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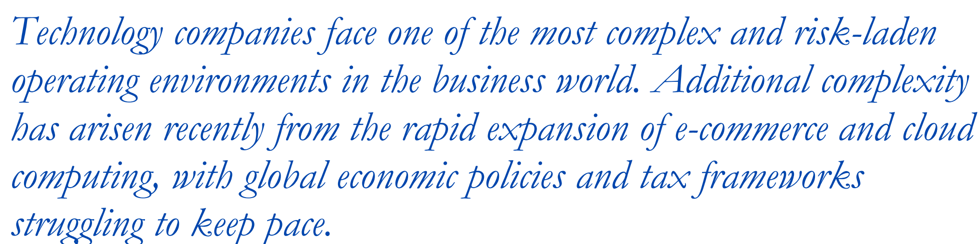
Industry Insights

Technology & media sector

The shifting business environment for global technology companies



Technology companies face one of the most complex and risk-laden operating environments in the business world. Additional complexity has arisen recently from the rapid expansion of e-commerce and cloud computing, with global economic policies and tax frameworks struggling to keep pace.

In this edition of Industry Insights, we focus on three important issues that technology businesses face as they look to grow in a fast-changing environment:

- *The challenge of globalisation*
- *Ensuring adequate protection of intellectual property*
- *Seizing opportunities for investment*

Managing the challenges of globalisation

Recent media attention has focused on the taxation of global revenues from the exploitation of intellectual property (IP) developed by technology companies. This has been buoyed by an increasing demand for fairness in tax outcomes by the public at large and the rise of technology brands to become the most valuable IP assets in the world. Popular headlines have accused tech giants such as Apple and Google of unfair tax minimisation, not only in Australia, but on a global basis. Repeatedly blamed for not playing fair, those companies have always stood firm in their position that they pay tax in compliance with national tax laws.

A 2014 survey of the world's most valuable brands positions technology companies as accounting for almost one third of the brand value of the top 100 brands, with a 16% increase in value for the sector since 2013. It is necessary to read down the list to number 5 before reaching the world's most valuable *non*-technology brand, McDonalds. The legendary Coca-Cola brand is now barely more than half the value of that of Google, which tops the list[1].

It is clear that the increasing value of technology-related IP and the advantages of e-commerce platforms will continue to both encourage and enable technology companies to structure their operations so as to make use of tax-effective jurisdictions. However, technology businesses should be acutely aware of the current focus of economic leaders to levy appropriate levels of tax on those companies that have the ability to host their IP or perform their e-commerce operations in low tax jurisdictions. Protecting the tax base of IP and e-commerce transactions is a hot-topic and a priority for all major economies.

Multi-national organisations operating in Australia need to be particularly alert to the brand damage that can be caused by a perceived failure to "pay their way". The recent Federal Budget is currently being portrayed in the media as an attack on lower-income earners, who are seen as bearing an unfair share of the tax burden. This only heightens the reputation risk for successful businesses that pay little or no tax on their Australian operations, irrespective of any valid commercial rationale.

Some of the difficulties for governments in regulating the taxation of IP and e-commerce platforms arise directly from the application of bricks and mortar tax law principles to 'virtual' businesses that can involve complex operational supply chains. As a result, the G20 members, through the global discussion on Base Erosion and Profit Shifting (BEPS), are concentrating their efforts in developing guidance for governments in determining the residence and taxable presence of IP and e-commerce platforms.

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[1] BrandZ™ Top 100 Most Valuable Global Brands 2014

Taxable presence and residence

The generation of a taxable presence based on IP rights is a focus for policy-makers, most notably the Organisation for Economic Cooperation and Development (OECD). Technology companies are finding themselves increasingly under scrutiny on tax residency in relation to their IP and e-commerce platforms, particularly those that rely heavily on the use of a server, the internet or a cloud environment to carry out commercial activities.

The operation of a server or other e-business activities may be sufficient to create a taxable presence or Permanent Establishment (PE) in a country other than the business' principal location. Where such a PE exists, a question arises as to what profit, if any, should be allocated to each of the jurisdictions involved in the supply chain.

The OECD Model Tax Convention provides only general guidance for its members on tax residence issues associated with the uses of servers. Broadly speaking, the model convention considers that, for a server to constitute a taxable nexus, the equipment must be set up in a manner that it is: owned or leased; operated in a fixed location; and perform core functions for the benefit of the taxpayer. It is important to note that human interaction is not required to meet the definition of taxable nexus.

However, very little guidance is available with respect to the taxation of more complex transactions, such as the sale of products via e-commerce platforms where the supplier and the customer are located in different jurisdictions. It remains unclear whether the transaction should be taxed in the location where the customer is located or in the place where the supplier regularly conducts its business.

E-commerce and the digital economy may fairly be regarded as the catalysts for the current BEPS dialogue. In March 2014, The Australian Financial Review brought to public attention reports that approximately $8.9 billion in untaxed profits had been channeled from Apple's Australian operations between 2002 and 2013 to a tax haven structure based in Ireland.

