Tax issues in the new digital environment

Media and entertainment
As the consumer appetite for media and entertainment (M&E) continues to change, M&E companies continually develop new digital business models to capitalize on trends. In their initial stages, these new models may not involve large amounts of money. Tax teams might be ignored until the ideas start generating real dollars. However, that may be too late.

As operating teams construct these new models, their tax teams should assess them in the early stages of development, determine their appropriate tax treatment and ensure that the company’s systems are equipped to handle their tax needs. Waiting until the new offering has gained traction can eventually lead to costly system changes, and tax risks can grow quickly. For example, VAT liabilities can accrue as a gross revenue-based amount, with significant penalties added.

And liabilities are not the only concern. Once a business line is set up in a tax-inefficient structure, changing or moving it once it becomes successful can be very expensive, commercially and tax-wise.

This booklet outlines some of the tax issues that surface in new digital environments. It is meant to help you stay on top of changes in your digital environment and address the tax implications before you risk financial exposure and tax controllership. The material contained herein complements two other thought leadership pieces from Ernst & Young explaining the new trends and sources of potential revenue. Monetizing digital media: creating value consumers will buy and Defining digital revenue in media and entertainment: establishing industry-wide consistency and comparability will familiarize you with the issues your colleagues are tackling. The latter further explores the accounting issues that arise as the revenue from digital distribution becomes a greater share of companies’ top lines.

The most appropriate methods of resolving these burgeoning tax issues are as varied as the M&E companies that will confront them. This document is not meant to answer every question, but it should spark further thought that could save you future time and expense.
New day, new demands

In the past, audiences consumed pre-packaged content through a few distribution channels that were largely set by content owners and broadcasters according to preferred models.

Increasingly, the marketplace seeks content on an à la carte, on-demand basis and in a digital format, whether it be in the form of books or music, newspapers or magazines, TV shows or films, games or social networks. More and more, audiences want the ability to access content, manipulate it and share it through social media. This new paradigm involves remote consumption and use of content often stored in “the cloud,” a method of computing that makes resources such as storage, databases and applications available through the internet.¹ The new delivery models can cross national and state boundaries, raising tax compliance responsibilities that many companies overlook.

These changes require tax teams to reconsider many standard questions, especially those involving characterization and sourcing, transfer pricing, state taxation and indirect taxation. And they can require critical tax compliance changes to customer service and financial systems.

We will briefly outline the tax concepts and issues that often need reassessment under new digital business models, and then review several commercial trends to see more specifically which concepts must be reanalyzed within the new paradigm.

International tax: characterization and sourcing

Existing tax law was developed primarily in a world of physical goods and in-person services. Today, entertainment content is increasingly provided digitally, with minimal human intervention, through computer servers instead of physical distribution chains.

The old rules don’t always address what happens in newer, virtual business models. As a result, the framework for determining the tax treatment of income from online transactions requires tax directors to reframe the following basic questions:

What type of transaction is it?
The type of transaction affects the character of the income, which in turn affects how it is taxed. Online transactions that involve transfers of property rights (e.g., online downloads of movies) typically involve limited licenses that are treated for tax purposes as royalties, rentals or sales, depending on the extent of the rights conveyed. For example, rights to alter or broadcast code, and whether the rights are time-limited, need to be considered.

Instead of involving transfers of property rights, other transactions might involve access to content or systems in the cloud that are more properly described as service transactions. Access to online games, music and news, for example, which are not downloaded, might be structured this way.

Finally, transactions might have elements of both a property transfer and a service, such as downloaded games or other software. They also may allow access to other benefits in the form of services.

Who (or what) earned the income, and where was it earned?
The location of income-producing activities can impact how and where the income is taxed under source-of-income and permanent establishment principles. In many cases, online transactions are provided automatically in the cloud. This raises numerous questions, the answers to which are fact-specific.

For example:

- How should we factor the machines’ roles into the source rules? Is the place of performance for a service the same as the server’s location? Does this mean that the source of service income could be part US and part foreign, based on the servers’ locale?
- How should income be allocated between humans and machines in the supply chain? What employee activities are income-producing? Consider delivery and IT functions vs. research and development and sales and marketing. Does it matter that humans in the US programmed machines that are located in Ireland?
- What impact do outsourced services have on place of performance? For example, if a US entity operates servers as a subcontractor, US “effectively connected income” and withholding tax rules could be implicated where services are purchased by a customer located outside the US due to nexus created by servers located in the US.

