At the intersection of international tax and digital transformation

Private equity meets public policy on new ground

EY

Building a better working world

At the intersection of international tax and digital transformation

Private equity meets public policy on new ground

EY is a regular contributor to CCH's *Global Tax Weekly*. As tax and technology professionals, from member firms around the world, we share our insight and technology perspective on topics of interest to executives faced with taxation issues resulting from disruptive innovation and technology enabled digital transformation. The content contained in this document was first published in *Global Tax Weekly* – and is being reprinted with full knowledge and permission from Wolters Kluwer, copyright 2016 CCH.

In this edition

3 **Overview**

4 **Highlights and takeaways**

5 **Item 1: Private equity (PE) firms face new tax challenges amid growing technology M&A** – in the midst of a record-breaking technology M&A market, PE firms face a particular set of challenges as global digital economy tax policies emerge.

7 **Item 2: Australia presses anti-avoidance law** – Australia presses ahead with its anti-avoidance law, seeking and publishing tax information from numerous companies.

8 **Item 3: Digital currencies subject to diverse tax interpretations** – digital currencies are the subject of increasingly diverse tax interpretations and policy formulations.

10 **Item 4: Italy taxes print, digital publications alike** – Italy decides to tax print and digital publications alike.

11 **Item 5: Turkey looks to document e-commerce activity** – Turkey looks to document e-commerce activity in a move that could pave the way for new e-commerce taxation.

12 **Item 6: Russia planning VAT on cross-border electronic services** – a draft Russian law aims to impose VAT on cross-border electronic services.

These local country and international dynamics present fundamental considerations for tax practitioners and international finance executives, who must:

1. Understand the level of uncertainty you face in monitoring and preparing for ongoing change in digital economy taxation worldwide.
2. Always keep in mind the current context of potentially varying tax treatment from country to country.
3. Map the tax treatment of IP, transfer pricing, research and development (R&D) and other issues related to your digital business models from the very outset, as you first develop your strategies, and build in flexibility for the long term.

Overview

As digital economy tax policies emerge across the world, we will begin this column by analyzing some unfamiliar tax challenges faced by one important group: PE firms, and particularly those investing in technology companies.

This column will also touch on both multilateral and national policy developments, following the Organisation for Economic Cooperation and Development's (OECD) recent publication of a set of 15 reports addressing base erosion and profit shifting (BEPS). New national tax policies, rulings and administrative practices are proliferating both in line with and in apparent contradiction to the OECD BEPS guidelines, which themselves continue to be clarified by global working groups.

Whether for PE firms or corporations, this all poses enough uncertainty to sap the digital confidence companies need to do business with speed, agility and innovation. Acting confidently in today's hypercompetitive economy requires an enterprise-wide grasp of current and future digital business catalysts, along with their tax, legal and policy implications. That's a tall order given the kaleidoscope of tax and technology change that has been set in motion.

PE firms face a particular set of challenges, including expectations for higher taxes on interest payments, a whole new level of tax reporting requirements and a learning curve about the tax implications of globally commercialized intellectual property (IP). New international tax trends may even dampen transaction pricing and investor returns. The potential impact is not insignificant in the global technology sector, which posted record (and quite likely growing) mergers and acquisitions (M&A) in 2015, including nearly 300 PE deals.

Preview of our next edition: a discussion of the significant legislation announced by the UK, Israel and India, which will likely impact technology and digital transactions.

We also invite you to explore EY's website devoted to digital economy taxation at ey.com/digitaltax. There, you will find our newest report – *When the sharing economy knocks, how will you answer?* Additionally, you are invited to watch an on-demand webcast titled *OECD BEPS project outcomes Part 3: Digital Economy Developments and Action 1*.[1]

