

Cloud Services v. Digital Infrastructure

Accounting, reporting and income tax implications

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Introduction

- ▶ CIOs have various cloud capabilities buying options:
 - ▶ Hosted cloud solutions designed as software as a service (e.g., third party hosted cloud services)
 - ▶ Digital infrastructure solutions comprising datacentre hardware and software products along with implementation and configuration services
- ▶ Buying decisions are influenced not only by maximizing ROI, minimizing cash outflows, but also other accounting and tax implications such as:
 - ▶ Capitalization of costs as capital assets and related amortization expense vs. operating expenses
 - ▶ Presentation of non-GAAP measures, specifically EBITDA metrics
 - ▶ Federal and state income, sales, and property tax matters

GAAP and EBITDA implications



GAAP and EBITDA implications

- ▶ The following summarizes the GAAP (financial reporting) and EBITDA implications for the purchase of hosted cloud and digital infrastructure offerings

	Hosted cloud – SAAS solution: Hosting service fees, implementation and set-up costs	Digital infrastructure:	
		Hardware and software purchases, implementation and set-up costs	Ongoing maintenance services
Balance sheet	Not a capital asset ¹	Capital asset ²	Not a capital asset
Income statement	Operating expenses	Depreciation or amortization expenses	Operating expenses
Statement of cash flows	Operating cash outflows	Investing cash outflows	Operating cash outflows
EBITDA	Included (as a reduction to EBITDA)	Excluded (does not reduce EBITDA)	Included (as a reduction to EBITDA)

¹ – The FASB / EITF has not yet finalized its guidance related to the accounting for implementation costs in a cloud computing service arrangement, but based on the proposed guidance, the asset would be treated similar to a leased asset rather than a capital asset and operating expenses (vs. depreciation) would be recognized. However, this conclusion is subject to finalization as part of the rulemaking process.

² – This assumes the implementation and set-up costs would be capitalizable under the internal-use guidance. Otherwise, such costs would be expensed as incurred as operating expenses.

Tax implications



Tax implications

- The following summarizes the Federal tax implications for the purchase of hosted cloud and digital infrastructure offerings

	Hosted cloud – SAAS solution: Hosting service fees, implementation and set-up costs	Digital infrastructure: Hardware and software purchases, implementation and set-up costs
Hosting fees ³	Deductible as services are performed ¹	N/A
Ongoing maintenance services	N/A	Deductible as services are performed ¹
Purchase of hardware ³	N/A	100% bonus depreciation eligible in year asset acquired and placed in service ²
Software subscription ⁴	Deductible as services are performed ¹	Deductible as services are performed ¹

¹ – Typically these costs would be expensed ratably over the term of the contract or agreement governing the services.

² – Available for property acquired and placed in service after September 27, 2017. This provision starts phasing out in 2023.

³ – Including any not separately stated software.





















⁴ – Purchase of software is eligible for 100% bonus depreciation. For hosted cloud, this would only apply if the customer purchased the software and had the rights to the software.

⁵ – State income, property, and sales tax consequences may vary.

Summary



GAAP, EBITDA and tax implication summary

		GAAP	EBITDA	Cash	Tax ⁴
Hosted cloud	Hosting fees				
	Implementation and setup fees				
Digital infrastructure	Purchase of hardware ¹				
	Software subscription ²				
	Implementation and setup fees if GAAP capitalization criteria is met ³				



Capitalized for GAAP, excluded from EBITDA and therefore not reducing it, cash outflow may be spread over time, and immediately expensed for tax purposes



Requires judgment based on facts and circumstances (could have no effect or could be unfavorable for cash if significant)



Operating expense for GAAP, included in EBITDA and therefore reducing it, upfront initial cash outflow, and expensed as incurred or over the life of the asset for tax purposes, rather than immediate expense

- ¹ – This treatment does not apply to a maintenance agreement that is purchased with the hardware. Treatment of a maintenance agreement is more similar to treatment of a software license.
- ² – If software is purchased rather than licensed as a subscription service, treatment would be similar to that of purchased hardware.
- ³ – If GAAP capitalization criteria is not met, treatment will differ for GAAP and EBITDA purposes.
- ⁴ – This analysis does not take into account state and local income, sales and use, or property taxes. Please consult your tax advisor.

Questions



Appendix



GAAP and financial reporting implications

- ▶ Accounting Standards Update (“ASU”) 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, provides guidance on a customer’s accounting for fees paid in cloud computing arrangements
 - ▶ If the customer has the *right to take possession* of the software and it is *feasible* to do so, the arrangement involves the purchase of a software license accounted for as an **intangible asset** (capital asset)
 - ▶ **internal-use software** guidance applies; costs to implement, configure and enhance the functionality of the offering are capitalizable over the expected life of the software
 - ▶ Otherwise, the arrangement is treated as a **service contract** for which costs, including the hosting, implementation and configuration fees are recognized as **operating expenses**
 - ▶ Outcome of the assessment could have a significant impact on the customer’s financial statements
- ▶ **Update:** The FASB proposed recent guidance that would require companies to apply internal-use guidance and recognize certain implementation costs as assets in a cloud computing arrangement accounted for as a service contract, but the costs would be presented in the same manner as hosting fees (i.e., as operating expenses other than amortization of a capital asset)

