5 Minutes on Modern Finance Best Practice Series

Tax Implications of Cloud Computing: What Every CFO Needs to Know

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Lost in the Cloud
The Tax Implications of Cloud Computing

If you’re like most chief financial officers, you trust your company’s taxes to the tax department. You wouldn’t trust the IT team, the CIO, or the line-of-business (LOB) leaders to make decisions about the company’s tax strategy. It’s not that these individuals aren’t intelligent or conscientious; it’s just outside their area of expertise. They are experts in their own fields; you need experts in the tax field.

And yet, with the move to cloud computing, many of these department heads are making decisions about IT spending that can have a huge impact on the company’s tax strategy—and they don’t even know it.

Cloud computing involves taking assets that the company currently owns (on-premise technology) and leasing it from someone else (a cloud vendor). What was once a capital expense becomes an operating expense. This is one of the chief cost drivers behind the move to cloud, but it also comes with a different organizational cost structure; this can add complexity to tax calculations, especially in jurisdictions where services (as well as goods) are taxed or where intercompany services are sold.

According to a KPMG survey on the tax implications of cloud computing, just 18 percent of tax departments among the 800 companies surveyed were maximizing the benefits of operating in the cloud. The vast majority (63 percent) said it was too difficult to determine when their organizations would realize the full benefits of the cloud. CFOs who work proactively with their tax teams to understand the implications of cloud computing, both from a tax liability and benefit standpoint, stand to gain the most. Those who don’t are potentially putting their organizations at risk and at competitive disadvantage, compared to rivals that are leveraging tax benefits and minimizing tax costs associated with migrating to the cloud.

“The technology shift between on-premise to the cloud is inevitable. It’s already happening, and it’s going to continue to happen. Think of electricity: at some point we moved from everyone having some their own generators to a shared grid as a utility. Cloud is the same way, and IT departments are embracing the fact that they can get higher quality resources at a much cheaper cost, and in a more flexible environment. It’s a natural evolution of things. If the CFO is not aware of the changing technology landscape and the company’s technology strategy, that’s just a recipe for disaster. It’s a result of people not communicating enough, where they should be communicating constantly.”

Reid S. Okimoto, National Tax Leader for Emerging Technology, KPMG
Make Tax Planning Part of the Strategic Conversation, Before the Taxman Arrives

When it comes to cloud strategy, tax has a valuable strategic role to play, helping to identify potential cost savings, greater return on investment, and enhanced risk management. The key is to make tax planning part of the conversation before any contract is signed for cloud services; once IT and LOB leaders have already made cloud purchases, tax strategy then becomes an afterthought—and that can create headaches for CFOs.

“A lot of times, the conversation is too narrowly set up,” said Reid S. Okimoto, national tax leader for emerging technology at KPMG. “Often the people making the buying decisions will think, ‘I don’t see how I’m impacting tax in any way because I’m only dealing with internal cost or allocation of resources.’ The reality is, when you’re talking about property and payroll and internal profits, and shifting those around within the company or between subsidiaries—that can create big corporate tax issues.”

The finance department has built a structure to make sure that the company is as tax efficient as possible and when you change that structure around, the company’s whole tax strategy can be affected. “The conversation needs to be broader,” Okimoto said. “It needs to be more inclusive.”

Okimoto gives the example of a global company with multiple subsidiaries, relying on both its own data centers and cloud providers. “When you’re global, you’ll almost certainly have a tax planning structure that has been put together to make sure that you’re paying the appropriate taxes in the right jurisdiction, country by country. If a siloed department starts to move pieces around and not inform the tax department, you’ll get blindsided by that at the end of the year.”

The following three recommendations can help you mitigate the tax burden of moving from an on-premise IT model to the cloud:

1. Understand how the shift from Cap-Ex to Op-Ex spending will affect the overall corporate tax strategy
2. Factor in sales tax (and other transaction-based taxes, including VAT) when calculating the total cost of purchase
3. Consider access to tax data and proper configuration of reporting requirements

What do you believe is the biggest tax issue related to doing business in the cloud?

