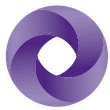

Grant Thornton

An instinct for growth™

Navigating tax in a digital world

Developing a tax strategy that can keep pace with your growth aspirations

Extract from technology, media, telecommunication report **Building tomorrow's billion dollar businesses**

Developing a tax strategy that can keep pace with your growth aspirations

When several world-leading tech companies made front-page news for their tax affairs in 2013, nobody in the business world was left in any doubt – tax matters more than ever to today's ambitious companies.

As global attitudes towards tax change, tech companies need to future-proof their tax practices to stand up to enhanced scrutiny. Any inconsistencies could result in serious damage to reputation, competitiveness or income. One thing is clear – tax matters more than ever to today's ambitious companies.

The way a growing company markets and sells its services can have a significant impact on its tax bill. Different countries treat different categories of products and services in different ways for tax purposes, making income characterisation a vital consideration.

In some US states, technology firms that specialise in software and services and are classified as selling 'services' will not be taxable – yet they will be if they are classified as 'software providers'. The differences between two income categories can be subtle, and often there are grey areas.

"The language that goes into contracts is often from a technology and marketing perspective," explains Randy Free, international tax practice leader at Grant Thornton US. "It can bolster your case in defining your services – or it can sink your case."

Once a tax authority in another state or country is made aware of a technology company's services being characterised in a particular way elsewhere, it may well seek to reassess its own treatment of the firm's services.

Increasing scrutiny

In 2013 when world-class tech companies made the news for their tax decisions, nobody in the business world was left in any doubt – companies that trade across borders need to get their tax affairs in order sooner rather than later.

While the companies under investigation were clearly operating within guidelines, and the majority of governments worldwide recognise that these companies create additional value for their countries – such as by driving job and wealth creation – there are several factors that are likely to keep tech companies firmly within the tax spotlight in years to come:

- tech business value is oriented in IP – which is inherently mobile
- software-oriented tech companies are light on fixed assets
- tech companies regularly source IP through international development centres and M&A, which pulls them into countries around the world
- many firms require little more than a high-speed internet connection to sell services in overseas markets.

> "Many technology groups structured themselves to keep the IP located in a low-tax jurisdiction and have minimal people around the ownership of that IP. The new rules will make that increasingly difficult as they'll create a taxable presence wherever companies do business."

Martin Lambert
Partner, Grant Thornton UK

Furthermore, as supranational bodies like the OECD, G8, EU and UN continue to make recommendations and amend the international tax landscape, tax planning will become increasingly complex. In this climate, tech companies need to define a strategic approach to tax planning that strikes a balance between upholding reputation and maintaining competitiveness.

Shift in attitudes

The climate for what is considered acceptable in tax planning has shifted considerably over recent years. For at least a couple decades, the concept of 'aggressive' tax planning was considered the norm. Today, it is under scrutiny from the media, politicians, activists and NGOs[1].

Technology firms – especially large multinationals – have suffered their fair share of this criticism[2]. Negative PR can hurt technology giants, but it has an even greater impact on firms still expanding and building their reputations. Even benefit corporations, whose mission is as much about helping society as it is about making a financial profit, have faced heightened scrutiny. In autumn 2015, for example, Americans for Tax Fairness, a US policy group, publicly criticised online crafts marketplace Etsy for its Irish tax structure. And tech companies are not just risking their reputations when it comes to tax.The OECD's base erosion and profit shifting (BEPS) project is creating new rules to outlaw and penalise artificial tax avoidance strategies. The project will, for

1 'David Cameron: Tax avoiding foreign firms like Starbucks and Amazon lack 'moral scruples',' The Telegraph, January 2013
2 'Amazon UK boycott urged after retailer pays just £4.2m in tax,' The Guardian, May 2014

example, aim to address inconsistencies between different jurisdictions in their approach towards transfer pricing. And the first action in its plan is to 'address the tax challenges of the digital economy' – including where and how to tax new digitally enabled business models.

Getting ahead of the game in a new tax era

Major international tax reform is inevitable. For high-growth technology firms, the key is to recognise where the rules are heading and plan accordingly.

The issues at hand are clear. Beyond the implementation of the OECD's BEPS measures, G20 countries have agreed an implementation package for country-by-country reporting in 2016[3]. The European Commission has proposed new requirements for EU member states to automatically exchange information on any tax rulings provided to businesses[4], discouraging companies from shifting profits to member states.

"The days of aggressive tax planning structures are over," asserts Phil Barrett, tax partner at Grant Thornton UK. "Technology firms need to assess where the substance of their business sits in terms of its value creators – the people, the assets, the IP – and align their tax strategy accordingly.

"This is not to say there are not choices to be made to align an efficient tax structure. [There are] and these are centred on thinking about what you do and where you can do it." Barrett explains.

"There are choices, but they're more about where you choose to carry out activities, as opposed to trying to manipulate rules between different countries where you haven't got that substance," Barrett explains. "It's about following where you're doing real activity, trying to keep things as simple as possible and managing your compliance."