GAAP and financial reporting implications

- ▶ Hosted cloud service offerings utilizing Amazon Web Services generally do not involve a software license and therefore are accounted for as service contracts
- ▶ Digital infrastructure solutions involve the purchase of equipment and software products along with implementation services to set-up and configure the customer's capabilities
 - ▶ Expenditures to purchase the equipment and on-premise software would be **capitalized as capital assets**, which are amortized over their useful lives
 - ▶ **Qualifying costs** incurred to setup and implement would be capitalizable under the internal-use guidance, as either a fixed asset or intangible asset (which would be subsequently depreciated or amortized)
 - ▶ Costs are capitalizable to the extent:
 - ▶ The preliminary planning phase is complete and management has committed to the cloud infrastructure project
 - ▶ It is probable the project will be completed and the solution will serve its intended purposes
 - ▶ The costs (either internal or external) are directly associated with the project, pertain to application development, and are recoverable

EBITDA implications

- ▶ Companies frequently present Non-GAAP financial measures to communicate information to investors about their operating performance (or liquidity)
- ▶ Common Non-GAAP measures include earnings before interest, tax, depreciation and amortization (“EBITDA”), variations of EBITDA such as adjusted EBITDA or EBITDA margin, and other Non-GAAP metrics that include adjustments to GAAP net income
- ▶ These measures are affected by purchasing decisions that affect the accounting and classification of costs associated with hosted cloud versus digital infrastructure offerings as follows:

	Hosted cloud – SAAS solution: Hosting service fees, implementation and set-up costs	Digital infrastructure:	
		Hardware and software purchases, implementation and set-up costs	Ongoing maintenance services
Impact on EBITDA, Adjusted EBITDA or Adjusted Income measures that exclude depreciation and amortization	No Adjustment from GAAP to Non-GAAP measures: These costs are not classified as depreciation and amortization expense and generally are not added back to GAAP to arrive at Non-GAAP measures ¹	Adjustment Required from GAAP to Non-GAAP measures: These costs are classified as depreciation and amortization and generally added back to GAAP to arrive at Non-GAAP measures	No Adjustment from GAAP to Non-GAAP measures: These costs are not classified as depreciation and amortization expense and generally are not added back to GAAP to arrive at Non-GAAP measures ¹

¹ –SEC rules and regulations often preclude companies from excluding costs that are considered normal, recurring cash operating expenses. Therefore, these operating expenses generally are not excluded, but a company’s Non-GAAP practices may vary and could exclude such costs in certain cases.

Tax implications

Federal

▶ Cloud solutions

- ▶ Payments for cloud services (including software embedded in cloud services)
 - ▶ Generally, expense is recognized as services are provided (i.e., ratably over the term of the contract)
- ▶ Purchase of separately stated software that is added to cloud environment
 - ▶ Computer software placed in service after September 27, 2017 is eligible for 100% bonus depreciation.
 - ▶ If bonus depreciation is not utilized, the software is generally capitalized and amortized over a 36 month period.
- ▶ Purchase of software subscription that is added to cloud environment
 - ▶ Deductible as services are incurred (i.e., ratably over the term of the subscription).

▶ On premise digital Infrastructure

- ▶ Purchase of hardware (including software that is not separately stated)
 - ▶ Property placed in service after September 27, 2017 is eligible for 100% bonus depreciation (i.e., the entire amount can be expensed in the year placed in service). If bonus depreciation is not utilized, property is generally capitalized and depreciated over the MACRS life of the asset.
- ▶ Purchase of separately stated software
 - ▶ Computer software placed in service after September 27, 2017 is eligible for 100% bonus depreciation.
 - ▶ If bonus depreciation is not utilized, the software is generally capitalized and amortized over a 36 month period.
- ▶ Purchase of software subscription
 - ▶ Deductible ratably over the term of the subscription.
- ▶ Purchase of digital infrastructure likely requires a separate maintenance agreement
 - ▶ The cost of a maintenance agreement is generally deductible as services are provided (i.e., ratably over of the term of the maintenance agreement).

▶ Coordination with the research credit

- ▶ Purchases of digital infrastructure are not eligible expenses for purposes of the research credit.
- ▶ Payments for cloud environments may be eligible expenses for the research credit if those environments are used for development and testing activities.

Tax implications

State and local

- ▶ **State Income Tax Considerations**
 - ▶ Federal bonus depreciation on eligible assets
 - ▶ A majority of states decouple from the 100% federal bonus depreciation and require bonus eligible assets to be depreciated over their useful life.
 - ▶ Expenses recognized for services
 - ▶ States generally conform to the federal treatment and timing of expenses for services.
- ▶ **State Sales and Use Tax Considerations**
 - ▶ Most states tax all sales of the tangible personal property, including tangible components of Digital Infrastructure, unless specifically exempted.
 - ▶ States vary in their approach and ability to tax Cloud Solutions as Software as a Service (“SaaS”), Infrastructure as a Service (“IaaS”) and Platform as a Service (“PaaS”) transactions.
 - ▶ The taxability landscape of SaaS, IaaS and PaaS services is continually changing as state judicial, legislative and revenue departments attempt to define the changing technology.
- ▶ **State Personal Property Tax Considerations**
 - ▶ Thirty eight states impose a personal property tax.
 - ▶ States take varying positions on computer equipment and application software.
 - ▶ Unless specifically exempted, states will assess personal property tax on tangible components of Digital Infrastructure and certain types of software.
 - ▶ As cloud solutions are generally service based and intangible in nature, cloud solutions may be exempted from personal property tax.