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SAAS ROUNDTABLE

Managing International Tax Exposure to Set Up Your SaaS Company for Success

KNOWLEDGE

Learning Objectives

Review VAT exposures for SaaS companies and how they vary by country

Determine the key tax considerations by stage and how to avoid common problems

Identify strategic tax planning and structuring opportunities

Discuss structure considerations for full-risk distributors vs. limited-risk distributors

WELCOME

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AGENDA

International Tax Issues Affecting SaaS Companies:

- Characteristics of SaaS providers
- Income Tax Issues during the International Growth "Life Cycle"
  - Sales and Distribution Models
  - IP Management Considerations
- Indirect Tax and Withholding Tax Considerations
  - Definitional Issues – Treatment may vary by jurisdiction
    - Services vs "Royalties": Withholding Tax issues and Problems
    - VAT/GST Issues

[Disclaimer – the following discussion discusses general principles and should not be considered tax advice. Consult with a tax advisor]

DEFINITIONS

What is SaaS?

Software as a service (**SaaS** /sæs/[1]) is a software licensing and delivery model in which software is licensed on a subscription basis and is centrally hosted.[2][3] SaaS is also known as "on-demand software" and Web-based/Web-hosted software.

SaaS is considered to be part of cloud computing, along with infrastructure as a service (IaaS), platform as a service (PaaS), desktop as a service (DaaS), managed software as a service (MSaaS), mobile backend as a service (MBaaS), data center as a service (DCaaS), integration platform as a service (iPaaS), and information technology management as a service (ITMaaS).[6]

SaaS has been incorporated into the strategy of nearly all enterprise software companies.

For our discussion we have made these assumptions:

- US Parent Company Entrepreneur (although the concepts apply similarly to foreign-owned SaaS providers.
- Keep-It-Simple-Stupid Approach (which is what we usually recommend)

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SaaS Company Life Cycle: International Expansion

- Typical SaaS start up is headquartered in one country (i.e., the US) where the IP is economically owned and all revenue is recognized.
- Most SaaS companies will go through a period of acquiring tax attributes (e.g., NOLs) before actually paying US federal income tax. But, to avoid unpleasant outcomes an expanding enterprise will still need to manage tax issues across multiple jurisdictions and consider strategic tax issues.
- Management will make decisions to allow growth to be conducted in an opportunistic manner. Taxes are only one set of issues and must be subordinated to the key business drivers of the enterprise.
- There is scope to achieve reasonable efficiencies amount the choices that are available given the business imperatives determined.

OVERVIEW

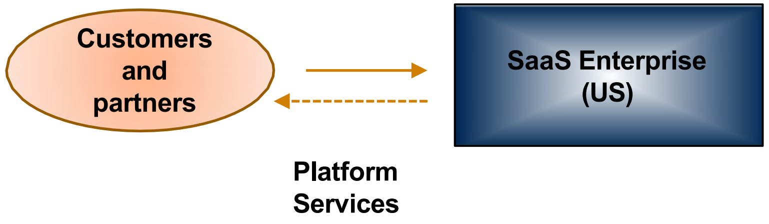
International Expansion: Life Cycle Approach

- We typically use a “life cycle” approach to illustrate to management the key foreign direct and indirect tax planning phases that the Company may evolve through – typically four phases:
  - **Phase 1**: basic operating phase with no foreign legal entities or substantial activity – minimizing foreign presence.
  - **Phase 2**: company may form local entities and the hire local R&D, service, and sales solicitation personnel, with most revenue being earned from the local customers (directly or through partners).
  - **Phase 3**: the establishment full-scope foreign distribution operations (revenue earned directly from local customers by the subsidiary).
- **Phase 4**: global management of IP rights and the development of multiple profit centers.

Although this life-cycle pattern is fairly-typical, every business is different.

