Top of Mind

Issues facing technology companies

The dawning of digital economy taxation

Building a better working world

Tax change*	Technology impact	Ask yourself
International tax models: The Organisation for Economic Co-operation and Development (OECD) is set to finalize new international tax models later this year.	The OECD's base erosion and profit shifting project (BEPS Project) aims to update taxation guidance for the global digital economy.	‣ Are you tracking this far-reaching project and its implications for your tax planning?
Diverted profits tax (DPT): UK's DPT was implemented in April 2015, with other countries moving to take similar steps.	Cloud-based, borderless business models are drawing greater scrutiny from tax authorities, worldwide.	‣ What is your economic ownership of intangible property (IP) by legal entities around the world and the transfer pricing of related intragroup/intercompany services?
Country-by-country (CbC) reporting: New CbC reporting will be due as early as 2017, for 2016 financial data, ushering in a new era of tax transparency.	Enabled by standardized digital exchange of more comprehensive information between companies and tax jurisdictions worldwide, CbC reporting is expected to exert upward pressure on tax rates around the world.	‣ Where are your greatest reporting risks? ‣ What measures are you taking to mitigate them?
US tax legislation: Broad new US tax legislation is under consideration, though unlikely to pass prior to the 2016 presidential election.	Repatriation of offshore earnings from globalized IP and other sources remains costly — and now these earnings face the prospect of higher taxes overseas.	‣ What restructuring of deferred earnings might be necessary pending legislation? ‣ How would you transition, if legislation ultimately replaces the US' current worldwide tax system with a modified-territorial system?
Value-added tax (VAT): New VAT rules increasingly tax electronically supplied services in the country of consumption rather than the country of supply.	Companies must manage more complex VAT requirements on internet sales and services effectively to make sure customers are charged, tax authorities are paid and opportunities for recovering VAT on costs are captured.	‣ Are your business models fit for recent and upcoming changes in VAT and other indirect taxes around the world?
Media coverage: Media coverage of taxation-related issues intensifies.	Global technology companies are targets of interest. Effective communication emerges as key to success.	‣ Are you painting a comprehensive picture of your global tax contributions, including calculations of: ‣ Property ‣ Payroll ‣ Sales ‣ Employee income taxes on stock-based compensation ‣ Corporate income tax

*Information subject to evolving policy deliberations and final G20 approval of the OECD BEPS Project expected in November 2015.

Awakening to the new realities of digital economy taxation

In all likelihood, multinational technology companies are going to see significant upward pressure on their global tax rates in 2016 — some of them, even sooner. This stark conclusion is not arrived at lightly; it is the product of several inexorable changes occurring as policymakers worldwide usher in digital economy taxation.

From the outset, technology companies have been in the vanguard of globalizing new digital business models that challenge sovereign borders. As such, they have also found themselves in the crosshairs of policymakers and the media as tax issues have risen to new prominence. Pressures on the technology sector to restructure tax planning are correspondingly high.

Among early corporate adopters of digital economy tax structures, a trend is emerging toward "onshoring" certain key assets and activities within their global tax bases (see box to right).

Onshoring

In this context, onshoring takes on new meanings, among them:

- Aligning IP and its development, enhancement, maintenance, protection and exploitation (DEMPE) functions to new jurisdictions, typically where there are existing business operations
- Re-evaluating deferred foreign earnings in overseas jurisdictions that are raising taxes
- "Re-shoring" VAT and other indirect taxes from the country of supply to the country of consumption

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>
> **Channing Flynn**
> EY Global Technology Industry Tax Leader

New tax horizon is fast approaching

Countries around the world are beginning to adopt new tax laws or dramatically change the way they interpret existing laws and bilateral tax treaties for an increasingly digitized, globalized economy.

At heart, the tax changes reflect governments' attempt to catch up with new cross-border business models employing borderless cloud computing and other cutting edge technologies. They are also being driven from the top down, by the OECD BEPS Project, whose new international tax models are expected to be finalized this year. While the OECD declined to "ring fence" the digital economy for special tax treatment within the BEPS Project, the organization nevertheless declared the overall global economy to be digital and proceeded writing tax guidelines with profound implications for technology companies.

Tax change is on the horizon — and approaching fast — but uncertainty about its timing and scope continues to keep many technology companies' tax departments from taking action. Some have the false sense that change is farther out in time. Others — particularly in the US — continue hoping for rescue from higher taxes by a government-proclaimed tax holiday or some kind of inversion (a once-fashionable cross-border acquisition and restructuring strategy that was stringently reined in last year by the Obama administration). Some may mistakenly expect they will automatically get a foreign tax credit for any overseas tax increase. Yet others may simply be unaware of forthcoming requirements, such as disclosing more information about their global value chains to more authorities around the world.

