IO 3.3. Case#3. Taxation in the Digital Era

On November 23rd, 2021, just before lunch, Annie K. put down the phone and looked at the notes she made while talking to the Company's CEO. As financial analyst of the DIGITAL Int. Company (UK-based), she has been asked to make suggestions for the expansion of the Company's operations by establishing a subsidiary in other EU country. The CEO has just given the final details and asked for several options with projections of the impact on the balance sheet and P&L statement.

It has been more than a year since the initial Board's discussions on expansion, however, the Board is still reluctant to make a decision. The key shareholder, K.L., has now requested a report for the Board meeting, scheduled to be held in two weeks. K.L. has been pushing the expansion of DIGITAL Int. operations from the outset. However, there has been uncertainty as to which country (or countries) will achieve the best results. Annie K. is aware that multinational companies, in general, make strategic decisions which take into consideration tax competition among countries. However, the EU anti-tax avoidance regulation has been pressuring companies to reconsider such aggressive taxation policies. Moreover, international taxation challenges arising from digitalisation, driven by development of fintech companies, are raising even stronger concerns for national policy makers.

Altogether, this causes uncertainties for DIGITAL Int. in terms of its corporate tax strategy and the effect of international expansion. The Board meeting is scheduled to examine tentative risks and the possible effects of the decision on the Company's financial performance.

Background

During the recent years the EU has introduced new regulations towards a fair and efficient tax system in the European Union for the digital single market. The new regulations were driven by the drastic changes in the business environment. Tax competition between countries has set up a very specific business environment, which has been exploited by multinationals. The international corporate tax system, which was designed more than a century ago, became outdated when based on old principles of tax residence and source. Digitalisation of the economy has brought the international corporate tax debate to a critical point, as digitization and the international operations of fintech companies challenge the existing tax policies.

International negotiations are focusing more and more on the international tax challenges. The new regulatory framework became driven by OECD Base Erosion and Profit Shifting (BEPS) project, with several Actions targeting tax avoidance behaviour of multinational companies. Among others, Action 4 focuses on limiting base erosion involving interest deductions and other financial payments with specific suggestions to limit the debt of companies and Action 1 focuses on tax challenges arising from digitalisation. Furthermore, back in 2019, the OECD launched a work programme addressed to the international taxation challenges arising from digitalisation, driven by development of fintech companies.

The OECD BEPS framework Action 4 provided recommendations how to limit the aggressive use of debt structures to achieve excessive interest deductions. One key recommendation is to included thin cap rules. According to regulatory strategies, the different thin capitalization rules

- are categorised in three approaches: the arm's length approach, the earnings stripping rule and the fixed ratio (safe harbor) approach.

Under the arm's length approach, countries target internal debt shifting; they do not apply specific interest deduction limitation rules, but follow the arm's length principle to assess if interest deductions are not excessive for tax purposes. The application of the key principle is the denial tax deductions of internal debt if the internal financing could not have been achieved from external debt at the same conditions. If interest is excessive, the deduction of the excessive part is disallowed for corporate tax purposes (e.g. it is reclassified as a dividend distribution).

The fixed ratio (safe harbor or safe haven) approach is based on a ratio derived from the balance sheet or P&L of a company. The most commonly used ratio is the debt to equity ratio; however, the allowed level of debt may vary from country to country, may apply only to related party debt (i.e. targeting internal debt shifting) or to both internal and external debt (targeting also external debt shifting through hybrid entities). Generally, the deduction of interest on the debt exceeding the fixed ratio of debt to equity is disallowed for corporate income tax purposes. To be more specific, in order to calculate the non-deductible interest expenses under safe harbor rules, accounting logic prevails:

- Firstly, the excess debt is calculated (i.e. the amount of debt that exceeds the allowed debt threshold, which is the amount of equity times the safe harbor debt-to-equity ratio);
- Secondly, this excess debt is expressed as a fraction of debt.
- Thirdly, this fraction is multiplied by the total amount of interest expenses arising from the loans from related parties which determines the amount of non-deductible interest expenses. Again, in some countries' non-deductible interest expenses are reclassified into dividends, which may be subject to withholding taxes.