SAAS LIFE CYCLE

Phase 1: Direct Licensing with minimal or no foreign presence



Facts:

- Direct licensing of platform to foreign and domestic customers
- All revenue is booked by US Enterprise
- US owns worldwide IP title and IP rights
- All R&D and platform development performed in the US or through "foreign contractors"

Corporate Income Tax - US

- Subject to income tax (21% federal rate) in the US only (no foreign branches or subsidiaries)
- If in a net taxable income position, Enterprise be eligible for the favorable FDII deduction for "export sales" - US sales to foreign customers resulting in an effective US federal tax rate on foreign sales as low as 13.125%.
- However: Enterprises increasingly wish to hire local R&D and sales personnel. "Contractor" arrangements and PEOs are often employed during this phase. These arrangements should be considered short to medium term and may involve some risk of local income and payroll taxation.

Corporate Income Tax - Foreign

- No entity or Permanent Establishment (PE) branch currently outside the US
- However:
  - "Contractor" arrangements currently coming under more scrutiny in EU and other OECD jurisdictions. Some 'contractors' have sued the Enterprises in order to make the Enterprises liable for local payroll taxes (e.g., gig controversy in the US).
  - "PEO" arrangements (professional service organizations. Employees are technically working for the local PEO. However, if the activities of the local employees are high value or involved in management or sales activities, these arrangements create some risk that should be quantified.

SAAS LIFE CYCLE

Phase 1: Direct Licensing with minimal or no foreign presence

General Withholding and Indirect Tax considerations:

Royalty Withholding Tax (WHT):

- Payment for SaaS services is generally expected to be treated as being for the provision of a service rather than as a license or royalty payment, provided the customer does not acquire a right to copy or modify the platform (e.g., by being provided with the source code or managing the platform themselves).
- Provision of a service is generally not subject to WHT under US tax principles; but foreign definitions may differ, therefore withholding tax may be a concern. However, most OECD treaties (e.g., Japan), provide for 0% withholding on royalties, so the “definition” is not worth arguing about in those situations.
- Certain non-OECD countries have interpretations treating payments for SaaS services a royalties subject to 20% to 30% withholding tax.

VAT/GST

- For B-to-B licenses VAT/GST registration is not usually required and collection of VAT not required. However, there are exceptions.

SAAS LIFE CYCLE

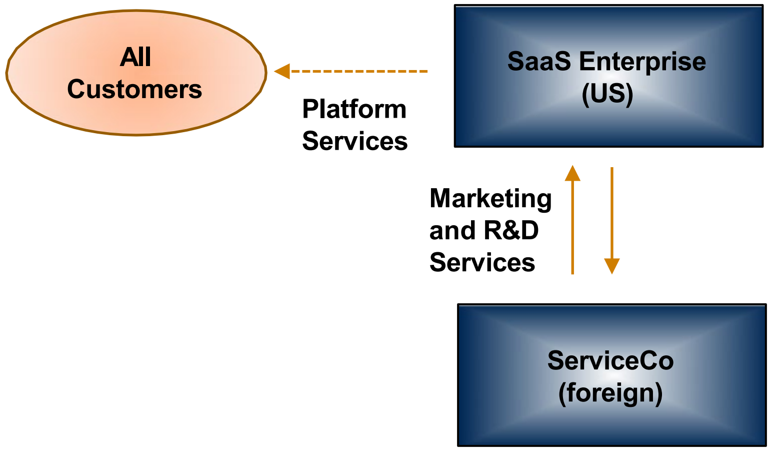
Phase 1: Direct Licensing with minimal or no foreign presence

Foreign Derived Intangible Income (“FDII”)

- Foreign SaaS license revenues should qualify for FDII benefits, which reduces the US federal tax rate from 21% to as low as 13.125% on ‘net taxable income’ (i.e., Enterprise must be in a tax payment position).
- FDII is a tax benefit that was intended by Congress to “de incentivize” software and other tech companies from locating IP and profit centers outside of the US.
- FDII is defined as income derived in connection with (1) property that is sold, leased, or licensed…by the U.S. taxpayer to a non-U.S. person for a foreign use, or from (2) services provided by the U.S. taxpayer to a person located outside the United States.
- As a “service”; SaaS revenues from foreign customers typically qualify for the benefit.

SAAS LIFE CYCLE

Phase 2: Cost-plus local service subsidiaries



Facts:

- Direct licensing of platform to foreign and domestic customers
- All revenue is booked by US Enterprise
- Enterprise owns worldwide IP title and IP rights
- R&D and platform development and operations are managed from the US, but can be perfomed outside the US. Local subsidiary employs R&D/administration/marketing personnel; Refers local customers to US parent/Does not negotiate or conclude contracts with customers
- US pays foreign subsidiaries arm's length cost-plus fee.