- Correctly identifying and calculating tax obligations and filling returns: 36%
- Staying current on the regulations across various jurisdictions: 27%
- Installing appropriate tax-risk management procedures: 29%
- Impact to your company’s existing tax planning: 08%
- Staying current on the regulations across various jurisdictions: 24%
- Installing appropriate tax-risk management procedures: 23%
- Impact to your company’s existing tax planning: 09%
Understand How the Shift from Cap-Ex to Op-Ex Spending will Impact the Overall Corporate Tax Strategy

Corporate income tax is largely driven by where the profits, people and property are located. With any major shift in your IT properties, the people who manage them, or your profit model, there will be an income tax consequence.

"Let’s say that I own all of my data centers,” explained Okimoto. “I decide I’m going to move from that model to owning some of my data centers and outsourcing some of the others to a cloud service provider. If my company operates in several different states or countries, I would typically make those decisions location by location, depending upon how robust the services are in those regions and what the cost is. I might also want to consider what type of data is being stored on those systems [some countries have laws in place mandating that certain customer data cannot be stored outside the country]. By changing the geographic footprint, making decisions about where I’m going to own property and where I’m going to outsource—the tax department should be aware of those conversation and decisions.”

One of the common tripwires is that individual lines of business have been empowered to go out and purchase their own cloud solutions. Occasionally this is done without the LOB ever consulting the CIO or the CFO. This can create tax issues for companies of any size.

"If it’s a large company that closes the books quarterly, the finance team might see fluctuations and changes in its IT footprint. A mid-sized company might not see it until four months after the year closes, when they’re preparing estimates for their tax returns. By that time, it’s too late to mitigate the tax burden.”

This, of course, is a situation that nobody wants to end up in. Okimoto recommends that LOB leaders, IT leaders and finance professionals talk to each other, clearly and often, about their plans for any new IT project. "If the tax department had known earlier about that purchase, they could have perhaps offset the tax impact by claiming credits or incentives that were available in the particular country or state—perhaps for engaging in certain types of qualified R&D activities on those servers—but once the year closes, it’s too late. It’s done.”

"CIO and line-of-business leaders really want to get a handle on the overall strategy,” Okimoto continued, “and so they need to share that with the CFO and the chief tax officer. Even if finance isn’t asking about it, it’s probably a good idea to try to bridge that gap. The last thing you want is to lose all your cloud cost savings at the end of the year because of a big tax hit that could have been avoided."
Factor in Sales Tax (and other Transaction-based Taxes, Including VAT) when Calculating the Total Cost of Purchase

Consumption taxes (sales taxes and VAT) vary widely from state to state and country to country—both as to the tax rate and what is taxed. When considering a migration to cloud computing, it’s critical to factor any taxes imposed on your cloud transactions into your cost-savings calculations.

“There are two big mistakes we often see,” said Okimoto. “One is forgetting to factor sales and other transaction taxes into the purchase budget. The second mistake is trusting the vendor to get it right. A lot of CIOs think, ‘Well, you’re the vendor of this product, so you must understand what’s taxable and what isn’t.’ If the vendor doesn’t include tax on the invoice, the CIO just assumes that the product or service isn’t taxable. That’s a flawed assumption.”

Such an assumption can lead to a situation where the finance department looks at an invoice and recognizes that the sales or value added tax is missing. On a three-year, $50-million contract, an 8-percent sales tax adds up to an extra $4 million. In the UK, where the VAT is 20 percent, it’s an even bigger hit.

“That conversation needs to happen early on,” Okimoto continued. “If the IT procurement process doesn’t include a tax evaluation, it should raise some alarm bells for the CFO. When approving the budget for any sort of major cloud project, you should be asking whether taxes are included in the numbers. And if the answer is, ‘The vendor says it’s not taxable,’ it’s the job of the tax department to confirm that—because ultimately, it could be your liability.”

“I think the economy as a whole is moving towards digital and streaming services just as a matter of course, and so we’re going to see changes in tax rules and regulations to cover those types of services. The existing tax structure [in the United States] today evolved around personal property in the 1940s and 50s. As the economy moves more towards digital goods and services, the tax law will have to shift with it. It’s relatively easy to say that something is a digital service and that it’s taxable; that’s the easy question. The harder question is figuring out where it’s taxable. And I think that is a concept with which business and regulators are struggling.”

