

Taxation in the Digital Era

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The better the question. The better the answer.
The better the world works.



Building a better
working world

Egidijus Kundelis

- **Education**

- Vilnius University, Accounting and Audit, 1997-2001
- BMI EMBA, 2016
- ISM, PhD in Economics 2017-2022

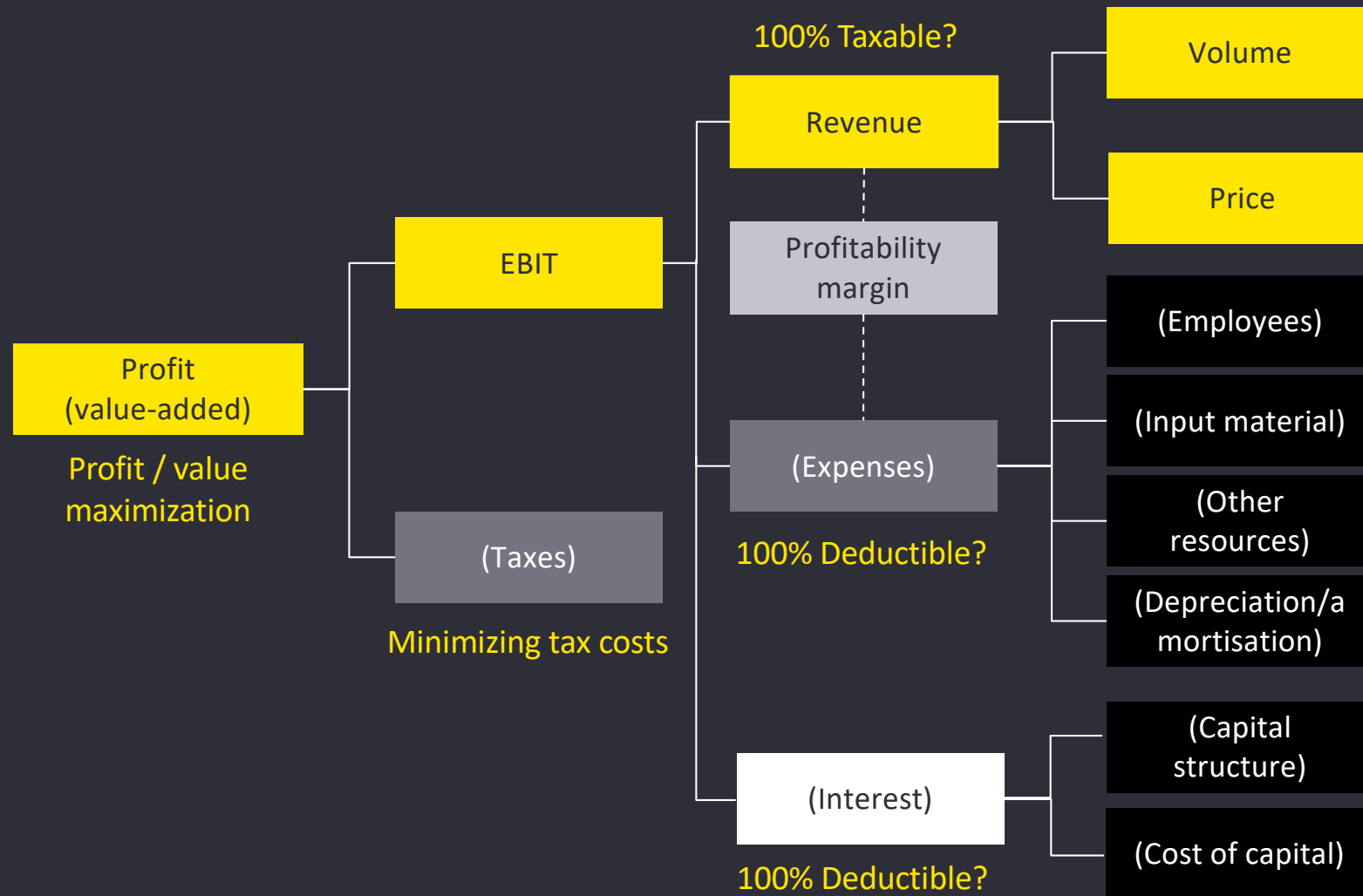
- **Work experience**

- PwC, 2001-2021
- EY, from 2021
- 3 years in audit, 18 years in tax
- FACCA

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Digital taxation

The Purpose of Business



Maximization of tax-free income and deductible expenses
 Minimization of other tax costs

Digital Taxation



- Information and Communication Technology (ICT) → Changes in all sectors → Transformed world economy → Digital economy*
- Digital economy → No Permanent Establishment (PE) → Tax challenges / Challenges for the traditional taxation / International Tax System no longer fit
- Where should taxes be paid?