Highlights and takeaways

Tax update	Technology impact	Ask yourself
PE firms face a particular set of challenges as global digital economy tax policies emerge.	PE firms buying technology companies need to be especially alert to shifting value-added taxes (VAT) and to the management of IP.	As a PE firm, are you fully integrating tax risk mitigation and IP planning into transaction analysis, portfolio management and firm operations?
Australia presses ahead with its anti-avoidance law, seeking and publishing tax information from numerous companies.	Australia is one of the first countries to implement multifaceted legislation that addresses digitally enabled multinationals under new tax guidelines from the OECD.	Is Australia setting any international precedents?
Digital currencies are the subject of increasingly diverse tax interpretations and policy formulations.	Recent rulings variously treat Bitcoin as a currency, a tangible property and not tangible property.	Will your strategy formulation for virtual currencies and other disruptive financial technologies integrate tax considerations to mitigate risk and or even reap innovation incentives?
Italy decides to tax print and digital publications alike.	Italy's move counters last year's ruling by the European Court of Justice, which some countries are contesting.	How will the Italian development ultimately play out across Europe?
Turkey looks to document e-commerce activity.	The move could pave the way for new e-commerce taxation.	How would new taxes affect your e-commerce pricing strategy and profits in Turkey?
A draft Russian law aims to impose VAT on cross-border electronic services.	Russia would join a growing list of countries in Europe and Asia that have recently done so.	Which of your services might be subject to new VAT rules, and how can you mitigate VAT risks and extra costs in Russia?

Item 1: PE firms face new tax challenges amid growing technology M&A

New multilateral and national policies are introducing greater tax complexity for PE firms, which are not only making deals at record-breaking levels, but often managing assets longer, as well.

There is a lot at stake in the global technology M&A market. One measure is PE firms' aggregate transaction value in this sector of USD55.9bn in 2015 (for PE deals with disclosed values), which represents a 41% increase over 2014, according to EY's recent *Global technology M&A report* (available at ey.com/technology). PE transaction volume in the technology sector was also up slightly, to 285 announced deals. And overall expectations for sector M&A indicate continued strength in both domestic and cross-border M&A in 2016.

Pinpointing technology sector PE challenges

As assets under management continue to increase, the tech sector remains very attractive for fund managers given the unparalleled growth opportunities it provides. The following two takeaways should be on top of mind of finance and tax executives managing investments in tech:

- New global trends in value-added taxes (VAT), sales and use taxes, and goods and services taxes (GST)
- Tax authorities' growing and changing focus on IP

To show why, let's analyze the following scenario: BigFund invests USD75m in CloudSAS Inc., looking to make a strategic exit in about four years with a targeted increase in initial valuation of more than 400%. When CloudSAS has achieved or exceeded this valuation, the company will have global reach and high sustainable margins. To get there, CloudSAS will initially concentrate on rapid growth in its top line and customer base, with profits expected to follow.

First takeaway: beware of unanticipated VAT

The first takeaway from this case is the expanding significance of transaction taxes, such as various VAT-like taxes, which raise revenues for various tax authorities regardless of whether the company generates a profit or not. These could range from 9% to more than 20% of gross sales, before any penalties and interest for non-compliance, if incurred.

National governments have been changing the VAT-related sourcing rules to the location of the customer (rather than supplier) and reducing the nexus threshold for establishing a taxable presence in their country, either in monetary terms or as measured by the level and type of activities. This is particularly challenging for global digital companies like CloudSAS, which could suddenly find themselves taxable in a particular jurisdiction.

A fast-growing tech company and its owners do not always understand the company's transaction tax profile well enough to make informed decisions about compliance. Limited resources, including management time, and the focus on growing the business may create a temptation to defer tax considerations and take more aggressive positions in light of what competitors are doing.

Care must be taken to get the balance right and avoid an all-too-familiar situation in which a strategic transaction is delayed and/or consummated at a discounted price due to financial exposures from deferred maintenance of transaction taxes. In general, CloudSAS should find it preferable to proactively structure its offerings to minimize exposures and compliance burdens rather than deal with tax audits and costly remediation including voluntary disclosure programs.

Second takeaway: understand IP exposures

The second takeaway is the importance of IP planning from an income tax perspective. Let's look again at CloudSAS, as a US tech company aiming for high margins with an effective cash and financial statements tax rate in the low double digits on foreign earnings.