Reid S. Okimoto, National Tax Leader for Emerging Technology, KPMG
Consider Access to Tax Data and Proper Configuration of Reporting Requirements

You may not realize it, but many on-premise ERP systems are plugged into rules engines that calculate tax with every transaction the company makes. These rules are often heavily configured, especially in larger companies that span multiple jurisdictions. Rules engines make it much easier for the company to ensure that it’s collecting the right amount of tax in the right jurisdiction. The engines typically include audit trails, so that if a mistake happens, tax departments can examine the data and trace the source of the error. Finally, a tax rules engine can be an invaluable source of reporting when tax time rolls around.

When moving to a cloud environment, all this can be lost without careful input and planning. Cloud environments tend to be more standardized than on-premises software; that’s one of the benefits of the cloud, because standardization offers lower maintenance than custom environments. However, too much standardization can mean that you lose access to the tax rules and reporting modules that can be so valuable.

“When a company moves to a new ERP system, those tax rules and reports need to come into play early on,” said Okimoto. “The tax team needs to get involved and say, these are the reports that I need to see, and these are the transactions where I need auditing. If you don’t get the tax return done right, that’s a high-risk situation for the company officer whose signature is on the return.”

When one company migrated from on-premise to a cloud-based ERP system, the previous tax engine was unplugged. Later, the company went back to the cloud vendor to see if they could get an API that would connect the tax engine to the new cloud ERP. The answer the company received from the vendor was, “We have to develop one,” which would take several months. The company was forced to manually check and adjust invoices for the next three months, creating an unforeseen burden in terms of time and resources.

Calculating an R&D tax credit, for example, involves a complicated formula in which all of the company’s investments must be accounted for—people, equipment, supplies, research and more. Nearly all of this data comes from a company’s ERP system, which holds payroll data, fixed assets, supplies, purchases, etc. Many companies have configured their existing on-premise ERP solutions to generate reports used for R&D calculation. When one such company migrated to an ERP cloud system, those reports were no longer available. The company didn’t have the supporting data required to claim the tax credit—so it ended up paying more tax for the year.

When migrating to a cloud-based ERP solution, companies should look at which tax engines are supported by the vendor. An application program interface (API) is required that can be configured to work with your tax engine. It must be tested and run, to ensure that it’s pulling the correct data, charging the right amount of tax with each invoice, and generating the necessary reports.

“You don’t want to find out at tax time that you’ve been charging the wrong amount of tax, or that your reports don’t have the level of granularity you need. These are issues that you should address early on. I recommend that you ask your ERP cloud vendor what tax services or APIs are available, and whether they’re compatible with your industry-specific tax engine. It’s also worthwhile for the chief tax officer to be given the chance to review the reporting and determine whether it’s going to be adequate.”

Reid S. Okimoto, National Tax Leader for Emerging Technology, KPMG
Companies are becoming accustomed to considering many variables when moving to the cloud. For an ERP migration, it has become common to think about how it will affect human resources or procurement. Yet tax considerations remain, strangely, near the bottom of the priority list. This needs to change, because leaving tax out of the equation doesn’t allow for a full picture—it can not only skew the cost-benefit calculations of moving to the cloud, but can also create a sizeable tax burden for those who do not plan appropriately.

A good start is to choose an ERP cloud vendor with experience across multiple jurisdictions—one that is used to handling the ins and outs of business operations at a global scale. ERP cloud vendors should provide robust systems capable of managing global sales, exemptions, input credits, multiple access points, and changing tax rules. Such capabilities can help reduce the risk of non-compliance and avoid potentially costly mistakes.

Another step in the right direction is to choose a business tax advisor with demonstrated experience and expertise in the cloud computing space. An advisor with high-tech expertise can add bench strength to your own team of in-house tax experts, helping you take full advantage of R&D credits, incentives, and other technology-related tax rules that might be less familiar to your own team.

Finally, communication between department leaders is critical, so that tax leaders can perform due diligence and give sound advice before, and during, any migration to the cloud. Help ensure that the tax team gets involved early in any cloud-related conversations, and work closely with the business to respond quickly to tax questions around cloud investments and services. A lack of cross-functional communication can lead not only to a failed implementation, but to financial penalties that could have been easily avoided.