What’s the impact on historic structures?
The transition to new types of income streams could create exposures within historic tax structures.

For example, Subpart F implications should be re-examined. Companies licensing content through a foreign distribution structure historically may have had US tax deferral on royalty income. However, if the character of the income streams changes to services, you must meet different requirements to maintain deferral.

In addition, revenue streams characterized as services may raise new local-country tax issues. Permanent establishment risks should be managed more closely in the context of services – e.g., a permanent establishment can exist for a services business without a fixed location.

A change in the type of transaction and the entity earning income may also affect the withholding taxes levied. While royalty streams generally attract withholding tax, sales and services income often don’t.
Transfer pricing

Companies that own entertainment content often have related entities whose engineers, programmers and artists convert traditional content into a digital format. The revised and reformatted content is likely to be marketed, sold and distributed by other related entities that provide valuable services and marketing intangibles. Distribution channels for digital content may be very different from the channels used for physical goods, and that can dramatically upset established transfer pricing analyses.

Take a fresh look at your supply chain

The answer to the question, “Who is doing what for whom?” may be very different in a digital model as compared to a physical model. New intercompany service and licensing relationships may require new transfer pricing analyses and documentation.

The technologies (e.g., software and programs) and assets (e.g., servers and branded websites) that companies develop or employ to digitally distribute content also might require separate compensation and documentation. When characters, stories or trade names that were used in traditional products are combined with new formats, technologies and applications, new value relationships arise. A new game played on a handheld device that uses trade names, characters or scenarios from published materials or films and television may involve contributions of value from multiple sources and entities. All of them may need to be valued separately, with payments going to the respective owners and developers.

While marketing intangibles may exist with respect to the traditional exploitation of media products, companies moving toward digital distribution typically find themselves with a host of new partners (e.g., hardware manufacturers or distribution channels) and approaches (e.g., 24-hour access rights vs. five-day rentals). This may necessitate new marketing strategies, which in turn may develop new marketing intangibles and raise questions about the value of traditional marketing intangibles. Tax departments will need to track the contributions, costs and locations of both old and new intangibles and be aware of their relative values and evolution over time.

Look ahead

Once you have a handle on the changes in the business model, consider whether there is a new way to optimize the operations going forward. The information uncovered for transfer pricing compliance undoubtedly will be useful in assessing opportunities for achieving tax efficiencies through cost-sharing, co-production or licensing transactions with affiliates in low-tax jurisdictions. Changes in business models may create planning opportunities that were not available under the prior model.
State and local tax (SALT)

As M&E companies devise ways to monetize new digital distribution models, states are trying to get their “fair share” of the profits in ways that would have been unavailable in the physical realm.

Sellers are, in some cases, dealing with new intermediaries, and in other cases they are dealing directly with end-users for the first time. These changes may raise state and local tax issues that sellers previously did not need to address on both the income and sales/use tax fronts.

Much of the law in this area remains unsettled, but states are nonetheless moving forward to tap companies for potential tax revenue.

Physical vs. economic presence

Many companies may not have brick and mortar locations within their borders, but quite a few states are getting creative to reap sales and use and income taxes from out-of-state businesses.

Historically, content publishers were able to avoid income tax nexus in states if they were not based therein. They were protected by Public Law 86-272 for income tax purposes, because they were soliciting sales of tangible personal property. But there is no clear answer as to whether the law protects bits and bytes delivered electronically. In fact, a strong position exists that there is no protection based on PL86-272.

Furthermore, states are increasingly viewing economic presence – rather than a physical presence – as the standard for nexus. Often, they use a de minimis amount, such as $500,000 in sales made to customers within the state, as their threshold. It doesn’t take many clicks to reach that figure. There are strategies you can employ to prevent nexus, potentially creating “nowhere income.”

Nearly a dozen states have formally adopted economic nexus standards, and other states are expected to follow. Moreover, while not formally contained within their statutes, many states are asserting economic nexus in controversial, rather than just putatively “abusive,” situations.