Corporate Income Tax - US

- Subject to income tax (21% federal rate) in the US. If in a net taxable income position, Enterprise be eligible for the favorable FDII deduction for "export sales" - US sales to foreign customers resulting in an effective US federal tax rate on foreign sales as low as 13.125%.
- Enterprise will pay ServiceCo a tax-deductible cost-plus amount for services.
- Under the US GILTI provisions, the income of the subsidiary may also be included in US taxable income. However, if the US company is paying US income tax, the income is reduced by up to 50% by Section 250, and a partial foreign tax credit. If the foreign tax rate is in excess of 18.9%, GILTI may not apply.

Corporate Income Tax - Foreign

- ServiceCo will pay local income tax on profit earned (cost plus) on Sales & Marketing or R&D services.
- ServiceCo, not Enterprise, will need to register for local VAT/GST for incidental expenses..
- PE risk of paremt needs to be managed. Need to ensure that the local support employees are not engaging in activities that will constitute a PE under a US tax treaty.
- Because the local tax base will be based on cost-plus revenue to local income tax will be simplified, managed, and predictable.
- Be careful, however, of share-based compensation arrangements (SBC).

RULE S

GILTI & Subpart F

Global Intangible Low Taxed Income (GILTI)

- Inclusion of foreign subsidiary income on US tax return
- High-Tax **exception** may apply if local country tax rate is at least 90% of US 21% tax rate (18.9%) *[but note: US tax rate may change in the future]*
- GILTI tax mechanism:
  - Creates net 10.5% US income tax rate on foreign profits - 50% tax deduction for US tax.
  - Availability of 80% of foreign tax credit may result in **no residual US federal tax** if foreign tax rate is at least 13.125%. 50% GILTI deduction requires US to first exhaust US NOLs and be 'tax paying'

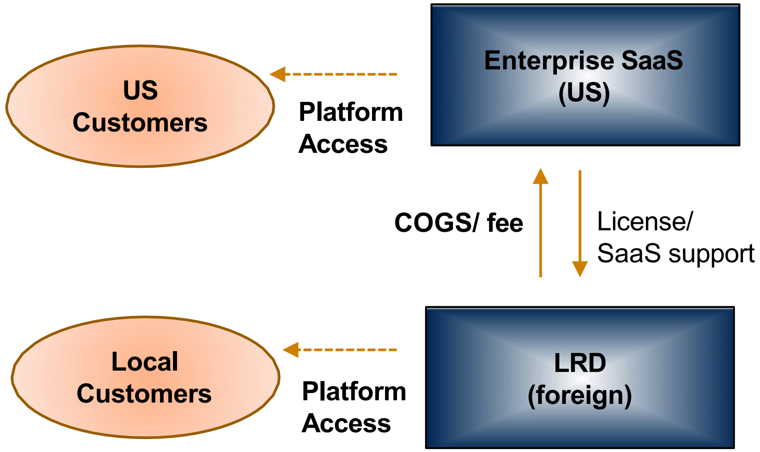
Subpart F Income

- A U.S. shareholder of a controlled foreign corporation (CFC) is subject to current U.S. taxation on the subpart F income of the foreign corporation. However, high-tax exception may exclude Subpart F income from US taxation if foreign tax rate is at least 18.9%.

The intended result of these rules is to reduce the incentive for US-based enterprises to put highly profitable, low-taxed operations offshore (flip side of the FDII provisions described earlier).

SAAS LIFE CYCLE

Phase 3: Limited Risk Distributor / Buy-Sell Operations



US Considerations:

- Enterprise still owns worldwide IP rights.
- Performs management, and US customer development, but incorporates foreign sales subsidiaries to better serve foreign customers.
- LRD licenses directly to local customers; compensates Enterprise for the use of the platform with a sublicense fee.
- Receives License fee (royalties and support) payments from foreign subsidiaries at arm's length rate.
- Operations are more complex than Phases 1 & 2 but allow for greater autonomy and access to customers in foreign jurisdictions.