Timing and scope of change come into focus

Time is not on technology companies' side, however, as the leader of the OECD BEPS Project stressed in a recently broadcast interview. "The impact of what we are doing will not take years, it will be immediate," said Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration. "We are already having an impact. A number of companies are changing their tax structures to anticipate BEPS," he told the BBC in May.[1]

What is more, the scope of change may be as broad as time is short (see table on page 7). For instance, new OECD CbC tax reporting rules are expected to begin ushering in an era of tax transparency when the first reports are due as early as 2017, exerting upward pressure on taxes around the world.

The upshot is that tax departments, CFOs, boards and audit committees all need to be intently analyzing the now-emerging contours of digital economy taxation and how to minimize the impact on their bottom line.

"Companies are facing a very complex set of changes," says Channing Flynn, EY Global Technology Industry Tax Leader. "They will need time to make the most tax-effective transition from where they are today to where they will have to be in late 2015 to 2016." Implications will require changes in global accounting and financial statements, adjustments to local tax profiles, preservation of foreign tax credits and more — all without disrupting global value chains and business operations.

IP life cycle faces realignment

IP is a focal point in the current environment. IP is often developed initially in one country and transferred offshore for future development in a tax-advantaged jurisdiction, while being commercialized in products and services that are sold in markets around the world. This pattern provides one example in which a company's fiduciary responsibility to make the best return on shareholders' investments has come into conflict with tax authorities' duty to secure public revenue.

For one thing, tax authorities in markets where the IP is commercialized can be left feeling they should have more tax coming to them. For another, US companies that accumulate significant income overseas at low effective tax rates find it difficult to bring those earnings back to the US without paying a much larger tax bill — resulting in the so-called "lockout effect."

Pressure to realign globally commercialized IP and reallocate related intragroup/intercompany services, including DEMPE functions, registered a distinct uptick in April 2015. That is when the UK implemented a new tax, called the diverted profits tax (DPT). The DPT rate of 25% is higher than the standard UK corporate tax rate to encourage companies to declare profits locally. Australia is among the countries following suit with similar measures, while related tax policy work is also expected to conclude later this year within the OECD's BEPS Project.

Onshoring IP, in this context, could mean migrating it from a low tax or zero-tax jurisdiction to a new principal company jurisdiction where it will be taxed — at a higher but, ideally, competitive rate.

[1] "OECD attacks 'aggressive' tech tax plans," BBC, 14 May 2015, http://www.bbc.com/news/business-32730305

Digitization ushers in tax transparency

Also exerting upward pressure on tax rates around the world will be the OECD's new CbC reports, which will be due as early as 2017, for 2016 financial data in countries adopting their use. Comprehensive global operational reporting by companies (including coverage of all locations, legal entities and branches of operation) would be shared among relevant countries via government information exchange mechanisms. Digitally enabled themselves, the standardized CbC reports are expected to usher in a new era of tax transparency.

In some ways, greater transparency in taxation has already taken center stage in the competition among nations to promote investment in their own digital economies. Competing tax jurisdictions have been known to debate the propriety of their peers' administrative rulings and whether they constitute illegal state aid to companies' local operations or housing of IP. The European Commission (EC) has been investigating major multinational corporations along these lines. Sensitive information that surfaces in CbC reports could provoke more state aid controversies.

Additionally, CbC reports could lead more countries to believe they are not getting their fair share of tax and to assess foreign companies accordingly. "Companies have to identify jurisdictions at risk and take other planning steps that can reduce the potential impact of CbC reporting," Flynn says. Notably, the requirements needed to implement CbC will also put new system and administrative burdens on corporate taxpayers.

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>
> **Stephen Bates**
> International Tax Principal
> Ernst & Young LLP

VAT rules relocate point of taxation

VAT-type taxes are having a growing impact on technology companies around the world, and they are increasingly applied to electronic services in the country of consumption rather than the country of supply. This pattern emerges from recent legislative changes in the EU, Japan, South Africa and elsewhere, along with global governmental cooperation on the OECD's BEPS Project.

Here, onshoring takes on yet another meaning, with suppliers liable to charge tax in so many more jurisdictions. Nonresident suppliers of digital consumer services, in particular, need to review VAT registration and compliance implications, and whether their corporate structure and business models are fit for recent and upcoming VAT changes, along with pricing strategies, profit and cash flow forecasting, and contractual arrangements with third parties in their supply chains.

US legislation lags as foreign tax risks grow

The US presidential campaign season, already underway, is expected to prolong already lengthy deliberations on tax legislation, as well as uncertainty about both its potential scope and timing. Meanwhile, deferred US foreign earnings, in the form of cash or of permanently reinvested earnings, are difficult to repatriate without facing income taxes that at least approach the 35% top-line corporate US tax rate.

Now, as seen above, these earnings face potentially higher taxes abroad. US companies may believe increased foreign tax expenses can be offset by US foreign tax credits, but this will not always be the case. The impact, instead, could go right to the bottom line of their financial statements.