It is unclear where the US Supreme Court will draw the constitutional line for assertions of economic nexus, but until the Court or Congress intervenes, states are establishing lower and lower thresholds to trigger nexus and filing requirements. As a result, businesses can start accruing liabilities quickly and without notice – especially since some of the states have bigger markets than some of the countries in the EU.

Sales tax nexus

The mode of delivery is extremely important and will dictate the imposition of sales tax in a jurisdiction. The use of content aggregators can raise difficult questions of sales tax collection responsibilities. Sellers need to determine whether they are primarily responsible for sales tax collection or if the intermediary is responsible. They must also determine whether contractual provisions reallocate economic risk for tax collection responsibility.

Determining where the customer is ultimately receiving the goods may be a challenge. Consider the customer who has a contract for his smart phone in New York, but downloads a movie while in Iowa. Is Iowa tax due on the sale? New York tax? Both? How does the media company obtain the data necessary for compliance?

Similar to the Internet Tax Freedom Act, there is a federal uniform sourcing statute relating to mobile phone providers, the Mobile Telecom Sourcing Act. That act applies to access charges, i.e., the standard monthly phone bill. But, similar to the Internet Tax Freedom Act, which never applied to exempt sales of tangible goods over the internet, the Mobile Telecom Sourcing Act doesn’t facially apply to sourcing of content delivered over a mobile phone.
In some states, content distribution is exempt from sales tax because it is taxed under an “admissions tax” scheme. Perhaps a particular state’s exclusion from sales tax is arguably broad enough — and the state’s inclusion for admissions tax narrow enough — to exempt a company’s sales. But what if the company plays in between those margins and, later, the state asserts liability when it is too late to collect the tax from the customer? Or what if the company more conservatively collects the tax — is it open to class-action liability for over-collection of the tax?

Distributors are making agreements with states to collect taxes that could impact your business model. If you are distributing content, including applications — or “apps” — through an online distributor, it is critically important to understand who bears the statutory obligation for sales tax collection.

Bundling also becomes important. Sellers will want to be as competitive as possible with price. If you are careful and carve out content for which you don’t have to impose a sales tax, you can optimize your pricing.

**Sourcing for income tax**

Two general types of sourcing rules exist — those for tangible property sales and those for everything else. There are two main ways of sourcing the latter: cost-of-performance and market base. That prompts questions in the following scenario:

If a film generates $100 million in revenue, do you allocate the income to the state where you incurred the production costs, or do you allocate the income among the states according to the number of viewers?

Income sourcing rules vary by state and are in flux in some states. Other states have taken positions that differ from what may appear to be statutory mandates about sourcing methodology.

There is a prevailing view that income from digital delivery of software should be sourced in the same way as revenue from software in a shrink-wrapped box. Would the same be true for entertainment delivered digitally? Should it be treated as tangible media similar to DVDs?
Value added tax (VAT)

A US company selling a video download to a customer in Europe has nothing to worry about with respect to VAT collection, right? Not so fast. For VAT purposes, the place of taxation is determined by the “place of supply.” The place of supply is where the customer receives electronically supplied services (ESS). If a California company provides ESS to a customer in Germany, the place of supply, for VAT purposes, is Germany.

Additionally, VAT is chargeable on what the customer pays, not what the seller receives. So, the seller must collect VAT on the gross selling price, not the net amount after payment processors or platform providers have withheld their fee.

Consequently, VAT exposure can be a significant trap for the unwary seller of digital content. With VAT rates on average in the 20% range and based on gross revenue, uncollected VAT exposure can drain a profitable business. When the risk goes unnoticed, it can later surface with significant financial statement impact and can raise concerns about internal financial controls.

Managing the risk

A seller’s financial systems must be set up to handle VAT obligations wherever customers reside and VAT obligations exist. Even determining the customer’s location can be an additional systems commitment. Fortunately, there are strategies to mitigate the burden and risk.

In the EU, there is a single point of registration (SPOR) simplification that allows a non-resident supplier to remain offshore, but register for VAT in one country to account for VAT in all 27 EU countries. A taxpayer will need a system that can collect information on all the countries, but it may file one return every quarter and submit it to the tax authority with whom it has registered. The registration process is handled online, as is the quarterly filing. Some non-EU countries have their own VAT registration simplification provisions.
Cloud delivery
This trend takes several forms, each of which may yield a different tax analysis. Customers may opt to purchase content and store it in the cloud, so they can download the material at another time. An aggregator could store a large pool of content and grant customers access for streaming. Customers also may purchase content and store it in the cloud themselves.