Counting the cost of compliance

In their eagerness to tap new markets, growing tech companies sometimes overlook the compliance costs associated with expansion. The Business Roundtable found that large US businesses were spending an average of $11 million on tax compliance, and dedicating 43.9 full-time employees to tax compliance activities[5].

Entering new jurisdictions means creating a distinct set of compliance requirements – not to mention new liabilities. Technology firms must ensure they are fully equipped. "I've seen technology companies wanting to expand very quickly," says Randy Free. "They set up 30 or 40 subsidiaries right away, and suddenly the business doesn't catch up as quickly as they thought and they're carrying the burden of that compliance."

As well as addressing the additional tax liability, companies must ensure their systems have centralised oversight and can communicate in the same language, at the same time, across borders. As complexity grows, they will increasingly rely on automation to bring together financial data from general ledger systems across the organisation.

Sophisticated modelling may also be required to test tax strategies that involve shifting revenues and assets among foreign subsidiaries, or to understand the impact of a potential acquisition. This may mean reverting to outsourcing initially, or centralising the tax compliance function as the resources become available.

> "The key is to ensure that in the countries you chose to operate in you have real business substance and try and keep things as simple as you can!"
>
> **Phil Barrett**
> Partner, Grant Thornton UK

3 'Action 13: Country-by-country reporting implementation package,' OECD, 2015
4 'Transparency and the fight against tax avoidance,' European Commission, March 2015
5 'Total tax contribution – How much do large US companies pay in taxes?' Business Roundtable, 2009

Incentivising tech companies

Opportunities abound for tech firms. Countries, states and cities are keen to revitalise themselves and be seen as destinations for talented people and cutting edge businesses. For example, in the US, cities such as Austin, Texas have benefitted from a strong campaign to attract technology companies away from traditional bases in California.

This has included assisting entrepreneurs with lower tax rates that incentivise businesses and their people to move and set up, creating new hubs with access to financing and infrastructure.

Likewise governments are taking similar steps to demonstrate their innovation credentials. Patent box regimes in place across Europe encourage investment in R&D through reduced tax rates and deductions for qualifying expenditure.

Summary of available 'patent box' regimes in different countries worldwide

The following table outlines some of the key incentives that different countries have in place to encourage growth and innovation.

Country	Standard corp. rate in 2015	Patent Box rate in 2015	Fully phased-in Patent Box rate	Qualified IP
France	38.0%	15.0%	15.0%	Patent granted in France, UK or European Patent Office
Ireland (proposed)	12.5%	n/a	5.0% to 6.25%	Patents and property functionally equivalent to patents
Italy	27.5%	19.25%	13.75%	Intellectual property, trademark, designs and models, secret formulas or process connected to industrial, commercial and scientific know-how
Luxembourg	29.22%	5.84%	5.84%	Patents, trademarks, designs, domain names, models and software copyrights
Netherlands	25.0%	5.0%	5.0%	Worldwide patents and IP arising from R&D activities for which the taxpayer has obtained declaration from the Dutch government (trademarks, non-technical design rights and literary copyrights are not included)
Spain	28.0%	11.2%	10.0%	Patents, drawings or models, plans, secret formulas or procedures and rights on information related to industrial, commercial or scientific experiments[6]
United Kingdom	20.0%	12.0%	10.0%	Patents granted by the United Kingdom Intellectual Property Office, European Patent Office and patent rights granted from 13 European Economic Area countries (excludes trademarks, copyright or know how)[7]

6 Additional note from Grant Thornton Spain: The CIT standard rate for 2015 in Spain is 28% and for 2016 onwards is 25%. The Patent Box reduces the taxable base by 60%, resulting 40%. Considering the CIT rates, the patent box rate for 2015 is 11.2%, and for 2016 is 10%. There are no increased or reduced rates regarding fully phased-in.

7 Additional note from Grant Thornton UK: The current UK Patent Box scheme will be closed to new entrants after 30 June 2016 but will continue for five years for companies that have 'elected in' on or before this date. In response to the OECD's concerns and the Forum on Harmful Tax Practices a new Nexus Patent Box scheme will then be available (details to be published later this year) which ensures that only companies that have undertaken R&D to develop the patented technology (the nexus) may claim.

"In Israel, innovation is seen as key to driving economic growth. The government recognises that it needs to encourage technology companies for this to happen, partly through tax incentives for investors backing seed companies. The country has a growing number of unicorns."

Mickey Blumenthal
Managing partner, Grant Thornton Israel

"These companies create high-skilled jobs, they typically don't have a huge environmental footprint, and they bring in often highly-educated people with lots of disposable income."

Doreen Griffith
Managing partner, California market territory, Grant Thornton US

Key questions: developing a tax strategy for growth

- To what extent should tax planning influence our global growth plans?
- To protect our business in today's high-litigation climate, how can we ensure we have implemented the right transfer pricing structure and have completed the required studies?
- How can we strike the right balance between enabling growth, optimising our tax liability, and mitigating the risk of unwanted regulatory scrutiny?
- How well do our existing structures stand up against the shifting tax landscape?
- Is our tax function in a position to keep pace with the new tax compliance requirements that will result from our growth rate?

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