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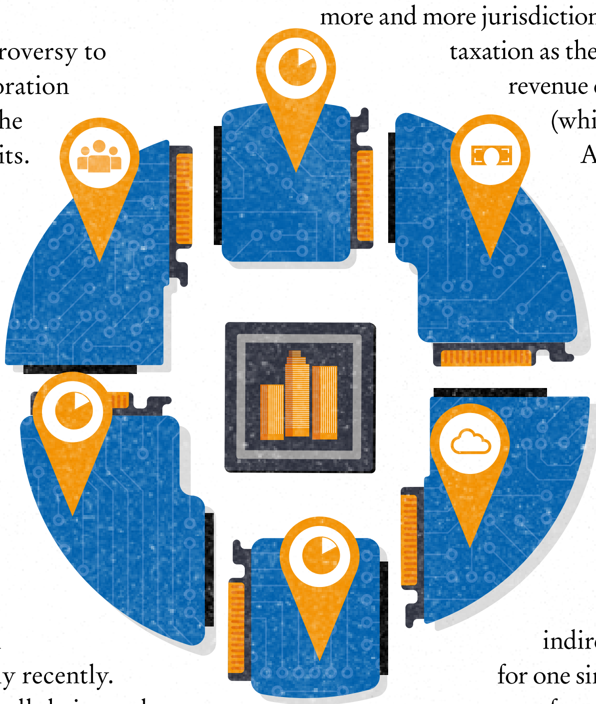
Priorities for tomorrow's unicorns

Indirect tax considerations for the digital economy

For tomorrow's billion-dollar tech companies, the challenge and complexity of tax should never be underestimated.

In recent years, governments have been ramping up their scrutiny – and their public criticism – of tax avoidance across the digital economy. Today, tech companies can expect to face financial penalties as well as reputational damage if their tax affairs are not in order.

But much of the controversy to date has related to corporation tax and other levies on the payer's income and profits. Indirect tax collected at the point of sale – such as value added tax (VAT) or goods and services tax (GST) – has so far received less attention. Things are, however, changing fast.



The direction of travel is clear

Indirect tax became a significant issue for tech companies only relatively recently. As software companies sell their products and services over the web – to customers in locations where they don't necessarily have a physical presence – they were not previously obliged to pay tax on each transaction.

But new regulation, such as the EU's 'place of supply' rules, requires VAT and GST to be collected where customers are located. Similarly, a key recommendation put forward by the OECD's Base Erosion and Profit Shifting (BEPS) initiative states that VAT should be collected where the company's customers – be they individuals or organisations – are based.

These changes are particularly important because more and more jurisdictions are adopting indirect taxation as their preferred method of revenue collection. From Malaysia (which introduced GST in April 2015[1]) to Puerto Rico (bringing in VAT in 2016[2]), and from India (currently expected to be bringing in GST during 2016[3]) to the United Arab Emirates (planning national VAT implementation[4]), governments worldwide are embracing indirect tax.

The shift towards indirect tax will continue for one simple reason: it makes more sense for governments. Malaysia's government has said that implementing GST will make its tax regime more 'effective, efficient, transparent and business friendly'[5]. Others, such as the UK, could justify indirect tax as a way of keeping corporation tax low, which makes the country more attractive for global corporations. UK corporation tax is just 18% – to compensate, the government raised VAT from 17.5% to 20%.

1 http://gst.customs.gov.my/en/Pages/default.aspx
2 http://www.reuters.com/article/2015/08/26/usa-puertorico-restructuring-idUSL1N1111M020150826#JMAKmaXf1MgDZVus.97
3 Although GST is planned for 2016 this is dependent on the passage of legislation through government.
http://indianexpress.com/article/india/india-news-india/hope-to-roll-out-gst-next-year-pm-narendra-modi/
4 http://www.arabianbusiness.com/gulf-states-set-target-introduce-vat-by-2018-says-uae-official-614511.html
5 http://www.customs.gov.my/en/cp/pages/cp_wy.aspx

Striking the right balance

So if tech companies must pay indirect tax where their customers are located – and if GST and VAT represent a growing share of their tax obligations – how should they respond? How can they stay competitive while meeting global tax obligations?

To strike the right balance between compliance and profitability, tech companies need to consider indirect tax at the outset of any major growth discussion. The head of tax will ensure the company is registered and making payments as required, and with the business' leadership team, should be exploring the wider implications of each market's regime. As a matter of course, they need to ask how each jurisdiction's requirements will affect their company's operations, pricing and market-entry strategy.

But, even before this discipline is in place, there are five priorities that tech companies should address as a matter of urgency, if they have not done so already:

1 Know where your customers are

Advance planning will ensure you are registered, compliant and paying in the right places at the right time. But, as a priority, you need to ensure you have a clear understanding of where all your existing customers are in the world. Otherwise, you may not be registered with the tax department in a country that has recently implemented indirect tax. You could also be overdue on remits in some regions that are required on a monthly basis.

For some companies, which have been doing business over the web with customers worldwide, this task can be complex and extremely time-consuming. How, for example, can you be sure you know exactly where your customers are? Some can be located through credit card addresses or by investing in software that shows the geographic location or tracks IP addresses. Others are likely to be even harder to find, especially where you are distanced from the customer by intermediaries.

2 Rethink your pricing and supply chain

When you have completed a thorough and transparent assessment of your markets, you need to calculate how your existing prices should vary across jurisdictions.

Keeping your price of downloads consistent worldwide may, for example, lead to lower profit margins in some jurisdictions. If the indirect tax rate is higher in one region than in others, you will need to charge a lower net amount in that region, per download, to maintain the final price to customers. In effect, individual downloads therefore may become less lucrative. In some markets, you may also need to distinguish between B2B and B2C customers, and adjust your pricing accordingly, as there may be different rates for each.

Move first; move quickly

Growing tech companies in today's tax environment won't become billion-dollar businesses without being proactive, flexible and realistic about the myriad tax regulations they face worldwide.

The task is far from easy. But, if you can move quickly to establish cost-effective and attractive prices you will have a clear competitive advantage over those that are slower to respond.

3 Automate to keep ahead of change

As more countries implement indirect tax, one of the biggest ongoing challenges will be keeping up to date with changing global regulation. This is a huge task, and the consequences of getting it wrong, such as not registering with each relevant tax department, can be severe.

As well as working closely with advisers with expert knowledge of local markets, you could consider automated tax-determination tools integrated with enterprise resource planning (ERP) systems. Many high-growth tech companies are also using automation to track how changing compliance regulations will affect pricing and profit margins on a global scale.

4 Clarify your channel strategy

You need to be clear about the practices of the channels you sell through, as their approaches vary. At present, for example, some digital distribution platforms will calculate and remit your indirect taxes, whereas others will not. As it isn't practical to simply avoid using a platform that may also offer the best route to the customer in certain markets, you need a full understanding of its individual indirect tax policies. You then need to mitigate where you need to be to ensure you are compliant.

5 Keep the data safe

There is conflict between keeping consumer data for five or ten years—as stipulated by many countries' VAT/GST rules—and storing and archiving that information to comply with data protection legislation. Ensuring you have sufficient data security is an additional concern that needs to be addressed as a priority.

If you would like to discuss any of the areas raised in this article, please speak to you usual Grant Thornton contact or one of those listed below.

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