Much will depend on the type of device the customer uses to access the content and what they do with the material – such as sharing and manipulating it through social media.

Character and source:
- In a stream-only model involving a pool of available content, is the transaction a license – albeit very short-term – or is it a service akin to surfing among available television channels?
- Does the customer receive anything else of value, beyond access to content?
- Does the character of the income matter for sourcing, Subpart F or other purposes?

Transfer pricing:
- Does your supply chain change in the cloud?
- Are new entities providing new value, or are old entities less relevant?

SALT:
- Are your customers intermediaries or end-users?
- Does the location of your customers create economic nexus?
- How should you source your revenue, and what is the impact of differing state rules?
- Are your systems set up to handle tax collection and sourcing requirements?

VAT:
- Where are your customers, and are you making a VAT-able supply in their country?
- Are your systems ready?
Intermediation vs. disintermediation

Changing to a digital supply chain may involve selling through an online aggregator, selling more directly to end-users or both.

Character and source:
- Who, and where, is your customer?
- Are you selling to, or through, the aggregator?

Transfer pricing:
- What does the pricing under the new model say about your existing intercompany pricing?
- Are some of your existing intercompany arrangements less relevant, and should the pricing change?

SALT:
- Here again, who and where are your customers?
- Who is collecting sales tax, and who assumes risk under a contract with an intermediary?
- Are your systems ready?

VAT:
- Where are your customers, and are you making a VAT-able supply in their country?
- Are your systems ready?

Bundle vs. unbundle

In the digital realm, formerly bundled content is often divided into separate elements, such as the individual songs customers load onto their MP3 players or the custom textbooks students order. Sometimes, bundling will involve giving the customer different combinations of value, such as a download of a chapter of a book plus an opportunity to join a chat session with the author. As you start to mix and match pieces in a bundle, it becomes harder to call it a single type of transaction.

Character and source:
- Does the transaction have a predominant character? If so, can you treat it as a single transaction, or do you still need to divide it?
- On what basis can you seek to allocate value between the various bundled elements?
- Have you performed a service or transferred property? If the latter, is it more akin to a transfer of a tangible or an intangible?

Transfer pricing:
- Is giving customers the ability to create their own bundles based on personal taste a value driver to your digital strategy? If so, which entity within the group will make the necessary investment to enable the customer to bundle (e.g., breaking down content, search, compile)?
- How will various group members exploit this capability, and what is an arm’s length charge for using it?

SALT:
- Do your invoices reflect the most advantageous presentation in order to take advantage of various sales or use tax exemptions?

VAT:
- Are you bundling the ESS with something else, such as hardware with an app? If so, are you separating the transactions in separate legal entities to avoid tainting the SPOR?

Revenue sharing

Someone clicks through an ad on your website and then makes a purchase from the sponsor’s site, entitling you to a share of their revenue. Or perhaps you are the sponsor, and the sales income you receive must be shared with the referral site.

Character and source:
- Is there real revenue sharing here, or is there simply a formula fee?
- If the agreement is cast as revenue sharing, how should the character and source rules apply?

Transfer pricing:
- This arrangement may be similar to your own intercompany arrangements. How does your pricing compare?

SALT:
- Many of the same sourcing and collection questions will flow from the determination of the nature of the revenue and the identification of the customer.

VAT:
- Here too, the character question is paramount. If the payment is a fee, is it for a separate ESS, requiring a separate, additional VAT?
Start now

While tracking the tax implications that come with these new digital distribution models can feel like navigating a mine field, it doesn’t have to work that way. Working in tandem with your marketing colleagues will help you to identify and mitigate potential risks.

Whether your customers are downloading your content while in transit or from their homes, there will be a plethora of implications for tax departments to consider. Taking the time to answer those questions now will allow you to capitalize on greater opportunities in the future.
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For more information on the tax implications of your digital supply chain, contact your local Ernst & Young member firm or any of the Ernst & Young professionals listed below.

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