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 a 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 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 income statement.

It has been more than a year since the initial Board's discussions on expansion, however, the Board was 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) the expansion will achieve the best results. Tentatively, following the expansion, operations in UK will stay "as-is". All the future growth in sales and profits of the newly formed business group would be routed via a new target company in another country. Such structure is due to expected lower corporate taxation. This may imply changes in the financial performance of the newly formed business group. During the last board meeting the proposition was made to invest into the Target Company with history of operations in the same area of digital business, and lacking capital for expansion. DIGITAL Int. would buy in Target Company newly issued shares, acquiring a minority interest (but at least 25% of ownership) and would provide additional debt financing, in total of 70 mEUR. However, some board members suggested also to consider the possibility acquiring a majority ownership (up to 90% of shares), and providing some debt financing, if needed.

Annie K. was 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 and supra-national policy makers.

Altogether, this caused uncertainties for DIGITAL Int. in terms of its corporate tax strategy and the effect of its international expansion on the Group's financial performance and tax risk profile/tax position. The Board meeting has been scheduled to examine tentative risks of equity and debt financing, and the possible financial performance of the Target Company.

Background

In 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 have been exploited by multinationals. The international corporate tax system, underpinned by source and residency principles designed more than a century ago, are challenged by digitalisation. New and emerging economies have brought the international corporate tax debate to a critical point, as digitization and the international operations of fintech companies challenge existing tax policies.

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.

On 8 October 2021 136 jurisdictions (out of the 140 members of the OECD/G20 Inclusive Framework on BEPS) joined the Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.

Pillar One will ensure a fairer distribution of profits and taxing rights among countries. It will re-allocate some taxing rights over MNEs from their home countries to the markets where they have business activities and earn profits, regardless of whether firms have a physical presence there. Specifically, MNEs with global sales above certain limit and profitability above certain ratio will be covered by the new rules.

Pillar Two introduces a global minimum corporate tax rate set at a certain rate and which will apply to companies with revenue above certain threshold.

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. Since the BEPS Project 1.0, the OECD have focused on international taxation challenges arising from digitalisation (driven by development of fintech companies) through Pillars I and II.

The OECD BEPS framework Action 4 provided recommendations on how to limit the aggressive use of debt structures to achieve excessive interest deductions. Key recommendations for countries were to introduce thin cap rule, if they did not exist before, strengthen the existing ones and making them homogenous/unilateral in substantial number of countries.

Generally, the different thin capitalization rules are categorised in three approaches: the arm's length approach, the earnings stripping rule and the fixed debt-equity (safe harbour) approach. In pre-BEPS period, most of the countries used one of the above-mentioned approaches, some countries used more than one approach in the regulatory strategies.

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 of tax deductions of internal debt if the internal financing could not have been achieved from external debt under the same conditions. If interest is deemed to be excessive, the deduction of the excessive part is disallowed for corporate tax purposes (e.g. it is reclassified as a non-deductible dividend distribution).

The fixed debt-equity ratio (safe harbour or safe haven) approach is based on a ratio derived from the balance sheet of a company. In the past the most used ratio was the debt-to-equity ratio (from 2019 in most of the EU countries it has been superseded by 30 % EBITDA rule). There are variations in how this approach is taken as 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, to calculate the non-deductible interest expenses under safe harbour 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 harbour 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.

European Commission adjusted thin cap rules based on earning stripping approach proposed by the OECD and transposed them into Anti-Tax Avoidance Directive (EC ATAD) which is implemented in local legislation of EU member states on 1 January 2019. The tax-deductible net interest expenses of companies are limited to 30% of taxable EBITDA (higher limit or ceiling or cap). However, if the interest expense exceeds interest income by no more than up to EUR 3 million (each EU country may opt for own limit), the interest limitation does not apply (lower limit or floor). There are also some other general and country specific exceptions.

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 she should not recommend one typical solution that other companies going digital would be taking. She intends to propose several options of equity and debt financing, which considers the effective tax rates for the Target Company. She is keen to examine several options of acquiring newly issued shares of the Target Company (from 25 to 90%) while providing debt financing. She intends to examine the respective financing effects on the balance sheet and income statement of the Target Company. The CEO has provided her with the preliminary information (see Tables 1, 2 & 3). Now she must focus on the important assumptions in developing several projections.

Final preparations

Having returned from lunch, Annie has sat down at the computer to prepare her report for tomorrow's meeting with the CEO. She knows that if her strategic planning propositions provide significant improvements in the Group's financial performance, her professional reputation and career progression will be significantly enhanced.

The questions she must consider include:

1) Which country from pre-selected countries feasible for digital business expansion (Austria, Germany, Hungary, Greece, Italy, Lithuania, Luxembourg, Portugal, Romania, Spain) has the most favourable corporate tax rules/regime?
2) Once the preferred country has been identified (e.g. the one with the most favourable corporate tax regime), what are the relevant tax-related debt financing limitations? Which are local ones and which are OECD/EU originated?
3) What is the EU digital (or national?) tax policy tentative impact on financial performance of a company in this selected country in short- and long term?
4) What are financing options of the Target Company in the suggested country?
5) What is the effect on balance sheet and income statement of Target Company of the proposed expansion option?
6) What are the benefits and drawbacks of expansion through acquisition of minority vs majority of share ownership (e.g. from 25% to 90% of new statutory capital) in the Target Company of the selected preferred country of entrance and subsequent debt financing?

APPENDICES

Table 1. Balance Sheet, Eur

	Current
Assets	**45 200 000**
Non-current assets	9 600 000
Current assets	5 400 000
Cash	200 000
Liabilities	**42 200 000**
Bank loans	12 000 000
Shareholder's loan 1	30 200 000
Shareholder's loan 2	0,00
Equity	**3 000 000**

Table 2. Income Statement, Eur

	Current
Revenue	122 000 000
Cost of Goods Sold	101 200 000
Operating Expenses	18 000 000
Earnings before interest, taxes & depreciation and amortization (EBITDA)	**2 800 000**
Interest expenses	3 165 000
Earnings before taxes	-365 000
Corporate income tax (CIT) expenses	81 750
Net profit	**-446 750**
Effective tax rate	

Table 3. Other information

Number of shares	100 units
100% shares market price	9 000 000
Market price per share	90 000
Nominal value per share	3 000
Market interest rate	7,5%