The earnings stripping rules apportion profitability into returns on debt and equity. These rules introduce lower and upper ceilings for returns on debt that qualify as tax deductible. In most cases, it applies to both third- and related-party loans. In some cases it applies only to one type of loans – related party loans. Net interest expenses (interest expenses less interest income) are deductible up to the limit, without restriction; but the lower limit does not work as a tax allowance. If the net interest expenses are below the limit, the earnings stripping rule is not applicable. If the net interest expenses are above the limit, the rule is applied on the total amount of net interest expenses, ignoring the limit. Depending on the limit established, relatively small firms may not be affected by earnings stripping rules.

In 2018, the European Commission proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly way in the EU. The main argument is that international corporate tax rules are not fit for the realities of the modern global economy and do not capture business models that are able to profit from digital services in a country in which they are not physically present. The existing tax rules fail to recognize the new ways in which profits are created in the digital world, in particular the role that users play in generating value for digital companies. As a result, there is a disconnect – or 'mismatch' - between where value is created and where taxes are paid.

The European Commission was concerned that in the digital economy, value is often created from a combination of algorithms, user data, sales functions and knowledge. For example, users contribute to value creation by sharing their preferences (e.g. liking a page) on a social media forum. This data will later be used and monetized for targeted advertising. The profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has been developed, for example. This means that the users' contribution to the profits are not taken into account when the company is taxed.

When addressing taxation of the digitized economy, the European Commission has moved towards two legislative proposals: 1) The first initiative aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This forms the Commission's preferred long-term solution; 2) The second proposal responds to calls from several Member States for an interim tax which covers the main digital activities that currently escape tax altogether in the EU. The proposals have not yet been introduced, however, they will change the tax environment and introduce changes into the current digital taxation regulatory differences between EU countries. Thus multinational companies were keen in taking the possible effects of new digital taxation regulatory changes into account for their business development solutions.

Most recently, the EC has followed with "Communication on Business Taxation for the 21st Century". While business models became more international, complex and digital, corporate income remained taxed on the national level. This created an environment for company's aggressive tax planning strategies, exploiting existing loopholes. In addition, COVID-19 pandemic contributed to significant increase in companies' debt. The long-term pro-debt bias tax rules, which allowed for interest deductibility, encouraged companies to accumulate debt. Thus, EC proposals will try to re-address the debt-equity bias and contribute to the increase in equity of companies.

The situation

The COVID-19 pandemic has put a strong pressure on traditional businesses to go digital. For DIGITAL Inc., it has resulted in pressure to expand Company operations internationally, capitalizing on its competitive advantages. DIGITAL Inc. has already developed and applied the solutions which could easily be scaled up. Thus, the Board was keen to see the significant growth of operations, especially in filling market gaps in EU countries. However, it wants reassurance that the expansion will not trigger EU anti-tax avoidance regulations while improving financial performance.

Annie knew that the worst she could recommend is a typical solution that other companies going digital would be taking. She is intending to propose several options, taking into account the effects on effective tax rate for the Company and its new subsidiaries. She is also keen to examine borrowing options for the subsidiaries, and their effects on the consolidated balance sheet and P&L statement. The CEO has provided her with the preliminary information (see Tables 1, 2, 3, 4 & 5). Now she has to focus on the important assumptions in developing several projections.

Final preparations

Having returned after lunch Annie is having a cup of tea and sitting down at the computer to prepare her report for tomorrow's meeting with the CEO. She knows that if her strategic planning provides for significant improvement in company performance, her professional reputation and career progression will be significantly enhanced.