Corporate Income Tax - US

- If paying US income tax, Enterprise is eligible for the favorable FDII deduction for "export sales" – including license revenue from LRD. This is an effective US federal tax rate on foreign sales as low as 13.125%. (see next slide). Under the US GILTI provisions, the income of the subsidiary will also be included in US taxable income. However, if the US company is paying US income tax, the income is reduced by up to 50% by Section 250, and a partial foreign tax credit is available.
- **Query – where are SaaS services actually provided?**

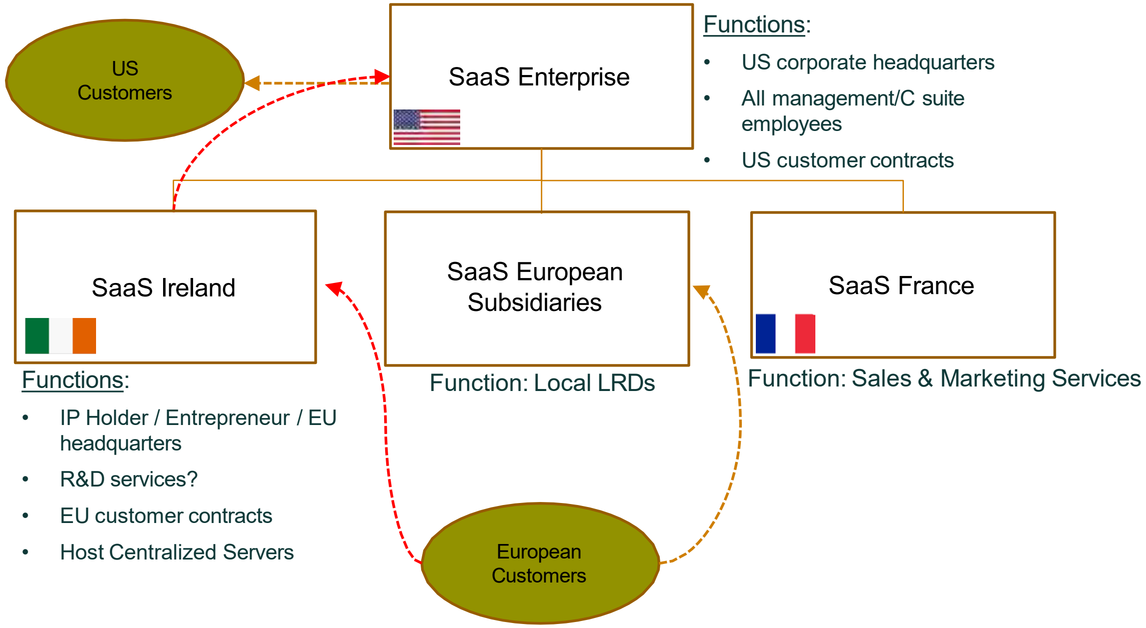
Corporate Income Tax - Foreign

- Operates as Limited Risk Distributor under license from US. Books revenues from local customers
- Pays service/license/royalty fee to the US
- Transfer pricing leaves LRD with an arm's length profit – generally considered to be within a reasonable range of percentage of sales.
- Local employees can take a broader role in the operation than under Phases 1 or 2
  - Taxes paid by foreign sub may result in a partial foreign tax credit in the US under GILTI; or GILTI may be blocked and not taxed in the US under the GILTI "high tax exception."

SAAS LIFE CYCLE

Phase 4: Strategic IP Planning

Irish Example – Long Term IP Cost Sharing



Foreign (Irish) IP/Management Example:

- Pre-TCJA planning would typically involve establishing operations in a “convenient” lower-tax jurisdiction to obtain the benefits of a rate arbitrage between the former US tax rate of 35% or more and the Irish (e.g.) tax rate of 12.5%.
- The offshore enterprise would be a profit center/entrepreneur in its own right; it would generally enter into a qualified cost sharing arrangement (QCSA) in order to pay for a proportionate amount of the development costs. IP is split between the US and Ireland.
- Although this type of IP management structure may still have tax benefits, the reforms of TCJA, including the GILTI provisions, have reduced the incentive of establishing foreign IP structures unless there are good business and operational reasons for doing so.
- Consider – where are services being provided? What regulatory or market hurdles impel the enterprise to intensify local operations?