Under transfer pricing guidelines, taxable profits are allocated among related entities (parent and subsidiaries) based on assets employed, functions performed and risks assumed. This means that for a high-margin business, very substantial residual profits are allocated to IP, which is arguably the most valuable intangible asset tech companies own. Proper IP planning — among other things — is primarily about investing in the right R&D and base IP earlier on, and properly managing infringement in a manner that optimizes the after-tax return. Given the amounts involved and the potential financial impact, proper planning and documentation are critical for a sustainable and efficient tax structure. Tax authorities around the world have been aggressively targeting actual and perceived abuses surrounding IP and transfer pricing.

Accordingly, companies like CloudSAS should not only make sure that their IP planning is technically sound from a tax and transfer pricing perspective, but that it also aligns with their business structure, takes into account their appetite for risk and strikes the right balance between benefit and controversy.

Most PE firms face impending challenges

For PE firms targeting any sector, recently issued OECD BEPS guidelines and their national implementations are bringing new considerations to the question of what to buy and where to buy it, as reported in a recent EY webcast titled *BEPS is broader than tax: Mergers and Acquisitions*. These policy changes could have a significant impact on acquisition and exit pricing — and even on a PE firm's own operations. Among the potential implications:

- BEPS Action 4 could lower allowable tax deductions on interest, increasing the tax burden — particularly for highly leveraged transactions.
- Action 6 has the potential to limit treaty benefits currently enjoyed, given PE reliance on double tax treaties to reduce withholding taxes on dividend, interest and royalty flows as well as relieve non-resident capital gains tax charges.
- Action 7 permanent establishment considerations could have an effect on how some PE firms themselves operate — for instance, on their global marketing, transaction sourcing and the conclusion of sales that are centrally controlled.
- Country-by-country (CbC) reporting under BEPS Action 13 could be a somewhat new experience for PE firms, whose current public documentation requirements have been relatively modest. And not only could the information they submit on global operations and transfer pricing open the door to greater tax audit risks, but prospective buyers of their assets could request CbC reports while conducting due diligence. Notably, revenue thresholds for reporting could be lower in some countries than the globally set level of EUR750m (USD833m).
- Aggressively structured deals could give rise to reputational risk.
- Increased uncertainty over the next one to three years, as these tax policy changes roll out, could impinge on deals.
- Indirect costs could be incurred to update targets' and portfolio companies' systems to the point of compliance.

Considerations

PE executives in the technology transactions market have to face new tax risks as squarely as do their corporate counterparts. These risks can be very substantial, and leaving their consideration for a later time can lead to financial penalties, reputational risk and even stalled or unprofitable dealmaking. Tax risk mitigation and IP planning should be more fully integrated into PE transaction analysis and decision-making, portfolio management and firm operations.

Contributor:
Alex Levchenko (alexander.levchenko@ey.com) Ernst & Young LLP, US

Item 2: Australia presses anti-avoidance law

Australian Tax Commissioner Chris Jordan recently projected active follow-through on the country's Multinational Anti-Avoidance Law (MAAL), which went into effect January 1, 2016. The Australian Taxation Office (ATO) has officially asked 86 multinational companies to provide more information on their business in Australia or, if uncooperative, face potential assessments, liabilities or lawsuits.

Notably, the legislation that passed Australia's parliament in December 2015 was also stronger than the draft submitted in May 2015. The number of multinational enterprises covered increased significantly, from the original 30 expected to be affected.

Australia is one of the first countries to implement multifaceted legislation that addresses digitally enabled multinationals in the OECD BEPS context. As such, its measures and their impact are being watched closely by government and industry worldwide.