*More information in OECD Action 1 2015 Final Report

Digital Taxation

Challenges

- More international, complex and digital business models
 - Current international tax framework is not able to ensure that profits are taxed where economic activities occur and where value is created
- BEPS issues – tax evasion and avoidance
 - MNEs use loopholes in domestic tax systems → reducing their taxable base through deductible payments → shifting their profits to countries with low or no tax rates (tax havens)
 - Most of these “schemes” are legal
- Developing countries’ high reliance on corporate income
- Governments facing budget shortfalls

Actions

- Digital Services Taxes (DST) – imposed on MNEs based on their digital activities in a particular jurisdiction
- The Anti-Tax Avoidance Directive (EC ATAD) – legally binding measures that establishes a minimum level of protection against corporate tax avoidance throughout the EU
- OECD/G20 Inclusive Framework on Base erosion and profit shifting (BEPS) – measures to tackle tax avoidance, ensure that profits are taxed in the jurisdiction where the profit-generating economic activities are performed
- Two-pillar solution – more focused on tax challenges arising because of the digital economy

Digital Taxation. Two-Pillar Solution

Pillar One

Applies to about 100 companies – MNEs with global sales above a certain limit and profitability above a certain ratio

- Re-allocation of profits → taxing rights
- Elective option on tax certainty

Pillar Two

Applies to a larger group of MNEs – companies with revenue above a certain threshold

- Global minimum corporate tax rate set at a certain rate
- Guaranteed availability of the Subject to tax rule (STTR)
 - Taxation on certain payments made to related parties abroad

International tax system is fit for purpose in a digital economy

Fairer distribution of profits and taxing rights

“Tax havens” no longer exist

Around 125 billion USD of profits reallocated each year

Around 150 billion USD generated in additional global tax revenues annually

Benefits for the developing countries

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Financing

Financing. The Basics

Two types of traditional financing: equity and debt

Equity: share capital, share premium, reserves and non-distributed profit/retained earnings

