Local revenues, global profits: a 'tax morality' controversy in the making?

Revenue leakage and tax morality: the 15-second download

5 Companies' tax policies have hit the front pages as a 'moral' issue—and ongoing digitisation and globalisation are putting entertainment and media companies in the front line.

10 In the long run, the only effective solution to tax uncertainty and controversy will be international alignment of tax regimes—and until that happens companies will have to manage the reputational risks.

15 Priorities for entertainment and media companies include considering the tax implications of strategies from the earliest planning stage; examining tax and business perspectives together; and conducting studies to quantify their 'total contribution' in local markets.

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Tax is hitting the front page …

Ten years ago, if you'd asked the tax director of an entertainment and media company whether they were worried they might find themselves appearing on the front pages of the newspapers, they would probably have laughed at the idea. Today they would take the prospect a lot more seriously.

Across the world and in all industries, tax is suddenly big news, thanks to an unprecedented convergence of factors. On the government side, countries are looking to replenish their depleted revenues following the economic downturn by collecting every dollar of tax due to them. On the business side, rapid globalisation and digitisation have left tax regimes struggling to keep pace with the realities of today's fast-evolving business models and cross-border transactions.

As a result, the management of tax affairs has assumed growing significance for global corporations, with several global brands suffering from negative perceptions about 'unfair' tax policies. And a further dynamic has been added to the debate by the argument from emerging markets that local profits are being transferred to sit in developed countries, impacting their share of overall tax.

… as legacy tax systems come under strain

Given the pace of technology-enabled change in recent years, it's hardly surprising that tax systems are stretched to breaking-point. The basis on which the US taxes international transactions was laid down in 1962. In the UK, key elements date from 1965. The core of the OECD's model for international taxation originates from the 1970s and in some cases even the 1920s. Even an emerging economy like India has its income tax law dating back to 1962. If tax codes are to work effectively, they must reflect the realities of today's global economy. The problem is they don't.

However, the fact that tax laws are outdated is little comfort to the growing numbers of companies which—despite complying fully with the letter of the applicable tax legislation—have found themselves pilloried for paying less tax than some people think they should. The resulting controversies have spawned the concept of 'tax morality': the idea that paying tax is not just a legal requirement for businesses, but an ethical choice.

The 'tax morality' debate revolves around the view that corporations should pay their 'fair share' of tax. While this is clearly justifiable, the real challenge is determining what is 'fair'. In former times, this would have meant complying with the tax regulations. But today the perception of what's 'fair' has shifted from legality to morality.

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Entertainment and media companies are in the front line

To date, much of the focus of the tax morality debate has fallen on companies outside entertainment and media, such as online retailers. But the ongoing shift to digital is set to put the industry increasingly in the front line of the debate. The nature of today's tax regimes means that whenever a product or service is delivered in a new way and/or in a new place, it raises a tax implication. With the migration to digital, this is happening everywhere in entertainment and media.

Whereas traditional physical media products could be tracked across national boundaries, digital distribution enables a content producer in one jurisdiction to distribute it seamlessly and instantaneously in others. This raises questions about whether and where the transaction should be taxed, and which government should collect any taxes on the revenues or profits. Also, some commentators are casting doubt on the relevance of the existing tax treaty model—of more than 60 years standing—in today's digital environment.

The potential for uncertainty and controversy doesn't end there. The migration to digital can trigger significant leakage from companies of content revenues, as conditional access systems and other safeguards are found wanting. Also, the entry of global digital media giants into local markets can have the effect of sucking out revenues that used to go to the local players in segments from book publishing to advertising. Commentators in some markets are linking this leakage from the local industry with the tax morality agenda, and blaming both effects on global players failing to 'do the right thing' in local markets.

A battle with no winners

The current confusion and controversy benefits no-one. Governments are struggling to regain control of the tax agenda, with the only long-term solution being multilateral reform of the global tax system—a goal being pursued via the OECD's action plan on Base Erosion and Profit Shifting (BEPS).

But in the meantime, governments feel they are missing out on much-needed tax revenues. The need for concerted global action is widely recognised—but delays in forging an international consensus have seen several emerging markets, including India, seek to partly address this issue through unilateral measures such as General Anti-avoidance Regulations. Meanwhile, governments are continuing to question publicly the tax effect of various types of transaction or arrangement. This can inflict reputational damage on companies that consider themselves fully compliant with legal frameworks—and the arbitrary nature of the 'front-page test' makes it hard to predict where or whom it will strike next.

Consider tax early—and in coordination with the business

Against this background, what should entertainment and media companies operating and/or expanding across borders do in order to manage their risks around tax? The long-term answer lies in reform of the international tax regime. But until that comes, there are a number of specific principles they should focus on.

The first is to consider the tax implications of any new activity, market entry or business model at the earliest possible stage of the planning process—and certainly before taking any action. This means looking closely at areas like transfer pricing and the locations where sales agreements are finalised.

At the same time, corporations should take advantage of forums on issues such as advance tax rulings and advance pricing arrangements, to seek certainty on the tax liabilities and obligations that could arise from a proposed activity, business model or transaction in any jurisdiction. This could prove crucial, especially in emerging markets where international taxation law is ever-evolving.

To pass the front page test, companies should also ensure that their tax numbers reflect business activities and entities with real substance. This means having the tax function work hand-in-hand with the business to ensure the two are aligned.

A further priority is to be clear about the business's risk appetite around tax. The recent escalation of tax as an issue has seen it become an increasingly important item on the board agenda. And boards should be setting an explicit level of risk that they're willing to bear to enable informed decision-making.

Finally, companies should consider conducting a 'total contribution' study to establish and report on their overall impact in the markets where they operate. This will cover not just all forms of tax—corporate, transaction, payroll and so on—but also their economic and social contribution in each country. If controversy strikes, this can be a useful tool to counteract negative publicity.

One day, tax regimes may catch up with the digital world. But until then, entertainment and media companies will need to remain alert and proactive in managing an expanding array of risks around tax—or face the prospect of suddenly finding themselves splashed across the front page.

Ten questions to ask:

1. *What are the major tax risks your business faces?*
2. *How do these risks vary in different jurisdictions?*
3. *To date, has your business found itself receiving negative coverage over tax? How did it respond?*
4. *Is your business currently planning any new strategies or business models that might have significant cross-border tax implications?*
5. *At what stage do you consider tax implications when planning new initiatives or market entries?*
6. *How closely does your tax function work with the business?*
7. *Are all your tax strategies based on operating companies, or do they include entities specifically created to minimise tax?*
8. *Do you believe all your tax affairs would pass the 'front page' test?*
9. *How clearly defined is your business's risk appetite in the tax domain?*
10. *Have you conducted a total contribution study across all your activities in each country where you operate?*