A roadmap to compliance
In January, the ATO provided a roadmap to the new law and related processes, to "increase the likelihood of reaching mutually agreeable positions and reduce the need to proceed with ordinary compliance activities." Key features of the guidance include:

- What questions a multinational taxpayer should use to frame its MAAL tax risk analysis
- Where the company sits within the ATO risk profile
- How and when to engage with the ATO
- How the ATO will categorize taxpayers for penalty purposes, based on the approach the taxpayer adopts to engaging with the ATO

In issuing the roadmap, the ATO had forewarned that some multinationals would receive letters advising of the risk that they could be within the scope of the MAAL. Other taxpayers were asked to apply the MAAL risk analysis and notify the ATO by March 31 of this year if certain "hallmarks" of anti-avoidance are found, to begin a process of engagement.

The process for MAAL engagement bears features of an advance pricing agreement (APA) between a tax authority and taxpayer, with a focus on transparency concerning the taxpayer's structure and transfer pricing. A company's response to this new process can result in its categorization as voluntary or responsive or not. Such categorizations can reduce maximum penalties from 100% of understated tax to as low as 5% (or as low as 20% for companies currently under audit), provided the taxpayer has a "reasonably arguable position."

Taking taxation public
As this column went to press, the ATO was expected in March to publicize a second batch of large companies' tax data. The first, released in December 2015, included details on more than 1,500 public companies — those with total income of AUD100m (USD71m) or more, based on their 2013/14 income tax return. The second batch is expected to cover Australian majority-owned private companies with income of more than AUD200m (USD143m).

Considerations
It is critical that multinationals doing business in Australia assess the risk of the MAAL applying to existing structures, consider options, potentially consult with the ATO and take appropriate action. They should also prepare for increased scrutiny by the media, advocacy groups and investors regarding tax information publicized in Australia. Finance executives around the world should keep an eye on developments in Australia in the event its approaches migrate to other shores, although the OECD has to date limited the sharing of so-called "country-by-country" reports of tax data to government authorities and not the general public.

Contributors:
Jarrod Thomas (jarrod.thomas@au.ey.com) and Tony Cooper (tony.cooper@au.ey.com), Ernst & Young, Australia

Item 3: Digital currencies subject to diverse tax interpretations

As digital currencies and other disruptive financial technologies (FinTech) continue to gain traction throughout the world, governments are beginning to take a diverse range of approaches toward taxing, regulating and promoting the use of these technologies.

Guidance for the tax treatment of Bitcoin continues to evolve and it is variously being viewed by financial and tax authorities as a currency, tangible property and not tangible property.

For example:

- The US Internal Revenue Service (IRS) took a different position in 2014, saying that digital currency will be treated as property, not currency, for tax purposes[2]
- While regulation and tax rules are still being discussed, Japan's financial regulatory agency is proposing to handle digital currencies as equivalent to conventional currencies, according to media reports earlier this year[3]
- The Court of Justice of the European Union ruled in October 2015 that the 'bitcoin' virtual currency cannot be characterized as 'tangible property' according to the VAT Directive

Meanwhile, some companies are pushing boundaries; one US online retailer recently signified its intent to issue stock via Bitcoin, in a form filed with the US Securities and Exchange Commission (SEC). For its part, the OECD bookmarked the subject in October 2015, when releasing its *BEPS Action 1 Report: Addressing the Tax Challenges of the Digital Economy*, by saying that virtual currencies represent one of the technology developments to be "monitored closely as they may generate additional challenges for tax policy makers in the near future."

To date, EY analysis shows that most FinTech activity has been concentrated in the payments space, where the changing habits of millennials to shop (and bank) via mobile has led to real demand from consumers and merchants. Other innovations entering the mainstream include alternative finance platforms, including crowdfunding and peer-to-peer lending. Future innovations attracting interest include virtual currencies and other opportunities leveraging blockchain technologies that enable these currencies.