IMPACT

SaaS Revenue Characterization: Indirect Taxes?

- Effect of GST/VAT/Indirect Taxes on Income:
  - Some foreign licensees will attempt to charge VAT/GST on license fees; often the biller is effectively an AP clerk who will simply add VAT to every bill they pay. But consider:
    - In general, a US licensor of BtoB SaaS services should NOT be subject to VAT/GST (there may be some exceptions)
    - In general, a US licensor of BtoB SaaS services will not be registered for VAT/GST and should not be subject to it; and
    - If VAT is added to invoice, the amount charged is a deadweight loss of 19% to 20% of gross revenue as the licensor will generally be unable to receive a refund for any withheld VAT/GST. .

  In conclusion, VAT/GST Indirect Taxes on BtoB licensing should be avoided if possible.

SAAS VARIANCE BY COUNTRY

VAT – EU Countries (Easy)

- Austria
- Belgium
- Bulgaria
- Croatia
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Republic of Cyprus
- Romania
- Slovakia
- Slovenia
- Spain
- Sweden

NOTE 1 – SAAS not subject to EU VAT registration unless Company has B2C sales

NOTE 2 - No EU VAT on B2B licenses unless tangible property or physical services are also provided.

SAAS VARIANCE BY COUNTRY

VAT – Selected Non-EU Countries
(Consult Your Tax Advisor)

- Australia
- Brazil
- Canada (1)
- Iceland
- Israel
- Japan (2)
- Liechtenstein
- Mexico
- Norway
- Peru
- Singapore
- Switzerland
- UK

NOTE 1 – Canada requires collection of GST registration # of B2B customers, to avoid GST liability

NOTE 2 – 10% Japan consumption tax for BtoC only

NOTE 3 – Unless otherwise noted, there should be no VAT on B2B sales, unless BOTH tangible and intangible goods are sold

IMPACT

SaaS Revenue Characterization: Services or Royalties?

Royalty Withholding Taxes and VAT/GST indirect taxes are theoretically supposed to be "tax neutral" for the licensor. Withholding taxes are supposed to generate a foreign tax credit in the US, VAT is intended to be a tax on the ultimate consumer. However,

- Effect of Withholding Taxes on Income:
  - If foreign licensee attempts to withhold on payments for SaaS services because it is a "royalty", they will typically argue that the withholding tax shouldn't 'cost' the company anything, because the taxes are creditable for US tax purposes. In reality this is usually not true, because:
    - In order to be creditable, the US company must be paying US income tax (many SaaS companies do not), and
    - In order to be creditable, the tax must be imposed on "foreign source income" – SaaS license fees are usually not foreign source income; accordingly, the withholding tax is effectively not creditable.

  In conclusion, a foreign withholding tax is a 20% to 30% reduction in gross revenue. Try to avoid them.

SAAS VARIANCE BY COUNTRY

Withholding Tax (not VAT) on SaaS Transactions

- Brazil (2) – 15%
- Israel (3) – 10%
- Japan (1) – 0%
- Mexico (3) – 10%
- Peru (2) – 30%

NOTE 1 – US-Japan Income Tax Treaty has 0% withholding tax, but requires filing exemption forms and providing a Form 6166 (US Tax Residency Certificate) from IRS

NOTE 2 – Brazil and Peru have no tax treaty with the US. Therefore, local country withholding tax rates apply. The SaaS payments are considered royalties under local law.

NOTE 3 – Israel and Mexico have a reduced US treaty rate of 10% - but require obtaining a Form 6166. Otherwise, the 20% to 30% withholding tax rate applies under their local/domestic law

KEY TAKEAWAYS

Summary

- Income Tax Issues:
  - Business comes first; tax planning should follow business imperatives.
  - Consider “life cycle” approach, and where the company wishes to place its tax attributes over the long run.
- GST/VAT Issues:
  - Avoid them if possible; If not possible, consider setting up local ops to register and neutralize the VAT charges
- Withholding Tax Issues:
  - Avoid them if possible. If not possible, try to reduce via Treaties.

Q&A

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WE'RE HERE TO HELP

Thank you for attending

Additional Questions?

Reach out to us at

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