Debt from bank, shareholders, associated (related) parties

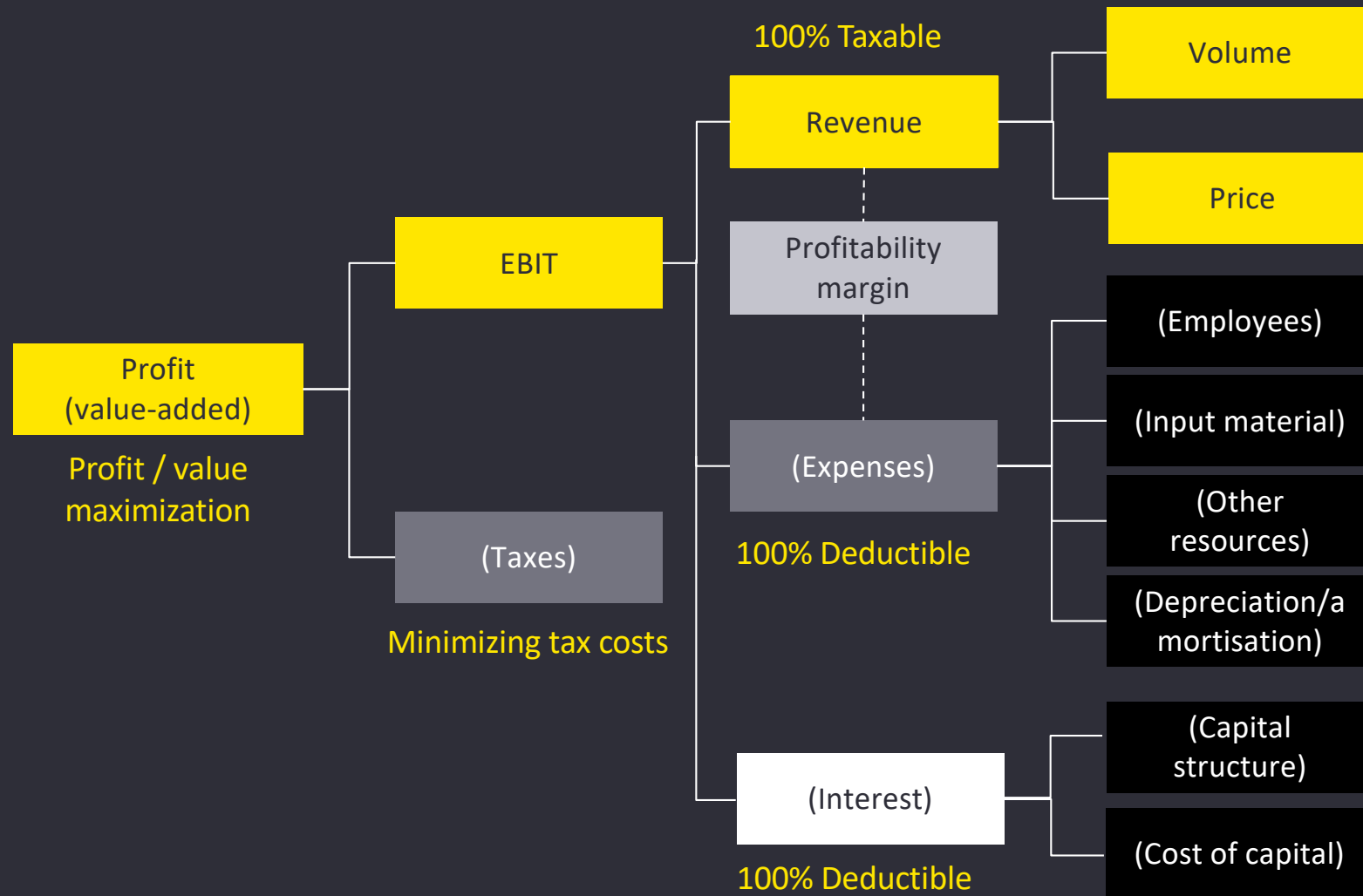
Return on debt – interest – deducted/deductions are permissible as long as requirements of thin cap/earnings stripping rules are fulfilled

Return on equity – dividends – non-deductible

Common objective → maximize the debt and interest → maximize allowable deductions for the purposes of corporate tax

Non-traditional financing → hybrid instruments: preferential shares, convertible bonds, etc.

The Purpose of Business



Maximization of tax-free income and deductible expenses
 Minimization of other tax costs



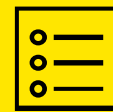




Accounting profit ≠ tax profit

Why is there a difference?

- Certain income is tax-free, certain costs are non-deductible, and vice versa.
- STR – statutory tax rate
- ETR – effective tax rate
- ETR shows the tax burden on the accounting profit
- Reducing the ETR – one of the objectives of business
- To reduce ETR → lower tax profits → increase non-taxable income and deductible costs → maximize the benefits

EUR in thousands	Accounting	Tax	Diff.
Sales	97 000	96 112	(888)
Cogs	(69 085)	(67 298)	1 787
Opex	(17 271)	(16 824)	447
EBITDA	10 644	11 990	1 346
<i>EBITDA</i>	<i>10,97%</i>	<i>12,47%</i>	<i>1,50%</i>
D&A	(6 337)	(6 742)	(405)
EBIT	4 307	5 248	941
<i>EBIT</i>	<i>4,44%</i>	<i>5,46%</i>	<i>1,02%</i>
Interest	(252)	(202)	50
EBT/PBT	4 055	5 046	991
<i>EBT/PBT</i>	<i>4,18%</i>	<i>5,25%</i>	<i>1,07%</i>
Income tax	(757)	(757)	-
EAT/PAT	3 298	4 289	991
<i>EAT/PAT</i>	<i>3,40%</i>	<i>4,46%</i>	<i>1,06%</i>
ROE	16,28%	N/A	
STR	15,00%	15,00%	
ETR	18,67%	15,00%	(3,67%)
TR DIFF	3,67%	0,00%	(3,67%)
LTL	11 389	14 810	