The questions she has to consider include:

- What are the differences in corporate income tax policies among EU countries being considered?
- What are the digital tax policies in the EU countries?
- Which EU country/ies have the most favorable corporate tax considerations? Are there advantages for fintech ecosystem in that country? If yes, what are they?
- Which are financing options for establishing a subsidiary in the suggested EU country? What are possible debt limitations?
- What will be the effect on balance sheet and P&L statement of the proposed expansion option (e.g. establishing the subsidiary)?

APPENDICES

Table 1. Subsidiary's Projected Balance Sheet and Income Statements, thous. Eur

Balance sheet	**Projected**
Assets	**952**
Non-current assets	654
Current assets	165
Cash	133
Liabilities	**?**
Current liabilities	122
Loan 1	302
Loan 2	?
Equity	**?**

Income statement	**Projected**
Revenue	1 748
Cost of Goods Sold	1 303
Operating Expenses	264
Earnings before interest, taxes & depreciation and amortization (EBITDA)	181
Interest expenses	?
Earnings before taxes	?
Corporate income tax (CIT) expenses	?
Net profit	**?**
Effective tax rate	?

Table 2. Other information

Other information	
Number of shares	100 units
100% shares market price	300 thous. Eur
Market price per share	3 thous. Eur
Nominal value per share	300 Eur
Market interest rate	5%
Corporate income tax rate	?%

Table 3. Borrowing and debt to equity scenario

	Scenario	
	Initial projections	**New investment**
Control	100%	0%
Shares	100	
Nominal value	30 thous. Eur	-
Share premium	-	-
Loan	302 thous.Eur	?
Total investment	332 thous.Eur	-

Table 4. Effective tax rate calculations

	Scenario results	**Rule applicability**
4 * Equity		
Controlled debt amount (Loan 1 plus Loan 2)		
Thin capitalization rule		Y/ N ?
Loan exceeding 4:1 ratio*		Y/ N ?
Non-deductible interest (5%)		
30% EBITDA ceiling		
30% rule		Y/ N ?
Taxable profit**		
Corporate income tax (CIT) expenses***		
Effective tax rate (CIT) expenses / Earnings before tax (EBT)		

* Loan exceeding 4:1 ratio = Debt - 4 * Equity
** Taxable profit = EBT + non-deductible interest
*** Corporate income tax (CIT) expenses = Taxable profit * Tax rate %

Table 5. Corporate income tax by country

Code	*Country*	*2019*	*2018*	*2017*
AT	Austria	25.0	25.0	25.0
BE	Belgium	29.0	29.0	34.0
CY	Cyprus	12.5	12.5	12.5
DK	Denmark	22.0	22.0	22.0
EE	Estonia	20.0	20.0	20.0
FI	Finland	20.0	20.0	20.0
FR	France	31.0	33.0	33.3
DE	Germany	30.0	30.0	29.8
HU	Hungary	9.0	9.0	9.0
IE	Ireland	12.5	12.5	12.5
IT	Italy	24.0	24.0	24.0
LV	Latvia	20.0	20.0	15.0
LI	Liechtenstein	12.5	12.5	12.5
LU	Luxembourg	24.9	26.0	27.1
MT	Malta	35.0	35.0	35.0
NL	Netherlands	25.0	25.0	25.0
NO	Norway	22.0	23.0	24.0
PL	Poland	19.0	19.0	19.0
PT	Portugal	21.0	21.0	21.0
ES	Spain	25.0	25.0	25.0
SE	Sweden	21.4	22.0	22.0
CH	Switzerland	18.0	18.0	17.8
GB	Great Britain	19.0	19.0	19.0
CZ	Czech Republic	19.0	19.0	19.0
LT	Lithuania	15.0	15.0	15.0
BG	Bulgaria	10.0	10.0	10.0
RO	Romania	16.0	16.0	16.0
SK	Slovakia	21.0	21.0	21.0

Note: for most recent statutory income tax rates see:
https://stats.oecd.org/Index.aspx?DataSetCode=CTS_CIT