision, the ITAT Mumbai referred to the judgment of the Karnataka High Court (HC) in \textit{Wipro Ltd.} (2011), in which a similar issue was considered and the consideration for online use of a database was regarded as royalty.\textsuperscript{27}

The \textit{Gartner Ireland/Wipro} saga shows that even cases involving the same taxpayers and the same legal rules may be decided differently by the same court and that the

\begin{thebibliography}{99}
  \bibitem{18} OECD Model Tax Convention on Income and on Capital: Commentary on \textit{Article 12} para. 14.1 (29 Apr. 2000), Models IBFD.
  \bibitem{19} Para. 12.2 \textit{OECD Model: Commentary on Article 12} (2010).
  \bibitem{20} Id., at para. 13.
  \bibitem{23} IN: ITAT (Mumbai), 20 June 2010, \textit{Gartner Ireland Ltd. v. DIT}, ITA No.1452/Mum/2008, Tax Treaty Case Law IBFD.
  \bibitem{24} \textit{Convention between the Government of Ireland and the Government of the Republic of India for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains} (6 Nov. 2000), Treaties IBFD.
  \bibitem{26} IN: ITAT (Mumbai), 24 July 2013, \textit{Gartner Ireland Ltd. v. DIT}, TS-346-ITAT-2013(Mum).
  \bibitem{27} IN: HC (Karnataka), 15 Oct. 2011, \textit{Wipro Ltd. v CIT}, ITA No. 2804/2005, Tax Treaty Case Law IBFD.
\end{thebibliography}
Indian courts favour a broad interpretation of the concept of royalties.

4.3.3. Storage of business records

The provision of server capacity for C’s business records can be considered a typical IaaS service. The income from making IT infrastructure available to customers could be classified as either business income or rental income, i.e. Article 6 of the OECD Model.

Generally, customers are interested in a virtualized data centre space, i.e. the exact location of the IT infrastructure is irrelevant for them. Some counties have strict rules on the storage of accounting and tax data, for example, such data can be stored only in a country that has concluded an agreement on exchange information in tax matters with the taxpayer’s residence state. However, even if the customer instructs the cloud provider to keep his data in a particular data centre, the customer does not “rent” the underlying infrastructure. The service provider retains the full control over the data centre and remains responsible for equipment maintenance. Thus, income for the provision of IT capabilities can be characterized as business income.

4.3.4. Support services

The provision of support services is not a transaction involving software but a transaction involving services with regard to the software. As there is no transfer of either copyright or a copyrighted article, payments for computer services cannot be regarded as royalties, but, rather, as business profits or income from independent personal services, and are not taxable in the source country if the service provider does not maintain a physical presence there. Although both the Commentary on Article 5 of the OECD Model and the UN Model provide for a service PE option that strengthens the source state rights to taxation, the service PE also requires physical presence in the source state, i.e. one or more individuals must be present there for a minimum time period.

In this context, it is pertinent to consider that fees for technical services have become a regular source of dispute worldwide. Many capital-importing countries are not prepared to leave untaxed payments for technical services that are used within the country territory and incorporate them into the definition of “royalties”. In most Indian tax treaties, technical service fees are included in the scope of Article 12 with taxing rights given to the source state regardless of the existence of a PE.

5. Recent Developments on PE Exposure

The international taxation of income is broadly based on some form of nexus between the income and the relevant jurisdiction. The right to tax business profits is primarily granted to the residence state, rather than the state where the company carries on its business. The constitution of a PE in the source state is an exception to this rule. According to the Commentary on Article 5 of the OECD Model (2010), computer equipment may constitute a “fixed place of business” of the enterprise that operates it. However, a combination of software and electronic data does not have a geographical location and cannot give rise to a PE.

Based on those considerations, the cloud provider is likely to have a PE in countries where its equipment is located, as computer equipment plays a significant role in the cloud business model. In contrast, the recipients of cloud-based services do not have PEs in the countries where the computer equipment they are using is located since the physical location of this equipment is not at their disposal, even if they are able to determine what applications should be hosted on a particular server. Only in the unlikely situation in which the customer uses storage capacity of a server based on a lease agreement, could the place where that server is located constitute a PE, provided that the other PE requirements are met.

The current PE definition cannot capture and tax business profits generated by non-residents conducting business via digital technology. The result is that cloud providers can easily avoid source taxation in countries where their customers are located and where they receive income from. The fact that enterprises exploit their digital presence to obtain significant income from a country without paying a ‘fair share’ of taxes has led to both national and international proposals to redefine the PE concept.

France took the initiative to address this matter by commissioning a report on the taxation of the digital economy, known as the Colin and Colin Report. Published on 18 January 2013, the report takes a novel approach by focusing on data collection that provides value for many enterprises. It suggests that the PE concept should be modified, but only for the purposes of the digital economy. A PE should be deemed to exist when a company carries on a business in a country using data obtained through the regular and systematic monitoring of users in that country. In other words, the role of consumers as value-generators for website owners could justify the conclusion that the consumers are creating a PE for those who own the website. However, the report does not state how the government where the consumers are located could determine and enforce the tax due by the non-resident website owner.