Treasury did not provide any specific response to these claims, but the news did much to ignite debate at both a public and governmental level. The then Federal Minister of Finance, Mathias Cormann, swiftly indicated that it was the government's intention that businesses in Australia pay their fair share of tax where they earn profits, and that Australia intends to address BEPS issues in a coordinated way through international forums such as the G20. It is timely that Australia has commenced its presidency of the G20 and little surprise that BEPS sits high on the agenda.

At this stage the OECD has identified a number of areas for discussion, including a proposal to modify the existing permanent establishment rules. As a result of the work at the OECD level, a series of recommendations may be adopted by the Australian government, such as changes to the regulations in connection with the taxation of the digital economy, the introduction of rules to neutralise the effects of hybrid instruments and the enforcement of information exchange agreements with other tax authorities.

Further, the ATO has commented that investigations are taking place to confirm that "e-commerce and digital approaches are being implemented in existing business operations to shift that part of the tax base from Australia."

The protection of Intellectual Property

While the world's biggest companies battle over IP rights in the courts, the protection of intellectual property remains a significant challenge facing the boardrooms of technology companies of any size.

According to the World Intellectual Property Organisation, 2012 saw the highest number of patents filed worldwide in the last 20 years. The volume and pace of registration of IP interests brings additional risks and complexity for the technology sector for which staying one step ahead of the competition is fundamental to success. A recent survey of 30 of Europe's most innovative technology companies, undertaken by CPA Global, identified that over 70% of respondents said they place significant efforts in ensuring that they can freely develop, manufacture and sell their products globally.

For technology companies, IP protection is a key element to successfully attracting investors or buyers. A failure to demonstrate adequate protection of IP may cause a company to struggle to obtain capital or funding. However, patent and trademark registration can be expensive to obtain and maintain and such ongoing expenditure can impose additional pressures on the financial performance of technology companies.

As the quantity of trademarks and patent applications and registrations increases, so too does the threat of patent infringement and litigation. Litigating over IP can be enough to cause a company to fail, irrespective of the merits of its claim. Technology companies must be increasingly vigilant of unwittingly infringing third-party patents, as the rise of so-called "patent trolls" has heightened the risk of litigation, even in relation to peripheral infringement. Patent trolls have in many instances proved to be extremely damaging to small and medium-sized technology companies in particular, on occasion prompting abandonment of promising IP in preference to costly and lengthy litigation or unforeseen license fees.

The method of IP protection and the deliberate location of IP can be significant drivers in the financial and tax outcomes for multi-national technology business. Choices made early on in the development of core technology can enable or inhibit tax efficiency, including through profit allocation to lower-taxed jurisdictions and repatriation of profits through royalty streams.

Further, by streamlining its supply chain, a technology company can achieve significant economies of scale and reduce costs or achieve a favourable worldwide effective tax rate. Strategies to help businesses optimise their operating structures may include:

- offshoring the development of IP to low cost jurisdictions;
- centralising e-commerce operations in a low tax jurisdiction;
- centralising business trademarks and brands to enable cost-effective cash repatriation

Each of these strategies will require careful consideration of the legal and tax environment in multiple jurisdictions and the issues to address are often complex. However, experience shows that comprehensive up-front planning is often rewarded by a reduced likelihood of a costly restructure. Movement of mature IP between jurisdictions can be one of the most expensive transactions that a technology company can undertake and should in most instances be avoided.

Investment opportunities

To support growth in their early years, technology companies must look to diverse methods to reduce costs and attract significant levels of capital investment. While the 2014 Federal Budget has garnered attention for the reduction in available research and development tax incentives and removal of various sources of funding for innovators, there remain a number of important incentives. It is perhaps timely to be reminded of some of the diverse sources of government support that remain available, albeit in some instances with reduced funding announced in the 2014 Federal Budget.

The R&D Tax Incentive

The change in Government has seen the continuation of the R&D tax incentive as a mechanism for supporting companies undertaking R&D, albeit soon to be at a reduced rate. Under this scheme, companies can potentially access refunds of up to 45 cents in the dollar (43.5 cents from 1 July 2014), with no cap on expenditure.

Many companies have identified and accessed the program and the refund is particularly important to the cash-flow of many small and medium technology enterprises. However, there remain companies who wrongly consider themselves as not undertaking qualifying R&D on the basis of an absence of laboratories and petri dishes. It is important to remember that this is not what is needed - companies need principally to demonstrate only that there is "experimentation" and the "creation of new knowledge".

Companies claiming, or thinking about claiming R&D, should take note of the compliance continuum which has been implemented by AusIndustry (the government body responsible for delivery of the R&D tax incentive). We are seeing an increasing volume of reviews and companies should expect one sooner rather than later.

To ensure claims are robust, companies should consider:

- The categorisation of activities as core and supporting activities. The terms are specifically defined and should be considered carefully. AusIndustry has the ability to categorise activities and a change from classification as a core activity could sometimes means it is no longer eligible;
- The evidence to support that experimentation was undertaken and that the knowledge created is new. In our experience, all reviews include a request for sample documents to be supplied to AusIndustry.