Debt Financing: 8 Most Relevant Tax Rules

-  **1** General Rule – economic benefit
-  **2** Fixed debt to equity rule
-  **3** Transfer Pricing (TP) Rule
-  **4** EBITDA 30% /3 mEUR (earning stripping rule)
-  **5** Anti-hybrid regulations
-  **6** Withholding tax
-  **7** Controlled Foreign Corporation (CFC) rules
-  **8** Substance over form

Measures to counter excessive leverage (1/2)

Measure	Implication
Transfer pricing rules	Applicable to related party debt. Transactions between associated/related parties should be at arm's length – fair market price. Violation of this principle may lead to non-deductible interest costs. Due to wide ranges of arm's length transfer prices can be manipulated or be incomparable.
Fixed debt to equity rules (Safe harbour)	Applicable to related party debt and bank debt guaranteed by related parties. Based on balance sheet data. Amount of debt from related parties is restricted. For example, in LT the controlled debt-to-equity ratio is 4:1. Exceeding interest expenses of the controlled debt are non-deductible.
EBITDA 30% /3 mEUR rule (earnings stripping)	Applicable to related party debt and bank debt. Based on PL data. Net interest costs up to 3 mEUR per year (floor) or up to 30% of taxable EBITDA (ceiling) deductible; exceeding part – non-deductible in current year but can be carried forward to next year .
Withholding tax (WHT) (CIT = Tax on profits + WHT)	Applicable to debt received from foreign countries. Based on actual interest payments to a foreign country. Such interest may be subject to withholding tax (WHT). Tax rate depends on local tax rules, EC I&R D and DTT. For example, in LT WHTR is 0% (EEA and DTT countries) or 10% (other 3 rd countries, no DTT). Depending on taxation clauses in loan agreement, WHT can be withheld from interest payment or paid on top. Withheld: $150 \text{ (interest)} \times 10\% \text{ (WHTR)} = 15 \text{ (WHT)}$, $150 - 15 = 135$ paid to lender, 15 paid to state budget; On top via grossing up: $150 / 90 * 100 = 167 * 10 = 17$, $167 - 17 = 150$ paid to lender, 17 paid to state budget, 17 also extra expenses accounted in PL which may be non-deductible

Measures to counter excessive leverage (2/2)

Measure	Implication
Controlled foreign companies (CFC) rules	Applicable to MNEs having companies in zero tax (tax haven, black-listed) or low tax jurisdictions and providing through them debt financing (i.e., earning interest income – passive income) to high tax countries. For example, in LT income of a CFC included in the taxable income of a controlling Lithuanian company if (1) CFC is established in blacklisted territory, (2) passive income of a CFC exceeds 1/3 of its total taxable income, and (3) the effective CIT of a CFC is less than 50% of CIT that would be calculated by the Lithuanian Law.
"Purpose" tests / General Anti-avoidance Rule (GAAR)	Applicable to artificial, purely tax driven financing transactions. Tax authority could deny tax benefit of financing arrangements which do not have any commercial substance and the only purpose of such transaction is achieving the tax benefit.
Anti-hybrid regulations	Applicable to complex financing instruments which may have different/asymmetric tax treatment in different countries. For example, interest income is non-taxable in one country, interest expenses are deductible in other country. Generally, such interest deductions are disallowed.
Exchange controls	Applicable to debts nominated in foreign currencies. Certain countries require the transactions in the foreign exchange market to be performed solely through market agents authorized by that country's Central Bank and/or at established foreign exchange rates.

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Case

Case. Taxation in the Digital Era - Situation

- Digitalization → expected growth of operations, expansion of the DIGITAL Int. Company (UK-based) by investing into a company in the EU country → desired assurance that the expansion will not result in negative tax consequences
 - Operations in the UK will stay the same → future growth in sales and profits of the new business group directed via a new Target Company in a foreign country → expected lower costs
 - Invest in the Target Company which has a history of operating in the same area of the digital economy, and lacks capital for expansion

Tables (1/4)

