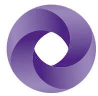


Grant Thornton

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

#GTtech

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.

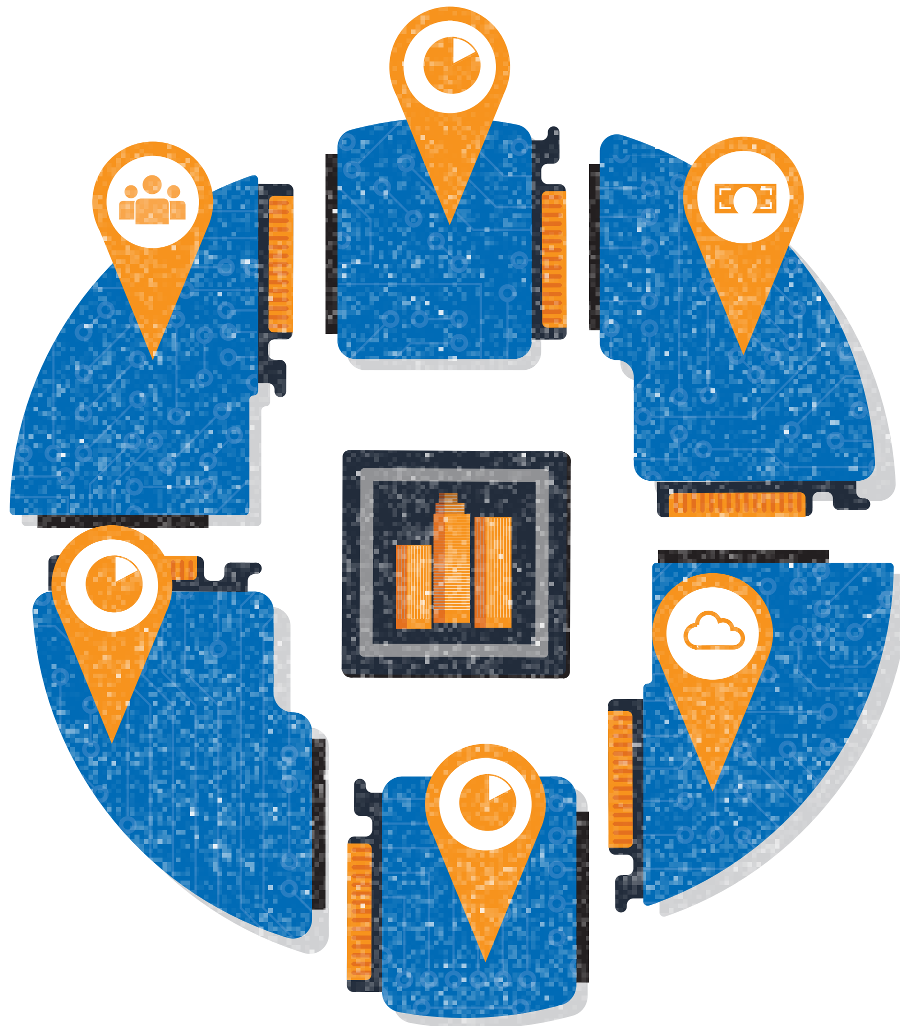
Increasing scrutiny

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; and
- many firms require little more than a high-speed internet connection to sell services in overseas markets.

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.



> "The new rules will see a much closer alignment of taxable profits and real substance. This will have a significant impact on the tax strategy of technology groups and see closer co-operation between the operations and tax divisions."

Peter Vale
Partner, Grant Thornton Ireland

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

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

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 Round-table 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.

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.

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

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	12.5%	n/a	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]

Knowledge Development Box (KDB)

What is it?

The Irish government introduced the Finance Act 2015 which provides for the introduction of the Knowledge Development Box (KDB). The broad objective of the KDB is to promote innovation and provide an incentive whereby profits arising from patented inventions, copyrighted software and certain other specific asset classes can effectively be taxed at a reduced rate of 6.25%. Any royalty or other sum in respect of the use of a qualifying asset, or income reasonably attributable to a qualifying asset, can benefit from the reduced rate.

Broadly, the relief is linked to the qualifying Research and Development (R&D) expenditure incurred by the Irish company as a proportion of its overall global R&D expenditure, thereby making the KDB very attractive to companies that carry on a significant element of their R&D activities in Ireland. The KDB will also be attractive to large groups that are capable of isolating individual qualifying assets, the R&D for which is carried on in Ireland.

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

What is a qualifying asset?

For the purposes of the KDB, a qualifying asset is copyrighted software, certain patented inventions, plant breeders' rights, protection certificates for medicinal products and plant protection certificates. To ensure the KDB includes patents granted by the Irish Patent Office, legislation is currently being drafted to ensure Irish patents include a substantive examination for novelty and inventive steps. Unexamined patents which are certified before 1 January 2017 may also be included.

Small and Medium Enterprises (SMEs) benefit from an expansion of the definition of Intellectual Property (IP) to include inventions that are certified by the Controller of Patents, Designs and Trademarks as being novel, non-obvious and useful. For the purposes of the KDB relief, SMEs are companies with annual income from IP not exceeding €7.5m and group turnover not exceeding €50m.

What income qualifies for the relief?

The following income generated from the qualifying assets qualifies for the relief:

- royalty income;
- licence fee income; and
- where a sales price includes an amount which is attributable to a qualifying asset, a portion of the income from those sales calculated on a just and reasonable basis.

How does the relief work?

The mechanics of the KDB relief are to allow a tax deduction of 50% of the qualifying profits from the R&D activities, thereby resulting in an effective tax rate of 6.25%. In arriving at the qualifying profits figure, there is a calculation required which broadly looks at the percentage of the R&D activities carried on by the Irish company, including third party outsourced costs (qualifying expenditure), as a proportion of the overall expenditure incurred on the qualifying asset (including acquisition costs and outsourcing costs, both group and third party).

The formula can be summarised as follows:

$$\frac{QE+UE}{OE} \times QA$$

- QE = Qualifying Expenditure on qualifying asset;
- UE = Uplift Expenditure;
- OE = Overall Expenditure on qualifying asset; and
- QA = profit from relevant Qualifying Asset.

When is it effective?

The relief is available to companies for accounting periods beginning on or after 1 January 2016 and before 31 December 2020.

Research and Development (R&D) tax credit

Ireland's R&D tax credit system is a major benefit to both multinational companies and SMEs operating in Ireland. The R&D tax credit offers a company undertaking R&D in Ireland a significant tax break representing a potential 25% refund of costs incurred. In essence, it means companies incurring qualifying R&D spend can potentially claim a refund of €25 for every €100 of expenditure on R&D. Profit making companies will see a direct reduction in their tax liability, whilst loss making companies can claim the credit in three instalments. Either way, it brings a cash benefit.

Profit making companies will see a direct reduction in their tax liability, whilst loss making companies can claim the credit in three instalments. Either way, it brings a cash benefit. The best way to demonstrate this is through the following case:

- Software Company Limited incurs €4m of eligible R&D expenditure in the year ended 31 December 2015. This will result in an R&D tax credit of (€4m x 25%) €1m;
- the R&D tax credit can be claimed in addition to the 12.5% corporation tax deduction for any qualify expenditure; and
- therefore, the total tax benefit is 37.5% i.e. 12.5% standard corporation tax rate plus 25% R&D tax credit.

The R&D tax credit is part of a suite of tax reliefs aimed at increasing Ireland's attractiveness as a location to house innovative activities.

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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