Countries look to become FinTech hubs
Tax incentives are on the table in several countries looking to attract inward investment in FinTech as well as grow local competence in the sphere. A February 2016 report conducted by EY for the UK Treasury also documents these policy developments among countries seeking to develop global FinTech hubs.[4]

- **Australia:** the Prudential Regulation Authority is expected to establish a public-private collaborative committee to facilitate financial system innovation in mid-2016
- **Germany:** an internal project group started work in November 2015 to analyze the latest developments in the FinTech market, with the goal of determining whether the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) needs to adjust its market oversight
- **Singapore:** in July 2015, the Monetary Authority of Singapore announced the formation of a new FinTech and Innovation Group, to develop policy, technology infrastructure and a technology innovation lab
- **UK:** the Financial Conduct Authority started Project Innovate in October 2014 to help FinTech companies test their technologies

EY's analysis also points to specialization among regional centers focused on specific emerging technologies. Examples include Israel's focus on cybersecurity, Benelux's focus on payments, Dublin's focus on fund administration, Malta and the Isle of Man's focus on digital currencies and Estonia's focus on financial identity.

Considerations
A great deal of both tax risk and opportunity clearly lie ahead for companies developing business models based on virtual currencies and other FinTech. While tax is only one strategic consideration, it could be an important determinant of the speed at which a company can innovate and the rate at which it can profit from these important new technologies. Once again, our advice is to integrate tax considerations into strategic planning early. Companies should also engage with tax authorities to help ensure rational tax policy is developed in this new arena.

Contributor:
Todd Scherzer (todd.scherzer@ey.com), Ernst & Young LLP, US

Item 4: Italy taxes print, digital publications alike

Italy has reduced VAT on a range of digital publications from the headline 22% to 4%.

The step was taken despite a European Court of Justice ruling last year that bars Europe's national tax authorities from giving VAT discounts on e-books, as they do for print publications. In fact, Italy is extending the discounted rate beyond e-books, to newspapers and periodicals.

Considerations

The move could have implications across Europe, which digital publishers of all stripes should monitor. In fact, Italy is one of a handful of European governments calling on the European Commission to reverse the court ruling, arguing for similar treatment between digital and print distribution. There are indications the Commission will review European VAT law regarding digital media, with the objective of being "technology neutral," but no such action has yet taken place.

Contributors:
Anne Freden (anne.freden@ey.com) and Corin Hobbs (corin.hobbs@ey.com),
Ernst & Young LLP, US

Item 5: Turkey looks to document e-commerce activity

The national government is looking to collect information from companies facilitating e-commerce in Turkey, in a step that is expected to provide the basis for greater taxation of the nascent but fast-growing sector.

In December 2015, the Government published a communiqué regarding information that will be required in connection with transactions from July 2016 going forward.

Companies that will be required to provide ongoing information include e-commerce portals and platforms, banks supporting internet commerce, online advertising networks, and delivery companies. The types of information requested include business customer data, revenue, methods of payment, number of shipments and more, depending on the type of company filing the information.

Last year, the Informatics Industry Association of Turkey reported that e-commerce represented only a small percentage of the economy, but that it was growing faster than traditional commerce. "Once based on a sound legal basis and backed by up-to-date legislation, the e-commerce sector will contribute more to the tax system, employment creation and overall trade," said association Chairman Kemal Ciliz.

Considerations

Companies doing e-commerce in Turkey should assess reporting requirements and monitor further tax developments, gauging the potential impact on pricing strategies and profits. For now, they can find details about the information gathering effort in a recent EY Global Tax Alert.[5]

Contributor:
Gabor Z. Toth (gabor.toth@ey.com), Ernst & Young LLP, US

Item 6: Russia planning VAT on cross-border electronic services

Russia looks likely to join a growing list of countries across Europe and Asia that have recently imposed VAT on cross-border electronic services.

Foreign companies providing business-to-business (B2B) and business-to-consumer (B2C) electronic services would be liable, and suppliers would have to register with Russian tax authorities if conducting B2C transactions.

A draft law contains principles similar to EU VAT. However, differences include the scope of electronic services; VAT payment mechanisms registration and reporting procedures; VAT offset/refund rules, control measures and many other aspects. The draft law would also abolish the VAT exemption for licensing of software and databases.

Considerations

Tax executives need to work with their business and strategy colleagues to review which of their services might be subject to new VAT rules, analyze possible adjustments of their business models, and develop a framework to mitigate VAT risks and extra costs in Russia.

