INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

GLOBAL TAXATION OF DIGITAL TRANSACTIONS: CONSIDERATIONS FOR PRIVATE EQUITY

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Private equity firms contemplating investing in or divesting themselves of digital businesses should be considering the potential impact of a global digital tax. As the Organisation for Economic Co-operation and Development (OECD) works toward its goal of creating consistency around how digital products and services are taxed, the prospect of new tax exposures for technology companies inches out of the realm of theory and into the realm of reality. Private equity firms should be taking steps to assess the extent to which a digital tax could lower EBITDA and, thus, valuations.

The OECD identified the issue of how to tax the digital economy in Action 1 of the Base Erosion and Profit Shifting (BEPS) project ("Tax Challenges of the Digital Economy"). On Oct. 12, 2020, the OECD released reports on the Blueprints of Pillar 1 (nexus and profit allocation) and Pillar 2 (global minimum tax to address remaining BEPS issues) that reflect the latest consensus on the direct tax challenges of taxing the digital economy. The reports on the blueprints will be used as a basis for seeking stakeholder input, and the OECD intends to work to resolve outstanding issues quickly and bring the process to a conclusion by mid-2021. Notably, some countries have already introduced their own digital tax regimes to capture tax revenue from tech giants such as Apple, Facebook and Google, and more countries may exercise a similar prerogative to protect their revenue base and, in particular, to mitigate the devastating economic impact of the coronavirus pandemic. While complying with whatever form the OECD's digital tax structure ultimately takes is bound to be complex, complying with multiple unilateral digital tax regimes would be vastly moreso.

ISSUES FOR PRIVATE EQUITY TO CONSIDER: NEXUS AND THRESHOLDS

Private equity firms should factor into their investment strategies and decisions not only the administrative and compliance issues that may result from having to file in multiple new jurisdictions, but the additional tax costs and advisor fees that would necessarily attend additional filings.

Issues that private equity firms should consider in relation to a potential investment include:

- Could the company's product, online solution or service be subject to digital taxation? Differing taxability and sourcing rules across countries can create the potential for double or multiple taxation (i.e., the same transaction is legally taxed by two or more countries).
- Does the company have nexus with each country to which it ships or delivers products and services? An assessment may reveal the business already has economic nexus via a physical presence.
- Does the company have a digital tax tracking system in place?

Separately, at the outset of a potential deal, private equity firms should conduct a nexus analysis of countries that have enacted or that plan to enact a tax on a digital product or service; if a target does not historically file in those countries, the tax implications could be great.

In addition, firms should evaluate whether a company's digital transactions will be subject to taxation based on the OECD's proposed thresholds: To be subject to digital taxation, a company, at the group level, would need to meet both a global revenue threshold (up to €750 million in some countries) and a domestic revenue threshold (varying by country).

Firms should also assess whether, based on deal structure, portfolio companies would be aggregated as being under common control. Where a digital tax regime includes minimum company size criteria (for instance, for companies with more than €750 million in annual revenues) but requires companies under common control to be aggregated, there will be logistical challenges to negotiate. This may be particularly relevant to private equity firms given their complex organizational structures, which can make common control analysis more challenging.

ASCERTAINING IMPACT ON EBITDA, INCOME TAX

When evaluating how EBITDA may be affected by compliance with taxation of digital products and services, firms should understand first what the taxes are based on. If the tax is an income tax, for example, then it would not affect EBITDA. However, if the tax is not based on income—such as a gross receipts tax, which characterizes most digital taxes—then the tax is above the line and would have an impact on EBITDA. In such cases, PE firms may want to consider future EBITDA addbacks for market-based digital taxes in credit agreements.

Another consideration arising from a change to EBITDA is debt covenants, as lending agreements may be measured off of EBITDA metrics. Private equity firm leaders should evaluate whether digital taxes suppress a company's ability to meet the required level of EBITDA.

HOW TO NAVIGATE COMPLEXITY AND MAXIMIZE RETURNS

Private equity funds and their portfolio companies should avail themselves of a suite of strategies to determine the impact and potential burden of compliance with the OECD's proposed digital tax framework, as well as existing or future unilateral digital tax regimes. Steps to take may include:

- Scenario planning for what the OECD's proposed plan, as well as unilateral versions of a digital tax, could mean for your firm, deal partners, portfolio and target companies
- Analyzing sales to customers to determine economic nexus as part of the due diligence process
- Quantifying any current exposure and remediation solutions
- Leveraging automation technology to analyze the nexus footprint and generate tax liabilities owed per jurisdiction
- Focusing on internal rate of return to maximize upfront cash proceeds and limit escrow holdback upon sale
- Determining how digital tax proposals, if enacted, would affect global investment strategies and targets' tax positions for impact on EBITDA and potential liabilities

While implementing a digital tax may take time, if the OECD's digital tax proposal gains traction this year, private equity firms considering a 2021 or 2022 investment or other type of transaction will want to have a firm grasp of the potential implications: Firms with a five-year holding period could have a different EBITDA profile by the time they go to exit in 2026 or 2027.

HOW BDO CAN HELP

Private equity firms should be at the forefront of planning for how to comply with a digital tax as the OECD continues its work and individual countries implement their own digital taxes. BDO's Private Equity, Tax, Transaction and Technology professionals collaborate to develop tailored strategies and solutions for PE firms and their portfolio companies to help them comply with emerging digital tax regimes. If you have any questions, please contact Verenda Graham at vgraham@bdo.com or Scott Hendon at shendon@bdo.com.

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