At the international level, proposals to redefine the PE concept by extending it to situations in which business activity is carried on without physical presence have been discussed within the debate on the taxation of electronic (e-)commerce and the digital economy led by the OECD. The OECD discussed the concept of a virtual PE in the final report presented by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms.

28. Para. 42.2 OECD Model Commentary on Article 5 (2010).
29. For the issue of profit attribution, see Bal, supra n. 3, at sec. 3. It is also important to mention that some countries, for example, Singapore, do not consider a server to be a PE. If computer equipment is located in such countries, the issue of profit attribution does not arise.
for Taxing Business Profits (the “Business Profits TAG”).\(^{31}\) However, at that time, in the view of the OECD, the standard PE definition was sufficient to address issues raised by e-commerce.

The concept of a non-physical PE is currently being discussed within the OECD Base Erosion and Profit Shifting (BEPS) project. The BEPS Report and Action Plan\(^{32}\) state that rules of international tax law failed to keep pace with the changing business environment and the latter sets out 15 Actions to remedy this mismatch. Action 1 deals with the issue of taxation of the digital economy. The Discussion Draft on BEPS Action 1,\(^{33}\) issued on 24 March 2014, endorses the approach of applying the same rules to the digital economy that are applied to all other activity, but, at the same time, it explores possible alternatives for the standard PE threshold. It asks for comments on whether or not “substantial digital presence” could constitute a PE. Under paragraph 214 of the Discussion Draft, if an enterprise is engaged in a fully dematerialized business, i.e. a business relying on digital goods and services, a significant digital presence could be deemed to exist when, for example:

- a significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;
- digital goods or services of the enterprise are widely used or consumed in the country;
- substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise’s core business; or
- an existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.

These proposals by the French government and the OECD radically depart from the current practice. The concept of a virtual PE questions the fundamental difference between consumption tax and income tax. The former is levied where the activities of the enterprise take place, whereas the latter where consumption occurs. Business profits should be taxed in the location of the factors that allow the enterprise to earn the profit and not in the location where its goods and services are used and/or consumed.

Any new forms of nexus should not create barriers to global trade. If an enterprise that can assess the global market through the Internet had taxable virtual presence in many countries, double taxation would inevitably arise, as it is highly unlikely that uniform rules on the profit attribution and cost allocation will be developed. A “global enterprise” would become a “global taxpayer” with filing and registration obligations in every country where its website can be viewed.

A nexus based on significant digital presence would not only create complexity and uncertainty, but it is also unlikely to work in practice. The main question that must be asked is how to collect tax from someone who has never set foot in the country. Hellerstein (2003) developed the concepts of substantive and enforcement jurisdiction.\(^{34}\) The former is related to the power of a state to impose tax on certain sources and persons, whereas the latter to the power of the state to compel collection of the tax over which it has “substantive jurisdiction”. Enforcement jurisdiction implicates both practical and legal considerations. The state may not have the authority to impose a tax collection obligation on some foreign persons, and, even if such authority exists, it may be impractical to effectively compel tax remittance. Tax systems face a problem when there is substantive jurisdiction to tax an item, but the taxing authority has no enforcement jurisdiction over a person who can effectively remit the tax. When this occurs, the generally accepted principles of neutrality and efficiency are compromised, as economically identical situations are treated differently.\(^{35}\)

### 6. Conclusions

Cloud computing is here to stay and will grow. The current demand for increased data means that web-based services will continue to flourish. And as for the cloud, the sky’s the limit. This article has reviewed two major issues: (1) the characterization of income from cloud-based services; and (2) the recent development on PE exposure of cloud providers.

Contracts concluded between cloud-service providers and their customers usually include a wider variety of service offerings. The question of whether or not such contacts must be split has important practical consequences if at least

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31. OECD (Business Profits TAG), Are the Current Treaty Rules for Taxing Business Profits Appropriately for E-Commerce? (OECD 2004), available at www.oecd.org/tax/treaties/35869032.pdf. The Business Profits TAG considered three broad alternatives: (1) “virtual fixed place of business” PE, which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website; (2) “virtual agency PE”, which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person; and (3) “on-site business presence” PE, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer’s location.


one component gives rise to the application of withholding taxes.

Under the OECD Model (2010), income from cloud-based services generally falls within article 12 or 7, depending on the nature of rights with regard to the use and exploitation of the software that the customer acquires under the contract. In both cases, income is taxed in the residence state of service provider, unless it has a PE in the state of the customer and the income is attributable to that PE. Many countries interpret the concept of royalties extensively to include payments for the use of databases and software as well as technical service fees. Such countries also subject royalties to source taxation.

The current PE concept is based on physical presence and allows cloud providers to offer their services without being subject to source taxation.\(^36\) Given the amount of revenue lost by the source state, proposals to modify the PE concept by extending it to “virtual presence” became attractive to some countries and are discussed within the framework of the BEPS project. If some countries move ahead without international consensus and adopt such proposals unilaterally, cloud providers having virtual presence everywhere where the Internet can be accessed may become “global taxpayers” subject to multiple taxation. The concept of a virtual PE would, therefore, not only create barriers to global trade, but also be difficult to apply in practice.

\(^36\) Unless payment for cloud services are characterized as royalties and subject to withholding tax at source.

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