Contributor:
Vladimir Zheltonogov (vladimir.zheltonogov@ru.ey.com), Ernst & Young (CIS) BV Cross Border Tax Advisory, Moscow

About the authors

Channing Flynn (channing.flynn@ey.com), Stephen Bates (stephen.bates@ey.com) and Jess Martin (jess.martin@ey.com) are collaborating on this column with members of the global EY organization's network of tax professionals in member firm technology practices.

Channing Flynn
is an International Tax Partner of Ernst & Young LLP (US) based in both San Francisco and San Jose and EY's Global Technology Industry Tax Leader

Stephen Bates
is an Ernst & Young LLP (US) International Tax Principal based in San Francisco

Jess Martin
is an International Tax Senior Manager of Ernst & Young LLP (US), based in San Francisco

Additional contributors to this issue of our column include:

Alex Levchenko
Item 1: Private equity (PE) firms face new tax challenges amid growing technology M&A

Jarrod Thomas and Tony Cooper
Item 2: Australia presses anti-avoidance law

Todd Scherzer
Item 3: Digital currencies subject to diverse tax interpretations

Anne Freden and Corin Hobbs
Item 4: Italy taxes print, digital publications

Gabor Z. Toth
Item 5: Turkey looks to document e-commerce activity

Vladimir Zheltonogov
Item 6: Russia planning VAT on cross-border electronic services

Sources

1 "*OECD BEPS project outcomes Part 3: Digital Economy Developments and Action 1*," EY webcast, access via www.ey.com/GL/en/Issues/webcast_2015-10-20-1600_oecd-beps-project-outcomes-digital-economy-developments-and-action-1

2 Internal Revenue Service, Notice 2014-21, accessed via www.irs.gov/pub/irs-drop/n-14-21.pdf

3 "Japan eyes treating bitcoins the same as real money," *Nikkei Asian Review*, 24 February 2016, via Factiva, © 2016 Nihon Keizai Shimbun, Inc.

4 "*UK FinTech — on the cutting edge: an evaluation of the international FinTech sector*," EY, © 2016 Ernst & Young LLP.

5 "Turkey imposes obligation on certain taxpayers to provide information regarding e-Commerce and other business activities," *EY Global Tax Alert*, 30 December 2015, © 2015 EYGM Limited.

For the record

EY's tax and technology professionals from our member firms around the world bring a particular focus on today's digital megatrends of smart mobility, social networking, big data analytics, cloud computing and accelerated digital adaptation. Writing regularly for Global Tax Weekly is a great way to share our insight and experience with you, so we look forward to receiving your comments and ideas for future columns. Please email your comments and suggestions to Jess Martin, Ernst & Young LLP, US, at **jess.martin@ey.com**.

Technology sector leader

Greg Cudahy
Global Leader — TMT
Technology, Media & Entertainment and Telecommunications
+1 404 817 4450
greg.cudahy@ey.com

Technology service line leaders

Channing Flynn
Global Technology Industry Leader
Tax Services
+1 408 947 5435
channing.flynn@ey.com

Jeff Liu
Global Technology Industry Leader
Transaction Advisory Services
+1 415 894 8817
jeffrey.liu@ey.com

Dave Padmos
Global Technology Industry Leader
Advisory Services
+1 206 654 6314
dave.padmos@ey.com

Guy Wanger
Global Technology Industry Leader
Assurance Services
+1 650 802 4687
guy.wanger@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's Global Technology Sector
EY's Global Technology Sector is a global network of more than 21,000 technology practice professionals from across our member firms, all sharing deep technical and industry knowledge. Our high-performing teams are diverse, inclusive and borderless. Our experience helps clients grow, manage, protect and, when necessary, transform their businesses. We provide assurance, advisory, transaction and tax guidance through a network of experienced and innovative advisors to help clients manage business risk, transform performance and improve operationally. Visit us at ey.com/technology.

EYG no: 00557-164GBL
ED None.
EY-GTC