Time spent at the outset on record-keeping and analysis is time well-spent as it leads to a smoother compliance process and greater level of comfort that the claim will either not be challenged or can be robustly defended.

Victorian Government Technology Innovation Fund

The Victorian Government has recently established the Victorian Government Technology Innovation Fund (VGTIF). This is intended to assist companies to undertake pilot projects with Victorian government agencies to demonstrate the application of leading-edge technologies which can:

- Harness advances in technology to manage information;
- Deliver new or improved services;
- Improve public sector productivity;
- Improve service delivery in regional Victoria (e.g. through use of broadband); or
- Strengthen citizen engagement with government.

The VGTIF has $12 million of funding available over a number of years, and is open for applications on a continuous basis. There is no upper limit on funding and there is no mandated requirement for matched funding, but contributions by the applicant may enhance the prospects of a successful application.

Screen Australia & Ministry for the Arts

The Australian Screen Production Incentive (ASPI) for the production and post-production of large-budget screen projects in Australia comprises 3 streams of funding:

- Producer Offset – offered to producers of Australian film and television projects with significant Australian content (40% tax rebate for eligible expenditure on eligible feature films and 20% tax rebate for eligible expenditure on eligible productions other than feature films – administered by Screen Australia);
- Location Offset – offered as an incentive for producers of eligible large-budget films to use Australian locations, cast, crew and service providers, in projects that do not satisfy the significant Australian content test for the Producer Offset (16.5% tax offset for qualifying Australian production expenditure – administered by the Ministry for the Arts); and
- PDV Offset – offered as an incentive for the Australian post, digital and visual (PDV) effects production sector, for Australian and overseas projects (30% tax offset for qualifying expenditure on Australian PDV activity – administered by the Ministry for the Arts).

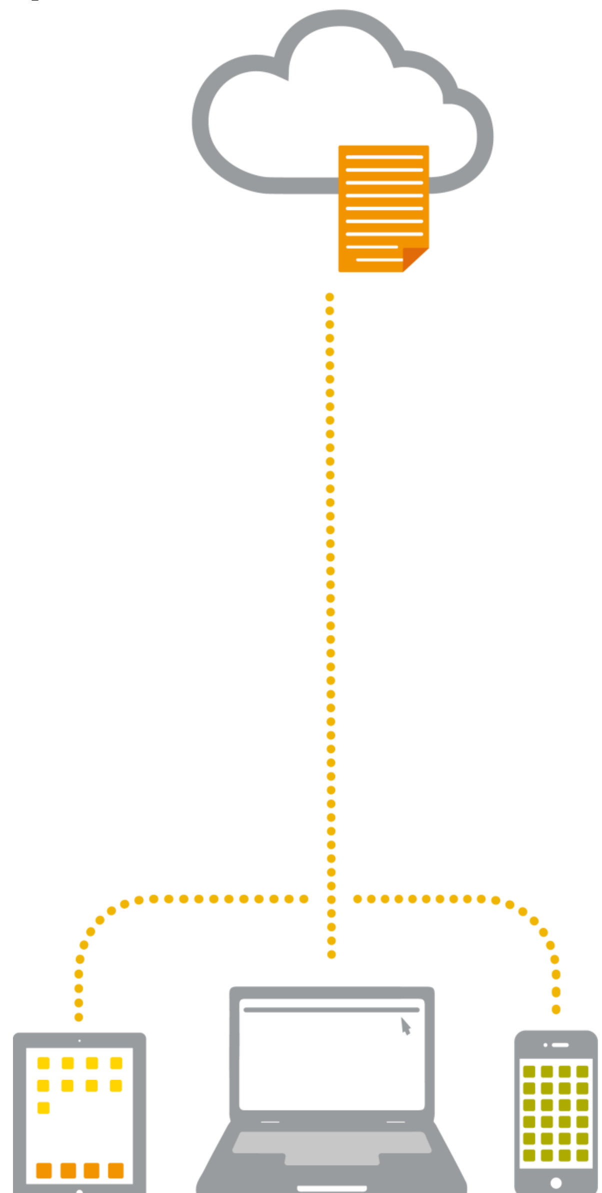
The 2014 Federal Budget has proposed significant cuts to funding of Screen Australia and there is widespread concern regarding the impact this will have on home-grown film and television production.

Export Market Development Grants (EMDG)

Companies undertaking export promotion activities for products or services may be eligible for an Export Market Development Grant reimbursement of up to 50% of the expenses incurred on export promotion activities. The scheme was recently granted an additional $50m in funding, demonstrating the Government's commitment to supporting exporters.

Each case will be assessed on its merits. However, an Australian individual or a business is likely to qualify if the following criteria are met:

- An annual income of less than $50 million;
- Expenditure of at least $15,000 on export promotion activities during the grant year; and
- Ownership of the product/service being promoted.



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