Balance sheet, Eur				
		Current	Forecasted	Difference
Assets		45 200 000	112 500 000	67 300 000
Non-current assets		39 600 000	65 400 000	25 800 000
Current assets		5 400 000	45 800 000	40 400 000
Cash		200 000	1 300 000	1 100 000
Liabilities		42 200 000		-42 200 000
Bank loans		12 000 000	12 000 000	0
Shareholder's loan 1		30 200 000	30 200 000	0
Shareholder's loan 2		0		0
Equity		3 000 000		-3 000 000
Income statement				
Revenue		122 000 000	174 800 000	
COGS		101 200 000	117 270 000	
OPEX		18 000 000	26 400 000	
EBITDA		2 800 000	31 130 000	
Interest expenses		5 275 000		
EBT	EBITDA	D/E	-2 475 000	
CIT expenses	45 750	81 750	0	
Net profit			2 475 000	
Effective tax rate				

Other information

Shares, units	100
100% shares market price	9 000 k
1 share market price	90 k
1 share nominal value	3,0 k
Market interest rate	12,5%

Tables (2/4)

Use this table to develop scenarios

	Option 1		Option 2		Option 3	
	Old investor	New investor	Old investor	New investor	Old investor	New investor
Control						
Shares	100		100		100	
Nominal value	300 k		300 k		300 k	
Share premium	-		-		-	
Loan	30 200k		30 200 k		30 200 k	-
Total investment	30 500 k	70 000 k	30 500 k	70 000 k	30 500 k	70 000 k

Tables (3/4)

Estimating effect of scenarios on Balance Sheet and P&L statement

Balance sheet		Option 1	Option 2	Option 3
Assets		112 500 000	112 500 000	112 500 000
Non-current assets		65 400 000	65 400 000	65 400 000
Current assets		45 800 000	45 800 000	45 800 000
Cash		1 300 000	1 300 000	1 300 000
Liabilities		109 200 000	102 200 000	42 200 000
Bank loans		12 000 000	12 000 000	12 000 000
Shareholder's loan 1		30 200 000	30 200 000	30 200 000
Shareholder's loan 2				
Equity				
		0,00	0,00	0,00
Income statement				
Revenue		174 800 000	174 800 000	174 800 000
COGS		117 270 000	117 270 000	117 270 000
OPEX		26 400 000	26 400 000	26 400 000
EBITDA		31 130 000	31 130 000	31 130 000
Interest expenses				
EBT				
CIT expenses				
Net profit				
Effective tax rate				

Tables (4/4) (Students slide)

Effective tax rate calculations

	Option 1	Option 2	Option 3
X * Equity			
Controlled debt amount (Shareholder loan 1 + loan 2)			
Thin capitalization rule			
Loan exceeding X:1 ratio (Controlled debt - X * Equity)			
Non-deductible interest (X %)			
3 mEUR Threshold met			
30% EBITDA ceiling			
30% rule			
Non-deductible interest			
Taxable profit (EBT+non-deductible interest)			
CIT rate%			
CIT expenses (Taxable profit * Tax rate%)			
ETR (CIT expenses / EBT)			

Case. Taxation in the Digital Era – Task 1

1. Which country from pre-selected 8 countries feasible for digital business expansion (UK, LT, EE, HU, GE, ...) has the most favorable corporate tax rules/regime?
2. What are the relevant tax-related debt financing limitations in this country? 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?

Case. Taxation in the Digital Era – Task 2

4. What are financing options for buying-in the newly issued shares in the Target company in the suggested country? (Expansion option through acquisition of minority vs majority of share ownership and subsequent debt financing in the Target Company of the selected preferred country of entrance).
5. What is be the effect on balance sheet and P&L statement of Target Company of the proposed expansion option? (Use tables for calculations).
6. What are the benefits and drawbacks of expansion through acquisition of minority vs majority of share ownership in the Target Company of the selected preferred country of entrance and subsequent debt financing?

Case. Taxation in the Digital Era – Task 2

Pro-bono questions (optional)

7. How the investment of 70 mEUR should be financed at level the DIGITAL Int. Company? What factors should we consider?
8. When DIGITAL Int. Company would have to consolidate the Target Company?
9. How an obligation to consolidate the Target Company would change the tax position of DIGITAL Int. ?
10. Can the Target Company transfer its tax losses to DIGITAL Int. Company ? Under what circumstances?