If and when US tax legislation is passed, it is expected to address a long-running debate over whether to continue with the current "worldwide" system or convert to a "modified-territorial" system. The former taxes corporations deemed "resident" in the US on income from all over the world (with offsets of foreign taxes to avoid double-taxation and with deferrals prior to repatriation of earnings). The latter, as a rule, would not impose US taxes on active business income earned by American corporations overseas, with various provisos and conditions included in different legislative proposals. Companies' transition planning should clearly be in the works well before any law is passed.

Variables and complexity multiply

Companies face various combinations of these and other tax risks under new digital economy taxation. As they do, realignment could take place along tactical lines, such as IP migration or the choice between transfer pricing and permanent establishment in a given jurisdiction. In other instances, such as preparing for greater tax transparency, companies may have to re-prioritize solutions to problem areas they have already recognized but have not yet corrected due to internal administrative issues or IT backlogs.

Whatever the risk and potential resolution of current tax positions, today's uncertainty also merits reexamination of how related reserves are measured and recognized on multinationals' financial statements as contingency for possible audits by tax authorities.

Despite the multiple variables and the time it will take for companies to optimize their tax structures for the new environment, some companies have not yet fully engaged in evaluating digital economy taxation.

Communicating tax matters up the hierarchy

Tax departments should already be communicating to upper management and the board that increased tax scrutiny and cost is coming. "CFO engagement in these tax matters has always been critical but is even more so now," says Stephen Bates, International Tax Principal, Ernst & Young LLP.

Major multinationals employing dozens of professionals in tax, legal and corporate governance roles could be ahead of the curve in actively addressing these matters, compared to midsized companies with fewer dedicated resources. Both groups nevertheless face similar pressures in the transition to digital economy taxation. And going forward, a key takeaway, often repeated, is that the tax function should be part of any internal discussion regarding significant business change.

Communicating tax matters to the media

Even before CbC reporting ushers in a new era of tax transparency, intensifying press coverage of tax matters has been presenting some companies with difficult choices between tax optimization and reputational risk. A low tax rate no longer speaks for itself in the marketplace as a good thing.

And the more digital the business model or innovative the company, the more likely it has been to attract the attention of policymakers and the press. Media scrutiny has so far subjected mainly the biggest technology brands to criticism, but could also turn to midsized technology companies — especially those with large consumer bases.

Rigorously developed communications strategies could help companies to blunt criticism, including proactive identification of their full economic contribution around the globe — not only in terms of income tax, but also property, payroll, sales and employee income taxes on stock-based compensation.

There may be some comfort in knowing that when CbC reports come into use, they will not automatically be made public. That said, companies will only have one chance to make a good first impression, as the saying goes, when they file their initial CbC report. They should be prepared to confidently assert their global tax position to tax authorities and the press.

Conclusion

Multinational technology companies need to be fully aware that global effective tax rates are trending upward — how much remains an open question. Those tax practitioners and international finance executives that prepare now will be in the best position to influence the answer for their own companies.

At issue	How to prepare
CbC reporting and BEPS	‣ Develop a sample CbC report, identifying hot spots and how to address them ‣ Estimate potential tax value exposed in current foreign tax positions ‣ Assess required changes in your supply chain structures and the impact on employees, software systems, etc. ‣ Consider transactions this year to prepare for forthcoming CbC reporting ‣ Map the BEPS timetable to your related financial statement considerations ‣ Understand potentially significant IT systems requirements for implementation
IP onshoring	‣ Qualify one to three onshoring proposals for potential implementation ‣ Identify where to enhance DEMPE functions for IP ‣ Develop an active strategy to manage transfer pricing versus permanent establishment ‣ Model the cost/benefit of onshoring options, including amortization deductions, debt financing, exit costs, etc.
UK DPT and similar measures	‣ Evaluate potential consequences in UK and be alert to other countries adopting similar measures
State aid	‣ Analyze foreign tax positions and administrative rulings for any appearance of state aid ‣ Develop a contingency plan, including a media strategy
US legislative proposals	‣ Evaluate deferred foreign earnings as overseas taxes trend upward ‣ Perform "transition rule planning," in the event that legislation ultimately replaces the US' current worldwide tax system with a modified-territorial system ‣ Identify one-time federal income tax planning opportunities in proposed US legislation
Operating model effectiveness	‣ Conduct supply chain analysis and planning to ensure that changes in the business are supported by an increasingly complex and quickly changing tax landscape
Indirect tax	‣ Ensure appropriate tax calculation, charging and collection mechanisms for VAT-like taxes ‣ Review VAT impact on pricing strategies, profit and cash flow forecasting and contractual arrangements with third parties in your supply chains ‣ Capture opportunities to recover VAT on costs

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EY resources

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